

## Management's Discussion and Analysis

### Summary of annual results

	2008	2007	2006
<b>Financial</b> (\$000s, except where noted)			
Oil and natural gas revenue	950,068	257,736	99,228
Funds flow from operations <sup>(1)</sup>	665,933	174,864	60,994
Per share – basic (\$)	8.09	2.31	0.91
– diluted (\$)	7.28	2.10	0.88
Net income	244,482	81,427	23,106
Per share – basic (\$)	2.97	1.08	0.35
– diluted (\$)	2.76	0.99	0.33
Capital expenditures			
Canadian Business Unit (“CBU”)	545,833	303,687	88,033
Latin American Business Unit (“LABU”)	281,748	152,151	83,223
Heavy Oil Business Unit (“HBU”)	82,332	54,426	58,437
Total Company	909,913	510,264	229,693
Total assets	2,361,707	1,145,908	447,531
Net debt/(net working capital) <sup>(1)</sup>	355,665	(16,068)	40,545
Common shares outstanding, end of year (000s)			
Basic	83,525	77,271	72,125
Diluted <sup>(2)</sup>	99,043	90,038	76,538
<b>Operations</b>			
CBU operating netback (\$/boe except where noted) <sup>(1) (3)</sup>			
Oil and NGL revenue (\$/bbl) <sup>(4)</sup>	92.80	75.64	61.18
Natural gas revenue (\$/mcf) <sup>(4)</sup>	8.06	6.35	6.21
Oil and natural gas revenue <sup>(4)</sup>	86.78	62.62	44.40
Royalties	10.03	4.86	6.28
Production expenses	8.76	8.19	7.28
Operating netback <sup>(5)</sup>	67.99	49.57	30.84
LABU operating netback (\$/bbl) <sup>(1)</sup>			
Oil revenue <sup>(4)</sup>	87.15	71.74	61.68
Royalties	8.46	6.68	4.95
Production expenses	9.08	7.37	7.78
Operating netback <sup>(5)</sup>	69.61	57.69	48.95
Average daily crude oil production <sup>(3)</sup>			
CBU – oil and NGL (bbls)	15,369	3,579	918
CBU – natural gas (mcf)	14,436	11,379	12,940
Total CBU (boe)	17,775	5,476	3,075
LABU – oil (bbls)	10,967	4,767	2,194
Total Company conventional (boe)	28,742	10,243	5,269

<sup>(1)</sup> Non-GAAP measure. See “Non-GAAP Measures” section within Management’s Discussion and Analysis (“MD&A”).

<sup>(2)</sup> Assumes 8.8 million common shares will be issued upon conversion of the Company’s convertible debentures which were issued in 2007.

<sup>(3)</sup> Six mcf of natural gas is equivalent to one barrel of oil equivalent (“boe”). HBU bitumen volumes are excluded from average daily production as Whitesands operations are considered to be in the pre-operating stage and accordingly are capitalized.

<sup>(4)</sup> Net of transportation expenses.

<sup>(5)</sup> Excludes hedging activities.

The following MD&A is dated March 11, 2009 and should be read in conjunction with the consolidated financial statements and accompanying notes of Petrobank Energy and Resources Ltd. (“Petrobank”, “we”, “our” or the “Company”) as at and for the years ended December 31, 2008 and 2007. Additional information for the Company, including the Annual Information Form (“AIF”), can be found on SEDAR at [www.sedar.com](http://www.sedar.com) or at [www.petrobank.com](http://www.petrobank.com). All amounts are in Canadian dollars, unless otherwise stated and all tabular amounts are in thousands of Canadian dollars, except share amounts or as otherwise noted. Natural gas volumes have been converted to barrels of oil equivalent (“boe”). Six thousand cubic feet (“mcf”) of natural gas is equal to one barrel based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead. Boes may be misleading, especially if used in isolation.

### **Forward-looking statements**

In addition to historical information, the MD&A contains forward-looking statements that are generally identifiable as any statements that express, or involve discussions as to, expectations, beliefs, plans, objectives, assumptions or future events of performance (often, but not always, through the use of words or phrases such as “will likely result,” “expected,” “is anticipated,” “believes,” “estimated,” “intends,” “plans,” “projection” and “outlook”). These statements are not historical facts and may be forward-looking and may involve estimates, assumptions and uncertainties which could cause actual results or outcomes to differ materially from those expressed in such forward-looking statements. The reader is cautioned that assumptions used in the preparation of such information, although considered reasonable at the time of preparation, may prove to be incorrect. Actual results achieved during the forecast period will vary from the information provided herein as a result of numerous known and unknown risks and uncertainties and other factors. Such factors include, but are not limited to: general economic, market and business conditions; fluctuations in oil and gas prices; the results of exploration and development of drilling and related activities; costs and availability of services; fluctuation in foreign currency exchange rates; the uncertainty of reserve estimates; changes in environmental and other regulations; risks associated with oil and gas operations; the ability to economically test, develop and utilize the Company’s patented technologies, the feasibility of the technologies; and other factors, many of which are beyond the control of the Company. Accordingly, there is no representation by Petrobank that actual results achieved during the forecast period will be the same in whole or in part as those forecasts. Except to the extent required by law, Petrobank assumes no obligation to publicly update or revise any forward-looking statements made in this MD&A or otherwise, whether as a result of new information, future events or otherwise. All subsequent forward-looking statements, whether written or oral, attributable to Petrobank or persons acting on the Company’s behalf, are qualified in their entirety by these cautionary statements.

### **Non-GAAP measures**

This report contains financial terms that are not considered measures under Canadian generally accepted accounting principles (“GAAP”), such as funds flow from operations, funds flow per share, EBITDA, net debt and operating netback. These measures are commonly utilized in the oil and gas industry and are considered informative for management and shareholders. Specifically, funds flow from operations and funds flow per share reflect cash generated from operating activities before changes in non-cash working capital. Management considers funds flow from operations and funds flow per share important as they help evaluate performance and demonstrate the Company’s ability to generate sufficient cash to fund future growth opportunities and repay debt. EBITDA is defined as earnings before interest, taxes, depreciation, amortization, non-controlling interest and non-cash items. Net debt includes bank debt plus accounts payable and accrued liabilities less current assets (excluding future income tax asset) and is used to evaluate the Company’s financial leverage. Profitability relative to commodity prices per unit of production is demonstrated by an operating netback. Funds flow from operations, funds flow per share, EBITDA, net debt and operating netbacks may not be comparable to those reported by other companies nor should they be viewed as an alternative to cash flow from operations, net income or other measures of financial performance calculated in accordance with GAAP.

## Q4 2008 highlights

- Petrobank's production more than doubled to 37,618 barrels of oil equivalent per day ("boepd") in the fourth quarter of 2008 compared to 17,829 in the fourth quarter of 2007, comprised of 22,274 boepd from the CBU (170% increase) and 15,344 barrels of oil per day ("bopd") from the LABU (60% increase).
- Funds flow from operations increased by 59% to \$147.8 million in the fourth quarter of 2008. On a per diluted share basis, funds flow from operations increased by 55% to \$1.63.
- Net income decreased by 30% to \$28.1 million in the fourth quarter of 2008. On a per diluted share basis, net income decreased by 24% to \$0.34.
- CBU operating netbacks averaged \$39.04/boe and LABU operating netbacks averaged \$42.45/bbl in the fourth quarter despite declining oil prices.

## 2008 highlights

- Production increased by 181% to 28,742 boepd in 2008 from 10,243 boepd in 2007. CBU production increased by 225% to 17,775 boepd while production from the LABU increased by 130% to 10,967 bopd in 2008.
- Funds flow from operations increased by 281% to \$665.9 million in 2008. On a per diluted share basis, funds flow from operations increased by 247% to \$7.28 in 2008.
- Net income tripled to \$244.5 million in 2008. On a per diluted share basis, net income increased by 179% to \$2.76 in 2008.
- CBU operating netbacks increased 37% to \$67.99/boe and LABU operating netbacks increased 21% to \$69.61/bbl.
- CBU proved plus probable ("2P") reserves increased by 95% to 59.5 million boe at December 31, 2008 and we replaced 2008 production more than 5.5 times.
- CBU proved plus probable plus possible ("3P") reserves increased by 83% to 86.2 million boe with net present value, before tax, discounted at 10% of \$2.0 billion.
- HBU 2P reserves increased by 171% to 69.0 million barrels with net present value, before tax, discounted at 8% of \$392.8 million.
- HBU 3P reserves plus high estimate contingent recoverable bitumen resources totalled 814.7 million barrels with net present value, before tax, discounted at 8% of \$3.6 billion.
- LABU 2P reserves were flat year over year at 36.8 million barrels with net present value, before tax, discounted at 10% of US\$1.2 billion.
- LABU 3P reserves increased by 6% to 55.0 million barrels with net present value, before tax, discounted at 10% of US\$1.8 billion.
- Petrobank's total company 2P reserves increased by 61% to 156.7 million boe with net present value of \$3.0 billion up from \$2.1 billion in 2007.
- Petrobank's total company 3P reserves increased by 12% to 205.9 million boe with net present value of \$4.2 billion up from \$3.2 billion in 2007.

## Significant transactions

- On January 28, 2008, Petrobank acquired Peerless Energy Inc. ("Peerless") for \$338.8 million, including net debt assumed. At the time of acquisition, Peerless was producing approximately 5,600 boepd, of which approximately 3,400 bopd was Bakken light oil strategically located within Petrobank's core properties in southeast Saskatchewan. Peerless' proved plus probable plus possible reserves totalled 18.7 million boe and the net present value discounted at 10% (before tax) totalled \$445.6 million at December 31, 2007. Production and financial results for Peerless have been included in Petrobank's results starting January 28, 2008.
- On October 2, 2008, Petrobank acquired Rocor Resources Inc. ("Rocor") for \$52.7 million, net of working capital assumed. Rocor's assets are focused on the Montney formation in northeast British Columbia and included 14 sections of land with two producing vertical wells, and a five mmmcf per day gas plant. Production and financial results for Rocor have been included in Petrobank's results starting October 2, 2008.
- On November 21, 2008, Petrobank announced the second licensing agreement in Canada and acquired a 50% interest in certain heavy oil lands in the Mannville conventional heavy oil channel in western Saskatchewan.
- On December 24, 2008, the Company issued 285,795 flow-through common shares at a price of \$33.00 per share for gross proceeds of \$9.4 million.

## Petrobank's business units

The Company is comprised of three business units: Canadian Business Unit ("CBU"), Heavy Oil Business Unit ("HBU"), and Latin American Business Unit ("LABU"). The CBU contains conventional oil and gas operations throughout western Canada with a primary focus on light oil development from the Bakken formation in southeast Saskatchewan. The HBU is operating the Whitesands oil sands project using Petrobank's patented THAI™ technology. The Whitesands project is in the pre-operating stage and accordingly all expenses, net of revenues, are capitalized. Therefore, it is important to note that throughout this MD&A, results relating to Whitesands are not included in operational results such as average daily production, revenue, royalties, production expenses, or depletion and depreciation expense. The LABU is comprised of the Company's 76.5% owned and publicly listed subsidiary, Petrominerales Ltd. ("Petrominerales"), which is focused on oil exploration and production in the countries of Colombia and Peru. Petrobank results include 100% of the results of Petrominerales; the minority interest share, which Petrobank does not own, is recorded as income applicable to non-controlling interest on the consolidated statements of operations and retained earnings and as non-controlling interest on the consolidated balance sheets.

## Financial and operational review

(Annual comparisons are 2008 compared to 2007 and quarterly comparisons are fourth quarter 2008 compared to the fourth quarter of 2007 unless otherwise noted)

Average daily crude oil production	Three months ended December 31,			Years ended December 31,		
	2008	2007	Change	2008	2007	Change
CBU						
Oil and NGL (bbls)	<b>19,841</b>	6,691	197%	<b>15,369</b>	3,579	329%
Natural gas (mcf)	<b>14,598</b>	9,379	56%	<b>14,436</b>	11,379	27%
Total CBU (boe)	<b>22,274</b>	8,254	170%	<b>17,775</b>	5,476	225%
LABU – light/medium oil (bbls)	<b>15,344</b>	9,575	60%	<b>10,967</b>	4,767	130%
Total Company conventional (boe)	<b>37,618</b>	17,829	111%	<b>28,742</b>	10,243	181%

Record production in the CBU and the LABU in the fourth quarter of 2008 helped the Company achieve record average daily production in 2008. HBU bitumen volumes are excluded from average daily production as Whitesands operations are considered to be in the pre-operating stage and accordingly revenues are offset against capitalized costs as opposed to being recognized in net income.

The significant increases in oil and NGL production in the CBU are due to production increases from the Company's Bakken light oil properties in southeast Saskatchewan, which accounted for approximately 84% of the CBU's production in 2008 and approximately 88% in the fourth quarter. The increases were achieved through continued drilling activity and the acquisition of Peerless. The Company drilled 161 operated Bakken wells in 2008 surpassing our goal of 154. To achieve this accomplishment, we had as many as 10 drilling rigs working in the area in 2008. We have since scaled back to two rigs due to the rapid decline in crude oil prices. We will continue to monitor industry conditions and position ourselves to be able to ramp up or scale down drilling activity with minimal delay. Natural gas production was higher in the fourth quarter and in 2008 due to the acquisition of Peerless and completion of the Company's second and third Bakken facilities allowing Petrobank to capture associated Bakken natural gas production.

LABU oil production increased in 2008 primarily due to drilling success at Corcel, Orito and Neiva. Corcel production began in the third and fourth quarters of 2007 from the A-1 and A-2 wells, and has increased through 2008 with additional production from the A-4, C-1, C-3 and D-1 wells. Corcel production contributed approximately 69% of the LABU's production in 2008 and approximately 85% in the fourth quarter. The Company continues to truck all Corcel production to various offloading stations. Access to this infrastructure is critical to growing Corcel production. The Company continues to evaluate and secure additional alternatives to increase offloading capacity which includes the construction of additional offloading facilities close to Corcel. As a major step in this strategy, the Company is constructing a key Llanos Basin facility at Monterrey that will give Petrominerales up to an initial 20,000 barrels per day of incremental offloading capacity. Start-up of this facility is targeted for the second quarter of 2009. Monterrey will be the closest offloading station to Corcel resulting in significant savings on trucking costs. Fourth quarter production increased to 15,344 bopd due to new production from Corcel offset by a 29% decrease in Orito production caused by a general strike in the Putamayo region that resulted in production being shut-in from November 20, 2008 to January 5, 2009. Production has continued to increase subsequent to year-end, averaging 25,897 bopd in February 2009. The increase relates to production additions from the Corcel-D2 well and drilling success at Neiva.

Average benchmark and realized prices net of transportation costs	Three months ended December 31,			Years ended December 31,		
	2008	2007	Change	2008	2007	Change
WTI (US\$/bbl)	59.08	90.50	(35%)	99.75	72.41	38%
WTI (\$/bbl)	70.95	88.69	(20%)	104.30	76.81	36%
AECO natural gas (\$/mcf)	6.69	6.15	9%	8.15	6.43	27%
US\$/\$ exchange rate	0.83	1.02	(19%)	0.94	0.93	1%
CBU – oil and NGL						
Realized plant gate price per bbl (\$/bbl)	57.71	80.83	(29%)	92.80	75.64	23%
US\$ discount as a % of WTI	18%	9%	100%	13%	3%	333%
CBU – natural gas realized plant gate price per mcf (\$/mcf)	6.86	6.05	13%	8.06	6.35	27%
LABU – light/medium oil						
Realized plant gate price per bbl (\$/bbl)	54.93	76.53	(28%)	87.15	71.74	21%
US\$ discount as a % of WTI	23%	14%	64%	18%	3%	500%

The realized oil and NGL prices, net of transportation, received by the CBU in 2008 increased by 23% as a result of higher average WTI prices offset by a larger discount to WTI. The CBU's realized oil and NGL price in the fourth quarter decreased by 29% due to the sharp decline in world crude oil prices and a larger discount to WTI. The discounts compared to WTI increased in 2008 mainly from higher trucking costs associated with pipeline capacity constraints in southeast Saskatchewan and larger benchmark crude differentials from WTI experienced by the industry in the fourth quarter.

In 2008 approximately 15% of natural gas production was sold under the Company's long-term physical natural gas sales contract at a price of \$5.22 per mcf (2007 – \$5.02 per mcf).

In Colombia, the realized oil prices also increased as a result of higher average WTI prices offset by a larger discount to WTI. The discounts compared to WTI increased in 2008 mainly due to higher trucking costs associated with Corcel production additions and fixed costs that increase on a percent basis when oil prices are lower. Fixed costs include marketing fees and pipeline fees that are charged on a flat per barrel basis.

Revenue	Three months ended December 31,			Years ended December 31,		
	2008	2007	Change	2008	2007	Change
CBU revenue	121,012	57,221	111%	585,800	129,997	351%
LABU revenue	85,149	70,087	21%	364,268	127,739	185%
Total revenue	206,161	127,308	62%	950,068	257,736	269%
CBU transportation expenses	6,463	2,239	189%	21,212	4,834	339%
LABU transportation expenses	7,610	2,675	184%	14,460	2,920	395%
Total transportation expenses	14,073	4,839	191%	35,672	7,754	360%
CBU revenue, net of transportation (“plant gate revenue”)	114,549	54,982	108%	564,588	125,163	351%
LABU revenue, net of transportation (“plant gate revenue”)	77,539	67,412	15%	349,808	124,819	180%
Total revenue, net of transportation (“plant gate revenue”)	192,088	122,394	57%	914,396	249,982	266%
CBU gross revenue (\$/boe)	59.05	75.35	(22%)	90.04	65.04	38%
CBU transportation expenses (\$/boe)	3.15	2.95	7%	3.26	2.42	35%
CBU plant gate revenue (\$/boe)	55.90	72.40	(23%)	86.78	62.62	39%
LABU gross revenue (\$/bbl)	60.32	79.57	(24%)	90.75	73.42	24%
LABU transportation expenses (\$/bbl)	5.39	3.04	77%	3.60	1.68	114%
LABU plant gate revenue (\$/bbl)	54.93	76.53	(28%)	87.15	71.74	21%

The significant increase in revenue, net of transportation, in the fourth quarter of 2008 was due to higher production, partly offset by lower realized prices, in both the CBU and LABU. The 266% increase in 2008 plant gate revenue was due to higher production and realized prices in both the CBU and LABU.

In the CBU, transportation costs increased due to higher production in southeast Saskatchewan and pipeline constraints in the region. The increase in costs on a unit of production basis is mainly due to the pipeline constraints, that began to alleviate in the fourth quarter, as well as fuel surcharges. In the LABU, transportation costs relate to trucking sales oil from Corcel to various offloading stations. Transportation expenses increased in 2008 in both dollar terms and on a per barrel basis due to higher production at Corcel and an increase in trucking costs.

Royalties	Three months ended December 31,			Years ended December 31,		
	2008	2007	Change	2008	2007	Change
CBU	17,664	3,882	355%	65,252	9,718	571%
LABU	6,612	6,818	(3%)	33,974	11,627	192%
Total royalties	24,276	10,700	127%	99,226	21,345	365%
CBU – \$ per boe	8.62	5.11	69%	10.03	4.86	106%
LABU – \$ per bbl	4.68	7.74	(40%)	8.46	6.68	27%
CBU – royalties as a % of plant gate revenue	15%	7%	114%	12%	8%	50%
LABU – royalties as a % of plant gate revenue	9%	10%	(10%)	10%	9%	11%

Total royalty expense increased as a result of increased production and commodity prices in 2008. CBU royalties as a percentage of plant gate revenue increased in the fourth quarter and all of 2008 as a portion of the Company's Bakken wells no longer receive their royalty holidays. The first 37,740 barrels of production from horizontal Bakken wells drilled on Saskatchewan Crown land incur a royalty rate of 2.5%.

Colombian government royalties are fixed at a rate of 8% until the Petrominerales' net production per field exceeds 5,000 bopd and then increase by 1% for each incremental 10,000 bopd of production per field. In addition, the Company paid a 3% overriding royalty on Corcel production that was converted to an 8% net profits interest ("NPI") upon payout in the year. The NPI account is a cumulative balance that includes capital investments such that when negative, no amount is payable. Royalties as a percent of plant gate revenue decreased to 9% in the fourth quarter due to lower overriding royalties and NPI costs.

Gain (loss) on risk management contracts	Three months ended December 31,			Years ended December 31,		
	2008	2007	Change	2008	2007	Change
CBU realized gain (loss)	4,461	–	–	(4,808)	–	–
LABU realized gain (loss)	1,512	–	–	(8,469)	–	–
CBU unrealized gain (loss)	34,517	(4,476)	–	37,854	(4,950)	–
LABU unrealized gain (loss)	2,504	(5,147)	–	6,465	(5,700)	–
Gain (loss) on risk management contracts	42,994	(9,623)	–	31,042	(10,650)	–

For the three months ended December 31, 2008, the realized gain for actual monthly settlements incurred during the period was \$2.18 per boe in the CBU and \$1.07 per barrel in the LABU. For 2008, the realized loss was \$0.74 per boe in the CBU and \$2.11 per barrel in the LABU. Unrealized gains and losses represent the change in fair value of the contracts related to expected future settlements.

At December 31, 2008 the Company had recorded a \$32.9 million asset related to the following risk management contract:

Business Unit	Term	Volume (bopd)	Price (US\$/bbl)	Benchmark
CBU	Jan. 1, 2009 – Dec. 31, 2009	2,000	90.00 floor/121.00 ceiling	WTI

Production expenses	Three months ended December 31,			Years ended December 31,		
	2008	2007	Change	2008	2007	Change
CBU	16,882	6,064	178%	56,983	16,360	248%
LABU	11,002	6,463	70%	36,409	12,816	184%
Total production expenses	27,884	12,527	123%	93,392	29,176	220%
CBU – \$ per boe	8.24	7.99	3%	8.76	8.19	7%
LABU – \$ per bbl	7.80	7.34	6%	9.08	7.37	23%

Consolidated production expenses increased in the fourth quarter and in 2008 as a result of increased production. Production expenses per unit of production in the CBU increased slightly in 2008, mainly due to new Bakken production being handled through higher cost single well oil batteries. We completed our second and third Bakken facilities in the second half of 2008 which have decreased operating costs in southeast Saskatchewan. In addition, these facilities have allowed Petrobank to add liquids rich natural gas production and reserves associated with Bakken light oil production.

Production expenses in the LABU increased in 2008 mainly due to higher Corcel production being processed through temporary facilities during the first half of the year which resulted in higher water handling costs. Petrominerales completed the first-phase expansion of the Corcel central processing facilities in July 2008 to increase fluid handling capacity to 70,000 barrels of fluid per day. These permanent facilities replaced higher cost, less efficient temporary facilities causing production expenses in U.S. dollars to decrease during the course of 2008, however, resulted in an increase on a Canadian dollar basis due to depreciation of the Canadian dollar relative to the U.S. dollar.

General and administrative expenses	Three months ended December 31,			Years ended December 31,		
	2008	2007	Change	2008	2007	Change
CBU and HBU	3,924	2,295	71%	13,826	6,314	119%
LABU	2,940	2,105	40%	10,744	6,822	57%
Total general and administrative expenses	6,864	4,400	56%	24,570	13,136	87%
CBU and HBU – \$ per CBU boe	1.91	3.02	(37%)	2.13	3.16	(33%)
LABU – \$ per bbl	2.08	2.39	(13%)	2.68	3.92	(32%)

Total general and administrative costs increased in the fourth quarter and 2008 primarily due to additional personnel as a result of expanding operations. On a unit of production basis, these costs have decreased due to higher production levels in both Canada and the LABU.

Stock-based compensation expenses	Three months ended December 31,			Years ended December 31,		
	2008	2007	Change	2008	2007	Change
CBU and HBU (Petrobank)	4,120	1,585	160%	14,791	5,153	187%
LABU (Petrominerales)	961	403	138%	2,843	1,446	97%
Total stock-based compensation expenses	5,081	1,988	156%	17,634	6,599	167%

Stock-based compensation expenses relate to stock options and deferred common shares granted by Petrobank and Petrominerales. The calculation of this non-cash expense is based on the fair value of stock options and deferred common shares granted, amortized over the vesting period of the option, or immediately upon grant of the deferred common shares.

In December 2008, Petrobank and Petrominerales modified the terms of certain non-executive stock options to enhance employee retention while balancing the interests of shareholders. Employees were given the option to reduce the exercise price on outstanding options in exchange for forfeiting 25% of their options and extending the vesting period of retained options. The modifications resulted in the exercise price on 1,833,675 Petrobank stock options being reduced from a weighted average of \$47.18 to \$22.58 and the forfeiture of 611,200 options with a weighted average exercise price of \$47.18. The incremental fair value attributed to the modifications will be recorded as stock-based compensation over the vesting period of the modified options.

Interest expense	Three months ended December 31,			Years ended December 31,		
	2008	2007	Change	2008	2007	Change
CBU and HBU	5,787	1,205	380%	16,554	4,339	282%
LABU	3,060	1,228	149%	11,398	2,914	291%
Total interest expense	8,847	2,433	264%	27,952	7,253	285%

Interest expense includes interest on bank debt and convertible debentures, fees on letters of credit and amortization of deferred financing costs. Interest expense includes non-cash accretion related to the convertible debentures of \$4.6 million in the fourth quarter (2007 – \$1.1 million). In 2008 interest expense included non-cash accretion of \$13.4 million (2007 – \$2.7 million). Petrobank issued US\$250 million of 3.0% annual coupon convertible debentures in May 2007 and Petrominerales issued US\$100 million of 3.375% annual coupon convertible debentures in December 2007, which combined with higher debt levels have resulted in higher interest expense in 2008. In addition, the depreciation of the Canadian dollar relative to the U.S. dollar in 2008 resulted in higher Canadian dollar denominated interest expense as interest on the convertible debentures is payable in U.S. dollars. Petrominerales repurchased US\$18.3 million of the convertible debentures for US\$11.1 million, or 61% of face value, which will result in an interest savings in future periods.

### Gain on repurchase of Petrominerales convertible debentures

Convertible debentures with a face value of US\$18.3 million were repurchased at a 39% discount by Petrominerales in October and November of 2008 for US\$11.1 million. A \$6.3 million gain was recorded in the fourth quarter of 2008 as a result of settling the liability portion related to the repurchased debentures.

Foreign exchange loss (gain)	Three months ended December 31,			Years ended December 31,		
	2008	2007	Change	2008	2007	Change
CBU	32,542	(952)	–	46,782	(16,520)	–
LABU	1,000	(18)	–	1,067	516	107%
<b>Total foreign exchange loss (gain)</b>	<b>33,542</b>	<b>(970)</b>	<b>–</b>	<b>47,849</b>	<b>(16,004)</b>	<b>–</b>

The Company recognized foreign exchange losses primarily due to the depreciation of the Canadian dollar relative to the U.S. dollar. Unrealized foreign exchange losses of \$33.0 million in the fourth quarter and \$47.2 million in 2008 were recorded on Petrobank's U.S. dollar denominated convertible debentures.

Depletion, depreciation and accretion ("DD&A") expense	Three months ended December 31,			Years ended December 31,		
	2008	2007	Change	2008	2007	Change
CBU	59,385	19,875	199%	187,695	48,435	288%
LABU	33,946	16,332	108%	87,681	31,221	181%
<b>Total DD&amp;A expense</b>	<b>93,331</b>	<b>36,207</b>	<b>158%</b>	<b>275,376</b>	<b>79,656</b>	<b>246%</b>
CBU – \$ per boe	28.98	26.17	11%	28.85	24.23	19%
LABU – \$ per bbl	24.05	18.54	30%	21.84	17.94	22%

Higher production caused DD&A expense to increase in the fourth quarter and 2008. The DD&A rates per unit of production in both business units have increased in 2008 due to significant capital expenditure programs including expenditures on key facilities in southeast Saskatchewan and at Corcel in Colombia, as well as future development costs associated with proved undeveloped reserves. The DD&A rate for the CBU also increased due to the acquisition of Peerless.

Current taxes	Three months ended December 31,			Years ended December 31,		
	2008	2007	Change	2008	2007	Change
Current taxes	(13,443)	871	–	4,938	3,784	30%

Current taxes consist of income, presumptive income and equity taxes in Colombia. Equity tax is based on equity capitalization levels in Colombia, while presumptive income tax is charged in periods where taxable income is below certain thresholds, and when paid, can be carried forward for five years and be recovered against income taxes in future periods. Petrominerales' pre-tax income is subject to the Colombian statutory income tax rate of 33%. A recovery was recorded in the fourth quarter of 2008 mainly due to enhanced tax allowances on capital expenditures in Colombia.

Future income taxes	Three months ended December 31,			Years ended December 31,		
	2008	2007	Change	2008	2007	Change
CBU and HBU (Canada)	4,591	(5,318)	–	59,015	7,054	737%
LABU (Colombia)	16,992	5,153	230%	27,089	(1,281)	–
<b>Total future income taxes</b>	<b>21,583</b>	<b>(165)</b>	<b>–</b>	<b>86,104</b>	<b>5,773</b>	<b>1,391%</b>

The Company's increased future tax expense in Canada for the fourth quarter of 2008 and for the year ending December 31, 2008 is consistent with increased income during these periods. The effective tax rate for 2008 in Canada was 30%, consistent with the statutory rate of 29.5%. The increase in the Canadian effective tax rate in the fourth quarter of 2008 was largely as a result of large unrealized foreign exchange losses during this period. The LABU recorded future income tax expense in 2008 compared to a recovery in 2007 when previously unrecognized future income tax assets were recognized. When combined with the current tax expense in Colombia, Petrominerales had a U.S. dollar denominated effective tax rate of 14% in the fourth quarter of 2008 and 19% for 2008. The effective tax rates are lower than the Colombian statutory income tax rate of 33% largely as a result of enhanced tax allowances received for the acquisition of fixed assets.

<b>Income applicable to non-controlling interest (“NCI”)</b>	Three months ended December 31,			Years ended December 31,		
	<b>2008</b>	2007	Change	<b>2008</b>	2007	Change
Income applicable to NCI	<b>5,968</b>	5,516	8%	<b>33,206</b>	10,686	211%

The income applicable to NCI represents the non-controlling interest share of Petrominerales' net income. The NCI share was 19.3% in the first quarter of 2007 and has since increased to 23.5%. The income applicable to NCI increased significantly in 2008 primarily due to the increase in Petrominerales' income and partially due to the larger NCI share.

Petrominerales announced a normal course issuer bid on August 14, 2008 authorizing Petrominerales to purchase up to 5,032,718 common shares by August 17, 2009. During the year, Petrominerales repurchased a total of 1,326,000 common shares. For every share purchased on the open market one share is also purchased from Petrobank; accordingly, Petrobank's ownership interest is increasing as a result of the bid as it is participating for less than its prorated ownership interest.

<b>Net income</b>	Three months ended December 31,			Years ended December 31,		
	<b>2008</b>	2007	Change	<b>2008</b>	2007	Change
Net income	<b>28,083</b>	40,146	(30%)	<b>244,482</b>	81,427	200%
\$ per share, diluted	<b>0.34</b>	0.45	(24%)	<b>2.76</b>	0.99	179%

The decreases in net income and net income per diluted share in the fourth quarter were mainly due to lower realized prices in both the CBU and LABU, unrealized foreign exchange losses on Petrobank's U.S. dollar denominated convertible debentures and higher DD&A expense, royalties, production expenses, and future income tax expenses, partly offset by gains on risk management contracts and a gain on the repurchase of Petrominerales' convertible debentures.

The significant increases in net income and net income per share in 2008 were mainly due to substantially higher production and realized prices in both the CBU and LABU, gains on risk management contracts and a gain on the repurchase of Petrominerales convertible debentures, partly offset by an increase in most expenses, but most significantly as a result of increases in royalties, production expenses, interest, foreign exchange losses, DD&A, future income taxes and income applicable to non-controlling interests.

<b>Funds flow from operations</b>	Three months ended December 31,			Years ended December 31,		
	<b>2008</b>	2007	Change	<b>2008</b>	2007	Change
Funds flow from operations	<b>147,813</b>	92,733	59%	<b>665,933</b>	174,864	281%
\$ per share, diluted	<b>1.63</b>	1.05	55%	<b>7.28</b>	2.10	247%

The increases in funds flow from operations and funds flow per share in the fourth quarter and in 2008 were driven by strong increases in production in both the CBU and LABU, partly offset by higher royalties, production expenses, and cash interest expense. The CBU and LABU experienced traditionally high realized prices in the first nine months of 2008 before a steep decline in realized prices in the fourth quarter.

The following table shows the reconciliation of funds flow from operations to cash flow from operating activities for the periods noted:

	Three months ended December 31,			Years ended December 31,		
	<b>2008</b>	2007	Change	<b>2008</b>	2007	Change
Funds flow from operations: Non-GAAP	<b>147,813</b>	92,733	59%	<b>665,933</b>	174,864	281%
Changes in non-cash working capital	<b>75,853</b>	23,384	224%	<b>(12,323)</b>	10,716	–
Cash flow from operating activities: GAAP	<b>223,666</b>	116,117	93%	<b>653,610</b>	185,580	252%

Capital expenditures	Three months ended December 31,			Years ended December 31,		
	2008	2007	Change	2008	2007	Change
CBU	200,186	79,045	153%	545,833	303,687	80%
LABU	56,325	36,598	54%	281,748	152,151	85%
HBU	23,471	20,885	12%	82,332	54,426	51%
<b>Total capital expenditures</b>	<b>279,982</b>	136,528	105%	<b>909,913</b>	510,264	78%

Q4 2008 capital expenditures by type	CBU	LABU	HBU	Total
Drilling and completions	97,975	35,820	2,695	136,490
Facilities	26,836	15,752	5,758	48,346
Land	70,581	–	6	70,587
Seismic	527	3,601	1,925	6,053
Pilot capital	–	–	10,043	10,043
Other <sup>(1)</sup>	4,267	1,152	3,044	8,463
<b>Total capital expenditures</b>	<b>200,186</b>	<b>56,325</b>	<b>23,471</b>	<b>279,982</b>

<sup>(1)</sup> CBU and LABU include capitalized salaries and office furniture. HBU includes \$2.8 million of capitalized cash interest and \$0.2 million of non-cash accretion.

2008 capital expenditures by type	CBU	LABU	HBU	Total
Drilling and completions	315,970	191,122	16,485	523,577
Facilities	83,519	64,462	22,042	170,023
Land	130,283	–	75	130,358
Seismic	4,426	22,953	2,389	29,768
Pilot capital	–	–	28,505	28,505
Other <sup>(1)</sup>	11,635	3,211	12,836	27,682
<b>Total capital expenditures</b>	<b>545,833</b>	<b>281,748</b>	<b>82,332</b>	<b>909,913</b>

<sup>(1)</sup> CBU and LABU include capitalized salaries and office furniture. HBU includes \$9.4 million of capitalized cash interest and \$3.4 million of non-cash accretion.

CBU expenditures in the fourth quarter and 2008 were spread amongst drilling, completions, and land acquisitions, primarily at the Company's southeast Saskatchewan light oil properties. Drilling activity included 33.4 net Bakken wells in southeast Saskatchewan in the fourth quarter, totalling 187.5 net Bakken wells for the year. Facility expenditures in 2008 include the construction of two major facilities in southeast Saskatchewan, providing the Company with long-term infrastructure, and significant land acquisitions were made in 2008 adding to our undeveloped land base in southeast Saskatchewan and in the Horn River shale basin of northeast British Columbia.

The Company's fourth quarter and 2008 LABU expenditures focused on continuing exploration and development at Corcel, ongoing development at Orito and work commitments on Petrominerales' exploration blocks. 2008 activity at Corcel included drilling six oil wells and two disposal wells, completing seven wells, acquisition of 100 square kilometres of 3D seismic, the construction and expansion of the central processing facility. 2008 activity at Orito included drilling nine oil wells and completing seven wells. Neiva expenditures included drilling four oil wells and completing one well. Exploration activity in 2008 included drilling five wells, resulting in three oil wells (one well at Joropo and two wells at Mapache) and two abandoned wells (one at Castor and Casanare Este). Petrominerales also acquired and interpreted 199 square kilometres of 3D seismic data on its heavy oil and Llanos blocks.

HBU expenditures in the fourth quarter and 2008 included facility modifications, workovers, operating expenses, and capitalized interest. Activity earlier the year included drilling a production well to test an improved completion design and the Company's proprietary CAPRI™ production catalyst. Currently, Whitesands operations are considered to be in the pre-operating stage and as a result, operating expenses net of revenues are capitalized. Facilities and pilot capital includes initial start-up costs and costs related to solving production and operational issues encountered post start-up. The post start-up costs include well workovers, additional desand facilities and disposal costs, revised produced gas facilities and operating costs to manage H<sub>2</sub>S, gas, water and oil analysis, waste water and oil disposal, and additional laboratory and research related costs. These extraordinary costs are consistent with a pilot project and are necessary to solve process and operational problems and to gain the necessary data for commercial design.

## HBU development projects

### ***Whitesands THAI™ project***

Petrobank, through the Whitesands Insitu Partnership, owns 72 sections (46,240 acres) of oil sands leases near Conklin, Alberta where we are operating the first field test of Petrobank's THAI™/CAPRI™ technologies. The project now consists of three producing horizontal well pairs. The P-3B well, incorporating our proprietary CAPRI™ technology, began production in the third quarter of 2008.

### ***May River project***

The May River Project is the commercial development of Petrobank's leases (including the Whitesands project) west of Conklin, Alberta utilizing THAI™. The May River design builds on the experience gained from the Whitesands pilot plant and is intended to be built in phases, with initial production capacity of 10,000 barrels of THAI™ oil per day, and an ultimate capacity of 100,000 barrels per day.

The regulatory application for May River's first phase was filed with the Energy Resources Conservation Board and Alberta Environment at the end of 2008. The application has been deemed complete and is now moving through the regulatory process.

The front end engineering and design for the project began in the fourth quarter of 2008, and we expect to complete this phase of engineering by mid-year.

## Summary of quarterly results

Significant factors influencing quarterly results were:

- Record production in both the CBU and LABU and high benchmark oil prices in the first three quarters of 2008 resulted in dramatic increases in revenue and funds flow from operations. In the fourth quarter of 2008 benchmark crude oil prices declined significantly, which negatively affected revenue, funds flow from operations and net income, despite higher production levels in both the CBU and LABU.
- Light oil production in the CBU in the fourth quarter of 2008 increased by 24% over the third quarter of 2008 and almost tripled since the fourth quarter of 2007, reflecting the acquisition of Peerless in January 2008 and the Company's industry leading drilling activity on the Bakken light oil resource play in southeast Saskatchewan. Higher netbacks in the first three quarters of 2008 reflect higher oil prices and the profitability of our Bakken light oil production.
- LABU production increased significantly in the last half of 2007 due to additions from the Corcel-A1 discovery well in the third quarter of 2007 and the follow up Corcel-A2 well in the fourth quarter of 2007.
- LABU production increased further in the third quarter of 2008 due to production additions from the Corcel-A4 and C1 wells.
- LABU production increased again in the fourth quarter of 2008 due to production additions from the Corcel-C3 and D1 wells, offset by a temporary suspension of operations at the Orito field from November 20, 2008 to January 5, 2009 due to a general strike in the region.

**Summary of quarterly results**

	2008				2007			
	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
<b>Financial</b> (\$000s except where noted)								
Oil and natural gas revenue	206,161	317,137	247,479	179,291	127,308	63,006	37,577	29,845
Funds flow from operations	147,813	216,709	177,923	123,488	92,733	42,316	21,580	18,235
Per share – basic (\$)	1.78	2.62	2.16	1.53	1.20	0.55	0.28	0.25
– diluted (\$)	1.63	2.36	1.92	1.36	1.05	0.48	0.26	0.25
Net income	28,083	123,226	57,636	35,537	40,146	20,978	16,564	3,739
Per share – basic (\$)	0.34	1.49	0.70	0.44	0.52	0.27	0.22	0.05
– diluted (\$)	0.34	1.35	0.64	0.40	0.45	0.25	0.22	0.05
EBITDA	138,529	235,377	182,349	126,998	94,200	44,168	22,475	19,187
Capital expenditures	279,982	257,305	172,356	200,270	136,528	135,417	165,707	72,612
<b>Operations</b>								
<b><i>CBU operating netbacks by product</i></b>								
Light/medium oil and NGL sales price, net of transportation (\$/bbl)	57.71	115.11	117.64	91.87	80.83	76.56	67.53	63.43
Royalties	8.90	13.36	11.83	6.44	5.70	5.09	5.35	7.31
Production expenses	8.68	9.56	9.55	10.25	8.94	10.13	10.64	9.07
Operating netback	40.13	92.19	96.26	75.18	66.19	61.34	51.54	47.05
Conventional heavy oil sales price (\$/bbl)	–	–	–	–	–	–	–	40.22
Royalties	–	–	–	–	–	–	–	1.08
Production expenses	–	–	–	–	–	–	–	56.36
Operating netback	–	–	–	–	–	–	–	(17.22)
Natural gas sales price, net of transportation (\$/mcf)	6.86	7.94	9.83	7.73	6.05	5.25	6.77	6.95
Royalties	1.06	1.38	1.81	1.35	0.43	0.36	0.54	0.80
Production expenses	0.77	0.66	0.83	0.89	0.64	0.68	1.06	1.10
Operating netback	5.03	5.90	7.19	5.49	4.98	4.21	5.17	5.05
Oil equivalent sales price, net of transportation (\$/boe)	55.90	106.51	109.43	83.55	72.42	62.68	54.65	50.46
Royalties	8.62	12.72	11.70	6.74	5.11	4.18	4.35	5.78
Production expenses	8.24	8.84	8.88	9.35	7.99	8.26	8.60	8.08
Operating netback	39.04	84.95	88.85	67.46	59.32	50.24	41.70	36.60
<b><i>LABU operating netback</i></b> (\$/bbl)								
Oil sales price, net of transportation	54.93	110.53	115.77	86.53	76.53	72.74	63.29	58.44
Royalties	4.68	11.71	11.11	8.25	7.74	6.32	5.09	4.67
Production expenses	7.80	8.38	10.86	10.86	7.34	7.42	6.74	8.26
Operating netback	42.45	90.44	93.80	67.42	61.45	59.00	51.46	45.51
<b><i>Average daily production</i></b>								
CBU – light/medium oil and NGL (bbls)	19,841	16,024	14,205	11,351	6,691	3,745	2,132	1,651
CBU – conventional heavy oil (bbls)	–	–	–	–	–	–	–	41
CBU – natural gas (mcf)	14,598	14,047	13,871	15,229	9,379	10,006	11,771	14,429
Total CBU conventional (boe)	22,274	18,365	16,517	13,889	8,254	5,413	4,094	4,097
LABU – oil (bbls)	15,344	12,485	7,339	8,635	9,575	4,522	2,848	2,042
Total Company conventional (boe)	37,618	30,850	23,856	22,524	17,829	9,935	6,942	6,139

## Commitments

The following is a summary of the estimated costs required to fulfill the Company's remaining contractual commitments as at December 31, 2008:

Type of obligation	< 1 Year	1-3 Years	3-5 Years	Thereafter	Total
<b>CBU</b>					
Canadian bank debt (\$)	–	315,658	–	–	<b>315,658</b>
Petrobank convertible debentures (US\$) <sup>(1)</sup>	–	–	250,000	–	<b>250,000</b>
Office operating leases (\$)	3,100	7,300	10,000	26,600	<b>47,000</b>
Flow-through expenditures (\$)	15,283	–	–	–	<b>15,283</b>
<b>LABU</b>					
Petrominerales convertible debentures (US\$) <sup>(2)</sup>	–	81,700	–	–	<b>81,700</b>
Exploration contracts (US\$)	34,600	14,000	–	–	<b>48,600</b>
Offloading facility (US\$)	15,300	–	–	–	<b>15,300</b>
Drilling rigs (US\$) <sup>(3)</sup>	9,100	–	–	–	<b>9,100</b>
<b>Total Company</b> <sup>(4)</sup>	<b>90,635</b>	<b>440,152</b>	<b>316,150</b>	<b>26,600</b>	<b>873,537</b>

<sup>(1)</sup> The debentures are convertible into common shares of Petrobank at a conversion price of US\$28.4902 per share.

<sup>(2)</sup> The debentures are convertible into common shares of Petrominerales at a conversion price of US\$27.3485 per Petrominerales share.

<sup>(3)</sup> The contracted drilling rigs will be used to satisfy a significant portion of the commitments on the Colombian exploration contracts.

<sup>(4)</sup> US\$ amounts have been converted using the December 31, 2008 exchange rate of \$1.2246.

## Liquidity and capital resources

During the year the Company completed the following share issuances:

Date of issue	Shares issued	Price per share	Gross value	Use of proceeds
January 28, 2008	4,931,204	\$43.23	\$213.2 million	Issued in connection with the acquisition of Peerless.
October 2, 2008	699,183	\$37.87	\$26.5 million	Issued in connection with the acquisition of Rocor.
December 24, 2008	285,795	\$33.00	\$9.4 million	Initially used to temporarily reduce bank debt, and will be used to fund 2009 exploration expenditures.

The current economic slowdown and recent volatile financial and commodity markets have impacted the Company's operations and plans for 2009. The Company intends to balance capital spending with existing cash balances, expected future cash flows and prudent use of its credit facilities to execute its capital plans. As a result, the Company has slowed the pace of capital expenditures from what was incurred in 2008. The Company believes it is well positioned financially with recent production additions, cash on hand in Colombia, available capacity through our credit facilities, assets that are providing strong production growth, operating netbacks and an inventory of prospects. The current economic environment, while challenging, is opening up opportunities and has resulted in lower costs and more availability of equipment and services.

At December 31, 2008, the Company had \$315.2 million of bank debt and accounts payable and accrued liabilities in excess of current assets of \$40.5 million, resulting in net debt of \$355.7 million.

The Company's secured Canadian credit facilities combined borrowing limit totals \$380 million. The facilities are comprised of a \$320 million reserve-based revolver and a \$60 million oil sands resource-based revolver with terms ending on July 2009, extendable by the lenders for an additional year. If the lenders were to not extend the term, the drawn amounts would be due in July 2010. The facilities carry floating interest rates at LIBOR plus a margin, based on a sliding scale ratio of the Company's debt to earnings before interest, taxes and non-cash items related to its Canadian operations. The facilities are secured by a \$500 million demand debenture and a securities pledge on the Company's subsidiaries with ownership of Whitesands Insitu Partnership's oil sands assets and the THAI™ technology, but does not include the Company's share ownership in Petrominerales.

The syndicate of lenders of the Canadian facilities assess the borrowing bases semi-annually. The borrowing bases are determined according to a number of factors; primarily the commodity price outlook of the lenders, the quantity of the Company's Canadian conventional proved producing and proved undeveloped reserves, the forecast production profile, the estimated quantity of recoverable bitumen resource and the value of our oil sands leases. The Company's borrowing capacity is expected to benefit from significant increases in proved developed producing reserves, up 222% to 26.5 million boe in the CBU.

The Company has an option to force conversion of the Petrobank convertible debentures at the prevailing conversion price commencing in May 2010, should the price of the Company's common shares exceed 120% of the prevailing conversion price of the debentures over a specified period. If conversion of the debentures is forced, or if the Company's share price is in excess of the prevailing conversion price upon maturity in May 2012, the debentures will be converted into equity. Alternatively, if the share price is below the prevailing conversion price at maturity, the Company can elect to redeem the principal amount in common shares or re-finance any remaining principal with new debt, equity and / or accumulated cash flows.

The Company is in compliance with the covenants on its convertible debenture and credit facility agreements. Petrobank's convertible debenture agreement stipulates the Company maintain a ratio of equity to total assets of at least 30% and to limit the amount of security and encumbrances the Company has on its total assets to 27.5%. The Company is not subject to restrictive financial covenants under its Canadian credit facilities.

Petrominerales also has a revolving credit facility with an US\$80 million borrowing base that is undrawn. The borrowing base is reviewed with the lender semi-annually and is expected to benefit from significant increases in proved developed producing reserves, up 56% to 14.2 million barrels. Petrominerales is in compliance with the covenants contained in its convertible debenture and credit facility agreements. In its credit facility agreement, the financial covenants are to maintain a ratio of bank debt to trailing twelve month earnings before interest, tax, depletion, depreciation and amortization under 2.0 and to maintain a current ratio greater than 1.0 (current assets divided by current liabilities less unused bank debt). In its convertible debenture agreement, the financial covenants are to maintain a ratio of equity to total assets of at least 30% and to limit the amount of security and encumbrances the Company has on its total assets to 27.5%.

Petrominerales also maintains local Colombian operating lines of credit that are primarily used to issue letters of credit to support exploration agreements. Advances under the facility are collateralized by a promissory note provided by Petrominerales. Petrominerales has used US\$7.9 million of its operating lines of credit for letters of credit to guarantee exploration work commitments. In January 2009, the Colombian operating line of credit was increased to US\$18.8 million.

The Company's working capital requirements fluctuate primarily due to capital expenditure activity and oil and gas revenues. Typically, the Company settles its vendor liabilities following collection of oil and gas revenues.

In addition to the credit facilities and the operating line of credit noted above, other possible sources of funds available to the Company include the following:

- Funds flow from operations.
- Issuance of subordinated or convertible debt.
- Petrobank may monetize risk management contracts.
- Petrobank may issue additional common shares.
- Petrobank is receiving a portion of the proceeds in relation to the Petrominerales Normal Course Issuer Bid.
- Petrobank has the option to sell all or a portion of its remaining shareholdings in Petrominerales in the secondary market.
- Project financing attributable to the significant development projects such as May River.
- Petrobank may sell producing or non-producing assets to raise funds in the short term. Incremental cash resources generated as a result would be reduced by any resulting decreases in future cash flows and any required debt payments.
- Petrominerales could raise additional funds through the issuance of additional common shares or subordinated or convertible debt.
- An alternative financing vehicle is a forward sale of a portion of future production in Canada or Colombia.
- The Company expects to satisfy ongoing working capital requirements with funds flow from operations, cash and available credit facilities.

### ***Normal course issuer bid***

In the third quarter of 2008 the Company repurchased and cancelled a total of 298,400 Petrobank common shares at an average cost of \$41.11 per share pursuant to a Normal Course Issuer Bid ("NCIB") approved by the Toronto Stock Exchange ("TSX"). Under the NCIB, the Company can purchase up to 157,107 common shares daily until August 18, 2009 to a maximum of 6,444,777 common shares, except for the period November 3, 2008 to March 30, 2009, where the Company may purchase up to 314,214 common shares daily pursuant to a temporary policy adopted by the TSX. Any common shares Petrobank purchases under the NCIB will be purchased on the open market through the facilities of the TSX at the prevailing market price at the time of the transaction. Common shares acquired under the NCIB are cancelled.

Petrominerales, the Company's 76.5% owned subsidiary also announced a NCIB on August 14, 2008 and repurchased a total of 1,326,000 Petrominerales common shares during the year ended December 31, 2008 at an average price of \$9.89 per share. Under the NCIB, Petrominerales can purchase up to 24,977 Petrominerales common shares daily until August 18, 2008 to a maximum of 5,032,719 common shares, except for the period November 3, 2008 to March 30, 2009, where Petrominerales may purchase up to 49,954 common shares daily pursuant to a temporary policy adopted by the TSX. For every share purchased on the open market one share is also purchased from Petrobank; accordingly, Petrobank's ownership interest is increasing as a result of the bid as it is participating for less than its prorated ownership interest.

### ***Capital plan***

The CBU's capital plan is focused on the development of Petrobank's Bakken light oil properties in southeast Saskatchewan, exploration and development of our northeast British Columbia and northwest Alberta properties, and leveraging the Company's significant undeveloped land base into new resource opportunities.

Activity in the LABU will continue to focus on defining the potential of the Corcel block and constructing essential facilities, acquiring and evaluating seismic data and drilling exploratory wells on the Company's exploration blocks in 2009.

HBU activity in 2009 will focus on upfront engineering and regulatory work for the first phase of the May River project, continuing operations and expansion at Whitesands, the initial development of the Dawson project in the Peace River region of Alberta, and drilling two wells near Kerrobert, Saskatchewan.

### **Outstanding share data**

The number of Petrobank shares outstanding at December 31, 2008 of 83,525,394 was unchanged as of the date of this MD&A.

### **Risks and uncertainties**

Petrobank is exposed to a variety of risks including, but not limited to: competitive, operational, political, environmental, and financial risks.

The oil and gas industry is intensely competitive. Competition is particularly intense in the acquisition of prospective oil and gas properties and oil and gas reserves. The competition for land and resources is especially intense. Competitors include companies larger than Petrobank, with greater access to financial resources. The Company's future success is driven, in large part, by its ability to find and exploit new oil and natural gas reserves at reasonable costs and reinvestment ratios. The process of evaluating prospects and estimating oil and natural gas reserves is complex and subject to significant uncertainty. Actual operating results, including production performance, will vary from those estimated, possibly materially. The Company manages these risks by maintaining a focused asset base with high working interests and by hiring qualified professionals, including independent reserve engineers, with appropriate industry experience. Petrobank also competes with other oil and gas companies in attempting to secure drilling rigs and other equipment necessary for drilling and completion of wells. Such equipment may be in short supply from time to time. Similarly, equipment and other materials necessary to construct production and transmission facilities may be in short supply from time to time. Petrominerales is also exposed to risks and uncertainties concerning the proximity and capacity of oil offloading infrastructure in Colombia, inability to deliver Petrominerales' production to market could have a material adverse effect on the Company's revenues and financial position. Petrominerales is mitigating these risks by constructing additional offloading capacity.

Petrobank is exposed to a number of operational risks inherent in the industry including accidents, well blowouts, uncontrolled flows, labour strikes and environmental risks. Operational risks are managed using prudent field operating procedures. The Company has a detailed emergency response plan to deal with potential incidents and maintains a comprehensive insurance program to reduce the risk of significant economic loss; however, not all risks can be eliminated. Losses resulting from the occurrence of these risks could have a material adverse impact on the Company's operations.

Petrobank currently has operations in Canada, Colombia and Peru and from time to time may evaluate projects internationally. To help mitigate the risks associated with operating in foreign jurisdictions, the Company seeks to operate in regions where the petroleum industry is a key component of the economy. Petrobank believes that management's experience operating both domestically and internationally helps reduce these risks. Some countries in which the Company may operate may be considered politically and economically unstable. In Colombia and Peru, the governments have a long history of democracy and an established legal framework that, in Petrobank's opinion, minimizes political risks.

Operating internationally, the Company and its personnel may be subject to security risks, but through effective security and social programs, Petrobank believes these risks can be effectively managed. It is difficult to obtain insurance coverage to protect against terrorist incidents and as a result the Company's insurance program excludes this coverage. Consequently, incidents like this in the future could have a material adverse impact on the Company's operations.

The Company's Whitesands THAI™ project entails risks incremental to those of conventional oil and gas operations. Although other operators have utilized the individual processes involved in the THAI™ technology in the past, the technology's configuration of wells, processes and operating procedures is a new combination, and thus Petrobank is subject to unknown operational risks. Other risks associated with the project include: the THAI™ technology will prove unsuccessful or commercially unviable; and, unknown future regulatory or commodity market factors will make the technology uneconomic. However, management believes that the technology can be a step change in heavy oil recovery technology and would address many of the existing risks and economic challenges currently facing the oil sands industry in Canada and heavy oil industry globally.

The Company is subject to extensive governmental and environmental approvals and regulations in its operating jurisdictions. Delays in obtaining regulatory approvals could result in project delays and the inability to meet contractual obligations. Changes to these regulations could increase the costs of conducting business in these jurisdictions. Environmental risks inherent in the oil and gas industry are subject to increasingly stringent legislation and regulation. The Company operates in accordance with all relevant environmental legislation and strives to minimize the environmental impact of its operations by providing for safety and environmental issues in all of its business plans.

The Company's operations are subject to political and economic uncertainties. Specifically, governments may change royalties and taxes which could have a material adverse impact on the economics of the Company's oil and gas activities.

Petrobank is exposed to normal financial risks inherent within the oil and gas industry, including commodity price risk, exchange rate risk, interest rate risk and credit risk. Management believes it is neither appropriate nor possible to eliminate 100% of the Company's exposure to these risks. As described in Note 15 to the consolidated financial statements, the Company monitors market conditions and may periodically utilize derivative instruments to mitigate these risks.

Commodity prices are the Company's most significant financial risk. Crude oil prices are influenced by global supply and demand, OPEC policy and worldwide political events. Natural gas prices in Canada are influenced primarily by North American supply and demand and to a lesser extent by local market conditions. Weather events and conditions also play a major role in the supply and demand of both commodities. Fluctuations in commodity prices not only affect the Company's cash flows, but may also result in changes to the borrowing capacity under Petrobank's credit facilities as assessed by the Company's lenders. Management believes it is neither appropriate nor possible to eliminate 100% of the Company's exposure to fluctuations in commodity prices. The Company monitors market conditions and may selectively utilize derivative instruments to reduce exposure to commodity price movements.

To the extent revenues and expenditures denominated in or strongly linked to the U.S. dollar are not equivalent; the Company is exposed to exchange rate risk. Revenues in Canada are largely determined by U.S. dollar reference prices. In Colombia, the functional currency is U.S. dollars; however portions of the Company's expenditures are denominated in Colombian pesos and Canadian dollars. To the extent revenues and expenditures denominated in or strongly linked to the U.S. dollar are not equivalent; the Company is exposed to exchange rate risk. The Company is not currently using exchange rate derivatives to manage exchange rate risks.

Petrobank is exposed to fluctuations in short-term interest rates on amounts drawn under its floating-rate bank facilities. The Company monitors market conditions and may selectively utilize derivative instruments to reduce exposure to interest rate movements.

Credit markets throughout the world have tightened recently which could limit the Company's ability to access incremental debt. This risk is mitigated somewhat by the Company's positive cash flows from operations, cash on hand held by Petrominerales, Petrominerales' undrawn US\$80 million credit facility, and a Canadian credit facility with approximately \$65 million of available capacity as at December 31, 2008. In the event additional capital is required, it may not be available to the Company or it may be available on unfavourable terms.

In addition to the foregoing risks, readers are directed to the section entitled, "Risk Factors" in the Company's AIF.

## Sensitivities

The Company's earnings and cash flow are sensitive to changes in crude oil and natural gas prices, exchange rates and interest rates.

The following factors demonstrate the expected impact on annualized before tax cash flow:

Change of:		(millions)
<b>Crude oil</b>	US\$1.00/bbl WTI reference price (assuming 37,500 bopd)	\$ 11.9
	500 bopd of CBU production @ US\$50/bbl WTI	\$ 7.9
	500 bopd of LABU production @ US\$50/bbl WTI	\$ 8.8
<b>Natural gas</b>	\$1.00/mcf AECO reference price (assuming 15 mmcf per day)	\$ 3.5
	1.0 mmcf per day of CBU production @ \$5.00/mcf AECO	\$ 1.3
<b>Currency</b>	US\$0.01 in exchange rate	\$ 6.8
<b>Interest rate</b>	1% change in interest rate	\$ 3.2

## Critical accounting policies and estimates

The Company's financial statements are prepared in accordance with Canadian GAAP, which require management to make judgements, estimates and assumptions, which may have a significant impact on the financial statements. A summary of the Company's significant accounting policies can be found in Note 2 to the Company's 2008 consolidated financial statements. The following is a discussion of those accounting policies and estimates that are considered critical in the determination of the Company's financial results.

### **Capital assets – full cost accounting**

The Company follows the full cost method of accounting as described in Note 2 to the consolidated financial statements. Alternatively, the Company could follow the successful efforts method of accounting whereby all costs related to non-productive wells are expensed in the period in which they are incurred.

Operating costs, net of revenues in relation to activities that are considered to be in the development stage, are capitalized. Judgement is required to determine whether operations are in the development stage. The factors considered include whether commercially viable production levels have been achieved on a consistent basis. Once the operations are no longer considered to be in the development stage, revenue is recognized and operating costs are recorded in net income during the year.

Under the full cost method of accounting, capitalized costs are subject to a country-by-country cost centre impairment test. Under the successful efforts method of accounting, the costs aggregated on a property-by-property basis and the carrying value of each property is subject to an impairment test. These policies may result in a different carrying value for capital assets and a different net income. The Company has elected to follow the full cost method and it is the method most commonly followed in Canada.

Under full cost accounting, a limit is placed on the carrying value of the net capitalized costs in each cost centre in order to test impairment. Impairment exists when the carrying value of developed properties of a cost centre exceeds the estimated undiscounted future net cash flows associated with the cost centre's proved reserves. Costs relating to undeveloped properties are subject to individual impairment assessments until it can be determined whether or not proved reserves exist. If impairment is determined to exist, the costs carried on the balance sheet in excess of the discounted future net cash flows associated with the cost centre's proved plus probable reserves are charged to net income.

### **Goodwill**

Goodwill is tested for impairment whenever an event or circumstance occurs that may reduce the fair value of a business unit below its carrying amount, and at least annually. The test is based on estimated future net cash flows of the business unit. If goodwill is impaired the carrying value is reduced to the estimated fair value and an impairment loss is recorded in net income.

### **Reserve estimates**

Reserve estimates can have a significant impact on net income and the carrying value of capital assets. The process of estimating reserves requires significant judgement based on available geological, geophysical, engineering, and economic data, projected rates of production, estimated commodity price forecasts and the timing of future expenditures, all of which are subject to interpretation and uncertainty. Reserve estimates impact net income through depletion expense and the application of impairment tests. Revisions or changes in reserve estimates can have either a positive or a negative impact on net income and can impact the carrying amount of capital assets.

Petrobank's lenders also use reserve estimates to assess the borrowing bases under the secured bank credit facilities. Changes to the reserve estimates can result in increases or decreases to the borrowing bases, which may impact the Company's financial position.

**Asset retirement obligations**

The Company recognizes the estimated fair value of future retirement obligations associated with capital assets as a liability. The Company estimates the liability based on the estimated costs to abandon and reclaim its net ownership in tangible long-lived assets such as wells and facilities and the estimated timing of the costs to be incurred in future periods. Actual payments to settle the obligations may differ from estimated amounts.

**Future income taxes**

The Company recognizes a future income tax liability based on estimates of temporary differences between the book and tax value of its assets. An estimate is also used for both the timing and tax rate upon reversal of the temporary differences. Actual differences and timing of the reversals may differ from estimates, impacting the future income tax balance and net income.

**Changes in accounting policies****New accounting policies**

Effective January 1, 2008, the Company prospectively adopted the Canadian Institute of Chartered Accountants ("CICA") Section 1535, *Capital Disclosures*, issued by the Accounting Standards Board ("AcSB"). The section establishes standards for disclosing information about the Company's capital and how it is managed. It requires disclosures of the Company's objectives, policies and processes for managing capital, the quantitative data about what the Company regards as capital, whether the Company has complied with any capital requirements and if it has not complied, the consequences of such non-compliance. The only effect of adopting this standard is disclosures on the Company's capital and how it is managed and is included in Note 14 to the consolidated financial statements.

Effective January 1, 2008, the Company prospectively adopted Section 3862, *Financial Instruments Disclosures* and Section 3863, *Financial Instruments Presentations*. These new accounting standards replaced Section 3861, *Financial Instruments – Disclosure and Presentation*. Section 3862 requires additional information regarding the significance of financial instruments for the Company's financial position and performance; and the nature, extent and management of risks arising from financial instruments to which the Company is exposed. The additional disclosures required under these standards are included in Note 15 to the consolidated financial statements.

**Recent accounting pronouncements**

In February 2008, the AcSB issued Section 3064, *Goodwill and Intangible Assets*, replacing Section 3062, *Goodwill and Other Intangible Assets* and Section 3450, *Research and Development Costs*. Various changes have been made to other sections of the CICA Handbook for consistency purposes. Section 3064 establishes standards for the recognition, measurement, presentation and disclosure of goodwill subsequent to its initial recognition and of intangible assets by profit-oriented enterprises. Standards concerning goodwill are unchanged from the standards included in the previous Section 3062. Effective January 1, 2009, the Company will prospectively adopt this standard and does not expect the adoption to have a material impact on the results of operations or financial position.

In January 2009, the AcSB issued Section 1582, *Business Combinations*, which replaces former guidance on business combinations and harmonizes the Canadian standards with International Financial Reporting Standards ("IFRS"). The section establishes principles and requirements of the acquisition method for business combinations and related disclosures, and applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after January 1, 2011, with earlier application permitted. Effective January 1, 2009, the Company will prospectively adopt this standard and does not expect the adoption to have a material impact on the results of operations or financial position.

In January 2009, the AcSB issued Section 1601, *Consolidated Financial Statements*, and Section 1602, *Non-controlling Interests*, which together replace Section 1600, *Consolidated Financial Statements*. Section 1601 establishes standards for the preparation of consolidated financial statements and Section 1602 provides guidance on accounting for a non-controlling interest in a subsidiary subsequent to a business combination. These standards are effective on or after the beginning of the first annual reporting period beginning on or after January 1, 2011, with earlier application permitted. Effective January 1, 2009, the Company will prospectively adopt these standards and does not expect the adoption to have a material impact on the results of operations or financial position.

### ***International financial reporting standards***

In February 2008, the AcSB confirmed the convergence of Canadian GAAP with International Financial Reporting Standards (“IFRS”) will be required for interim and annual financial statements effective for fiscal years beginning on or after January 1, 2011, including comparatives for 2010.

The International Accounting Standards Board (“IASB”) has also issued an exposure draft relating to certain amendments and exemptions to IFRS 1, *First-time Adoption of International Financial Reporting Standards*. It is anticipated that this exposure draft will not result in an amended IFRS 1 standard until late 2009. The amendment, if implemented, will permit the Company to apply IFRS prospectively by utilizing its current reserves at the transition date to allocate the Company’s full cost pool, with the provision that a ceiling test, under IFRS standards, be conducted at the transition date.

Although the amended IFRS 1 standard would provide relief, the changeover to IFRS represents a significant change in accounting standards and the transition from current Canadian GAAP to IFRS will be a significant undertaking that may materially affect the Company’s reported financial position and reported results of operations.

In response, the Company has completed its high-level IFRS impact study and established a preliminary timeline for the execution and completion of the conversion project. The impact study included a preliminary assessment of the differences between Canadian GAAP and IFRS and the potential effects of IFRS to accounting and reporting processes, information systems, business processes and external disclosures. This assessment has provided insight into what are anticipated to be the most significant areas of difference applicable to the Company.

During the next phase of the project, scheduled to take place during 2009, the Company will perform an in-depth review of the significant areas of difference, identified during the preliminary assessment, in order to identify all specific Canadian GAAP and IFRS differences and select ongoing IFRS policies. Key areas addressed will also be reviewed to determine any information technology issues, the impact on internal controls over financial reporting and the impact on business activities including the effect, if any, on covenants. Where required, external advisors will be retained and assist management with the project on an as needed basis. Staff training programs will commence in 2009 and be ongoing as the project unfolds.

The Company will also continue to monitor standards development as issued by the IASB and the AcSB as well as regulatory developments as issued by the Canadian Securities Administrators (CSA), which may affect the timing, nature or disclosure of its adoption of IFRS.

## **Regulatory policies**

### ***Certification of disclosures in annual filings***

In accordance with Multilateral Instrument 52-109 of the Canadian Securities Administrators, the Company annually issues a “Certification of Annual Filings” (“Certification”). The Certification requires certifying officers to state that they are responsible for establishing and maintaining disclosure controls and procedures (“DC&P”) and internal control over financial reporting (“ICFR”).

The Certification requires certifying officers to state that they designed DC&P, or caused it to be designed under their supervision, to provide reasonable assurance that: (i) material information relating to Petrobank is made known to the certifying officers by others; (ii) information required to be disclosed by Petrobank in reports filed with, or submitted to, securities regulatory authorities is recorded, processed, summarized and reported within the time periods specified under Canadian securities legislation. In addition, the Certification requires certifying officers to state that they have designed ICFR, or caused it to be designed under their supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes.

The certifying officers have evaluated, or caused to be evaluated under their supervision, the effectiveness of the Company’s DC&P and ICFR and, based on such evaluation, concluded that the Company maintained effective DC&P and ICFR as of December 31, 2008.

During the year ended December 31, 2008, there has been no change in the Company’s ICFR that has materially affected, or is reasonably likely to materially affect, the Company’s ICFR. The Company has continually had in place systems relating to DC&P and ICFR and will continue to monitor such procedures as the Company’s business evolves.

## **Outlook**

In addition to the plans discussed in this MD&A, please see the Company’s 2008 Annual Report.

## Management's Report

Management is responsible for the integrity and objectivity of the information contained in this report and for the consistency between the consolidated financial statements and other financial and operating data contained elsewhere in this report. The accompanying consolidated financial statements have been prepared by management in accordance with accounting principles generally accepted in Canada using estimates and careful judgement, particularly in those circumstances where transactions affecting a current period are dependent upon future events. The accompanying consolidated financial statements have been prepared using policies and procedures established by management and fairly reflect the Company's financial position, results of operations and changes in financial position, within Canadian generally accepted accounting principles. Management has established and maintains a system of internal controls that is designed to provide reasonable assurance that assets are safeguarded from loss or unauthorized use and the financial information is reliable and accurate.

The Company's external auditors, Deloitte & Touche LLP, have examined the consolidated financial statements. Their examination provides an independent view as to management's discharge of its responsibilities insofar as they relate to the fairness of reported financial results and the financial condition of the Company.

The Audit Committee of the Board of Directors has reviewed in detail the consolidated financial statements with management and the external auditors. The Audit Committee has reported its findings to the Board of Directors who have approved the consolidated financial statements..



COREY RUTTAN  
SENIOR VICE-PRESIDENT  
AND CHIEF FINANCIAL OFFICER

John D. Wright  
President & Chief Executive Officer

Calgary, Canada  
March 6, 2009

Corey C. Ruttan  
Senior Vice-President & Chief Financial Officer

## Auditors' Report

TO THE SHAREHOLDERS OF PETROBANK ENERGY AND RESOURCES LTD.:

We have audited the consolidated balance sheets of Petrobank Energy and Resources Ltd. (the "Company") as at December 31, 2008 and 2007, the consolidated statements of operations and retained earnings, comprehensive income and cash flow for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

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

Chartered Accountants

Calgary, Canada  
March 6, 2009

## Consolidated Balance Sheets

(Thousands of Canadian dollars)

As at December 31,	2008	2007
<b>Assets</b>		
Current assets		
Cash and cash equivalents	\$ 102,181	\$ 171,439
Restricted cash (Note 7)	5,487	–
Accounts receivable	81,702	41,745
Risk management asset (Note 15)	32,904	–
Future income tax asset (Note 12)	–	1,473
	<b>222,274</b>	214,657
Other assets	3,256	248
Capital assets (Note 4)	2,073,006	902,884
Goodwill (Note 5)	63,171	28,119
<b>Total assets</b>	<b>\$ 2,361,707</b>	<b>\$ 1,145,908</b>
<b>Liabilities and shareholders' equity</b>		
Current liabilities		
Accounts payable and accrued liabilities	\$ 262,777	\$ 167,917
Risk management liabilities (Note 15)	–	10,677
Future income tax liability (Note 12)	9,860	–
	<b>272,637</b>	178,594
Bank debt (Note 7)	315,162	29,199
Convertible debentures (Note 8)	337,574	272,597
Obligations under gas sale contract (Note 10)	3,170	3,997
Asset retirement obligations (Note 11)	22,100	12,254
Future income tax liabilities (Note 12)	194,685	48,664
	<b>1,145,328</b>	545,305
Non-controlling interest (Note 13)	181,177	149,297
Commitments and contingencies (Note 18)		
Shareholders' equity		
Convertible debentures (Note 8)	64,089	64,089
Common shares (Note 6)	574,060	322,038
Contributed surplus (Note 6)	19,795	6,496
Accumulated other comprehensive income (loss) (Note 6)	42,848	(41,774)
Retained earnings	334,410	100,457
	<b>1,035,202</b>	451,306
<b>Total liabilities and shareholders' equity</b>	<b>\$ 2,361,707</b>	<b>\$ 1,145,908</b>

See accompanying notes to these consolidated financial statements.

Signed on behalf of the Board:



James D. Tocher  
Chairman



Ian S. Brown  
Director

## Consolidated Statements of Operations and Retained Earnings

(Thousands of Canadian dollars, except per share amounts)

Years ended December 31,	2008	2007
<b>Revenues</b>		
Oil and natural gas	\$ 950,068	\$ 257,736
Royalties	(99,226)	(21,345)
Gain (loss) on risk management contracts (Note 15)	31,042	(10,650)
Interest income	3,022	3,499
	<b>884,906</b>	<b>229,240</b>
<b>Expenses</b>		
Production	93,392	29,176
Transportation	35,672	7,754
General and administrative	24,570	13,136
Stock-based compensation	17,634	6,599
Interest (Note 9)	27,952	7,253
Foreign exchange loss (gain)	47,849	(16,004)
Gain on repurchase of Petrominerales convertible debentures (Note 8)	(6,269)	–
Depletion, depreciation and accretion	275,376	79,656
	<b>516,176</b>	<b>127,570</b>
<b>Income before taxes and non-controlling interest</b>	<b>368,730</b>	<b>101,670</b>
Current taxes	4,938	3,784
Future income taxes (Note 12)	86,104	5,773
<b>Income before non-controlling interest</b>	<b>277,688</b>	<b>92,113</b>
Income applicable to non-controlling interest (Note 13)	33,206	10,686
<b>Net income</b>	<b>244,482</b>	<b>81,427</b>
<b>Retained earnings, beginning of year</b>	<b>100,457</b>	<b>19,030</b>
Repurchase of common shares (Note 6)	(10,529)	–
<b>Retained earnings, end of year</b>	<b>\$ 334,410</b>	<b>\$ 100,457</b>
<b>Basic earnings per share (Note 6)</b>	<b>\$ 2.97</b>	<b>\$ 1.08</b>
<b>Diluted earnings per share (Note 6)</b>	<b>\$ 2.76</b>	<b>\$ 0.99</b>

See accompanying notes to these consolidated financial statements.

## Consolidated Statements of Comprehensive Income

(Thousands of Canadian dollars)

Years ended December 31,	2008	2007
<b>Net income</b>	<b>\$ 244,482</b>	<b>\$ 81,427</b>
Other comprehensive income:		
Unrealized gain (loss) on translation of financial statements of self-sustaining foreign operations (Note 6)	84,622	(31,147)
<b>Comprehensive income</b>	<b>\$ 329,104</b>	<b>\$ 50,280</b>

See accompanying notes to these consolidated financial statements.

## Consolidated Statements of Cash Flow

(Thousands of Canadian dollars)

Years ended December 31,	2008	2007
<b>Operating activities</b>		
Net income	\$ 244,482	\$ 81,427
Depletion, depreciation and accretion	275,376	79,656
Future income taxes	86,104	5,773
Unrealized foreign exchange (gain) loss	47,171	(22,299)
Unrealized (gain) loss on risk management contracts	(44,319)	10,650
Stock-based compensation	17,634	6,599
Income applicable to non-controlling interest	33,206	10,686
Accretion on convertible debentures	13,438	2,678
Gain on repurchase of Petrominerales convertible debentures	(6,269)	–
Amortization of deferred financing costs	958	729
Asset retirement obligations settled	(1,848)	(1,035)
	<b>665,933</b>	174,864
Changes in non-cash working capital (Note 17)	(12,323)	10,716
	<b>653,610</b>	185,580
<b>Financing activities</b>		
Issuance (repayment) of bank debt	241,484	(1,651)
Issuance (repurchase) of convertible debentures – net of costs	(14,152)	363,728
Equity issued (repurchased) by Petrominerales – net of costs	(11,350)	61,275
Financing costs relating to bank debt	(1,002)	(978)
Issuance of common shares – net of costs	12,603	84,680
Repurchase of common shares (Note 6)	(12,475)	–
Amortization of obligations under gas sale contract	(827)	(826)
Changes in non-cash working capital (Note 17)	–	1,178
	<b>214,281</b>	507,406
<b>Investing activities</b>		
Expenditures on capital assets	(909,913)	(510,264)
Acquisitions (Note 5)	(94,540)	(120,250)
Sale of interest in subsidiary (Note 6)	6,738	–
Changes in restricted cash	(5,487)	–
Expenditures on other assets	(2,644)	–
Changes in non-cash working capital (Note 17)	53,586	69,455
	<b>(952,260)</b>	(561,059)
Effect of exchange rate changes on cash and cash equivalents	15,111	3,100
<b>Net change in cash and cash equivalents</b>	<b>(69,258)</b>	135,027
<b>Cash and cash equivalents, beginning of year</b>	<b>171,439</b>	36,412
<b>Cash and cash equivalents, end of year</b>	<b>\$ 102,181</b>	\$ 171,439
Cash and cash equivalents consist of:		
Cash	\$ 7,518	\$ 2,589
Cash equivalents	\$ 94,663	\$ 168,850
Other cash flow information:		
Cash taxes paid	\$ 4,206	\$ 3,450
Cash interest paid	\$ 22,395	\$ 7,433
Cash interest received	\$ 2,509	\$ 2,987

See accompanying notes to these consolidated financial statements.

## Notes to the Consolidated Financial Statements

As at and for the years ended December 31, 2008 and 2007

(All tabular amounts are expressed in thousands of Canadian dollars, except share amounts or as otherwise noted)

### NOTE 1 – FORMATION OF THE COMPANY AND BASIS OF PRESENTATION

Petrobank Energy and Resources Ltd. (the “Company” or “Petrobank”), is a public company listed on the Toronto Stock Exchange and incorporated under the Business Corporations Act (Alberta). Petrobank is engaged in the exploration for and development and production of oil and natural gas in the Western Canadian Sedimentary Basin and the countries of Colombia and Peru. Petrobank operates through three business units. The Canadian Business Unit has conventional oil and gas operations in the Western Canadian Sedimentary Basin focused in southeast Saskatchewan, central and northwest Alberta and northeast British Columbia. The Latin American Business Unit, with exploration and development operations in Colombia and Peru, is comprised of a public company listed on the Toronto Stock Exchange, Petrominerales Ltd. (“Petrominerales”, TSX: PMG), 76.5% of which is owned by Petrobank. The consolidated financial statements and other financial information of Petrominerales are located on SEDAR at [www.sedar.com](http://www.sedar.com) or at [www.petrominerales.com](http://www.petrominerales.com). The Heavy Oil Business Unit has oil sands and heavy oil leases in northern Alberta and Saskatchewan, and operates the Whitesands project at Conklin, Alberta which is field-demonstrating Petrobank’s patented THAI™ heavy oil recovery process.

### NOTE 2 – SIGNIFICANT ACCOUNTING POLICIES

These consolidated financial statements are presented in accordance with Canadian generally accepted accounting principles (“GAAP”) and include the accounts of the Company and its subsidiaries as at and for the years ended December 31, 2008 and 2007. Inter-company transactions and balances are eliminated upon consolidation.

#### Measurement uncertainty

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as at the date of the balance sheets as well as the reported amounts of revenues, expenses, and cash flows during the periods presented. Such estimates relate primarily to unsettled transactions and events as of the date of the financial statements. Actual results could differ materially from estimated amounts.

Amounts recorded for depletion, depreciation and accretion costs and amounts used for ceiling test and goodwill impairment calculations are based on estimates of crude oil reserves and future costs required to develop those reserves. Stock-based compensation is based upon expected volatility and option life estimates. Asset retirement obligations are based on estimates of abandonment costs, timing of abandonment, inflation and interest rates. The provision for income taxes is based on judgements in applying income tax law and estimates on the timing, likelihood and reversal of temporary differences between the accounting and tax bases of assets and liabilities. These estimates are subject to measurement uncertainty and changes in these estimates could materially impact the financial statements of future periods.

#### Capital assets

All costs related to the acquisition, exploration and development of oil and natural gas properties are capitalized. Such costs include land and lease acquisition costs, annual charges on non-producing properties, geological and geophysical costs, costs of drilling and equipping productive and non-productive wells, and carrying costs.

Operating costs, net of revenues in relation to the Company’s initial Whitesands project at Conklin, Alberta are capitalized. Judgement is required to determine whether operations continue to be in the development stage. The factors considered include whether commercially viable production levels have been achieved on a consistent basis. Once the operations are no longer considered to be in the development stage, revenue is recognized and operating costs are recorded in net income during the year.

Prior to the commencement of commercial operations, the Company capitalizes interest costs in relation to its major development project.

Gains and losses are not recognized upon disposition of oil and natural gas properties unless crediting the proceeds against accumulated costs would result in a change in the rate of depletion of more than 20%.

Capitalized costs are accumulated in cost centres on a country-by-country basis and are depreciated and depleted using the unit-of-production method based upon estimated proved reserves before royalties, as determined by independent engineers. Costs subject to depletion include estimated costs to develop proved reserves and exclude estimated salvage value. Reserve and production volumes of oil and natural gas are converted to common units on the equivalency basis of six mcf to one bbl, reflecting the approximate relative energy content. Costs relating to undeveloped properties are excluded from the depletion base until it is determined whether or not proved reserves exist or if impairment of such costs has occurred. These unproved properties are assessed at least annually to determine whether impairment has occurred.

Depreciation of corporate and other fixed assets is calculated using the straight-line method over the estimated life of the asset.

A limit is placed on the carrying value of the net capitalized costs in each cost centre in order to test impairment. The Company is required to perform this impairment test at least annually. An impairment loss may be indicated when the carrying value of a cost centre exceeds the estimated undiscounted future net cash flows associated with the cost centre’s proved reserves. If there is indication of an impairment loss, the costs carried on the balance sheet in excess of the discounted future net cash flows associated with the cost centre’s proved plus probable reserves are charged to depletion, depreciation and accretion on the statement of operations. Reserves are determined pursuant to National Instrument 51-101, *Standards of Disclosure for Oil and Gas Activities*.

The Company does not capitalize indirect general and administrative overhead costs.

## **Goodwill**

The Company's goodwill is attributable to the Canadian and Heavy Oil Business Units. It has been recorded at cost and is not amortized. Goodwill is tested for impairment at least annually or whenever events or circumstances indicate that goodwill is impaired. The test is based on estimated future net cash flows of the business unit. If goodwill is impaired the carrying value is reduced to the estimated fair value and an impairment loss is recorded in net income. No impairment to goodwill has been recorded to date.

## **Asset retirement obligations**

The Company recognizes the estimated fair value of future retirement obligations associated with capital assets as a liability in the period in which they are incurred, normally when the asset is purchased or developed. The Company estimates the liability based on the estimated costs to abandon and reclaim its net ownership interest in all wells and facilities and the estimated timing of the costs to be incurred in future periods. This estimate is evaluated on a periodic basis and any adjustment to the estimate is applied prospectively. The change in net present value of the future retirement obligations due to the passage of time is expensed as accretion. The asset retirement cost, which is the fair value of the asset retirement obligations at the inception of the assets, is capitalized as part of the cost of the related long-lived asset and amortized using the unit-of production method. Actual retirement obligations settled during the period reduce the asset retirement liability.

## **Non-controlling interest**

On June 29, 2006, Petrobank completed an initial public offering of the common shares of its indirectly owned subsidiary, Petrominerales, which comprises Petrobank's Latin American Business Unit. At December 31, 2008, Petrobank owns 76.5% of Petrominerales, the remaining 23.5% of which is reflected on the consolidated balance sheet within non-controlling interest. Petrominerales' earnings or losses are included in the Company's net income and adjusted to reflect the portion attributable to the non-controlling interest.

## **Financial instruments**

All financial assets and liabilities are recognized on the balance sheet when the Company becomes a party to the contractual provisions of the instrument and are initially recognized at fair value. Subsequent measurement of the financial instruments is based on their classification. Each financial instrument is classified into one of the following categories: financial assets and financial liabilities held for trading; loans or receivables; financial assets held to maturity; financial assets available for sale; and other financial liabilities. The classification depends on the characteristics and the purpose for which the financial instruments were acquired. Except in very limited circumstances, the classification of financial instruments is not subsequently changed. Financial instruments carried at fair value on our balance sheet include cash and cash equivalents, restricted cash and risk management contracts. Realized and unrealized gains and losses on financial assets and liabilities carried at fair value are recognized in net income in the periods such gains and losses arise. Transaction costs related to these financial assets and liabilities are included in net income when incurred. Financial instruments carried at cost or amortized cost include accounts receivable, accounts payable and accrued liabilities, bank debt, convertible debentures and obligations under gas sale contract. Transaction costs are included in net income when incurred for these types of financial instruments except for bank debt and convertible debentures. Transaction costs related to bank debt and convertible debentures are included with the initial fair value and the instrument is carried at amortized cost using the effective interest rate method. When bank debt is nil these costs are recorded as other assets. Gains and losses on financial assets and liabilities carried at cost or amortized cost are recognized in net income when these assets or liabilities settle.

## **Derivatives**

The Company may use derivative financial instruments to manage fluctuations in commodity prices, foreign currency exchange rates and interest rates. These derivative instruments are recorded at fair value at the balance sheet date and any changes in fair value are recorded in net income during the period of change unless the requirements for hedge accounting are met.

## **Joint operations**

The Company's oil and natural gas operations are conducted jointly with others and accordingly these consolidated financial statements reflect only the Company's proportionate interest in such activities.

## **Revenue recognition**

Revenues from the sale of crude oil, natural gas and natural gas liquids are recognized when title passes to the customer.

## **Foreign currency translation**

The Company translates foreign currency denominated assets and liabilities of its self-sustaining foreign operations into Canadian dollars at the exchange rate in effect at the balance sheet date, while revenues and expenses are translated using average monthly rates. Translation gains and losses relating to the self-sustaining foreign operations are deferred and included in an accumulated other comprehensive income account in shareholders' equity.

Monetary assets and liabilities denominated in a currency other than the Canadian dollar are translated at the rates of exchange in effect at the balance sheet date while revenues and expenses are translated at transaction date exchange rates. Exchange gains or losses are included in the determination of net income as foreign exchange gain or loss.

## **Comprehensive income**

Comprehensive income consists of net income and other comprehensive income ("OCI"). OCI includes gains and losses resulting from the translation of the Company's net investments in self-sustaining foreign operations and the effective portion of derivatives used as a hedging item in a cash flow hedge or net investment hedge. Accumulated other comprehensive income ("AOCI") is a separate component of shareholders' equity comprised of the cumulative amounts of OCI. Amounts included in AOCI are reclassified to income when realized.

### Earnings per share

The Company computes basic earnings per share using net income divided by the weighted-average number of common shares outstanding. The Company computes diluted earnings per share using net income adjusted for interest expense on the convertible debentures and the impact of Petrominerales dilution on net income divided by the weighted-average number of diluted common shares outstanding. The Company uses the treasury stock method in computing the weighted-average number of diluted common shares outstanding. This method assumes that proceeds on the exercise of in-the-money stock options and deferred common shares are used to repurchase the Company's common shares at the average market price during the relevant period. The number of diluted common shares outstanding also reflects the potential dilution that would occur if the convertible debentures were converted into common shares at the beginning of the period, or when they were issued.

### Stock-based compensation

The Company accounts for stock-based compensation using the fair-value method of accounting for stock options and deferred common shares (collectively referred to as "Rights") granted to directors, officers, employees and consultants using the Black-Scholes option-pricing model. Stock-based compensation expense is recorded for Rights granted, with a corresponding amount reflected in contributed surplus. Stock-based compensation expense is calculated as the estimated fair value of the related Rights at the time of grant, amortized over their vesting period. When Rights are exercised, the associated amounts previously recorded as contributed surplus are reclassified to common share capital. The Company has not incorporated an estimated forfeiture rate for stock options that will not vest, rather, the Company accounts for actual forfeitures as they occur. Stock-based compensation expense recognized by Petrominerales is recorded as an adjustment to non-controlling interest.

### Income taxes

The Company accounts for income taxes using the liability method. Under this method, the Company records a future income tax asset or liability to reflect any difference between the accounting and tax bases of assets and liabilities, using substantively enacted income tax rates. The effect on future tax assets and liabilities of a change in tax rates is recognized in net income in the period in which the change occurs. Future income tax assets are only recognized to the extent it is more likely than not that sufficient future taxable income will be available to allow the future income tax asset to be realized.

### Risk management contracts

The Company is exposed to market risks resulting from fluctuations in commodity prices, foreign currency exchange rates and interest rates in the normal course of its business. The Company may use a variety of instruments to manage these exposures. For transactions where hedge accounting is not applied, the Company accounts for such instruments using the fair value method by initially recording an asset or liability, and recognizing changes in the fair value of the instruments in income as gains or losses on risk management contracts. Fair values of financial instruments are determined from third party quotes or valuations provided by independent third parties. Any realized gains or losses on risk management contracts are recognized in income in the period they occur.

The Company may elect to use hedge accounting when there is a high degree of correlation between the price movements in the financial instruments and the items designated as being hedged and has documented the relationship between the instruments and the hedged item as well as its risk management objective and strategy for undertaking hedge transactions. At December 31, 2008 the Company had not designated any of its outstanding financial instruments as hedges.

### Convertible debentures

The Company presents outstanding convertible debentures in their debt and equity component parts on the consolidated balance sheet. The debt component represents the total discounted present value of the semi-annual interest obligations to be satisfied by cash and the principal payment due at maturity, using the rate of interest that would have been applicable to a non-convertible debt instrument of comparable term and risk at the date of issue. This results in an accounting value assigned to the debt component of the convertible debentures which is less than the principal amount due at maturity. The debt component presented on the balance sheet increases over the term of the debenture to the full face value of the outstanding debentures at maturity. The difference, accretion on convertible debentures, is reflected as increased interest expense with the result that adjusted interest expense reflects the effective yield of the debt component of the convertible debentures.

The equity component of the convertible debentures is presented under shareholders' equity in the consolidated balance sheet. The equity component represents the fair value of the conversion right granted to the holder, which remains a fixed amount over the term of the related debentures. Where the Company's subsidiary has issued convertible debentures, the fair value of the conversion right is presented within non-controlling interest in the consolidated balance sheet.

Upon conversion of the Petrobank debentures into common shares by the holders, the debt and equity components would be transferred to common share capital, while Petrominerales debentures would be transferred to non-controlling interest.

Upon repayment of the Petrobank debentures in cash, the debt component would be derecognized and the equity portion transferred to contributed surplus. If Petrobank settles the debt portion through the issuance of shares, the redemption value of the debt portion is credited to share capital. Upon repayment of the Petrominerales debentures in cash, the debt component is derecognized with no adjustment to non-controlling interest.

### **Government assistance**

The Company records the benefit of government assistance as a reduction in the related capital expenditures as they are incurred and when there is reasonable assurance of collection.

### **Investment tax credits**

Investment tax credits arise as a result of incurring qualified scientific research and development expenditures ("SR&ED"), and are recorded as a reduction of the related expenses or capital expenditures when there is reasonable assurance of collection.

### **Flow-through common shares**

The Company has financed a portion of its exploration activities in Canada through the issuance of flow-through shares. Under the terms of these shares, the tax attributes of the related expenditures are renounced to subscribers. To recognize the foregone tax benefits, share capital is reduced and a future income tax liability is recorded in the period in which the related tax attributes are renounced.

### **Cash and cash equivalents**

Cash and cash equivalents include investments and deposits with a maturity of three months or less when purchased.

## **NOTE 3 – CHANGES IN ACCOUNTING POLICIES**

### **Capital disclosures**

Effective January 1, 2008, the Company prospectively adopted the Canadian Institute of Chartered Accountants ("CICA") Section 1535, *Capital Disclosures*, issued by the Accounting Standards Board ("AcSB"). The section establishes standards for disclosing information about the Company's capital and how it is managed. It requires disclosures of the Company's objectives, policies and processes for managing capital, the quantitative data about what the Company regards as capital, whether the Company has complied with any capital requirements and if it has not complied, the consequences of such non-compliance. The only effect of adopting this standard is disclosures on the Company's capital and how it is managed and is included in Note 14.

### **Financial instruments disclosures and presentation**

Effective January 1, 2008, the Company prospectively adopted Section 3862, *Financial Instruments Disclosures* and Section 3863, *Financial Instruments Presentations*. These new accounting standards replaced Section 3861, *Financial Instruments – Disclosure and Presentation*. Section 3862 requires additional information regarding the significance of financial instruments for the Company's financial position and performance; and the nature, extent and management of risks arising from financial instruments to which the Company is exposed. The additional disclosures required under these standards are included in Note 15.

### **Recent accounting pronouncements**

In February 2008, the AcSB confirmed the convergence of Canadian GAAP with International Financial Reporting Standards ("IFRS") will be effective January 1, 2011. The Company has performed an initial scoping process and will manage the transition in order to ensure successful implementation within the required timeframe. The impact on the Company's consolidated financial statements is not reasonably determinable at this time. Key information will be disclosed as it becomes available during the transition period.

In February 2008, the AcSB issued Section 3064, *Goodwill and Intangible Assets*, replacing Section 3062, *Goodwill and Other Intangible Assets* and Section 3450, *Research and Development Costs*. Various changes have been made to other sections of the CICA Handbook for consistency purposes. Section 3064 establishes standards for the recognition, measurement, presentation and disclosure of goodwill subsequent to its initial recognition and of intangible assets by profit-oriented enterprises. Standards concerning goodwill are unchanged from the standards included in the previous Section 3062. Effective January 1, 2009, the Company will prospectively adopt this standard and does not expect the adoption to have a material impact on the results of operations or financial position.

In January 2009, the AcSB issued Section 1582, *Business Combinations*, which replaces former guidance on business combinations. The section establishes principles and requirements of the acquisition method for business combinations and related disclosures, and applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after January 1, 2011, with earlier application permitted. Effective January 1, 2009, the Company will prospectively adopt this standard and does not expect the adoption to have a material impact on the results of operations or financial position.

In January 2009, the AcSB issued Section 1601, *Consolidated Financial Statements*, and Section 1602, *Non-controlling Interests*, which together replace Section 1600, *Consolidated Financial Statements*. Section 1601 establishes standards for the preparation of consolidated financial statements and Section 1602 provides guidance on accounting for a non-controlling interest in a subsidiary subsequent to a business combination. These standards are effective on or after the beginning of the first annual reporting period beginning on or after January 1, 2011, with earlier application permitted. Effective January 1, 2009, the Company will prospectively adopt these standards and does not expect the adoption to have a material impact on the results of operations or financial position.

**NOTE 4 – CAPITAL ASSETS**

December 31, 2008	Cost	Accumulated Depletion and Depreciation	Net Book Value
<b>Oil and natural gas assets</b>			
<b>Canada</b>	<b>\$1,527,573</b>	<b>\$ 329,378</b>	<b>\$ 1,198,195</b>
<b>Heavy oil</b>	<b>332,631</b>	<b>–</b>	<b>332,631</b>
<b>Petrominerales</b>	<b>733,879</b>	<b>197,800</b>	<b>536,079</b>
<b>Corporate and other</b>	<b>12,945</b>	<b>6,844</b>	<b>6,101</b>
	<b>\$2,607,028</b>	<b>\$ 534,022</b>	<b>\$ 2,073,006</b>

December 31, 2007	Cost	Accumulated Depletion and Depreciation	Net Book Value
<b>Oil and natural gas assets</b>			
Canada	\$ 551,647	\$ 142,719	\$ 408,928
Heavy Oil	248,186	–	248,186
Colombia (Petrominerales)	323,073	78,458	244,615
Corporate and other	7,271	6,116	1,155
	\$ 1,130,177	\$ 227,293	\$ 902,884

The Company capitalized interest related to its Whitesands project totalling \$12.8 million for the year ended December 31, 2008 (2007 – \$10.7 million).

At December 31, 2008, oil and natural gas assets included \$289.7 million (2007 – \$94.1 million) relating to unproved properties in the Canadian Business Unit, \$332.6 million (2007 – \$248.2 million) relating to the Heavy Oil Business Unit unproved properties, and US\$72.1 million (2007 – US\$44.3 million) related to Petrominerales' unproved properties in Colombia and Peru that have been excluded from the depletion calculation.

An impairment test calculation was performed for each of the Canadian and Colombian cost centres at December 31, 2008 in which the estimated undiscounted future net cash flows associated with the proved reserves exceeded the carrying amounts. In determining the undiscounted future net cash flows for each cost centre, the Company utilized benchmark pricing forecasts from two reserve evaluators, one for Canadian assets and one for Colombian assets. The benchmark prices used in their forecasts at December 31, 2008 are outlined in the following table:

Year	Canada		US\$/	Colombia
	WTI Crude Oil <sup>(1)</sup> (US\$/bbl)	AECO Natural Gas <sup>(1)</sup> (\$/mcf)		WTI Crude Oil <sup>(1)</sup> (US\$/bbl)
2009	53.73	6.82	0.80	57.00
2010	63.41	7.56	0.85	69.53
2011	69.53	7.84	0.85	76.38
2012	79.59	8.38	0.90	86.99
2013	92.01	9.20	0.95	94.74
Thereafter inflation % change	2%	2%	nil	2.5%

<sup>(1)</sup> Actual prices used in the impairment tests were adjusted for crude oil quality differentials, natural gas heat content, transportation and marketing costs specific to the Company's operations.

## NOTE 5 – ACQUISITIONS

### Peerless Energy Inc.

On January 28, 2008, Petrobank acquired all of the issued and outstanding shares of Peerless Energy Inc. (“Peerless”) for a total cost of \$338.8 million, including Peerless bank debt and working capital deficiency assumed. Peerless was a publicly traded company with the majority of its properties producing from the Bakken formation in southeast Saskatchewan.

This transaction has been accounted for using the purchase method whereby the assets acquired and the liabilities assumed are recorded at fair values. The following table summarizes the net assets acquired pursuant to the acquisition:

<b>Net assets acquired</b>	<b>Amount</b>
Capital assets	\$ 371,730
Working capital deficiency	(14,358)
Bank debt	(44,007)
Asset retirement obligations	(2,631)
Goodwill	26,741
Future income tax liability	(57,031)
<b>Total net assets acquired</b>	<b>\$ 280,444</b>

<b>Consideration paid</b>	<b>Amount</b>
Cash	\$ 60,462
Petrobank shares issued (4,931,204 common shares)	213,196
Acquisition costs	6,786
<b>Total purchase price</b>	<b>\$ 280,444</b>

### Rocor Resources Inc.

On October 2, 2008, Petrobank acquired all of the issued and outstanding shares of Rocor Resources Inc. (“Rocor”) for a total cost of \$52.7 million, net of working capital acquired. Rocor was a private company with properties focused on the Montney formation in northeast British Columbia.

This transaction has been accounted for using the purchase method whereby the assets acquired and the liabilities assumed are recorded at fair values. The following table summarizes the net assets acquired pursuant to the acquisition:

<b>Net assets acquired</b>	<b>Amount</b>
Capital assets	\$ 56,876
Working capital	1,080
Asset retirement obligations	(161)
Goodwill	8,311
Future income tax liability	(12,333)
<b>Total net assets acquired</b>	<b>\$ 53,773</b>

<b>Consideration paid</b>	<b>Amount</b>
Cash	\$ 26,481
Petrobank shares issued (699,183 common shares)	26,481
Acquisition costs	811
<b>Total purchase price</b>	<b>\$ 53,773</b>

### Whitesands

On June 11, 2007, Petrobank acquired all of the shares of the Company's Whitesands subsidiary that were held by minority shareholders for \$120 million (\$120.3 million including costs), increasing Petrobank's ownership of Whitesands from 84% to 100%.

This transaction has been accounted for using the purchase method whereby the assets acquired and the liabilities assumed are recorded at fair values. The Company has historically consolidated the book value of Whitesands and accordingly has reflected a reduction of non-controlling interests previously recognized on the Company's balance sheet. The following table summarizes the net assets acquired pursuant to the Whitesands acquisition:

Net assets acquired	Amount
Capital assets	\$ 121,228
Net working capital	(613)
Asset retirement obligations	(615)
Goodwill	28,119
Future income tax liability	(27,869)
<b>Total net assets acquired</b>	<b>\$ 120,250</b>

### NOTE 6 – SHARE CAPITAL

#### Authorized

Unlimited number of common shares.

Unlimited number of preferred shares, issuable in series.

#### Normal course issuer bid

Pursuant to the Company's Normal Course Issuer Bid ("NCIB"), as approved by the Toronto Stock Exchange ("TSX") on August 14, 2008, the Company is authorized to purchase up to 6,444,777 common shares, subject to daily trading restrictions, and representing approximately 10% of the issued and outstanding common shares. The Company is authorized to make purchases during the period of August 18, 2008 to August 17, 2009, or until such earlier time as the NCIB is completed or terminated at the option of the Company. Any common shares Petrobank purchases under the NCIB will be purchased on the open market through the facilities of the TSX at the prevailing market price at the time of the transaction. Common shares acquired under the NCIB are cancelled.

In the third quarter of 2008, the Company repurchased and cancelled a total of 298,400 Petrobank common shares under the NCIB, at an average cost of \$41.11 per share. Of the amount paid, \$1.9 million reduced the book value of the common shares and the remaining \$10.5 million has been recorded as a reduction to retained earnings.

Petrominerales, the Company's 76.5% owned subsidiary also announced a NCIB on August 14, 2008 and repurchased a total of 1,326,000 Petrominerales common shares during the year ended December 31, 2008 at an average price of \$9.89 per share. For every share purchased on the open market, one share is also purchased from Petrobank; accordingly, Petrobank's ownership interest is increasing as a result of the bid as it is participating for less than its prorated ownership interest. Petrobank has recorded the repurchase of Petrominerales common shares as an adjustment to non-controlling interest (Note 13).

## Common shares

Common share continuity	Number	Amount
Balance at December 31, 2006	72,125,274	\$ 244,022
Issued for cash <sup>(1)</sup>	4,000,000	84,000
Share issue costs	–	(4,466)
Tax effect of share issue costs	–	1,362
Exercise of stock options	1,125,463	5,145
Exercise of deferred common shares	20,000	1
Transfer from contributed surplus related to stock options and deferred common shares exercised	–	1,823
Tax benefit renounced to shareholders <sup>(2)</sup>	–	(9,849)
Balance at December 31, 2007	77,270,737	\$ 322,038
Issued in connection with acquisition of Peerless (Note 5)	4,931,204	213,196
Issued in connection with acquisition of Rocor (Note 5)	699,183	26,481
Repurchase of common shares	(298,400)	(1,945)
Flow-through shares issued in December 2008 <sup>(3)</sup>	285,795	9,431
Share issue costs	–	(674)
Tax effect of share issue costs	–	195
Exercise of stock options	608,375	3,845
Exercise of deferred common shares	28,500	1
Transfer from contributed surplus related to stock options and deferred common shares exercised	–	1,492
<b>Balance at December 31, 2008</b>	<b>83,525,394</b>	<b>\$ 574,060</b>

<sup>(1)</sup> In April 2007, the Company issued 4.0 million common shares at a price of \$21.00 per common share for gross proceeds of \$84.0 million.

<sup>(2)</sup> In December 2006, the Company issued 1.5 million flow-through common shares at a price of \$23.00 and renounced \$34.5 million of resource expenditures to flow-through share investors effective December 31, 2006. The tax effect of those expenditures was recorded in 2007.

<sup>(3)</sup> In December 2008, the Company issued flow-through common shares at a price of \$33.00 and renounced \$9.4 million of resource expenditures to flow-through share investors effective December 31, 2008. The tax effect of those expenditures will be recorded in 2009. The Company has until December 31, 2009 to incur these resource expenditures.

## Contributed surplus

Changes in contributed surplus	Amount
Balance at December 31, 2006	\$ 3,166
Stock-based compensation	5,153
Transfer from contributed surplus related to stock options exercised	(1,823)
Balance at December 31, 2007	\$ 6,496
Stock-based compensation	14,791
Transfer from contributed surplus related to stock options and deferred common shares exercised	(1,492)
<b>Balance at December 31, 2008</b>	<b>\$ 19,795</b>

## Accumulated other comprehensive income

Changes in accumulated other comprehensive income	Amount
Balance at December 31, 2006	\$ (10,627)
Unrealized loss on translation of financial statements of self-sustaining foreign operations	(31,147)
Balance at December 31, 2007	\$ (41,774)
Unrealized gain on translation of financial statements of self-sustaining foreign operations	84,622
<b>Balance at December 31, 2008</b>	<b>\$ 42,848</b>

### Stock options

The Company has established a stock option plan whereby the Company may grant stock options to its directors, officers, employees and consultants. The plan allows for the issuance of up to 10% of the outstanding common shares of the Company. The exercise price of each option is no less than the five day weighted average trading price of the Company's common shares on the Toronto Stock Exchange prior to the date of grant. Stock option terms are determined by the Company's Board of Directors but typically, options vest evenly over a period of four years from the date of grant and expire between five and 10 years after the date of grant.

The following is a continuity of stock options outstanding:

	2008		2007	
	Stock Options	Weighted-Average Exercise Price	Stock Options	Weighted-Average Exercise Price
Opening	3,837,049	\$ 12.91	4,262,387	\$ 7.65
Granted	4,302,089	43.94	849,500	29.39
Exercised	(608,375)	6.32	(1,125,463)	4.57
Forfeited	(934,687)	45.01	(149,375)	19.32
Closing	6,596,076	\$ 22.37	3,837,049	\$ 12.91

In December 2008, the Company modified the terms of certain non-executive stock options that resulted in the exercise price on 1,833,675 options being reduced from a weighted average of \$47.18 to \$22.58 and the forfeiture of 611,200 options with a weighted average exercise price of \$47.18. The incremental fair value attributed to the modification is recorded as stock-based compensation over the vesting period of the modified options.

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

Range of Exercise Prices	Stock Options Outstanding			Stock Options Exercisable	
	Number	Weighted-Average Remaining Contractual Life (Years)	Weighted-Average Exercise Price	Number	Weighted-Average Exercise Price
1.85 – 2.76	488,225	0.8	\$ 2.21	485,225	\$ 2.20
2.90 – 4.15	753,750	1.2	4.09	524,500	4.11
6.85 – 10.16	142,962	1.7	8.52	70,962	8.79
10.40 – 14.39	441,900	5.1	14.04	144,400	14.18
16.42 – 23.66	3,245,489	6.3	21.36	280,625	18.08
24.98 – 36.01	426,250	6.8	30.05	122,500	32.69
43.23 – 58.52	1,097,500	9.0	49.05	81,250	48.53
	6,596,076	5.6	\$ 22.37	1,709,462	\$ 11.07

### Deferred common share compensation plan

The Company has a deferred share compensation plan whereby the Company may grant deferred common shares to its directors, officers and employees. The plan allows holders to receive one common share upon payment of \$0.05 per share. The deferred common shares vest after three years or immediately upon resignation or retirement, and expire 10 years from the date of grant. Up to 0.5 million deferred common shares have been approved for issuance under this plan.

The following is a continuity of deferred common shares outstanding:

	2008	2007
Opening	155,250	150,500
Granted	20,060	24,750
Exercised	(28,500)	(20,000)
Closing	146,810	155,250

### Stock-based compensation

The fair value of Petrobank stock options and deferred common shares granted have been estimated on their respective grant dates using the Black-Scholes option-pricing model using the following assumptions:

Years ended December 31,	2008	2007
Risk free interest rate	1.5% – 3.25%	4.0% – 4.5%
Dividend rate	0%	0%
Expected life – options (years)	3.75 – 4	3.5
Expected life – deferred common shares (years)	8	8
Expected volatility	42.5% – 47.5%	40% – 42.5%

The average fair value per stock option granted during the year was \$13.45 (2007 – \$10.90) as at the date of grant. The average fair value per deferred common share granted during the year was \$48.00 (2007 – \$23.02) as at the date of grant.

Stock-based compensation expense for the year ended December 31, 2008 totalled \$17.6 million (2007 – \$6.6 million), of which \$2.8 million (2007 – \$1.4 million) related to Petrominerales.

### Earnings per share

The following tables summarize the net income and weighted average number of common shares used in calculating basic and diluted earnings per share.

Years ended December 31,	2008	2007
<b>Net income adjustments</b>		
Net income, basic	\$ 244,482	\$ 81,427
Interest expense on Petrobank's convertible debentures	8,654	3,529
Tax effect	(2,554)	(1,134)
Impact of Petrominerales dilution on net income	(1,852)	(788)
Net income, diluted	\$ 248,730	\$ 83,034
<b>Weighted average common share adjustments</b>		
Weighted average common shares outstanding, basic	82,267,822	75,552,264
Effect of convertible debentures	6,569,223	5,817,910
Effect of stock options and deferred common shares	1,258,514	2,429,880
<b>Weighted average common shares outstanding, diluted</b>	<b>90,095,559</b>	<b>83,800,054</b>

### NOTE 7 – BANK DEBT AND RESTRICTED CASH

The Company's secured Canadian credit facilities combined borrowing limit totals \$380 million. The facilities are comprised of a \$320 million reserve-based revolver and a \$60 million oil sands resource-based revolver with terms ending on July 2009, extendable by the lenders for an additional year. If the lenders decide not to extend the term, the drawn amounts become due in July 2010. The facilities carry floating interest rates at LIBOR plus a margin, based on a sliding scale ratio of the Company's debt to earnings before interest, taxes and non-cash items related to its Canadian operations. The facilities are secured by a \$500 million demand debenture and a securities pledge on the Company's subsidiaries with ownership of Whitesands Insitu Partnership's oil sands assets and the THAI™ technology, but does not include the Company's share ownership in Petrominerales. The borrowing bases under these facilities are reviewed semi-annually.

At December 31, 2008, Petrominerales was not drawn on its secured credit facility. The borrowing base under this facility as at December 31, 2008 was US\$80 million and is reviewed semi-annually. The facility is secured by a pledge over all property of Petrominerales.

Petrominerales also has a US\$13.9 million operating line of credit, which was increased subsequent to year-end to US\$18.8 million, under which Petrominerales can borrow at the fixed term deposit rate set by the Central Bank of Colombia plus six percent. Advances under the facility are collateralized by a promissory note provided by Petrominerales. Petrominerales has used US\$7.9 million of its operating lines of credit for letters of credit to guarantee work commitments under exploration blocks.

At December 31, 2008, the Company had restricted cash of US\$4.5 million (2007 – \$nil), consisting of cash deposited to guarantee work commitments under exploration contracts expected to be completed in 2009.

## NOTE 8 – CONVERTIBLE DEBENTURES

### Petrobank

In May 2007, Petrobank issued US\$250 million of convertible debentures due in May 2012. The debentures are convertible into common shares of Petrobank at a conversion price of US\$28.4902 per share, which represented a 40% conversion premium to the Company's share price when initially priced, and have an annual coupon of 3.0%. Interest on the debentures is payable semi-annually in cash. The Company has the option to redeem the principal amount upon maturity in cash or common shares.

Upon conversion, 8,774,947 common shares may be issued, subject to normal provisions for adjustments of the conversion price such as a special distribution to shareholders or upon a change of control of the Company. Petrobank has an option to force conversion of the debentures at the conversion price commencing in May 2010, should the price of the Company's common shares exceed 120% of the prevailing conversion price for at least 20 trading days within a 30-day trading period.

Petrobank's debentures have been classified into their debt and equity components based on fair values. On issuance, this resulted in \$205.3 million being classified as a liability and \$64.1 million being classified as equity. The liability portion will accrete up to the principal balance at maturity. The accretion and cash interest payable are accrued and reflected as interest expense in the consolidated statement of operations, creating an effective yield of 9.4%. If the debentures are converted to common shares, the relative portion of the value of the conversion feature under shareholders' equity will be reclassified to common share capital along with the principal amounts converted.

### Petrominerales

In December 2007, Petrominerales issued US\$100 million of convertible debentures due in December 2010. The amount of debentures outstanding at December 31, 2008 is US\$81.7 million as debentures with a face value of US\$18.3 million were repurchased by Petrominerales in October and November of 2008 for US\$11.1 million. A \$6.3 million gain was recorded as a result of settling the liability portion related to the repurchased debentures. The outstanding debentures are convertible into common shares of Petrominerales at a conversion price of US\$27.3485 per Petrominerales share, which represented a 38% conversion premium to the share price of Petrominerales when initially priced, and have an annual coupon of 3.375%. Interest on the debentures is payable semi-annually in cash or common shares.

Upon conversion, 2,987,367 Petrominerales common shares may be issued, subject to normal provisions for adjustments of the conversion price such as a special distribution to shareholders or upon a change of control of Petrominerales. Petrominerales has an option to force conversion of the debentures at the conversion price commencing in December 2009, should the price of Petrominerales' common shares exceed 130% of the prevailing conversion price of the debentures over a specified period.

Petrominerales' debentures have been classified into their debt and non-controlling interest components based on fair values. On issuance, this resulted in \$82.4 million being classified as a liability and \$12.6 million being classified as non-controlling interest. The liability portion will accrete up to the principal balance at maturity. The accretion and cash interest payable are accrued and reflected as interest expense in the consolidated statement of operations, creating an effective yield of 9.7%.

The following table summarizes the debentures' liability, non-controlling interest and equity components at December 31, 2008:

	Petrobank	Petrominerales	Total
Gross proceeds	\$ 276,725	\$ 98,780	\$ 375,505
Costs	(7,942)	(3,835)	(11,777)
Tax effect of equity component of issue costs	572	–	572
Net proceeds	\$ 269,355	\$ 94,945	\$ 364,300
Fair value of equity component on issuance <sup>(1)</sup>	64,089	12,582	76,671
Value attributed to liability component on issuance	205,266	82,363	287,629
Accretion	6,926	322	7,248
Change in exchange rate	(22,299)	19	(22,280)
Balance of liability component, December 31, 2007	\$ 189,893	\$ 82,704	\$ 272,597
Accretion	11,845	5,075	16,920
Repurchased <sup>(2)</sup>	–	(20,381)	(20,381)
Change in exchange rate	47,171	21,267	68,438
<b>Balance of liability component, December 31, 2008</b>	<b>\$ 248,909</b>	<b>\$ 88,665</b>	<b>\$ 337,574</b>

<sup>(1)</sup> The fair value of the equity component related to the Petrominerales issuance is reflected as non-controlling interest on the consolidated balance sheet.

<sup>(2)</sup> The repurchased amount of \$20.4 million represents the carrying amounts of the liability portion on the repurchase dates.

## NOTE 9 – INTEREST EXPENSE

Interest expense includes the following:

Years ended December 31,	2008	2007
Cash interest	\$ 22,910	\$ 10,016
Accretion on Petrobank convertible debentures	11,845	6,926
Accretion on Petrominerales convertible debentures	5,075	322
Amortization of deferred financing costs	958	729
Capitalized interest related to Whitesands project <sup>(1)</sup>	(12,836)	(10,740)
Interest expense	\$ 27,952	\$ 7,253

<sup>(1)</sup> Capitalized interest includes \$9.4 million of cash and \$3.4 million of non-cash accretion (2007 – \$6.2 million and \$4.5 million, respectively).

## NOTE 10 – OBLIGATIONS UNDER GAS SALE CONTRACT

The Company assumed a physical natural gas sales contract upon the acquisition of Barrington Petroleum Ltd. in 2001. The Company recorded a liability for these obligations at that time, which is being amortized to oil and natural gas revenues over the term of the related contract.

## NOTE 11 – ASSET RETIREMENT OBLIGATIONS

The total future asset retirement obligations were estimated by management based on the Company's net ownership interest in all wells, gathering lines and facilities, estimated costs to reclaim and abandon the wells and facilities and the estimated timing of the costs to be incurred in future periods.

Changes to asset retirement obligations were as follows:

	2008	2007
Asset retirement obligations, beginning of year	\$ 12,254	\$ 10,520
Obligations incurred	4,253	1,763
Obligations acquired	2,792	–
Obligations settled	(1,848)	(1,035)
Accretion expense	1,197	883
Changes in foreign exchange rates	386	(165)
Changes in estimated future cash flows	3,066	288
Asset retirement obligations, end of year	\$ 22,100	\$ 12,254

The obligations have been calculated using an inflation rate of two percent in Canada and four percent in Colombia, and discounted using a credit-adjusted risk free rate of eight percent per annum in Canada and nine percent per annum in Colombia. Most of these obligations are not expected to be paid for several years extending up to 45 years in the future in Canada and 27 years in the future in Colombia, and are expected to be funded from general resources of the Company and Petrominerales at their respective settlement dates. The total undiscounted amount of estimated cash flows required to settle the obligations at December 31, 2008 is \$62.8 million (2007 – \$49.1 million) for the obligations in Canada and US\$26.2 million (2007 – US\$6.5 million) for the obligations in Colombia.

## NOTE 12 – INCOME TAXES

The provision for income taxes differs from the amount that would have been expected by applying expected statutory corporate income tax rates to income before taxes and non-controlling interests. The principal reasons for this difference are as follows:

Years ended December 31,	2008	2007
Income before taxes and non-controlling interests	\$ 368,730	\$ 101,670
Canadian statutory income tax rate	29.50%	32.12%
Expected tax expense	\$ 108,775	\$ 32,656
Increase (decrease) in income tax provision resulting from:		
Enhanced foreign tax allowances	(34,398)	(13,124)
Foreign income taxable at a higher statutory rate	6,035	985
Change in tax rates	–	(7,904)
Non-deductible expenses	5,014	3,663
Non-deductible foreign exchange loss (gain)	6,958	(3,581)
Stock-based compensation	5,302	2,119
Change in estimates and other	(6,644)	(5,257)
Provision for taxes	\$ 91,042	\$ 9,557
Consisting of:		
Current taxes	\$ 4,938	\$ 3,784
Future income taxes	\$ 86,104	\$ 5,773

The Company's pre-tax income from Colombian operations is subject to the Colombian statutory tax rate of 33%. Presumptive income and equity taxes are based on equity levels in Colombia. Presumptive income tax can be carried forward for five years and recovered against income taxes in future periods. A reduction in Canadian tax rates was substantively enacted in December 2007 resulting in a future income tax recovery in 2007.

The components of the Company's future income tax assets and liabilities arising from temporary differences are as follows:

As at December 31,	2008		2007	
	Future Income Tax Assets	Future Income Tax Liabilities	Future Income Tax Assets	Future Income Tax Liabilities
Capital assets	\$ –	\$ 183,206	\$ –	\$ 62,037
Deferred income	–	42,329	–	–
Convertible debentures	3,229	–	–	2,810
Investment tax credits	8,850	–	8,850	–
Non-capital losses	6,235	–	9,302	–
Share issue costs	4,848	–	3,212	–
Asset retirement obligations	6,204	–	3,202	–
Risk management contracts <sup>(1)</sup>	–	9,860	1,473	–
Obligations under gas sale contract	891	–	1,111	–
Other	593	–	72	–
	30,850		27,222	64,847
Valuation allowance	–	–	(9,566)	–
	\$ 30,850	\$ 235,395	\$ 17,656	\$ 64,847

<sup>(1)</sup> Recorded as a current future income tax liability in 2008 (2007 – future income tax asset).

The Company has reflected its future income tax liability net of future tax assets on the consolidated balance sheet. In 2007 future tax assets were reduced by the valuation allowance relating to the Company's Colombian operations.

As at December 31, 2008, the Company had non-capital losses in Canada totalling \$18.8 million (2007 – \$11.8 million), which expire between 2010 and 2028. In Colombia, non-capital losses totalled US\$2.7 million (2007 – US\$19.2 million) and carryforward indefinitely.

### NOTE 13 – NON-CONTROLLING INTEREST

The components of the Company's non-controlling interest in Petrominerales, the Company's 76.5% owned subsidiary are as follows:

	Petrominerales	Whitesands	Total
Balance at December 31, 2006	\$ 65,766	\$ 16,525	\$ 82,291
Attributable income	10,686	–	10,686
Issuance of common shares <sup>(1)</sup>	58,817	–	58,817
Issuance of convertible debentures <sup>(2)</sup>	12,582	–	12,582
Stock-based compensation	1,446	–	1,446
Contributed from non-controlling interest	–	2,458	2,458
Acquisition of non-controlling interest (Note 5)	–	(18,983)	(18,983)
Balance at December 31, 2007	\$ 149,297	\$ –	\$ 149,297
Attributable income	33,206	–	33,206
Issuance of common shares	1,758	–	1,758
Repurchase of common shares <sup>(3)</sup>	(13,108)	–	(13,108)
Common shares repurchased from Petrobank <sup>(3)</sup>	6,738	–	6,738
Stock-based compensation and other	3,286	–	3,286
<b>Balance at December 31, 2008</b>	<b>\$ 181,177</b>	<b>\$ –</b>	<b>\$ 181,177</b>

<sup>(1)</sup> In September 2007, Petrominerales issued 5,060,000 common shares at a price of \$12.05 per common share for gross proceeds of \$61.0 million (net – \$58.0 million). This amount also includes the exercise of Petrominerales stock options in 2007.

<sup>(2)</sup> In December 2007, Petrominerales issued US\$100 million of convertible debentures. The amount relates to the equity portion recorded by Petrominerales.

<sup>(3)</sup> Petrominerales repurchased a total of 1,326,000 Petrominerales common shares during the second half of 2008. For every share purchased on the open market one share was also purchased from Petrobank, accordingly, Petrobank's ownership interest increased as a result as it is participating for less than its prorated ownership interest.

### NOTE 14 – CAPITAL MANAGEMENT

The Company's policy is to maintain a strong capital base in order to provide flexibility in the future development of the business and maintain investor, creditor and market confidence.

The Company manages its capital structure and makes adjustments to it in light of changes in economic conditions and the risk characteristics of the underlying assets. The Company considers its capital structure to include common share capital, convertible debentures, bank debt and working capital (a non-GAAP measure defined as cash and cash equivalents plus restricted cash, accounts receivable, and risk management asset less accounts payable and accrued liabilities). In order to maintain or adjust the capital structure, from time to time the Company may issue common shares or other securities, obtain project financing on its heavy oil projects, sell assets or adjust its capital spending to manage current and projected debt levels. Petrobank is also able to raise funds by selling a portion of its 76.5% ownership interest in Petrominerales or by issuing debt secured by this interest.

Petrominerales manages its capital structure independently and generates its own cash flows, and has the ability to fund its operations through the issuance of secured and unsecured debt as well as equity financing.

As at December 31,	2008	2007
Bank debt – Petrobank	\$ 315,162	\$ 20,000
Bank debt – Petrominerales	–	9,199
Total bank debt	\$ 315,162	\$ 29,199
Working capital deficiency (surplus)	\$ 40,503	\$ (45,267)
Convertible debentures – Petrobank principal amount (US\$)	250,000	250,000
Convertible debentures – Petrominerales principal amount (US\$)	81,700	100,000
Total convertible debentures (US\$)	\$ 331,700	\$ 350,000
Common share capital	\$ 574,060	\$ 322,038

The Company monitors leverage and adjusts its capital structure based on the ratio of Canadian bank debt to annualized Canadian earnings before interest, taxes and non-cash items. This ratio is based solely on Canadian bank debt and Canadian cash earnings as Petrominerales manages its leverage and capital structure independently. At December 31, 2008, the ratio of debt to annualized Canadian earnings before interest, taxes and non-cash items was 1 to 1, within a range acceptable to the Company. Petrobank uses the ratio of debt to annualized Canadian earnings before interest, taxes and non-cash items as a key indicator of the Company's leverage and to monitor the strength of the balance sheet. In order to facilitate the management of this ratio, the Company prepares annual budgets, which are updated as necessary depending on varying factors including current and forecast commodity prices, changes in capital structure, execution of the Company's business plan and general industry conditions. The annual budget is approved by the Board of Directors and updates are prepared and reviewed as required.

The Petrobank convertible debentures are considered to be equity as opposed to debt. The Petrominerales convertible debentures are considered to be debt. If Petrobank's share price is below the prevailing conversion price at maturity, Petrobank can elect to redeem the principal amount in common shares or re-pay the remaining principal with new debt, equity and/or accumulated cash. The Company has an option to force conversion of the debentures at the prevailing conversion price commencing in May 2010, should the price of the Company's common shares exceed 120% of the prevailing conversion price of the debentures over a specified period. If conversion of the debentures is forced, or if the Company's share price is in excess of the prevailing conversion price upon maturity in May 2012, the debentures will be converted into equity.

The Company is in compliance with the covenants on its convertible debenture and credit facility agreements. Petrobank's and Petrominerales' convertible debenture agreements stipulate they each maintain a ratio of equity to total assets of at least 30% and to limit the amount of security and encumbrances the Company has on its total assets to 27.5%. The Company is not subject to restrictive financial covenants under its Canadian credit facilities.

Neither the Company nor its subsidiaries has paid or declared any dividends since the date of incorporation.

The repurchase of common shares pursuant to the Petrobank and Petrominerales NCIB's, and the repurchase of Petrominerales' convertible debentures have been the only changes to the Company's capital management during 2008.

Credit markets throughout the world have tightened recently which could limit the Company's ability to access incremental debt. The Company has positive cash flow from operations, cash and cash equivalents and restricted cash totalling \$107.7 million, a Canadian credit facility with \$64.3 million of available capacity and a US\$80 million credit facility available to Petrominerales.

## NOTE 15 – FINANCIAL INSTRUMENTS AND FINANCIAL RISK MANAGEMENT

The Company has exposure to the following risks from its use of financial instruments: credit risk, liquidity risk and market risk. This note presents information about the Company's exposure to each of these risks and the Company's objectives, policies and processes for measuring and managing risk. Further quantitative disclosures are included throughout these consolidated financial statements.

The Board of Directors has overall responsibility for the establishment and oversight of the Company's financial risk management framework and monitors risk management activities. The Company identifies and analyzes the risks faced by the Company and may utilize financial instruments to mitigate these risks.

### Credit risk

A substantial portion of the Company's accounts receivable are with customers and joint-venture participants in the oil and natural gas industry and are subject to normal industry credit risks. The carrying amount of accounts receivable reflects management's assessment of the credit risk associated with these customers and participants. The majority of the Company's Canadian oil production is sold to a large international marketing company, while the majority of natural gas production is sold to an international oil and gas company. To mitigate the risk associated with the significant amount of Canadian oil production being sold to one purchaser, the Company has arranged for early payments and or letters of credit. Colombian oil production is sold, as determined by market based prices adjusted for quality differentials, to three main counterparties: Ecopetrol, the Colombian national oil company, and two international oil companies. Colombian oil revenue is received in Bermuda and is denominated in United States dollars. Typically, Petrominerales' maximum credit exposure to customers is up to two months' sales revenue except for the production month of December where sales proceeds from the main oil purchaser are received by the end of December. Petrominerales does not anticipate non-performance by this counterparty. At December 31, 2008, the Company's receivables consisted of \$57.1 million (2007 – \$25.1 million) of receivables from oil and natural gas customers and \$24.6 million (2007 – \$16.6 million) of other trade receivables.

Receivables from oil and natural gas marketers are normally collected 25 to 45 days after the month following production. The Company's policy to mitigate credit risk associated with these balances is to establish marketing relationships with large purchasers and, where practical, obtain support in the form of guarantees or letters of credit. Receivables from joint-venture partners related to capital and operating expenses are generally collected between 45 and 90 days after the month of billing. The Company historically has not experienced any collection issues with its oil and natural gas customers or joint interest partners.

The Company's accounts receivables are aged as follows:

As at December 31,	2008	2007
Not past due	\$ 78,697	\$ 38,977
Past due	3,005	2,768
<b>Total</b>	<b>\$ 81,702</b>	<b>\$ 41,745</b>

Cash and cash equivalents and restricted cash consist of cash bank balances and short term deposits maturing in less than 90 days. The Company manages the credit exposure related to short term investments by selecting counter parties based on credit ratings and monitors all investments to ensure a stable return, avoiding investment vehicles with higher risk such as asset backed commercial paper.

The carrying amount of accounts receivable, cash and cash equivalents and restricted cash represent the Company's maximum credit exposure. The Company had a \$0.8 million allowance for doubtful accounts as at December 31, 2008. For the years ended December 31, 2008 and 2007 the Company did not provide for any doubtful accounts and wrote off less than \$0.1 million of receivables in both years.

### Liquidity risk

The Company's approach to managing liquidity is to ensure, as far as possible, that it will have sufficient liquidity to meet its liabilities when due, under both normal and unusual conditions without incurring unacceptable losses or jeopardizing the Company's business objectives.

The Company prepares annual capital expenditure budgets, which are monitored and updated as considered necessary. Production is monitored regularly to provide current cash flow estimates and the Company utilizes authorizations for expenditures on projects to manage capital expenditures. To facilitate the capital expenditure program, the Company has revolving asset based credit facilities, as outlined in Note 7, that are reviewed semi-annually by the lenders.

The following are the contractual maturities of financial liabilities at December 31, 2008:

Financial liability	< 1 Year	1-3 Years	3-5 Years	Total
Accounts payable and accrued liabilities	\$ 262,777	\$ –	\$ –	\$ 262,777
Canadian bank debt – principal	–	315,658	–	315,658
Petrobank convertible debentures – principal (US\$)	–	–	250,000 <sup>(1)</sup>	250,000
Petrominerales convertible debentures – principal (US\$)	–	–	81,700 <sup>(2)</sup>	81,700
<b>Total</b> <sup>(3)</sup>	<b>\$ 262,777</b>	<b>\$ 315,658</b>	<b>\$ 406,200</b>	<b>\$ 984,635</b>

<sup>(1)</sup> The debentures are convertible to common shares of Petrobank at a conversion price of US\$28.4902 per share. Upon conversion, a total of 8,774,947 common shares may be issued. At maturity, the Company has the option to redeem the principal amount in cash or common shares if the debentures have not been converted.

<sup>(2)</sup> The debentures are convertible to common shares of Petrominerales at a conversion price of US\$27.3485 per Petrominerales share. Upon conversion, 2,987,367 Petrominerales common shares may be issued. At maturity, Petrominerales will redeem the principal amount in cash if the debentures have not been converted.

<sup>(3)</sup> US\$ amounts have been converted using a period end exchange rate of \$1.2246.

### Market risk

Market risk is the risk that changes in market factors, such as foreign exchange rates, commodity prices, and interest rates will affect the Company's cash flows, net income, liquidity or the value of financial instruments. The objective of market risk management is to mitigate market risk exposures where considered appropriate and maximize returns.

The Company may utilize derivative instruments to manage market risk. The Board of Directors periodically reviews the results of all risk management activities and all outstanding positions.

### Foreign currency risk

The Company is exposed to foreign currency fluctuations as Colombian revenues are denominated in United States dollars and Colombian expenses are denominated primarily in United States dollars and Colombian pesos. The Company is also exposed as Petrobank's convertible debentures are denominated in United States dollars and Canadian revenues are strongly linked to United States dollar denominated benchmark prices. At December 31, 2008, if the Canadian dollar had depreciated five percent against the United States dollar with all other variables held constant, net income would have been \$9.5 million lower for the year ended December 31, 2008 (2007 – \$8.3 million lower), due to Petrobank's United States dollar denominated convertible debentures, offset by the risk management contracts related to Canadian production. Other comprehensive income would have been \$14.5 million higher (2007 – \$4.8 million higher) due to the foreign currency balances of Petrominerales that are translated into Petrobank's consolidated financial statements and risk management contracts related to Canadian production, offset by the Petrobank's convertible debentures.

The Company had no forward exchange rate contracts in place as at or during the year ended December 31, 2008.

*Commodity price risk*

Changes in commodity prices may significantly impact the results of the Company's operations and cash generated from operating activities, and can also impact the Company's borrowing base under its secured credit facilities. Lower commodity prices can also reduce the Company's ability to raise capital. Crude oil prices are impacted by world economic events that dictate the levels of supply and demand. Natural gas prices in Canada are influenced primarily by North American supply and demand. From time to time the Company may attempt to mitigate commodity price risk through the use of financial derivatives. The Company's policy is to only enter into commodity contracts considered appropriate to a maximum of 50% of forecasted production volumes.

The Company had the following risk management contract outstanding at December 31, 2008:

Country	Term	Volume (bopd)	Price (US\$/bbl)	Benchmark
Canada	Jan. 1, 2009 – Dec. 31, 2009	2,000	90.00 floor/121.00 ceiling	WTI

Years ended December 31,	2008	2007
Realized loss on risk management contracts	\$ (13,277)	\$ –
Unrealized gain (loss) on risk management contracts	44,319	(10,650)
Gain (loss) on risk management contracts	\$ 31,042	\$ (10,650)

The unrealized gain (loss) represents the change in fair value of the risk management contracts related to expected future settlements. The fair value of the remaining risk management asset at December 31, 2008 was \$32.9 million (2007 – \$10.7 million liability). If crude oil prices had been 10% lower on December 31, 2008, with all other variables held constant, the change in the fair value of the risk management contracts would have resulted in net income and other comprehensive income that was \$3.3 million higher for the year then ended (2007 – \$5.7 million higher).

*Interest rate risk*

The Company is exposed to interest rate cash flow risk on floating interest rate bank debt, to the extent it is drawn, due to fluctuations in market interest rates and interest rate risk on fixed rate convertible debentures. The remainder of the Company's financial assets and liabilities are not exposed to interest rate risk. The Company's sensitivity to year end interest rates is currently immaterial.

The Company had no interest rate swap or financial contracts in place as at or during the year ended December 31, 2008.

**Long-term physical gas sale contract**

The Company is committed to deliver 2,209 GJ per day of natural gas under an escalating price contract which expires October 31, 2012. The wellhead price under this contract in 2008 was \$4.95 per GJ and was increased to \$5.15 per GJ effective January 1, 2009. The Company applies the expected purchase and sale exemption to this contract and accordingly does not apply hedge accounting principles to this contract.

## Fair value of financial instruments

The Company's financial instruments are classified as cash and cash equivalents, restricted cash, accounts receivable, risk management asset, accounts payable and accrued liabilities, bank debt and convertible debentures on the balance sheet. The carrying value and fair value of these financial instruments at December 31, 2008 is disclosed below by financial instrument category, as well as any related gain, loss, expense or revenue for the year ended December 31, 2008:

Financial instrument	Carrying Value	Fair Value	Gain/(Loss)	Interest Expense	Revenue
<i>Assets held for trading</i>					
Cash and cash equivalents <sup>(1)</sup>	102,181	102,181	–	–	–
Restricted cash	5,487	5,487	–	–	–
Risk management contracts	32,904	32,904	31,042 <sup>(2)</sup>	–	–
<i>Loans and receivables</i>					
Accounts receivable	81,702	81,702	–	–	–
<i>Other liabilities</i>					
Accounts payable and accrued liabilities	262,777	262,777	–	–	–
Bank debt	315,162	315,658	–	5,383 <sup>(3)</sup>	–
Convertible debentures	337,574	276,336 <sup>(4)</sup>	(47,171) <sup>(5)</sup>	22,569 <sup>(6)</sup>	–
Obligations under gas sale contract	3,170	3,348	–	–	827 <sup>(7)</sup>

<sup>(1)</sup> The effective yield on cash equivalents at December 31, 2008 was 0.6% (2007 – 4%).

<sup>(2)</sup> Included in gain (loss) on risk management contracts on the statement of operations and retained earnings, and statement of comprehensive income. The unrealized gain of \$44.3 million representing the change in fair value of the contracts is included on the statement of cash flow.

<sup>(3)</sup> Included in interest expense net of capitalized interest on the statement of operations and retained earnings and statement of comprehensive income. The amortization of deferred financing costs is included on the statement of cash flow. The effective yield on bank debt before capitalized interest at December 31, 2008 was 3.5% (2007 – 6.4%).

<sup>(4)</sup> The Company estimated the fair value of the convertible debentures based on market transactions close to December 31, 2008. The principal amounts of the Petrobank and Petrominerales convertible debentures at December 31, 2008 are US\$250 million and US\$81.7 million, respectively.

<sup>(5)</sup> Included in foreign exchange loss (gain) on the statement of operations and retained earnings, statement of comprehensive income and statement of cash flow.

<sup>(6)</sup> Included in interest expense net of capitalized interest on the statement of operations and retained earnings and statement of comprehensive income. The non-cash interest expense relating to the accretion of the initial discounts and transaction costs that are netted against the liabilities are included in accretion on convertible debentures on the statement of cash flow. The effective yields on the convertible debentures issued by Petrobank and Petrominerales are 9.4% and 9.7%, respectively.

<sup>(7)</sup> Included in oil and natural gas revenues on the statement of operations and retained earnings and statement of comprehensive income. The amortization of obligations under gas sale contract is included on the statement of cash flow.

The risk management contracts are recorded at their fair value based on quoted market prices in the futures market on the balance sheet date; accordingly, there is no difference between fair value and carrying value. The fair value of the obligations under gas sale contract is based on the estimated cash payment necessary to settle the contract at the balance sheet date. Cash payments are calculated based on discounted cash flow analysis using prevailing market prices at the time. Bank debt is recorded on the balance sheet net of deferred financing costs which results in a difference between carrying value and the fair value. Due to the short term nature of: cash and cash equivalents, restricted cash, accounts receivable, and accounts payable and accrued liabilities their carrying values approximate their fair values.

## NOTE 16 – TECHNOLOGY PARTNERSHIPS CANADA AND INNOVATIVE ENERGY TECHNOLOGIES PROGRAM FINANCING

Technology Partnerships Canada (“TPC”) will invest up to \$9.0 million towards the development and field demonstration of the Company's THAI™ technology at the Whitesands project. Under the TPC funding commitment, TPC agreed to contribute 20.134% of eligible expenditures for the Whitesands project to a maximum of \$9.0 million, all of which has been recorded as a reduction in capital assets. Upon commercialization of the THAI™ technology, TPC is entitled to receive a royalty based on three separate revenue streams. The first stream is based on three percent of the initial Whitesands project revenues earned after January 1, 2006 with initial payments due May 1, 2010. The second stream is based on 0.6% of Whitesands Insitu Partnership revenues (excluding initial project revenues) earned after January 1, 2009 with initial payments due May 1, 2010. The third stream is based on three percent of all third-party THAI™ licensing revenues earned after January 1, 2008 with initial payments due May 1, 2009. If, as of December 31, 2017 the cumulative royalty paid from the three royalty streams has not reached \$26.2 million, royalty payments will continue until \$26.2 million has been paid or until December 31, 2022, whichever occurs first.

The Company has received a \$10.0 million grant, from the Government of Alberta, in the form of a royalty credit for Alberta Crown royalties. This program is administered by Alberta Energy's Innovative Energy Technologies Program. For the year ended December 31, 2008, the Company recorded a benefit of \$3.2 million (2007 – \$nil) as a reduction of capital assets and royalties payable.

**NOTE 17 – CHANGES IN NON-CASH WORKING CAPITAL**

Years ended December 31,	2008	2007
Change in:		
Accounts receivable	\$ (39,957)	\$ (28,198)
Accounts payable and accrued liabilities	94,860	109,185
Depletion related to other current assets	(362)	362
	<b>54,541</b>	81,349
Working capital deficiencies acquired (Note 5)	<b>(13,278)</b>	–
	<b>\$ 41,263</b>	\$ 81,349
Changes relating to:		
Attributable to operating activities	\$ (12,323)	\$ 10,716
Attributable to financing activities	\$ –	\$ 1,178
Attributable to investing activities	\$ 53,586	\$ 69,455

**NOTE 18 – COMMITMENTS AND CONTINGENCIES**

The following is a summary of the estimated costs required to fulfill the Company's remaining contractual commitments at December 31, 2008:

Type of commitment	2009	2010	2011	2012	2013	Thereafter	Total
<i>Canadian business unit</i>							
Canadian bank debt (\$)	\$ –	\$ 315,658	\$ –	\$ –	\$ –	\$ –	\$ 315,658
Petrobank convertible debentures (US\$)	–	–	–	250,000	–	–	250,000
Office operating leases (\$)	3,100	3,650	3,650	4,900	5,100	26,600	47,000
Flow-through expenditures (\$) <sup>(1)</sup>	15,283	–	–	–	–	–	15,283
<i>Latin American business unit</i>							
Petrominerales convertible debentures (US\$)	–	81,700	–	–	–	–	81,700
Exploration contracts (US\$)	34,600	14,000	–	–	–	–	48,600
Offloading facility (US\$)	15,300	–	–	–	–	–	15,300
Drilling rigs (US\$) <sup>(2)</sup>	9,100	–	–	–	–	–	9,100
<b>Total commitments <sup>(3)</sup></b>	<b>\$ 90,634</b>	<b>\$ 436,502</b>	<b>\$ 3,650</b>	<b>\$ 311,050</b>	<b>\$ 5,100</b>	<b>\$ 26,600</b>	<b>\$ 873,537</b>

<sup>(1)</sup> Includes \$5.9 million of commitments assumed on the acquisition of Rocor.

<sup>(2)</sup> The contracted drilling rigs will be used to satisfy a portion of Petrominerales' exploration work commitments.

<sup>(3)</sup> US\$ amounts have been converted using the December 31, 2008 exchange rate of \$1.2246.

The development of certain of the Company's assets and the success of its operations are dependent on obtaining sufficient financing to fund its working capital requirements and future capital expenditure commitments. The Company plans to fund these commitments with existing cash balances, funds flow from operations, available credit facilities, new debt and potentially through the issuance of equity.

The Company is party to certain legal actions arising in the normal course of business, the outcome of which cannot be reasonably determined. In the opinion of management, the resolution of these matters will not have a material effect on the Company's financial position or results of operations.

The minority shareholders that previously owned a 16% interest in Whitesands have indicated that they are challenging the Whitesands valuation amount that determined the purchase price for the acquisition of their interest (Note 5). The Company considers the likelihood of liability under this proceeding not to be determinable and, accordingly, an estimate of any contingent loss cannot be made.

**NOTE 19 – SEGMENTED INFORMATION**

Years ended December 31,	2008			2007		
	Canada and Other <sup>(1)</sup>	Colombia	Total	Canada and Other <sup>(1)</sup>	Colombia	Total
<b>Revenues</b>						
Oil and natural gas	\$ 585,800	\$ 364,268	\$ 950,068	\$ 129,997	\$ 127,739	\$ 257,736
Royalties	(65,252)	(33,974)	(99,226)	(9,718)	(11,627)	(21,345)
Gain (loss) on risk management contracts	33,046	(2,004)	31,042	(4,950)	(5,700)	(10,650)
Interest income	536	2,486	3,022	2,832	667	3,499
	<b>554,130</b>	<b>330,776</b>	<b>884,906</b>	118,161	111,079	229,240
<b>Expenses</b>						
Production	56,983	36,409	93,392	16,360	12,816	29,176
Transportation	21,212	14,460	35,672	4,834	2,920	7,754
General and administrative	13,826	10,744	24,570	6,314	6,822	13,136
Stock-based compensation	14,791	2,843	17,634	5,153	1,446	6,599
Interest	16,554	11,398	27,952	4,339	2,914	7,253
Foreign exchange loss (gain)	46,782	1,067	47,849	(16,520)	516	(16,004)
Gain on repurchase of Petrominerales convertible debentures	–	(6,269)	(6,269)	–	–	–
Depletion, depreciation and accretion	187,695	87,681	275,376	48,435	31,221	79,656
	<b>357,843</b>	<b>158,333</b>	<b>516,176</b>	68,915	58,655	127,570
<b>Income before taxes and non-controlling interest</b>	<b>196,287</b>	<b>172,443</b>	<b>368,730</b>	49,246	52,424	101,670
Current taxes	–	4,938	4,938	–	3,784	3,784
Future income taxes (recovery)	59,015	27,089	86,104	7,054	(1,281)	5,773
<b>Income before non-controlling interest</b>	<b>137,272</b>	<b>140,416</b>	<b>277,688</b>	42,192	49,921	92,113
Income applicable to non-controlling interest	–	33,206	33,206	–	10,686	10,686
<b>Net income</b>	<b>\$ 137,272</b>	<b>\$ 107,210</b>	<b>\$ 244,482</b>	\$ 42,192	\$ 39,235	\$ 81,427
Identifiable assets	\$ 1,682,617	\$ 679,090	\$ 2,361,707	\$ 724,810	\$ 421,098	\$ 1,145,908
Capital expenditures	\$ 628,165	\$ 281,748	\$ 909,913	\$ 358,113	\$ 152,151	\$ 510,264

<sup>(1)</sup> Canada includes Heavy Oil Business Unit capital expenditures of \$82.3 million in 2008 (2007 – \$54.4 million), identifiable assets at December 31, 2008 of \$363.4 million (2007 – \$281.6 million) including goodwill of \$28.1 million (2007 – \$28.1 million), and negligible revenues and expenses as operations are considered to be in the pre-operating stage and accordingly are capitalized.