Terra Energy Corp.
Consolidated Financial Statements
For the years ended December 31, 2008 and 2007

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Consolidated Financial Statements

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Auditors' Report

To the Shareholders of
Terra Energy Corp.

We have audited the consolidated balance sheets of Terra Energy Corp. as at December 31, 2008 and 2007 and the consolidated statements of operations, comprehensive income (loss) and retained earnings (deficit) and cash flows for the years then ended. These financial statements are the responsibility of the Corporation'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 present fairly, in all material respects, the financial position of the Corporation 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.

Deloitte & Touche LLP

Chartered Accountants

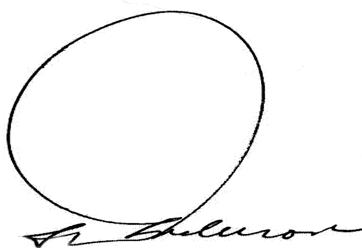
Calgary, Alberta
February 27, 2009

Terra Energy Corp.
Consolidated Balance Sheets

As at December 31	2008	2007
ASSETS		
Current		
Accounts receivable	$ 12,842,594	$ 7,960,046
Prepaid expenses	2,089,828	1,787,287
Other assets (Note 5)	583,538	–
	15,515,960	9,747,333
Oil and gas properties (Note 6)	137,551,824	157,024,959
	$153,067,784	$ 166,772,292
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Bank overdraft (Note 7)	$ 4,463,264	$ 1,828,943
Accounts payable and accrued liabilities	17,950,307	22,196,372
Asset retirement obligation (Note 8)	589,190	398,798
Financial instruments (Note 3)	–	567,483
	23,002,761	24,991,596
Deferred credit (Note 13)	116,250	182,670
Long-term financing (Note 7)	6,315,792	54,631,003
Asset retirement obligation (Note 8)	5,356,504	5,166,555
Future income taxes (Note 11)	23,798,937	12,933,520
	58,590,244	97,905,344
SHAREHOLDERS' EQUITY		
Share capital and warrants (Note 9)	67,880,302	65,195,721
Contributed surplus (Note 10)	9,680,456	9,365,272
Retained earnings (deficit)	16,916,782	(5,694,045)
	94,477,540	68,866,948
	$153,067,784	$ 166,772,292

Commitments and contingencies (Notes 14)

Approved on behalf of the Board:



Theodore Anderson, Director

Robert Penner, Director

The accompanying notes are an integral part of these consolidated financial statements.

Terra Energy Corp.
Consolidated Statements of Operations, Comprehensive Income (Loss) and Retained Earnings (Deficit)

For the years ended December 31	2008	2007
REVENUE		
Petroleum and natural gas	**$ 81,705,034**	$ 49,334,797
Realized gain on financial instruments (Note 3)	**883,652**	1,035,524
Unrealized gain (loss) on financial instruments (Note 3)	**567,483**	(2,409,344)
	83,156,169	47,960,977
Royalties	**(16,950,207)**	(10,397,746)
	66,205,962	37,563,231
EXPENSES		
Production	**17,112,185**	15,356,361
General and administrative	**4,400,919**	4,310,677
Accretion of asset retirement obligation (Note 8)	**471,447**	462,300
Stock based compensation (Note 9)	**1,835,701**	1,182,479
Depletion and amortization	**21,746,710**	17,335,354
Interest on long-term debt	**1,546,679**	3,483,975
Unrealized foreign exchange loss (gain) (Note 3)	**336,133**	(336,420)
Realized foreign exchange loss (gain) (Note 3)	**6,695**	(50,293)
	47,456,469	41,744,433
Income (loss) before income taxes and other income	**18,749,493**	(4,181,202)
Gain on disposition of P&NG rights (Note 6)	**15,087,598**	–
Income (loss) before income taxes	**33,837,091**	(4,181,202)
Income tax expense (Note 11)		
Current tax	**5,262**	1,374
Future tax (recovery)	**10,865,417**	(2,416,905)
	10,870,679	(2,415,531)
Net income (loss) and comprehensive income (loss) for the year	**22,966,412**	(1,765,671)
Deficit, beginning of year	**(5,694,045)**	(3,477,604)
Repurchase of common shares (Note 9)	**(355,585)**	(450,770)
Retained earnings (deficit), end of year	**$ 16,916,782**	$ (5,694,045)
Income (loss) per share (Note 9)		
Basic	**$ 0.31**	$ (0.02)
Diluted	**$ 0.30**	$ (0.02)

The accompanying notes are an integral part of these consolidated financial statements.

Terra Energy Corp
Consolidated Statements of Cash Flows

For the years ended December 31	2008	2007
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (loss) for the year	**$ 22,966,412**	$ (1,765,671)
Items not affecting cash:		
Future income tax expense (recovery)	**10,865,417**	(2,416,905)
Accretion of asset retirement obligation (Note 8)	**471,447**	462,300
Stock based compensation	**1,835,701**	1,182,479
Unrealized loss (gain) on financial instruments (Note 3)	**(567,483)**	2,409,344
Unrealized loss (gain) on foreign exchange	**336,133**	(336,420)
Gain on disposition of P&NG rights	**(15,087,598)**	–
Asset retirement obligation settled (Note 8)	**(384,945)**	–
Amortization of deferred credit (Note 13)	**(66,420)**	(66,420)
Depletion, depreciation and amortization	**21,746,710**	17,335,354
	42,115,374	16,804,061
Changes in non-cash working capital from operations (Note 12)	**(8,537,536)**	2,754,669
	33,577,838	19,558,730
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from (repayment of) long-term financing	**(48,651,344)**	19,488,586
Increase (decrease) in bank overdraft	**2,634,321**	(6,583,909)
Issuance of common shares, net of issuance costs	**2,538,177**	211,356
Repurchase of common shares	**(1,729,698)**	(3,022,229)
	(45,208,544)	10,093,804
CASH FLOWS FROM INVESTING ACTIVITIES		
Additions to oil and gas properties	**(59,095,716)**	(39,170,209)
Proceeds from disposition of oil and gas properties (Note 6)	**72,203,578**	3,583,990
Additions to other assets	**(583,538)**	–
Changes in non-cash working capital from investing (Note 12)	**(893,618)**	5,933,685
	11,630,706	(29,652,534)
Increase (decrease) in cash and cash equivalents	**–**	–
Cash and cash equivalents (bank overdraft), beginning of year	**–**	–
Cash and cash equivalents, end of year	**$ –**	$ –

The accompanying notes are an integral part of these consolidated financial statements.

Terra Energy Corp.
Notes to Consolidated Financial Statements
December 31, 2008 and 2007

1. NATURE OF OPERATIONS

Terra Energy Corp. (the “Corporation”) was formed on January 30, 2004 as a result of the amalgamation of Rhodes Resources Corp. (“Rhodes”), Terrapet Energy Corp. (“Terrapet”), and Terra Energy Corp (“Terra”) pursuant to the Business Corporations Act of Alberta. The amalgamated Corporation operates under the name Terra Energy Corp. The Corporation’s principal business is the exploration, development, and production of oil and natural gas in Western Canada.

2. SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements of the Corporation have been prepared by management in accordance with generally accepted accounting principles (“GAAP”) in Canada. The preparation of consolidated financial statements in conformity with Canadian GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates. The consolidated financial statements have, in management’s opinion, been properly prepared using careful judgment with reasonable limits of materiality and within the framework of the significant accounting policies summarized below:

Consolidation

These consolidated financial statements include the accounts of the Corporation and its wholly owned subsidiaries, Constar Resources Ltd. and Terra Energy Partnership. The latter is a general partnership between Terra Energy Corp. and Constar Resources Ltd.

Revenue Recognition

Revenue from the sales of petroleum and natural gas are recognized when the risks and rewards of ownership pass to the purchaser, including delivery of the product, the selling price being fixed or determinable and collectibility being reasonably assured.

Cash and cash equivalents

Cash and cash equivalents are comprised of cash on deposit and cheques issued in excess of deposits, cash on hand and short-term deposits with maturity dates less than 90 days.

Joint Venture Operations

Some of the Corporation's oil and gas activities are conducted jointly with others. These consolidated financial statements reflect only the Corporation's proportionate interest in such activities.

Oil and Gas Properties

The Corporation follows the full cost method of accounting whereby all costs related to the exploration, acquisition and development of petroleum and natural gas reserves are initially capitalized. Such costs include lease acquisition costs, geological and geophysical expenditures, lease rentals on non-productive properties, costs of drilling both productive and non-productive wells, equipment costs and general and administrative expenses applicable to these activities.

In applying the full cost method, the Corporation performs a ceiling test on properties which restricts the capitalized costs less accumulated depletion from exceeding an amount equal to the estimated undiscounted value of future net revenues from proved oil and gas reserves, as determined by independent engineers, based on sales prices achievable under existing contracts and quoted benchmark prices in effect at year end and current costs, and after deducting estimated, production related expenses, abandonment and reclamation costs. If the carrying value of the cost center exceeds the undiscounted cash flows, an impairment loss will be determined. The impairment loss is measured as the amount by which the carrying amount of assets capitalized in a cost center exceeds the fair value of proved and probable reserves and the associated costs less any impairment of unproved properties that have been subject to a separate test for impairment and contain no probable reserves.

Gains or losses on sales of properties are recognized only when crediting the proceeds to costs would result in a change of 20% or more in the depletion and amortization rate.

Amortization and depletion of petroleum and natural gas properties and equipment is provided for using the unit-of-production method based on estimated proven petroleum and natural gas reserves before any royalty deductions as determined by independent engineers. For the purpose of this calculation, petroleum and natural gas reserves are converted to a common unit of measurement on the basis of their relative energy content where six thousand cubic feet of gas equates to one barrel of oil. Costs of acquiring and evaluating unproven properties are excluded from costs subject to amortization and depletion until it is determined whether proven reserves are attributable to the properties or impairment occurs.

Asset Retirement Obligation (“ARO”)

Asset retirement costs and liabilities associated with site restoration and abandonment of tangible long-lived assets are initially measured at a fair value which approximates the cost a third party would incur in performing the tasks necessary to retire such assets. The fair value is recognized in the consolidated financial statements as the present value of expected future cash out flows. Subsequent to the initial measurement, the effect of the passage of time on the liability for the asset retirement obligation (accretion expense) and the amortization of the asset retirement cost are recognized in the results of operations. Revisions to the estimated undiscounted cost would also be an increase or decrease to the ARO. Actual costs incurred upon settlement of the ARO are charged against the ARO to the extent of the liability recorded. Any difference between the actual costs incurred upon settlement of the ARO and the recorded liability is recognized in the Corporation’s earnings in the period in which the settlement occurs.

Future Income Taxes

The Corporation follows the asset and liability method for accounting for income taxes. Under this method, future tax assets and liabilities are recognized for the future tax consequences attributable to differences between financial statement carrying amounts of assets and liabilities and their respective tax bases, and measured using substantially enacted tax rates and laws that will be in effect when the differences are expected to reverse.

Flow-through Shares

Expenditure deductions for income tax purposes related to exploratory and development activities funded by flow-through share arrangements are to be renounced to investors in accordance with income tax legislation. A future tax liability is recognized upon the renunciation of tax pools and related filings with the tax authorities, and share capital is reduced.

Foreign Currency Translation

Monetary assets and liabilities denominated in foreign currencies have been translated into Canadian dollars at the rate of exchange prevailing at period end. Revenue and expense items are translated at the average rate of exchange for the year.

Measurement Uncertainty

The preparation of consolidated financial statements in accordance with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates. The consolidated financial statements have, in management's opinion, been properly prepared using careful judgment with reasonable limits of materiality.

The amounts recorded for depletion and amortization of petroleum and natural gas properties and equipment, the liability for retirement obligations and the amount recorded for future income taxes are based on estimates. The impairment test is based on estimates of proved reserves, production rates, oil and gas prices, future costs and other relevant assumptions. By their nature, these estimates are subject to measurement uncertainty and the effect on the consolidated financial statements of changes and estimates in future periods could be significant.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which were fully tradable with no vesting restrictions. This option valuation model requires the input of highly subjective assumptions including the expected stock price volatility. Because the Corporation's stock options and performance incentive warrants have characteristics significantly different from those of traded options and because changes in the subjective input assumptions can materially affect the calculated fair value, such value is subject to measurement uncertainty.

The consolidated financial statements include accruals based on the terms of existing joint venture agreements. Due to varying interpretations of the definition of terms in these agreements the accruals made by management in this regard may be significantly different from those determined by the Corporation's joint venture partners. The effect on the consolidated financial statements resulting from such adjustments, if any, will be reflected prospectively.

Stock Based Compensation

The Corporation follows the fair value method for stock options granted to employees, directors and service providers. The Corporation recognizes compensation expense, with corresponding increase to contributed surplus, based on the fair value of the options at the time of grant over the vesting period of grant. The contributed surplus balance is reduced as the options are exercised with the amount initially recognized being credited to share capital.

Per Share Amounts

Basic earnings per share are computed by dividing earnings by the weighted average number of common shares outstanding during the year. Diluted per share amounts reflect the potential dilution that could occur if stock options or warrants to purchase common shares were exercised and converted to common shares. The treasury stock method of calculating diluted per share amounts is used whereby any proceeds from the exercise of stock options or warrants are assumed to be used to purchase common shares of the Corporation at the average market price during the year.

Financial Instruments

All financial instruments are initially recognized at fair value on the balance sheet. The Company has classified each financial instrument into one of the following categories: held-for-trading (assets and liabilities), loans and receivables, financial assets available-for-sale, financial assets held-to-maturity, and other financial liabilities. Subsequent measurement of financial instruments is based on their classification.

Financial assets and liabilities "held-for-trading" are subsequently measured at fair value with changes in those fair values recognized in net earnings. Financial assets "available-for-sale" are subsequently measured at fair value with changes in fair value recognized in other comprehensive income, net of tax.

Financial assets "held-to-maturity", "loans and receivables", and "other financial liabilities" are subsequently measured at amortized cost using the effective interest method.

Bank overdraft, commodity contracts, and foreign exchange contracts are designated as "held-for-trading" and measured at fair value. Accounts receivable are designated as "loans and receivables" and measured at amortized cost. Other assets are classified as "available for sale" with any changes in fair value being recognized in other comprehensive income. Accounts payable and accrued liabilities and long-term financing are designated as "other financial liabilities" and measured at amortized cost.

Changes in Accounting Policies

On January 1, 2008, the Company adopted the following new Canadian Institute of Chartered Accountants ("CICA") Handbook Sections, which were effective for fiscal years beginning on or after October 1, 2007:

Section 3862 – "Financial Instruments – Disclosures", describes the required disclosure for the assessment of the significance of financial instruments to an entity's financial position and performance and of the nature and extent of risks arising from financial instruments to which the entity is exposed and how the entity manages those risks. This section and Section 3863, "Financial Instruments – Presentation" replaced Section 3861, "Financial Instruments – Disclosure and Presentation".

Section 3863 – "Financial Instruments – Presentation", establishes standards for presentation of financial instruments and non-financial derivatives.

Section 1535 – "Capital Disclosures", establishes standards for disclosing information about an entity's capital and how it is managed. It describes the disclosure requirements of the entity's objectives, policies and processes for managing capital, the quantitative data relating to what the entity regards as capital, whether the entity has complied with capital requirements, and, if it has not complied, the consequences of such non-compliance.

These new standards require additional disclosure with no effect on the consolidated financial statements.

Section 1400 – "General Standards of Financial Statement Presentation", amended for interim periods beginning on or after January 1, 2008, to include requirements to assess and disclose the Company's ability to continue as a going concern. The adoption of this new section did not have an impact on the financial statements.

Accounting Pronouncements

In February 2008, the CICA issued Section 3064, Goodwill and intangible assets, replacing Section 3062, Goodwill and other intangible assets and Section 3450, Research and development costs. The new Section will be applicable to financial statements relating to fiscal years beginning on or after October 1, 2008. Accordingly, the Company will adopt the new standard for its fiscal year beginning January 1, 2009. The section establishes standards for the recognition, measurement, presentation and disclosure of goodwill subsequent to its initial recognition and of intangible assets by profit-oriented enterprises. The Company does not expect that the adoption of this new Section will have a material impact on its consolidated financial statements.

A decision of the CICA Accounting Standards Board (the "AcSB") will require the Company to report under International Financial Reporting Standards in 2011, although specific requirements of the transition continue to be under review by the AcSB. The Company is monitoring the requirements but is unable to assess the impact on the financial statements at this time.

In January 2009, the AcSB issued Section 1582, Business Combinations, which replaces former guidance on business combinations. Section 1582 establishes principles and requirements of the acquisition method for business combinations and related disclosures. This statement 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 2011 with earlier application permitted. The Company does not expect that the adoption of this new Section will have a material impact on its consolidated financial statements.

In January 2009, the AcSB issued Sections 1601, Consolidated Financial Statements, and 1602, Non-controlling Interests, which replaces existing guidance. Section 1601 establishes standards for the preparation of consolidated financial statements. Section 1602 provides guidance on accounting for a non-controlling interest in a subsidiary in consolidated financial statements 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 2011 with earlier application permitted. The Company does not expect that the adoption of this new Section will have a material impact on its consolidated financial statements.

3. FINANCIAL INSTRUMENTS AND CAPITAL MANAGEMENT

The Company is exposed to financial risk in a range of financial instruments including accounts receivable, accounts payable, bank overdraft, long term financing and financial derivative contracts. The Company manages its exposure to financial risks by operating in a manner that minimizes its exposure to the extent practical. The main financial risks affecting the Company are discussed below:

Credit Risk

Credit risk arises when a failure by counterparties to discharge their obligations could reduce the amount of future cash inflows from financial assets on hand at the balance sheet date. The Company's accounts receivable at the balance sheet date arise from sales of crude oil, natural gas liquids and natural gas. Industry standard dictates that commodity sales are settled on the 25th day of the month following the month of production. The Company markets its oil and natural gas through several marketers so that the exposure to any one entity is minimized.

Joint venture receivables are generated from conducting joint operating or capital operations with joint venture partners. Collections from these operations are usually paid within three months of the joint venture bill being issued to the partner. Circumstances can arise which extend the terms of collection beyond this period as specific items on these joint venture billings may need to be resolved between partners. Smaller partners may be cash called to pay for their share of costs in advance of a project. The Company also has the ability to take measures such as withholding production volumes as recourse for collections on receivables.

The Company monitors receivable accounts and actively pursues collection and payment. If any accounts are considered impaired, they will be charged to an allowance for doubtful accounts. During the year ended December 31, 2008 there was no allowance for doubtful accounts recorded due to historical success of collecting receivables. The Company does not have any significant credit risk exposure with respect to accounts receivable to any single counterparty or any group of counterparties having similar characteristics.

The carrying value of accounts receivable approximates its fair value due to the relatively short periods to maturity on this instrument. The maximum exposure to credit risk is represented by the carrying amount on the balance sheet. There are no material financial assets that the Company considers past due and at risk of collection.

Interest Rate Risk

Interest rate risk refers to the risk that the value of a financial instrument or cash flows associated with the instrument will fluctuate due to changes in market interest rates. The Company is exposed to interest rate risk as it can borrow funds at floating interest rates as disclosed in Note 7. The Company currently does not use interest rate hedges or fixed interest rate contracts to manage the Company's exposure to interest rate fluctuations.

At December 31, 2008, the increase or decrease in net income before taxes for each 1% change in interest rates on floating rate debt amounts to approximately $63,000 (2007 – $546,000) per annum.

Commodity Price Risk

The Company is exposed to fluctuations in commodity prices for crude oil, natural gas and natural gas liquids. Commodity prices are affected by many factors including supply and demand. The Company monitors these risks and when appropriate, utilizes financial instruments to manage its exposure to these risks.

At December 31, 2008 the Corporation had no outstanding derivative contracts.

Liquidity Risk

Liquidity risk includes the risk that, as a result of the Company's operational liquidity requirements:

– The Company will not have sufficient funds to settle a transaction on the due date; or

– The Company will be forced to sell financial assets at values which are less than what they are worth.

The Company's operating cash requirements, including amounts projected to complete the Company's existing capital expenditure program, are continuously monitored and adjusted as input variables change. These variables include but are not limited to, available credit, oil and natural gas production from existing wells, results from new wells drilled, commodity prices, cost overruns on capital projects and regulations relating to prices, taxes, royalties, land tenure, allowable production and availability of markets. As these variables change, liquidity risks may necessitate the Company conduct equity issues or obtain project debt financing. The Company also mitigates liquidity risk by maintaining an insurance program to minimize exposure to insurable losses.

Foreign Exchange Risk

The Company is exposed to fluctuations in foreign exchange rates which will have an impact on commodity prices, foreign denominated cash on hand, foreign denominated payables and foreign denominated long-term financing held by the Company.

Commodities are sold to marketers at prices that are commonly based upon reference prices denominated in a foreign currency. Any changes in the foreign exchanges rates will have a direct impact on petroleum and natural gas revenue received by the Company. Foreign denominated cash held by Company is subject to revaluations at period ends with any changes being reflected as realized foreign exchange gains and losses. Changes in the value of payables and long-term financing denominated in a foreign currency are reflected as unrealized foreign exchange gains and losses. Upon settlement, the unrealized foreign exchange gain or loss is reversed and a realized foreign exchange gain or loss is recorded.

Following is a list of the financial liabilities at December 31, 2008 and their due dates:

	Total	Current Within 1 Year	Withiin 1 to 2 Years
Bank overdraft	$ 4,463,264	$ 4,463,264	$ –
Accounts payable and accrued liabilities	17,950,307	17,950,307	–
Long-term financing[1]	6,315,792	–	6,315,792
Total	$ 28,729,363	$ 22,413,571	$ 6,315,792

[1] *Interest payments are not reflected*

Fair Value

The carrying value of the financial assets and financial liabilities approximates its fair value.

Capital Management

The Company's objective when managing capital is to safeguard its ability to continue as a going concern so that it can continue to provide returns to shareholders and benefits for other stakeholders. The Company manages the capital structure and makes adjustments to it in light of changes in economic conditions and the risk characteristics of the underlying assets. The Company's objective is met by retaining adequate equity to provide for the possibility that cash flows from assets will not be sufficient to meet future cash flow requirements. The Board of Directors does not establish quantitative return on capital criteria for management. The Company defines capital as the aggregate of total equity, bank overdraft and long-term financing less cash and cash equivalents, which at December 31, 2008 was $105,256,596.

The Company is not subject to any externally imposed cash flow requirements other than covenants on its operating credit facility with its lender. At December 31, 2008 the Company was in compliance with these financial covenants.

4. RELATED PARTY TRANSACTIONS

Except as disclosed elsewhere in these consolidated financial statements, the Corporation had the following related party transactions:

a) The Corporation entered into transactions with the following related parties:

- Pioneer Land Services Ltd. – a Director is an employee of Pioneer
- Borden Ladner Gervais LLP – a Director is partner with the law firm

b) Transactions

		2008		2007
Expenses				
Legal consulting – Borden Ladner Gervais LLP	$	183,134	$	346,194
Consulting – Pioneer Land Services Ltd.		–		1,463
	$	183,134	$	347,657
Other				
Recorded as part of Oil and Gas Properties – Pioneer Land Services Ltd	$	15,889	$	18,030
Recorded as part of Oil and Gas Properties – Borden Ladner Gervais LLP		10,636		29,866
Recorded as part of share issuance cost – Borden Ladner Gervais LLP		–		71,123
	$	26,525	$	119,019

c) These transactions are in the normal course of operations and have been valued in these consolidated financial statements at the exchange amount which is the amount of consideration established and agreed to by the related parties, which approximate fair value.

5. OTHER ASSETS

At December 31, 2008, the corporation held 3,927,400 common shares of a publicly traded company. The Corporation has classified the investment as an "available for sale" financial asset with any changes in fair value being recognized in other comprehensive income. At December 31, 2008 there were no material changes in the fair value of the financial asset from the original transaction date.

6. OIL AND GAS PROPERTIES

	2008	2007
Oil and gas properties	**$ 205,886,306**	$ 203,612,731
Accumulated depletion	**(68,334,482)**	(46,587,772)
Net book value	**$ 137,551,824**	$ 157,024,959

At December 31, 2008 there was no equipment inventory not in use and development costs for wells where reserves have yet to be assigned (2007 - $3,096,702). Undeveloped land costs of approximately $6,964,030 (2007 - $18,651,101) are also not being depleted. General administrative expenses of $1,059,912 (2007 - $1,059,914) have been capitalized to oil and gas properties.

The Corporation applied a ceiling test to its capitalized assets at December 31, 2008 and determined that there was no impairment. The following table outlines benchmark prices used in the impairment test at December 31, 2008:

Year	WTI Crude Oil US$/bbl	Exchange Rate US$/CDN$	Edm Light Crude CDN$/bbl	AECO Natural Gas CDN$/GJ
2009	57.50	0.825	68.61	7.58
2010	68.00	0.850	78.94	7.94
2011	74.00	0.875	83.54	8.34
2012	85.00	0.925	90.92	8.70
2013	92.01	0.950	95.91	8.95
2014	93.85	0.950	97.84	9.14
After 2019 (inflation %)	2%/yr	0%/yr	2%/yr	2%/yr

In 2008, the Corporation sold approximately 110 sections of Montney Petroleum and Natural Gas ("P&NG") rights for net proceeds received of $66.5 million.

Full cost accounting requires a pooling of all costs. The disposition of a specific asset within that pool must be allocated an appropriate share of all costs, resulting in the use of a deemed cost of disposition in the calculation of a gain. All costs related to the exploration, acquisition and development of petroleum and natural gas reserves are initially capitalized under the full cost method of accounting. Such costs include lease acquisition costs, geological and geophysical expenditures, lease rentals on non-productive properties, costs of drilling both productive and non-productive wells, equipment costs and general and administrative expenses applicable to these activities. This calculation resulted in a deemed cost of disposition of $48.0 million, which resulted in a gain of $15.1 million. The actual cost incurred by the Corporation to acquire these P&NG rights over the years is approximately $3.3 million.

7. LONG-TERM FINANCING

The Corporation has a revolving line of credit, with a syndicate of chartered banks, of up to $70 million (2007 - $70 million), which bears interest at prime plus 0.00% (2007 – 0.50%). The facility is secured by a general security agreement, a floating charge debenture in the amount of $150 million and an unlimited liability guarantee by Terra Energy Corp. At December 31, 2008, the Corporation was indebted on the revolving line of credit in amount of $6,315,792 (2007 - $54,631,003). Outstanding cheques issued in the amount of $4,463,264 (2007 – $1,828,943) are shown as bank overdraft until they clear against the revolving line.

The Corporation's bank credit facility is structured as a 364 day revolving credit facility with a one year term out. If the credit facility is not renewed at maturity, the corporation is required to pay the outstanding balance one year from the maturity. The credit facility is subject to a renewal in June 2009. As a result the liability has been classified as a non-current liability. In addition, the credit facility includes a change of control clause whereby in the event of any change of control, the creditors, at their discretion, may terminate the credit facility and therefore the entire amount outstanding will be due and payable upon demand.

As at December 31, 2008 and 2007, the Corporation was in compliance with all loan covenants.

8. ASSET RETIREMENT OBLIGATION

The undiscounted amount of expected cash flows required to settle the asset retirement obligations is estimated at $16,453,119 (2007 - $15,565,360). The liability for the expected cash flows, as reflected in the consolidated financial statements, has been discounted at 9% (2007 – 9%) and the inflation rate used is 2% (2007 – 2%).

The schedule below is a reconciliation of the Corporation's liability for the years ended December 31:

	2008	2007
Opening balance, beginning of year	**$ 5,565,353**	$ 5,033,926
Liabilities disposed	**(327,458)**	(164,030)
Revisions to estimates	**(134,043)**	(32,601)
Liabilities settled	**(384,945)**	–
Liabilities incurred	**755,340**	265,758
Accretion	**471,447**	462,300
Ending balance, end of year	**$ 5,945,694**	$ 5,565,353

The majority of costs attributable to these obligations are expected to be incurred between 2009 and 2017 and are to be funded mainly from the Corporation's cash provided by operating activities. The actual costs may differ from those estimated. Although the ultimate impact of these matters on net income cannot be determined at this time, it could be material for any one quarter or year.

9. SHARE CAPITAL

a) Authorized

i) Unlimited number of common voting shares

ii) Unlimited number of preferred shares

b) Issued and outstanding

	2008		2007	
	Number of Shares	**Amounts**	Number of Shares	Amounts
Common shares				
Balance, beginning of year	**74,297,484**	**$ 65,195,721**	76,900,833	$ 72,570,457
Issued on exercise of options	**2,127,300**	**2,538,177**	206,000	214,480
	76,424,784	**67,733,898**	77,106,833	72,784,937
Tax effect of flow through share renouncement	**–**	**–**	–	(5,106,725)
Reclassification of contributed surplus (note 10)	**–**	**1,520,517**	–	90,067
Shares repurchased for cancellation	**(1,538,251)**	**(1,374,113)**	(2,809,349)	(2,571,459)
Cash share issue costs, net of tax of Nil (2007 -$2,025)	**–**	**–**	–	(1,099)
	(1,538,251)	**146,404**	(2,809,349)	(7,589,216)
Balance, end of year	**74,886,533**	**67,880,302**	74,297,484	65,195,721
Share purchase warrants				
Balance, beginning of year	**–**	**–**	1,093,700	434,258
Expired	**–**	**–**	(1,093,700)	(434,258)
Balance, end of year	**–**	**–**	–	–
Total Common Shares and Warrants	**74,886,533**	**$ 67,880,302**	74,297,484	$ 65,195,721

On May 17, 2007, the Corporation obtained permission from the TSX Venture Exchange for a Normal Course Issuer Bid to repurchase for cancellation up to 5,000,000 common shares from May 17, 2007 to May 17, 2008. On June 9, 2008 the Corporation obtained permission from the TSX Venture Exchange for a Normal Course Issuer Bid to repurchase for cancellation up to 3,700,000 common shares from June 9, 2008 to June 9, 2009.

In the twelve month period ended December 31, 2008, the Corporation purchased 1,538,251 common shares for total costs of $1,729,698, at an average price of $1.12 per common share. Share capital was reduced by $1,374,113 and the excess of $355,585 was charged to retained earnings.

In the twelve month period ended December 31, 2007, the Corporation purchased 2,809,349 common shares for total costs of $3,022,229, at an average price of $1.08 per common share. Share capital was reduced by $2,571,459 and the excess of $450,770 was charged to deficit.

Of the repurchased shares, 783,000 were being held for cancellation, at December 31, 2008 (December 31, 2007 – 477,849) but have subsequently been cancelled.

c) Stock Options

The Corporation's Employee Stock Option Plan provides for officers, directors, employees, and consultants to be granted options of up to 10 percent of the issued and outstanding common shares of the Corporation. These options entitle the holder to purchase common shares of the Corporation subject to various vesting periods and other terms and conditions specified in the stock option plan.

Details of all options outstanding after giving effect to the re-pricing of 2,107,000 employee stock options previously granted (Note 9d) are as follows:

	2008		2007	
	Number of Options	**Weighted average exercise price**	Number of Options	Weighted average exercise price
Employee Stock Options				
Balance, beginning of year	**6,693,000**	**1.35**	5,802,000	1.58
Granted	**2,244,300**	**1.73**	1,756,000	1.32
Exercised	**(2,127,300)**	**(1.20)**	(206,000)	(1.04)
Expired	**(155,000)**	**(1.38)**	(659,000)	(1.36)
Balance, end of year	**6,655,000**	**1.53**	6,693,000	1.35
Agent Options				
Balance, beginning of year	**–**	**–**	654,959	1.40
Expired	**–**	**–**	(654,959)	(1.40)
Balance, end of year	**–**	**–**	–	–
Total Options, balance, end of year	**6,655,000**	**1.53**	6,693,000	1.35

During 2008, the Corporation granted options to officers, directors and employees to purchase 2,244,300 (2007 – 1,756,000) common shares ranging at prices between $1.26 and $2.25 (2007 - $1.03 and $1.38). Options outstanding as at December 31, 2008:

Options Exercise Price $	Weighted Average Remaining Contract Life	Outstanding December 31, 2008	Exercisable December 31, 2008
$1.00	0.12 years	610,000	610,000
$1.03	3.96 years	140,000	35,000
$1.08	1.96 years	659,400	176,000
$1.15	1.52 years	100,000	60,000
$1.30	1.11 years	132,000	100,000
$1.35	1.91 years	160,000	112,000
$1.36	3.48 years	1,078,100	593,900
$1.38	2.91 years	24,000	8,000
$1.51	1.47 years	376,000	320,000
$1.60	1.47 years	60,000	48,000
$1.66	2.12 years	355,000	355,000
$1.70	2.53 years	860,000	516,000
$1.77	2.35 years	119,000	119,000
$1.79	2.78 years	176,000	176,000
$1.81	1.27 years	213,000	213,000
$1.83	1.69 years	191,000	191,000
$1.85	2.87 years	141,200	141,200
$1.89	1.75 years	60,000	48,000
$1.90	2.19 years	300,000	300,000
$1.94	2.19 years	186,000	186,000
$1.95	1.58 years	258,000	258,000
$1.96	1.33 years	61,800	61,800
$2.00	2.28 years	88,000	88,000
$2.05	1.65 years	123,000	123,000
$2.10	3.48 years	4,000	4,000
$2.11	2.58 years	140,500	100,500
$2.19	3.89 years	4,000	4,000
$2.25	3.96 years	35,000	35,000
	2.15 years	6,655,000	4,982,400

d) Stock Based Compensation

For stock options granted to employees, compensation expense of $1,835,701 has been recorded for the year ended December 31, 2008 (2007 - $1,182,479) with the offsetting charge to contributed surplus. The fair value of stock options granted was estimated using the Black Scholes option-pricing model with the following assumptions: Dividend yield Nil (2007 – Nil); expected volatility at 56% to 68% (2007 – 50% to 66%); risk-free interest rate of 4.0% (2007 – 3.5% to 4.0%); weighted average life of 2.53 years (2007 – 1.39 years).

For the options granted during 2008, the estimated fair value expected to be recognized over the vesting period is approximately $1,512,928 (2007 - $2,318,370).

In 2007, the exercise prices of 2,107,000 employee stock options previously granted ranging from $1.15 to $2.27 were re-priced to $1.08. The options held by the directors and senior officers were excluded from the re-pricing. The differences between fair values of the repriced options issued as compared to the old options has been expensed over the vesting periods of the options.

e) Per share amounts

The following table summarizes the calculation of basic net income and diluted net income per share.

	2008	2007
Net income (loss) available to common shareholders	$ 22,966,412	$ (1,765,671)
Weighted-average number of common shares outstanding – basic	74,972,282	75,124,521
Dilutive effect of stock options	561,771	–
Weighted-average number of common shares outstanding – diluted	75,534,053	75,124,521
Net income per share ($/share)		
Basic	$ 0.31	$ (0.02)
Diluted	$ 0.30	$ (0.02)

In calculating the dilutive effect of stock options 3,375,500 stock options (2007 - 6,693,000) were anti-dillutive and excluded.

10. CONTRIBUTED SURPLUS

The details of contributed surplus are as follows:

	2008	2007
Balance, beginning of year	$ 9,365,272	$ 7,838,602
Stock based compensation	1,835,701	1,182,479
Warrants expired	–	434,258
Reclassification resulting from exercise of options and warrants to common shares	(1,520,517)	(90,067)
Balance, end of year	$ 9,680,456	$ 9,365,272

11. INCOME TAXES

a) The components of future income tax balances are as follows:

	2008	2007
Oil and gas properties	$ 14,977,605	$ 9,138,212
Valuation allowance	1,111,765	1,111,765
Deferred partnership income	13,654,069	6,943,379
Attributed crown royalty income benefit	(550,082)	(550,082)
Non-capital loss carryforwards	(5,038,727)	(2,895,430)
Share issuance costs	(355,693)	(644,079)
Other	–	(170,245)
Future income tax liability	$ 23,798,937	$ 12,933,520

The future tax liability is calculated based on management's best estimates of available tax pool balances and non-capital losses available. In calculating the current provision management has made certain estimates and taken certain filing positions based on current and proposed legislation. Tax provision calculations are based on substantively enacted rates and projected profitability. As such, by their nature, the tax provision is subject to measurement uncertainty. Tax filings made by the Company are subject to review and confirmation by Canada Revenue Agency ("CRA"). Such review and reassessment may result in changes to the available tax pools. Adjustments, if any, resulting from CRA's review of the Company's tax filings will be reflected in the period of adjustment.

b) The provision for income taxes recorded in the consolidated financial statements differs from the amount which would be obtained by applying the statutory income tax rate of 30.0% (2007 - 33.0%) to the earnings as follows:

	2008	2007
Expected income tax expense (recovery)	$ 10,151,127	$ (1,379,797)
Capital tax	5,262	1,374
Stock based compensation	550,711	390,218
Effect of change in tax rate	–	(1,067,830)
Adjustment to opening tax pool balances	(87,814)	(186,277)
Other	251,393	(173,219)
Actual income tax expense (recovery)	$ 10,870,679	$ (2,415,531)

c) The Corporation has exploration and development expenditures (direct and successor) and undepreciated capital costs which may be carried forward indefinitely to reduce future taxable income:

	2008	2007
Canadian oil and gas property expenses (COGPE)	**$ –**	$ 31,798,807
Canadian development expenses (CDE)	**20,319,196**	31,641,766
Canadian exploration expenses (CEE)	**22,143,488**	17,631,405
Foreign development expenses (FDE)	**1,870,172**	1,870,172
Foreign development expenses successored (FDE)	**2,594,118**	3,705,883
Undepreciated capital costs	**26,696,565**	34,340,320
Non-capital loss carryforwards	**24,842,449**	9,651,434
Share issue costs	**1,185,644**	2,146,930
Alberta royalty deduction	**5,000,741**	5,000,741
	$104,652,373	$ 137,787,458

The tax pools disclosed have not been reduced by approximately $45.5 million in partnership income from February 1, 2008 to December 31, 2008 which has been deferred to January 31, 2009 (2007 – $23.1 million).

12. STATEMENT OF CASH FLOWS

Change in non-cash working capital

	2008	2007
Accounts receivable	**$ (4,882,548)**	$ (2,207,200)
Prepaid expenses	**(302,541)**	(525,567)
Accounts payable and accrued liabilities	**(4,246,065)**	11,421,121
	(9,431,154)	8,688,354
Change in non-cash working capital from investing	**(893,618)**	5,933,685
Change in non-cash working capital from operations	**(8,537,536)**	2,754,669
	$ (9,431,154)	$ 8,688,354

Other information

	2008	2007
Interest paid	**$ 1,680,066**	$ 2,799,509
Taxes paid	**$ 5,262**	$ 1,374

13. DEFERRED CREDIT

The Corporation was reimbursed $299,000 of leasehold improvements. The amount is being amortized over the term of the lease, and rent expense has been reduced accordingly.

14. COMMITMENTS AND CONTINGENCIES

The Corporation has lease commitments relating to office space expiring November 30, 2010 and gathering and processing contracts expiring between October 31, 2009 and October 31, 2013.

Year	Amount
2009	$ 6,716,481
2010	$ 6,707,636
2011	$ 4,738,034
2012	$ 4,891,878
2013	$ 4,419,765

a) The Corporation is involved in various claims arising in the normal course of business. While the outcome of these matters is uncertain and there can be no assurance that such matters will be resolved in the Corporation's favour, the Corporation does not currently believe that the outcome of adverse decisions in any proceedings related to these matters or any amount which it may be required to pay would have a material adverse impact on its financial position, results of operations or liquidity.

b) The Corporation had outstanding letters of credit to various parties for a total of $525,927 (2007 - $625,927) which expire at various dates during 2009.

c) The Corporation has employment agreements with two executive officers defining the terms of employment. Under the terms of the agreements, one executive is entitled to 1.0 year of compensation for termination without cause or in the event of a change of control and the other executive receives 1.5 years of compensation.

15. COMPARATIVE FIGURES

Certain comparative figures have been reclassified to conform to current financial presentation.