

Terra Energy Corp.

Management's Discussion & Analysis

For the three and six months ended June 30, 2008

Management's Discussion & Analysis

This Management's Discussion and Analysis ("MD&A") of financial condition and results of operations of Terra Energy Corp. ("Terra Energy" or the "Corporation") is dated August 12, 2008. It should be read in conjunction with the unaudited interim consolidated financial statements and the corresponding notes for the three and six month periods ended June 30, 2008 and June 30, 2007 and with the audited year end consolidated financial statements of the Corporation for the years ended December 31, 2007 and December 31, 2006.

Terra Energy's Board of Directors and Audit Committee have reviewed and approved the June 30, 2008 unaudited consolidated financial statements and related MD&A.

All references to dollar values refer to Canadian dollars unless otherwise stated.

This MD&A provides certain financial measures that do not have a standardized meaning prescribed by Canadian generally accepted accounting principles ("GAAP"). These non-GAAP financial measures may not be comparable to similar measures presented by other issuers.

This MD&A contains the terms "cash flow from operations" and "cash flow from operations per share", which should not be considered an alternative to, or more meaningful than, cash flow from operating activities as determined in accordance with Canadian generally accepted accounting principles as an indicator of the Corporation's performance. Cash flow from operations per share is calculated using the same weighted average basic and diluted number of shares outstanding used in the calculation of net income (loss) per share. All references to cash flow throughout this MD&A are based on cash flow before changes in non-cash working capital.

Petroleum and natural gas volumes are converted to an equivalent measurement basis referred to as a "barrel of oil equivalent" ("boe") using a conversion rate of six thousand cubic feet of natural gas to one barrel of oil ("6:1"). The 6:1 conversion ratio is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead. Readers are cautioned that boe figures may be misleading, particularly if used in isolation.

The continuous disclosure materials of the Corporation, including its annual MD&A and audited financial statements, Information Circular and Proxy Statement, Annual Information Form, material change reports and press releases issued by the Corporation are available through the SEDAR system at www.sedar.com.

FORWARD LOOKING ADVISORY

Statements in this document may contain forward-looking information. Such information is subject to known and unknown risks, uncertainties and other factors that could influence actual results or events, and cause actual results or events to differ materially from those stated, anticipated or implied in the forward looking information. As such, readers are cautioned not to place undue reliance on the forward-looking information, as no assurances can be provided as to future results, levels of activity or achievements. In addition, the reader is cautioned that historical results are not necessarily indicative of future performance.

DESIGN OF INTERNAL CONTROLS OVER FINANCIAL REPORTING

Effective for the year end 2007, securities regulations state that the Corporation is to design and implement internal controls over financial reporting and disclose in its MD&A any material changes in the Corporation's internal control over financial reporting that occurred during the Corporation's most recent interim period. Internal controls are processes designed and implemented by management to provide reasonable assurance regarding the reliability the Corporation's financial reporting and the preparation of financial statements and other financial information for external purposes in accordance with Canadian GAAP. For the year ended December 31, 2007, the Chief Executive Officer and the Chief Financial Officer have designed internal controls over financial reporting, or caused them to be designed under their supervision. Management has concluded that internal controls are adequately designed in this regard, considering the employees involved and the control procedures in place, including management and Audit Committee oversight and quarterly external auditor reviews. Occasionally, the Corporation requires outside assistance and advice on taxation, new accounting pronouncements and complex accounting and reporting issues, which is common with companies of a similar size. It should be noted, that the Corporation's control system, no matter how well designed, can provide only reasonable, but not absolute, assurance of detecting, preventing and deterring errors or fraud.

CORPORATE HISTORY

Terra Energy is a publicly traded corporation, amalgamated under the Business Corporations Act of Alberta, and formed as a result of the amalgamation of Terra Energy Corp., Terrapet Energy Corp., and Rhodes Resources Corp. on January 30, 2004. This Management Discussion and Analysis along with the associated financial statements referenced above include the accounts of the Corporation and its wholly-owned subsidiary Constar Resources Ltd. and Terra Energy, a general partnership between Terra Energy Corp. and Constar Resources Ltd.

The Corporation's principal business is the exploration, development and production of petroleum and natural gas in Western Canada.

SELECTED QUARTERLY INFORMATION

Financial

THREE MONTHS ENDED JUNE 30	2008	2007	%Growth
Gross Revenue	20,807,645	12,268,331	69.6
Cash Flow From Operations	10,453,069	4,659,989	124.3
Net Income	5,778,180	618,863	833.7
Weighted Average Shares – Basic	74,597,170	75,165,101	(0.8)
Weighted Average Shares – Diluted	75,535,672	75,858,163	(0.4)
Shares at Period End – Basic	75,658,684	75,071,384	0.8

AS AT	JUNE 30, 2008	DECEMBER 31, 2007	%Growth
Total Assets	128,852,286	166,061,884	(22.4)
Long-term Financing	–	54,631,003	N/A

Operational

THREE MONTHS ENDED	JUNE 30, 2008	JUNE 30, 2007	%Growth
Production			
Average Daily Production (boe/d)	3,414	3,005	13.6
Wells Drilled			
Gross	0.0	0.0	–
Net	0.0	0.0	–

2008 Second Quarter Highlights

- > Average production per day increased 13.6% to 3,414 barrels per day compared to the same quarter last year
- > Gross revenue increased 69.6% to \$20,807,645 from \$12,268,331 compared to the same quarter last year
- > Cash flow from operations rose 124.3% to \$10,453,069 from \$4,659,989 compared to the same quarter last year
- > Net income increased 833.7% to \$5,778,180 from \$618,863 compared to the same quarter last year
- > Production expense decreased by 5.3% to \$12.08 per BOE in the second quarter of 2008 compared to \$12.75 per BOE in the second quarter of 2007.

RESULTS OF OPERATIONS**Production**

THREE MONTHS ENDED JUNE 30	2008 Average	2007 Average	%Growth
Oil (bbl/d)	207	284	(27.1)
Natural Gas (Mcf/d)	14,465	13,297	8.8
Liquids (bbl/d)	796	505	57.6
Combined (boe/d)	3,414	3,005	13.6

SIX MONTHS ENDED JUNE 30	2008 Average	2007 Average	%Growth
Oil (bbl/d)	229	297	(22.9)
Natural Gas (Mcf/d)	17,107	11,796	45.0
Liquids (bbl/d)	961	479	100.6
Combined (boe/d)	4,041	2,742	47.4

Approximately 90% of Terra's gas production is processed through third party facilities at the McMahon gas plant in Northeast British Columbia. The McMahon facility was shut down for scheduled maintenance for substantially all of June 2008. As a result of the shut down, production for the second quarter of 2008 was reduced by 27% when compared to the first quarter of 2008. The maintenance was performed successfully and will not impact production volumes going forward. In addition, the amount of gas being processed at a third party facility was limited due to operational issues. Management is working with the third party to resolve this.

Operations

THREE MONTHS ENDED JUNE 30	2008 \$	2007 \$	2008 (\$/boe)	2007 (\$/boe)	%Growth %
Gross Revenues	20,807,645	12,268,331	66.98	44.86	49.3
Realized Gain (Loss) on Financial Instrument	(614,727)	265,801	(1.99)	0.98	(303.1)
Unrealized Gain (Loss) on Financial Instrument	(9,243,546)	978,907	(29.75)	3.58	(931.0)
Revenue Before Royalties	10,949,372	13,513,039	35.24	49.42	(28.7)
Royalties	(4,279,537)	(2,533,942)	(13.77)	(9.26)	48.7
Revenue After Royalties	6,669,835	10,979,097	21.47	40.16	(46.5)
Production Expenses	(3,752,789)	(3,485,514)	(12.08)	(12.75)	(5.3)
Operating Netback	2,917,046	7,493,583	9.39	27.41	(65.7)
General & Administrative Expenses	(1,259,463)	(983,357)	(4.05)	(3.60)	12.5
Interest Expense	(369,301)	(854,725)	(1.19)	(3.13)	(62.0)
Realized Foreign Exchange Loss	-	-	-	-	-
Non-cash Expenses	(6,331,087)	(4,577,193)	(20.38)	(16.74)	21.7
Income (Loss) Before Income Taxes and Other Income	(5,042,805)	1,078,308	(16.23)	3.94	(511.9)
Gain on Disposition of P&NG Rights	14,478,281	-	46.60	-	N/A
Income Before Income Taxes	9,435,476	1,078,308	30.37	3.94	670.8
Income Tax Expense	(3,657,296)	(459,445)	(11.77)	(1.68)	600.6
Net Income	5,778,180	618,863	18.60	2.26	723.0
Per Share – Basic	0.08	0.01			
Per Share - Diluted	0.08	0.01			
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SIX MONTHS ENDED JUNE 30	2008 \$	2007 \$	2008 (\$/boe)	2007 (\$/boe)	%Growth %
Gross Revenues	41,063,056	22,652,456	55.83	45.64	22.3
Realized Gain (Loss) on Financial Instrument	(868,864)	574,894	(1.17)	1.16	(200.9)
Unrealized Gain (Loss) on Financial Instrument	(12,278,790)	(1,867,739)	(16.70)	(3.76)	344.1
Revenue Before Royalties	27,915,402	21,359,611	37.96	43.04	(11.8)
Royalties	(9,018,978)	(4,756,647)	(12.27)	(9.59)	27.9
Revenue After Royalties	18,896,424	16,602,964	25.69	33.45	(23.2)
Production Expenses	(8,464,519)	(6,605,843)	(11.51)	(13.31)	(13.5)
Operating Netback	10,431,905	9,997,121	14.18	20.14	(29.6)
General & Administrative Expenses	(2,279,708)	(2,232,412)	(3.10)	(4.50)	(31.1)
Interest Expense	(1,251,833)	(1,490,101)	(1.70)	(2.99)	(43.1)
Realized Foreign Exchange Loss	(6,740)	-	(0.01)	-	N/A
Non-cash Expenses	(13,446,304)	(8,381,075)	(18.28)	(16.89)	8.2
Loss Before Income Taxes and Other Income	(6,552,680)	(2,106,467)	(8.91)	(4.24)	110.1
Gain on disposition of P&NG Rights	14,478,281	-	19.69	-	N/A
Gain (Loss) Before Income Taxes	7,925,601	(2,106,467)	10.78	(4.24)	354.2
Income Tax Recovery (Expense)	(3,248,324)	556,914	(4.42)	1.12	(494.6)
Net Income (Loss)	4,677,277	(1,549,553)	6.36	(3.12)	303.8
Per Share – Basic	0.06	(0.02)			
Per Share – Diluted	0.06	(0.02)			

Revenue

THREE MONTHS ENDED JUNE 30	2008 \$	2007 \$	2008 (\$/boe)	2007 (\$/boe)	%Change %
Gross Revenue	20,807,645	12,268,331	66.98	44.86	49.3
Realized Gain (Loss) on Financial Instrument	(614,727)	265,801	(1.99)	0.98	(303.1)
Unrealized Gain (Loss) on Financial Instrument	(9,243,546)	978,907	(29.75)	3.58	(931.0)
Revenue Before Royalties	10,949,372	13,513,039	35.24	49.42	(28.7)

SIX MONTHS ENDED JUNE 30	2008 \$	2007 \$	2008 (\$/boe)	2007 (\$/boe)	%Change %
Gross Revenue	41,063,056	22,652,456	55.83	45.64	22.3
Realized Gain (Loss) on Financial Instrument	(868,864)	574,894	(1.17)	1.16	(200.9)
Unrealized Gain (Loss) on Financial Instrument	(12,278,790)	(1,867,739)	(16.70)	(3.76)	344.1
Revenue Before Royalties	27,915,402	21,359,611	37.96	43.04	(11.8)

Gross revenue increased by 69.6% to \$20,807,645 for the three month period ended June 30, 2008 compared to \$12,268,331 for the same period ended June 30, 2007 primarily as a result of a 49.3% increase commodity prices in conjunction with a 13.6% increase in production volumes. Revenue before royalties on a per unit of production decreased by 28.7% to \$35.24 from \$49.42 per boe for the three month period ended June 30 largely due to a increase in the unrealized loss on financial instruments in the current period compared to the prior period.

For the six month period ended June 30, 2008, revenues increased by 81.3% to \$41,063,056 from \$22,652,456 as the result of a 22.3% increase in commodity prices and a 47.4% increase in production volumes. Revenue before royalties on a per unit of production decreased by 11.8% to \$37.96 from \$43.04 per boe for the six month period ended June 30 largely due to a increase in the unrealized loss on financial instruments in the current period compared to the prior period.

At period ends, in accordance with generally accepted accounting principles, the Corporation is required to calculate and reflect a “mark-to-market” value of its financial instruments. Further, during each period, the prior periods “unrealized loss” or gains are reversed and a new mark to market adjustment is calculated as at the period end.

For the six month period ended June 30, 2008, the Corporation’s financial statements reflect a unrealized loss of \$12,278,790 on financial instruments. This is the result of the reversal of the December 31, 2007 unrealized loss on financial instruments of \$567,483 and an unrealized “mark-to-market” loss on financial instruments of \$12,846,273 that the Corporation has on outstanding contracts at June 30, 2008.

The unrealized losses on financial instruments are non-cash items and, as a result, do not affect Terra Energy’s cash flow from operations.

Below is a breakdown of gross revenue prices realized by the Corporation:

THREE MONTHS ENDED JUNE 30	2008	2007	%Growth
Crude Oil (\$ / bbl)	118.52	76.51	54.9
Natural Gas Liquids (\$ / bbl)	66.29	37.70	75.8
Natural Gas (\$ / Mcf)	10.37	7.28	42.4

SIX MONTHS ENDED JUNE 30	2008	2007	%Growth
Crude Oil (\$ / bbl)	104.55	67.68	54.5
Natural Gas Liquids (\$ / bbl)	52.35	37.26	40.5
Natural Gas (\$ / Mcf)	8.80	7.40	18.9

Royalties

THREE MONTHS ENDED JUNE 30	2008	2007	2008	2007	%Change
	\$	\$	(\$/boe)	(\$/boe)	%
Royalties	4,279,537	2,533,942	13.77	9.26	48.7

SIX MONTHS ENDED JUNE 30	2008	2007	2008	2007	%Change
	\$	\$	(\$/boe)	(\$/boe)	%
Royalties	9,018,978	4,756,647	12.27	9.59	27.9

Royalties increased 68.9% to \$4,279,537 for the three month period ended June 30, 2008 compared to \$2,533,942 for the same period ended June 30, 2007 which is consistent with the 69.6% increase in gross revenue. Royalties as a percentage of gross revenues remains relatively stable at 20.6% compared to 20.7% in the prior period.

For the six month period ended June 30, 2008 royalties increased by 89.6% to \$9,018,978 from \$4,756,647. This is consistent with the 81.3% increase in gross revenues as royalties as a percentage of gross revenues increased marginally to 22.0% in 2008 compared to 21.0% in 2007.

Production Expenses

THREE MONTHS ENDED JUNE 30	2008	2007	2008	2007	%Change
	\$	\$	(\$/boe)	(\$/boe)	%
Production Expenses	3,752,789	3,485,514	12.08	12.75	(5.3)

SIX MONTHS ENDED JUNE 30	2008	2007	2008	2007	%Change
	\$	\$	(\$/boe)	(\$/boe)	%
Production Expenses	8,464,519	6,605,843	11.51	13.31	(13.5)

Production expenses increased 7.7% to \$3,752,789 for the three month period ended June 30, 2008 compared to \$3,485,514 for the same period ended June 30, 2007. Higher operating costs can be attributed to two factors. Firstly, a proportion of Terra's operating costs are variable, as production increases, operating costs increase. Secondly, coinciding with the shut down of the McMahon gas plant for a significant portion of June, the opportunity was taken to perform maintenance on Terra owned facilities. Both factors contributed to a net increase in operating costs. On a per unit of production basis declined 5.3% to \$12.08 for the three month period ended June 30, 2008 compared to \$12.75 for the same period ended June 30, 2007 primarily due to the impact of fixed costs on increased production volumes.

Production expenses increased 28.1% to \$8,464,519 for the six month period ended June 30, 2008 compared to \$6,605,843 in 2007 reflecting higher production volumes. Production expenses on a per unit of production basis declined 13.5% to \$11.51 in 2008 compared to \$13.31 for 2007 primarily due to the impact of fixed costs on increased production volumes.

General and Administrative Expenses

THREE MONTHS ENDED JUNE 30	2008	2007	2008	2007	%Change
	\$	\$	(\$/boe)	(\$/boe)	%
General and Administrative Expenses	1,259,463	983,357	4.05	3.60	12.5

SIX MONTHS ENDED JUNE 30	2008	2007	2008	2007	%Change
	\$	\$	(\$/boe)	(\$/boe)	%
General and Administrative Expenses	2,279,708	2,232,412	3.10	4.50	(31.1)

General and administrative expenses increased 28.1% to \$1,259,463 for the three month period ended June 30, 2008 compared to \$983,357 for the same period ended June 30, 2007. General and administrative expenses on a per unit of production basis increased 12.5% to \$4.05 for the three month period ended June 30, 2008 compared to \$3.60 for the same period ended June 30, 2007.

General and administrative expenses increased 2.1% to \$2,279,708 for the six month period ended June 30, 2008 compared to \$2,232,412 for the same period ended June 30, 2007. General and administrative expenses on a per unit of production basis decreased 31.1% to \$3.10 in 2008 compared to \$4.50 for the same period ended June 30, 2007. General and administrative expenses on a per unit of production will be lower than an equivalent amount in 2007 as a result of an increased production base. Incremental production is not expected to add any significant overhead going forward.

Interest Expense

THREE MONTHS ENDED JUNE 30	2008 \$	2007 \$	2008 (\$/boe)	2007 (\$/boe)	%Change %
Interest Expense	369,301	854,725	1.19	3.13	(62.0)
SIX MONTHS ENDED JUNE 30	2008 \$	2007 \$	2008 (\$/boe)	2007 (\$/boe)	%Change %
Interest Expense	1,251,833	1,490,101	1.70	2.99	(43.1)

Interest expense decreased by 56.8% to \$369,301 for the three month period ended June 30, 2008 compared to \$854,725 for the same period ended June 30, 2007. For the six month period ended June 30, 2008, interest expense decreased by 16.0% to \$1,251,833 compared to \$1,490,101 for the same period in 2007. For both periods, interest expense decreased when compared to the prior year period as a result of the disposition of Montney P&NG rights, the proceeds of which were used to repay the debt held by the Corporation.

Non Cash Expenses

THREE MONTHS ENDED JUNE 30	2008 \$	2007 \$	2008 (\$/boe)	2007 (\$/boe)	%Change %
Depletion and Amortization	4,704,465	3,912,799	15.14	14.31	5.8
Accretion Expense	113,457	111,517	0.37	0.41	(9.8)
Stock Based Compensation	1,513,147	552,877	4.87	2.02	141.1
Unrealized Foreign Exchange Loss	18	—	—	—	—
Non Cash Items	6,331,087	4,577,193	20.38	16.74	21.7
SIX MONTHS ENDED JUNE 30	2008 \$	2007 \$	2008 (\$/boe)	2007 (\$/boe)	%Change %
Depletion and Amortization	10,901,118	7,288,313	14.82	14.69	0.9
Accretion Expense	232,428	223,034	0.31	0.45	(31.1)
Stock Based Compensation	1,976,320	869,728	2.69	1.75	53.7
Unrealized Foreign Exchange Loss	336,438	—	0.46	—	N/A
Non Cash Items	13,446,304	8,381,075	18.28	16.89	8.2

Non cash expenses rose 38.3% to \$6,331,087 for the three month period ended June 30, 2008 compared to \$4,577,193 for the same period ended June 30, 2007. On a per unit of production basis, non cash expenses increased 21.7% to \$20.38 for the three month period ended June 30, 2008 compared to \$16.74 for the same period ended June 30, 2007. The majority of this change is attributable to stock based compensation and depletion and amortization expense. Stock based compensation increased by 173.7% to \$1,513,147 in the current period compared to \$552,877 in the prior period largely as the result of replacement stock options granted to employees. Replacement options issued to employees have the same characteristics as the original options except that they are issued at current market price giving rise to an increased compensation recognition. Depletion and amortization increased by 20.2% to \$4,704,465 from \$3,912,799 as a result of increased production.

For the six month period ended June 30, 2008 Non cash expenses rose 60.4% to \$13,446,304 in 2008 compared to \$8,381,075 in 2007. On a per unit of production basis, non cash expenses increased 8.2% to \$18.28 for the six month period ended June 30, 2008 compared to \$16.89 for the same period ended June 30, 2007. The majority of this change is attributable to stock based compensation and depletion and amortization expense. Stock based compensation increased by 127.2% to \$1,976,320 in the current period compared to \$869,728 in the prior period largely as the result of the replacement stock options granted to employees. Depletion and amortization increased by 49.6% to \$10,901,118 from \$7,288,313 which is consistent with a 47.4% increase in average production volumes.

Gain on Disposition of Petroleum and Natural Gas ("P&NG") Rights

On May 13, 2008 the Corporation sold approximately 110 sections of Montney P&NG rights for net proceeds received of \$65.2 million. Under full cost accounting the sale of undeveloped P&NG property uses a deemed cost of disposition, which resulted in a gain of \$14.5 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 \$47.3 million. The actual cost incurred by the Corporation to acquire these P&NG rights over the years is approximately \$3.3 million.

The closing on one section of mineral rights associated with sale remains outstanding which is expected to result in a further \$1.3 million of additional proceeds to the Corporation once certain criteria are met. The contingent consideration has not been included in the determination of the gain recognized in the second quarter of 2008. An adjustment will be recorded in a subsequent period if and when the criteria is met.

Income Taxes

THREE MONTHS ENDED JUNE 30	2008	2007	2008	2007	%Change
	\$	\$	(\$/boe)	(\$/boe)	%
Current Tax	—	—	—	—	—
Future Tax	3,657,296	459,445	11.77	1.68	600.6
Income Taxes	3,657,296	459,445	11.77	1.68	600.6
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SIX MONTHS ENDED JUNE 30	2008	2007	2008	2007	%Change
	\$	\$	(\$/boe)	(\$/boe)	%
Current Tax	3,605	—	—	—	—
Future Tax (Recovery)	3,244,719	(556,914)	4.42	(1.12)	(494.6)
Income Taxes	3,248,324	(556,914)	4.42	(1.12)	(494.6)

A future income tax expense of \$3,657,296 for the three month period ended June 30, 2008 was recorded compared to a expense of \$459,445 for the same period ended June 30, 2007. The increase in the future income tax expense is largely the result of the \$14,478,281 gain recorded on the disposition of P&NG rights recorded in the second quarter of 2008. On a per unit of production basis, the future income tax expense was \$11.77 for the three month period ended June 30, 2008 compared to an expense of \$1.68 for the same period ended June 30, 2007.

A future income tax expense of \$3,244,719 for the six month period ended June 30, 2008 was recorded compared to a recovery of \$556,914 for the same period ended June 30, 2007. The increase in the future income tax expense is consistent with the increase in income before income taxes as a result of increased production and gain on sale of P&NG rights. On a per unit of production basis, the future income tax expense was \$4.42 for the six month period ended June 30, 2008 compared to a recovery of \$1.12 for the same period ended June 30, 2007.

LIQUIDITY AND FINANCIAL CONDITION

	June 30, 2008	December 31, 2007	%Growth
	\$	\$	%
Working Capital before Financial Instruments	10,117,349	(14,676,780)	168.9
Financial Instruments	(12,846,273)	(567,483)	2163.7
Working Capital	(2,728,924)	(15,244,263)	82.1
Oil and Gas Properties	104,967,264	157,024,959	(33.2)

Working capital before financial instruments at June 30, 2008 was \$10,117,349 compared to a deficit of \$14,676,780 at December 31, 2007. The improvement in working capital before financial instruments was driven largely by the disposition of Montney P&NG rights on May 13, 2008. The gross proceeds received of \$65.2 million was used to repay debt.

Terra Energy's bank credit facility is structured as a \$70.0 million 364 day revolving credit facility with a one year term-out provision. If the credit facility is not renewed at maturity, the Corporation has the ability to repay any amounts outstanding on the credit facility one year from maturity. As a result of this one year repayment feature, Terra Energy has classified its bank credit facility as a long-term financial obligation.

As at June 30, 2008, Terra Energy was in compliance with all of its bank covenants and no amounts had been drawn on the facility

Capitalized resource properties as at June 30, 2008 were \$104,967,264 net of accumulated depletion, compared to \$157,024,959 as at December 31, 2007. Oil and gas properties decreased primarily as a result of the disposition of the Montney P&NG rights. For the three and six month periods ended June 30, 2008, Terra Energy incurred \$5,252,716 and \$14,522,340 in capital expenditures broken down as follows:

THREE MONTHS ENDED JUNE 30	2008	2007
	\$	\$
Exploration	(463,099)	410,001
Development	1,778,831	(55,127)
Undeveloped Land	447,278	791,775
Geological / Geotechnical	96,784	608,034
Facilities	2,061,381	2,087,424
Other Assets	1,331,541	289,342
Total Capital Expenditures	5,252,716	4,131,449
Net Property Dispositions	(63,863,482)	-
Net Capital Expenditures	(58,610,766)	4,131,449

SIX MONTHS ENDED JUNE 30	2008 \$	2007 \$
Exploration	2,197,658	2,536,158
Development	4,804,416	995,137
Undeveloped Land	607,927	976,924
Geological / Geotechnical	493,261	1,411,455
Facilities	4,876,886	6,228,095
Other Assets	1,542,192	420,653
Total Capital Expenditures	14,522,340	12,568,422
Net Property Dispositions	(69,876,568)	—
Net Capital Expenditures	(55,354,228)	12,568,422

Terra Energy financed its capital expenditures for the period through cash flow from operations.

Cash Flow from Operations (non-GAAP measure)

Cash flow from operations (“Cash Flow”), representing cash generated from operating activities before changes in non-cash working capital items, is a non-GAAP measure. Management utilizes Cash Flow as a key measure to assess the ability of the Corporation to finance operating activities and capital expenditures. Additionally, Cash Flow has been described and presented in order to provide shareholders and potential investors with information regarding the Corporation’s liquidity and its ability to generate funds to finance its operations. This performance indicator may not be comparable to similar measures used by other companies.

The following table presents the non-GAAP financial measure “cash flow from operations”.

THREE MONTHS ENDED JUNE 30	2008 \$	2007 \$
Net income (loss) for the period	5,778,180	618,863
Future income tax	3,657,296	459,445
Accretion expense	113,457	111,517
Stock based compensation	1,513,147	552,877
Unrealized loss (gain) on financial instruments	9,243,546	(978,907)
Unrealized foreign exchange loss	18	—
Gain on disposition of P&NG rights	(14,478,281)	—
Asset retirement obligations settled	(62,154)	—
Amortization of deferred credit	(16,605)	(16,605)
Depletion and amortization	4,704,465	3,912,799
Cash flow from operations	10,453,069	4,659,989

SIX MONTHS ENDED JUNE 30	2008 \$	2007 \$
Net income (loss) for the period	4,677,277	(1,549,553)
Future income tax	3,244,719	(556,914)
Accretion expense	232,428	223,034
Stock based compensation	1,976,320	869,728
Unrealized loss on financial instruments	12,278,790	1,867,739
Unrealized foreign exchange loss	336,438	–
Gain on disposition of P&NG rights	(14,478,281)	–
Asset retirement obligations settled	(156,667)	–
Amortization of deferred credit	(33,210)	(33,211)
Depletion and amortization	10,901,118	7,288,313
Cash flow from operations	18,978,932	8,109,136

For the three month period ended June 30, 2008, the Corporation generated cash flows from operations of \$10,453,069 (\$0.14 per basic and diluted share), an increase of 124.3% compared to \$4,659,989 (\$0.06 per basic and diluted share) for the three month period ended June 30, 2007. The primary driver for the increase in cash flow from operations was a 49.3% increase commodity prices in conjunction with a 13.6% increase in production volumes.

For the six month period ended June 30, 2008, the Corporation generated cash flows from operations of \$18,978,932 (\$0.26 per basic share and \$0.25 per diluted share), an increase of 134.0% compared to \$8,109,136 (\$0.11 per basic and diluted share) for the six month period ended June 30, 2007. The primary driver for the increase in cash flow from operations was a 47.4% increase production volumes and a 22.3% increase in realized commodity prices.

Capital Resources

The Corporation's share capital is as follows:

	JUNE 30, 2008		DECEMBER 31, 2007	
	No. of Shares	Amounts	No. of Shares	Amounts
Common Shares	75,658,684	68,571,949	74,297,484	65,195,721

During the three month period ended June 30, 2008, 1,417,700 common shares were issued on the exercise of stock options for cash proceeds received of \$1,758,889. During the six month period ended June 30, 2008 2,118,300 common shares were issued on the exercise of stock options for cash proceeds received of \$2,525,937

During the three month period ended June 30, 2008, no common shares were repurchased under normal course issuer bid by the Corporation. During the six month period ended June 30, 2008, 757,100 common shares were repurchased under normal course issuer bid by the Corporation for \$1,013,035 at an average price of \$1.34 per common share. The Corporation recorded \$664,352 as a reduction of share capital and the excess of \$348,683 charged to deficit. As at June 30, 2008, 215,400 repurchased shares were held for cancellation. Shares repurchased under the normal course issuer bid held for cancellation are excluded from the outstanding number of shares.

The Corporation has no immediate requirement for additional capital.

COMMITMENTS AND CONTINGENCIES

The Corporation had outstanding letters of credit to various parties for a total of \$575,927 (2007- \$345,000). The amounts expire at various dates during 2008.

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.

OFF-BALANCE SHEET ARRANGEMENTS

The Corporation is party to certain derivative instruments, including crude oil and natural gas contracts. The Corporation enters into these contracts to manage commodity price risk in future earnings and cash flow. These contracts reduce the Corporation's exposure to the fluctuations in petroleum and natural gas revenues by locking in fixed forward prices on a portion of the Corporation's crude oil and natural gas production.

At June 30, 2008 the Corporation had entered into derivative contracts, the terms of which are summarized as follows:

Contract Type	Price	Volumes Per Day	Contract Term
Financial	Sell \$92.00 per Bbl	100 Bbls	January 1, 2008 to December 31, 2008
Financial	Sell \$95.00 per Bbl	100 Bbls	February 1, 2008 to December 31, 2008
Financial	Sell \$90.55 US per Bbl	200 Bbls	January 1, 2009 to December 31, 2009
Financial	Sell \$7.84 per GJ	2,000 GJ	July 1, 2008 to September 30, 2008
Financial	Sell \$7.55 per GJ	5,000 GJ	July 1, 2008 to September 30, 2008
Financial	Sell \$8.23 per GJ	2,000 GJ	October 1, 2008 to December 31, 2008
Financial	Sell \$8.00 per GJ	5,000 GJ	October 1, 2008 to December 31, 2008
Financial	Sell \$ 8.40 per GJ	4,000 GJ	January 1, 2009 to March 31, 2009
Financial	Sell \$8.60 per GJ	2,000 GJ	January 1, 2009 to March 31, 2009
Financial	Sell \$8.60 per GJ	1,000 GJ	January 1, 2009 to March 31, 2009

The mark to market value of the above commodity products transactions of \$12,846,273 has been recorded as a liability as at June 30, 2008.

RELATED PARTY TRANSACTIONS

The Corporation entered into transactions with the following related parties:

Rhodes Petroleum Corp., controlled by an officer of the Corporation

Pioneer Land Services Ltd. – a Director is an employee of Pioneer

Borden Ladner Gervais LLP – a Director is partner with the law firm

	JUNE 30, 2008	JUNE 30, 2007
	\$	\$
Expenses		
Consulting - Pioneer Land Services Ltd.	–	209
Legal Consulting – Borden Ladner Gervais LLP	90,155	265,532
	90,155	265,741
Other		
Recorded as part of oil and gas properties – Pioneer Land Services Ltd	13,214	5,685
Recorded as part of oil and gas properties – Rhodes Petroleum Corp.	151	–
Recorded as part of oil and gas properties – Borden Ladner Gervais LLP	9,602	–
Recorded as part of share issuance cost – Borden Ladner Gervais LLP	–	71,123
	22,967	76,808

The above transactions are in the normal course of operations and have been valued at the exchange amounts agreed by the related parties.

OUTLOOK

The Company has expanded the 2008 Capital Expenditure Plan. Terra Energy plans to spend \$52 million and drill 16 gross wells in its Fort St. John Area. The company is targeting an exit production of rate for 2008 of 5,700 BOED.

Terra Energy has previously identified three principal activities this year. The first involves the development of the Company's Sunrise Gas Field. Terra Energy's only major infrastructure project for 2008 is the construction of a 25.4 kilometer, 8" pipeline connecting its Sunrise Gas Field to its Tower Dehydration and Compression Facility, together with the installation of a second compressor which will expand the design capacity of the facility to approximately 20MMcf per day. The expansion of Tower facility is required to handle anticipated production volumes coming on-stream this year from North Eight Mile and Sunrise. Included in the expanded capital plan are a minimum of 7 wells in Sunrise, each of which will be targeting the Doig sand as the primary target and each of which will have one or more secondary targets.

The Company's second principal activity for 2008 will be the exploitation of the Red Creek Oil Pool. The Company plans two projects at Red Creek in 2008. The first is the re-entry and recompletion of an existing horizontal well using multi-stage frac technique with a view toward ascertaining the most efficient method of extracting the oil. The second project planned for Red Creek is the drilling of a vertical well with a view towards expanding the total size of the pool to west and to the north. It is hoped that the two projects together will set the Company up for a major oil development opportunity for 2009.

The third principal activity for 2008 consists of series of exploration plays in the Fort St. John area. The Company has just under 200 net sections of land in the vicinity of Fort St. John, which are has demonstrated hydrocarbon prospectivity in more than 20 different formations. Included in the exploration plans are two or more wells which could be considered high impact plays and which could provide the Company with additional development drilling opportunities in 2009.

The total budget of \$52 million is broken down to approximately 60% drilling and completions costs, approximately 30% equipping and infrastructure, and the remaining 10% being allocated to land, seismic and other costs. Of significance is the reduction of percentage of the budget being allocated to infrastructure costs as compared to 2006 and 2007. With the substantial capital investment which was made by Terra Energy over past two years in pipelines and facilities, the Company can now dedicate a higher percentage of its capital on growing the production base and reserves. With most of the major infrastructure in place, the Company can look forward to being able to tie-in new production without undue delays.

With the expanded 2008 Capital Expenditure Plan, the Company is targeting a production exit rate of approximately 5,700 BOED. Total revenues are forecast to be approximately \$85 million based upon an estimated natural gas price of \$8.75 per Mcf and \$100 per bbl of oil, resulting in a forecast cash flow from operations of approximately \$40 million or \$0.52 per common share (basic).

CHANGES IN ACCOUNTING POLICIES

Financial Instruments

On January 1, 2008, the Company adopted the following new Handbook Sections, which were effective for interim periods 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 for 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.

Section 3031 – “Inventories”, will be adopted on January 1, 2008. This new standard did not have an impact on the Company’s financial statements.

The CICA has amended Section 1400, “General Standards of Financial Statement Presentation”, which is effective 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 will not have an impact on the financial statements.

International Financial Reporting Standards

In January 2006, the CICA Accounting Standards Board ("AcSB") adopted a strategic plan for the direction of accounting standards in Canada. As part of that plan, accounting standards in Canada for public companies are expected to converge to International Financial Reporting Standards ("IFRS") by the end of 2011. The Corporation continues to monitor and assess the impact of convergence of Canadian GAAP and IFRS.

CRITICAL ACCOUNTING ESTIMATES

In preparing financial statements in accordance with generally accepted accounting principles, management undertakes certain judgments and estimates. Changes in these judgments and estimates could have a material impact on the financial results and condition. The following discussion outlines accounting policies and practices that are critical to determining the Corporation's financial results.

Proved Oil and Gas Reserves

Under Canadian Securities Regulations National Instrument 51-101 "Standards of Disclosure for Oil and Gas Activities" (NI 51-101), "proved" reserves are those reserves that can be estimated with a high degree of certainty to be recoverable (it is likely that the actual remaining quantities recovered will exceed the estimated proved reserves). In accordance with this definition, the level of certainty targeted by the reporting Corporation should result in at least a 90% probability that the quantities actually recovered will equal or exceed the estimated reserves. There was no such consideration of probability under National Policy 2B (NP 2B). In the case of "probable" reserves, which are obviously less certain to be recovered than proved reserves, NI 51-101 states that it must be equally likely that the actual remaining quantities recovered will be greater or less than the sum of the estimated proved plus probable reserves. With respect to the consideration of certainty, in order to report reserves as proved plus probable, the reporting Corporation must believe that there is at least a 50% probability that the quantities actually recovered will equal or exceed the sum of the estimated proved plus probable reserves. The implementation of NI 51-101 has resulted in a more rigorous and uniform standardization of reserve evaluation.

The oil and gas reserve estimates are made using all available geological, reservoir and historical production data. Estimates are reviewed and revised as appropriate. Revisions may occur as a result of changes in prices, costs, fiscal regimes, reservoir performance or a change in the Corporation's plans.

Ceiling Test

Under the Canadian Institute of Chartered Accountants (CICA) full cost accounting guidelines, the Corporation calculates a ceiling test annually whereby the carrying value of petroleum and natural gas properties is compared to estimated future cash flow from the production of proved reserves. The Corporation has early adopted the requirement of CICA Accounting Guideline 16 "Oil and Gas Accounting - Full Cost" ("AcG 16"). The requirements of the guideline were to be followed for all fiscal years beginning on or after January 1, 2004. At June 30, 2008, the Corporation calculated the ceiling test using AcG 16 without any material adverse impact on the Corporation's financial position or results of operations.

Asset Retirement Obligation

CICA Handbook Section 3110 “Asset Retirement Obligations” requires accrued reclamation and abandonment obligations be recognized on the balance sheet by increasing oil and gas properties offset by a liability of an equal amount. Estimates are required to determine the future obligation. The asset and liability are initially measured at fair value, being the discounted future value of the liability, and then capitalized as part of the cost of the asset and subsequently amortized over the life of the asset. The liability then accretes until the retirement obligation is settled.

Litigation

The Corporation is involved in various claims and litigation arising from 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 favor, the Corporation does not currently believe that the outcome of adverse decisions in any pending or threatened proceeding related to these and other matters or any amount which it may be required to pay by reason thereof, would have a material adverse effect on its financial position or results of operations.

Depletion and Depreciation Expense

Terra Energy uses the full cost method of accounting for exploration and development activities whereby all costs associated with these activities are capitalized, whether successful or not. The aggregate of capitalized costs, net of certain costs related to unproved properties, and estimated future development costs is amortized using the unit-of-production method based on estimated proved reserves. Changes in estimated proved reserves or future development costs have a direct impact on depletion and depreciation expense. Certain costs related to unproved properties and major development projects may be excluded from costs subject to depletion until proved reserves have been assigned, at which point they would be included in the depletion calculation, or for impairment, for which any write-down would be charged to depletion and depreciation expense.

Stock Based Compensation and Share Purchase Warrants

The Corporation calculates the fair value of the options granted and share purchase warrants issued. This calculation is based on estimates which could differ significantly from actual results. This could have a significant impact on the financial statements.

Income Taxes

The determination of Terra Energy’s income and other tax liabilities requires interpretation of complex laws and regulations often involving multiple jurisdictions. All tax filings are subject to audit and potential reassessment after the lapse of considerable time. Accordingly, the actual income tax liability may differ significantly from that estimated and recorded.

Financial Instruments

The Corporation's results are impacted by external market risks associated with fluctuations in commodity prices, operational and safety and environmental risks. The Corporation partially mitigates its exposure to market risks through the use of various financial instruments and physical contracts. The Corporation does not utilize derivative instruments for speculative purposes.

RISK FACTORS RELATING TO OIL AND GAS EXPLORATION, DEVELOPMENT AND PRODUCTION**Uncertain Discovery of Viable Commercial Prospects**

The Corporation's future success may be dependent upon its ability to economically locate commercially viable oil or gas deposits. Terra Energy can make no representations, warranties or guaranties that it will be able to consistently identify viable prospects, or that such prospects will be commercially exploitable. An inability of the Corporation to consistently identify and exploit commercially viable hydrocarbon deposits would have a material and adverse effect on the Corporation's business and financial position. Exploratory drilling is subject to numerous risks, including the risk that no commercially productive oil and gas reservoirs will be encountered. The cost of drilling, completing and operating wells is often uncertain, and drilling operations may be curtailed, delayed or canceled as a result of a variety of factors, including unexpected formation and drilling conditions, pressure or other irregularities in formations, blowouts, equipment failures or accidents, as well as weather conditions, compliance with governmental requirements and/or shortages or delays in the delivery of equipment. The inability to successfully locate and drill wells that will economically produce commercial quantities of oil and gas could have a material adverse effect on the Corporation's business and financial position. Terra Energy's properties are in various stages of exploration and development. Whether the Corporation ultimately drills a property may depend on a number of factors including funding, the receipt of additional seismic data or reprocessing of existing data, material changes in oil or gas prices, the costs and availability of drilling equipment, success or failure of wells drilled in similar formations or which would use the same production facilities, changes in estimates of costs to drill or complete wells, the Corporation's ability to attract industry partners to acquire a portion of its working interest to reduce exposure to drilling and completion costs, decisions of the Corporation's joint working interest owners, and/or restrictions under provincial regulators.

Volatility of Oil and Natural Gas Contracts

The ultimate profitability, cash flow and future growth of the Corporation will be affected by changes in prevailing oil and gas prices. Oil and gas prices have been subject to wide fluctuations in recent years in response to changes in the supply and demand for oil and natural gas, market uncertainty, competition, regulatory developments and other factors which are beyond the control of the Corporation. It is impossible to predict future oil and natural gas price movements with any certainty. An extended or substantial decline in oil and gas prices would have a material adverse effect on (i) the Corporation's access to capital, and (ii) the Corporation's financial position and results of operations.

Exploration, Development and Production Risks

Oil and natural gas exploration involves a high degree of risk and there is no assurance that expenditures made on exploration by Terra Energy will result in new discoveries of oil or natural gas in commercial quantities. It is difficult to project the costs of implementing an exploratory drilling program due to the inherent uncertainties of drilling in unknown formations, the costs associated with encountering various drilling conditions such as over pressured zones and tools lost in the hole, and changes in drilling plans and locations as a result of prior exploratory wells or additional seismic data and interpretations thereof.

Future oil and gas exploration may involve unprofitable efforts, not only from dry wells, but from wells that are productive but do not produce sufficient net revenues to return a profit after drilling, operating and other costs. Completion of a well does not assure a profit on the investment or recovery of drilling, completion and operating costs. In addition, drilling hazards or environmental damage could greatly increase the cost of operations, and various field operating conditions may adversely affect the production from successful wells. These conditions include delays in obtaining governmental approvals or consents, shut-ins of connected wells resulting from extreme weather conditions, insufficient storage or transportation capacity or other geological and mechanical conditions. While close well supervision and effective maintenance operations can contribute to maximizing production rates over time, production delays and declines from normal field operating conditions cannot be eliminated and can be expected to adversely affect revenue and cash flow levels to varying degrees.

New Alberta Royalty Regime

On October 25, 2007, the Alberta government released a report entitled "The New Royalty Framework" (the "NRF") containing the government's proposals for Alberta's new royalty regime which is scheduled to be effective on January 1, 2009. Terra Energy cannot provide any assurance that the NRF will be implemented in the form proposed. If changes are made to the NRF before it is implemented by the Alberta government, such changes could result in the implementation of a new royalty regime that impacts Terra Energy in a materially different manner, and that is more adverse to Terra Energy, than the NRF as currently proposed. As Terra Energy's assets are primarily in British Columbia, this impact will be minimal.

Prices, Markets and Marketing of Crude Oil and Natural Gas

Oil and natural gas are commodities whose prices are determined based on world demand, supply and other factors, all of which are beyond the control of Terra Energy. World prices for oil and natural gas have fluctuated widely in recent years. Any material decline in prices will result in a reduction of net production revenue. Certain wells or other projects may become uneconomic as a result of a decline in world oil prices and natural gas prices, leading to a reduction in the future volume of Terra Energy's oil and gas production. Terra Energy might also elect not to produce from certain wells at lower prices. All these factors could result in a material decrease in Terra Energy's future net production revenue, causing a reduction in its oil and gas acquisition and development activities. In addition, bank borrowings available to Terra Energy will be in part determined by the borrowing base of Terra Energy. A sustained material decline in prices from historical average prices could reduce Terra Energy's future borrowing base, therefore reducing the bank credit available to Terra Energy, and could require that a portion of any existing bank debt of Terra Energy be repaid.

In addition to establishing markets for its oil and natural gas, Terra Energy must also successfully market its oil and natural gas to prospective buyers. The marketability and price of oil and natural gas which may be acquired or discovered by Terra Energy will be affected by numerous factors beyond its control. Terra Energy will be affected by the differential between the price paid by refiners for light quality oil and the grades of oil produced by Terra Energy. The ability of Terra Energy to market natural gas may depend upon its ability to acquire space on pipelines which deliver natural gas to commercial markets. Terra Energy will also likely be affected by deliverability uncertainties related to the proximity of its reserves to pipelines and processing facilities and related to operational problems with such pipelines and facilities and extensive government regulation relating to price, taxes, royalties, land tenure, allowable production, the export of oil and natural gas and the management of other aspects of the oil and natural gas business. Terra Energy has limited direct experience in the marketing of oil and natural gas.

Substantial Capital Requirements; Liquidity

Terra Energy anticipates that it will make substantial capital expenditures for the acquisition, exploration, development and production of oil and natural gas reserves in the future. If Terra Energy's future revenues or reserves decline, Terra Energy may have limited ability to expend the capital necessary to undertake or complete future drilling programs. There can be no assurance that debt or equity financing, or cash generated by operations will be available or sufficient to meet these requirements or for other corporate purposes or, if debt or equity financing is available, that it will be on terms acceptable to Terra Energy. Moreover, future activities may require Terra Energy to alter its capitalization significantly. The inability of Terra Energy to access sufficient capital for its operations could have material adverse effect on Terra Energy's financial condition, results of operations or prospects.

Competition

The Corporation engages in the highly competitive industry of exploration for and production of oil and gas. The Corporation competes directly and indirectly with major and independent oil and gas companies in its exploration for and development of desirable oil and gas properties. Many companies and individuals are engaged in the business of acquiring interests in and developing oil and gas properties in Canada, and the industry is not dominated by any single competitor or a small number of competitors. Many of such competitors have substantially greater financial, technical, sales, marketing and other resources, as well as greater historical market acceptance than does the Corporation. The Corporation will compete with numerous industry participants for the acquisition of land and rights to prospects, and for the equipment and labor required to operate and develop such prospects. Competition could materially and adversely affect the Corporation's business, operating results and financial condition. Such competitive disadvantages could adversely affect the Corporation's ability to participate in projects with favorable rates of return.

Shortage of Supplies and Equipment

The Corporation's ability to conduct operations in a timely and cost effective manner is subject to the availability of natural gas and crude oil field supplies, rigs, equipment and service crews. Although none are expected currently, any shortage of certain types of supplies and equipment could result in delays in our operations as well as in higher operating and capital costs.

Interruption From Severe Weather

The Corporation's operations are conducted principally in the central region of Alberta, northeastern British Columbia and Saskatchewan. The weather in these areas can be extreme and can cause interruption or delays in our drilling and construction operations.

Dependence on Third-Party Pipelines

Substantially all of Terra Energy's sales of natural gas production were through deliveries to local third-party gathering systems to processing plants. In addition, the Corporation relies on access to interprovincial pipelines for the sale and distribution of substantially all of our gas. As a result, a curtailment of our sale of natural gas by pipelines or by third-party gathering systems, an impairment of our ability to transport natural gas on interprovincial pipelines or a material increase in the rates charged to us for the transportation of natural gas by reason of a change in federal or provincial regulations or for any other reason, could have a material adverse effect upon us. In such event, we would have to obtain other transportation arrangements. There can be no assurance that we would have economical transportation alternatives or that it would be feasible for us to construct pipelines. In the event such circumstances were to occur, our netbacks from the affected wells would be suspended until, and if, such circumstances could be resolved.

Operating Hazards and Uninsured Risks

The oil and gas business involves a variety of operating risks, including fire, explosion, pipe failure, casing collapse, abnormally pressured formations, adverse weather conditions, governmental and political actions, premature reservoir declines and environmental hazards such as oil spills, gas leaks and discharges of toxic gases. The occurrence of any of these events with respect to any property operated or owned (in whole or in part) by us could have a material adverse impact on us. The Corporation and the operators of our properties, maintain insurance in accordance with customary industry practices and in amounts that we believe to be reasonable. However, insurance coverage is not always economically feasible and is not obtained to cover all types of operational risks. The occurrence of a significant event that is not insured or insured fully could have a material adverse effect on our financial condition.

Restoration, Safety and Environmental Risks

Our operations are in Alberta, British Columbia and Saskatchewan. Certain laws and regulations exist that require companies engaged in petroleum activities to obtain necessary safety and environmental permits to operate. Such legislation may restrict or delay us from conducting operations in certain geographical areas. Further, such laws and regulations may impose liabilities on us for remedial and clean-up costs, personal injuries related to safety and environmental damages, such liabilities collectively referred to as "asset retirement obligations".

Expiration of Licenses and Leases

The Corporation's properties are held in the form of licenses and leases and working interests in licenses and leases. If the Corporation or the holder of the license or lease fails to meet the specific requirement of a license or lease, the license or lease may terminate or expire. There can be no assurance that any of the obligations required to maintain each license or lease will be met. The termination or expiration of the Corporation's licenses or leases or the working interests relating to a license or lease may have a material adverse effect on the Corporation's results of operations and business.

Title

Title to oil and natural gas interests is often not capable of conclusive determination without incurring substantial expense. In accordance with industry practice, Terra Energy will conduct such title reviews in connection with its principal properties as it believes are commensurate with the value of such properties. However, no absolute assurances can be given that title defects do not exist. If title defects do exist, it is possible that Terra Energy may lose all or a portion of its right title and interest in and to the properties to which the title defects relate.

Environmental Risks

All phases of the oil and natural gas business present environmental risks and hazards and are subject to environmental regulation pursuant to a variety of international conventions and federal, provincial and municipal laws and regulations. Environmental legislation provides for, among other things, restrictions and prohibitions on spills, releases or emissions of various substances produced in association with oil and gas operations. The legislation also requires that wells and facility sites be operated, maintained, abandoned and reclaimed to the satisfaction of applicable regulatory authorities. Compliance with such legislation can require significant expenditures and a breach may result in the imposition of fines and penalties, some of which may be material. Environmental legislation is evolving in a manner expected to result in stricter standards and enforcement, larger fines and liability and potentially increased capital expenditures and operating costs. The discharge of oil, natural gas or other pollutants into the air, soil or water may give rise to liabilities to governments and third parties and may require Terra Energy to incur costs to remedy such discharge. Implementation of strategies with respect to climate change and reducing greenhouse gases whether to meet the limits required by the Kyoto Protocol or as otherwise determined by federal or provincial governments could have a material impact on the nature of oil and natural gas operations, including those of Terra Energy. See "Industry Conditions – Environmental Regulation". Terra Energy is in material compliance with environmental laws. No assurance can be given that the application of environmental laws to the business and operations of Terra Energy will not result in a curtailment of production or a material increase in the costs of production, development or exploration activities or otherwise adversely affect Terra Energy's financial condition, results of operations or prospects.

Reserve Estimates

There are numerous uncertainties inherent in estimating quantities in oil, natural gas and natural gas liquids reserves and cash flows to be derived therefrom, including many factors beyond the Corporation's control. The reserve and associated cash flow information set forth herein represents estimates only. In general, estimates of economically recoverable oil and natural gas reserves and the future net cash flows therefrom are based upon a number of variable factors and assumptions, such as historical production from the properties, production rates, ultimate reserve recovery, timing and amount of capital expenditures, marketability of oil and gas, royalty rates, the assumed effects of regulation by governmental agencies and future operating costs, all of which may vary from actual results. All such estimates are to some degree speculative, and classifications of reserves are only attempts to define the degree of speculation involved. For those reasons, estimates of the economically recoverable oil and natural gas reserves attributable to any particular group of properties, classification of such reserves based on risk of recovery and estimates of future net revenues expected therefrom prepared by different engineers, or by the same engineers at different times, may vary. The Corporation's actual production, revenues, taxes and development and operating expenditures with respect to its reserves will vary from estimates thereof and such variations could be material. Further, the evaluations are based in part on the assumed success of exploitation activities intended to be undertaken in future years. The reserves and estimated cash flows to be derived therefrom contained in such evaluations will be reduced to the extent that such exploitation activities do not achieve the level of success assumed in the evaluation.

Estimates of proved reserves that may be developed and produced in the future are often based upon volumetric calculations and upon analogy to similar types of reserves rather than actual production history. Estimates based on these methods are generally less reliable than those based on actual production history. Subsequent evaluation of the same reserves based upon production history and production practices will result in variations in the estimated reserves and such variations could be material.

In accordance with applicable securities laws, GLJ, the independent reserves evaluator, has used forecast price and cost estimates in calculating reserve quantities included herein. Actual future net revenue will be affected by other factors such as actual production levels, supply and demand for oil and natural gas, curtailments or increases in consumption by oil and natural gas purchasers, changes in governmental regulation or taxation and the impact of inflation on costs. Actual production and revenues derived therefrom will vary from the estimates contained in the GLJ Report, and such variations could be material. The GLJ Report is based in part on the assumed success of activities the Corporation intends to undertake in future years. The reserves and estimated cash flows to be derived therefrom contained in the GLJ Report will be reduced to the extent that such activities do not achieve the level of success assumed in the GLJ Report. The GLJ Report is effective as of a specific effective date and has not been updated and thus does not reflect changes in the Corporation's resources since that date.

Reserve Replacement

Terra Energy's future oil and natural gas reserves, production, and cash flows to be derived therefrom are highly dependent on Terra Energy successfully acquiring or discovering new reserves. Without the continual addition of new reserves, any existing reserves Terra Energy may have at any particular time and the production therefrom will decline over time as such existing reserves are exploited. A future increase in Terra Energy's reserves will depend not only on Terra Energy's ability to develop any properties it may have from time to time, but also on its ability to select and acquire suitable producing properties or prospects. There can be no assurance that Terra Energy's future exploration and development efforts will result in the discovery and development of additional commercial accumulations of oil and natural gas.

Reliance on Operators and Key Employees

To the extent Terra Energy is not the operator of all of its oil and gas properties, Terra Energy will be dependent on such operators for the timing of activities related to such properties and will largely be unable to direct or control the activities of the operators. In addition, the success of Terra Energy will be largely dependent upon the performance of its management and key employees. Terra Energy does not have any key man insurance policies, and therefore there is a risk that the death or departure of any member of management or any key employee could have a material adverse effect on Terra Energy.

Corporate Matters

To date, Terra Energy has not paid any dividends on its outstanding common shares and does not anticipate the payment of any dividends on its common shares for the foreseeable future. Certain of the directors and officers of Terra Energy are also directors and officers of other oil and gas companies involved in oil and gas exploration and development, and conflicts of interest may arise between their duties as officers and directors of Terra Energy and as officers and directors of such other companies. Such conflicts must be disclosed in accordance with, and are subject to such other procedures and remedies as apply under the ABCA.

Management of Growth

The Corporation may be subject to growth-related risks including capacity constraints and pressure on its internal systems and controls. The ability of the Corporation to manage growth effectively will require it to continue to implement and improve its operational and financial systems and to expand, train and manage its employee base. The inability of the Corporation to deal with this growth could have a material adverse impact on its business, operations and prospects.

Permits and Licenses

The operations of Terra Energy may require licenses and permits from various governmental authorities. There can be no assurance that Terra Energy will be able to obtain all necessary licenses and permits that may be required to carry out exploration and development at its properties.

Additional Funding Requirements

Terra Energy's cash flow from its reserves may not be sufficient to fund its ongoing activities at all times. From time to time, Terra Energy may require additional financing in order to carry out its oil and gas acquisition, exploration and development activities. Failure to obtain such financing on a timely basis could cause Terra Energy to forfeit its interest in certain properties, miss certain acquisition opportunities and reduce or terminate its operations. If Terra Energy's revenues from its reserves decrease as a result of lower oil and natural gas prices or otherwise, it will affect Terra Energy's ability to expend the necessary capital to replace its reserves or to maintain its production. If Terra Energy's cash flow from operations is not sufficient to satisfy its capital expenditure requirements, there can be no assurance that additional debt or equity financing will be available to meet these requirements or available on favourable terms. Any equity financing may result in a change of control of Terra Energy or holders of its common shares suffering further dilution.

Variations in Foreign Exchange Rates

World oil and gas prices are quoted in United States dollars and the price received by Canadian producers is therefore effected by the Canadian/U.S. dollar exchange rate, which will fluctuate over time. In recent years, the Canadian dollar has increased materially in value against the United States dollar. Such material increases in the value of the Canadian dollar have negatively impacted Terra Energy's operating entities production revenues. Further material increases in the value of the Canadian dollar would exacerbate this negative impact. This increase in the exchange rate for the Canadian dollar and future Canadian/United States exchange rates could accordingly impact the future value of Terra Energy's reserves as determined by independent evaluators.

Issuance of Debt

From time to time Terra Energy may enter into transactions to acquire assets or the shares of other corporations. These transactions may be financed partially or wholly with debt, which may increase Terra Energy's debt levels above industry standards. Neither Terra Energy's articles nor its bylaws limit the amount of indebtedness that Terra Energy may incur. The level of Terra Energy's indebtedness from time to time could impair Terra Energy's ability to obtain additional financing in the future on a timely basis to take advantage of business opportunities that may arise. Terra Energy's ability to meet its debt service obligations will depend on Terra Energy's future operations which are subject to prevailing industry conditions and other factors, many of which are beyond the control of Terra Energy. As certain of the indebtedness of Terra Energy bears interest at rates which fluctuate with prevailing interest rates, increases in such rates would increase Terra Energy's interest payment obligations and could have a material adverse effect on Terra Energy's financial condition and results of operations. Further, Terra Energy's indebtedness is secured by substantially all of Terra Energy's assets. In the event of a violation by Terra Energy of any of its loan covenants or any other default by Terra Energy on its obligations relating to its indebtedness, the lender could declare such indebtedness to be immediately due and payable and, in certain cases, foreclose on Terra Energy's assets. In addition, oil and gas operations are subject to the risks of exploration, development and production of oil and natural gas properties, including encountering unexpected formations or pressures, premature declines of reservoirs, blow-outs, cratering, sour gas releases, fires and spills. Losses resulting from the occurrence of any of these risks could have a materially adverse effect on future results of operations, liquidity and financial condition.

Financial Instruments

From time to time the Corporation may enter into agreements to receive fixed prices on its oil and natural gas production to offset the risk of revenue losses if commodity prices decline; however, if commodity prices increase beyond the levels set in such agreements, the Corporation will not benefit from such increases. Similarly, from time to time the Corporation may enter into agreements to fix the exchange rate of Canadian to United States dollars in order to offset the risk of revenue losses if the Canadian dollar increases in value compared to the United States dollar; however, if the Canadian dollar declines in value compared to the United States dollar, the Corporation will not benefit from its fluctuating exchange rate.

Availability of Drilling Equipment and Access Restrictions

Oil and natural gas exploration and development activities are dependent on the availability of drilling and related equipment in the particular areas where such activities will be conducted. Demand for such limited equipment or access restrictions may affect the availability of such equipment to Terra Energy and may delay exploration and development activities.

Aboriginal Claims

Aboriginal peoples have claimed aboriginal title and rights to portions of western Canada. The Corporation is not aware that any claims have been made in respect of its property and assets; however, if a claim arose and was successful this could have an adverse effect on the Corporation and its operations.

Seasonality

The level of activity in the Canadian oil and gas industry is influenced by seasonal weather patterns. Wet weather and spring thaw may make the ground unstable. Consequently, municipalities and provincial transportation departments enforce road bans that restrict the movement of rigs and other heavy equipment, thereby reducing activity levels. Also, certain oil and gas producing areas are located in areas that are inaccessible other than during the winter months because the ground surrounding the sites in these areas consists of swampy terrain. There can be no assurance that these seasonal factors will not adversely affect the timing and scope of the Corporation's exploration and development activities, which could in turn have a material adverse impact on the Corporation's business, operations and prospects.

Third Party Credit Risk

The Corporation is, or may be exposed to, third party credit risk through its contractual arrangements with its current or future joint venture partners, marketers of its petroleum and natural gas production and other parties. In the event such entities fail to meet their contractual obligations to the Corporation, such failures could have a material adverse effect on the Corporation and its cash flow from operations. In addition, poor credit conditions in the industry and of joint venture partners may impact a joint venture partner's willingness to participate in the Corporation's ongoing capital program, potentially delaying the program and the results of such program until the Corporation finds a suitable alternative partner.

Alternatives to and Changing Demand for Petroleum Products

Fuel conservation measures, alternative fuel requirements, increasing consumer demand for alternatives to oil and natural gas, and technological advances in fuel economy and energy generation devices could reduce the demand for crude oil and other liquid hydrocarbons. The Corporation cannot predict the impact of changing demand for oil and natural gas products, and any major changes may have a material adverse effect on the Corporation's business, financial condition, results of operations and cash flows.

Kyoto Protocol

Canada is a signatory to the United Nations Framework Convention on Climate Change and has ratified the Kyoto Protocol established thereunder to set legally binding targets to reduce nationwide emissions of carbon dioxide, methane, nitrous oxide and other so-called "greenhouse gases". Terra Energy's exploration and production facilities and other operations and activities emit a small amount of greenhouse gases which will likely subject Terra Energy to legislation regulating emissions of greenhouse gases. The Government of Canada has developed a "Turning the Corner" climate change plan, which outlines future regulatory requirements that will set greenhouse gas emission reduction requirements for various industrial activities, including oil and gas exploration and production. Future federal legislation, together with provincial emission reduction requirements, such as those contained in Alberta's Climate Change and Emissions Management Act and in British Columbia's Bill 18: Greenhouse Gas Reduction (Cap and Trade) Act, may require the reduction of emissions or emissions intensity with Terra Energy's operations and facilities. The direct or indirect costs of these regulations may adversely affect the business of Terra Energy.

Environmental Regulation

The oil and natural gas industry is currently subject to environmental regulations pursuant to provincial and federal legislation. Environmental legislation provides for restrictions and prohibitions on releases or emissions and regulation on the storage and transportation of various substances produced or utilized in association with certain oil and gas industry operations and can affect the location and operation of wells and facilities and the extent to which exploration and development is permitted. In addition, legislation requires that well and facility sites be abandoned and reclaimed to the satisfaction of provincial authorities. As well, applicable environmental laws may impose remediation obligations with respect to property designated as a contaminated site upon certain responsible persons, which include persons responsible for the substance causing the contamination, persons who caused the release of the substance and any past or present owner, tenant or other person in possession of the site. Compliance with such legislation can require significant expenditures and a breach of such legislation may result in the suspension or revocation of necessary licences and authorizations, civil liability for pollution damage, the imposition of fines and penalties or the issuance of clean-up orders.

Applicable environmental laws in Alberta are consolidated in the Environmental Protection and Enhancement Act (the "EPEA"). In British Columbia, environmental laws are primarily found in the Environmental Management Act (the "EMA"). Under the EPEA and the EMA, environmental standards and compliance for releases, clean-up and reporting are stricter and more onerous than in previous legislation. Also, the range of enforcement actions available and the severity of penalties have been significantly increased. These changes will have an incremental effect on the cost of conducting operations in both provinces. Both Alberta and British Columbia review energy projects through an environmental assessment process, which may be held in conjunction with a federal assessment. These review processes involve public participation.

Climate change is an issue that is increasingly subject to government regulation. Although Canada has ratified the Kyoto Protocol and despite legislation to this end introduced by opposition parties in Parliament, it remains uncertain whether the targets in the Kyoto Protocol will be enforced in Canada. Alberta, British Columbia and the federal Government have all introduced climate change action plans that include various means of achieving emissions or emissions intensity reductions, including direct reductions, emissions trading, carbon capture and storage, technology fund contributions and credit for early action. Coordination between these plans has not yet been developed and remains a source of uncertainty. Given the evolving regulatory schemes related to climate change and the control of greenhouse gases and resulting requirements, it is not currently possible to predict the final form these requirements will take or the impact on Terra Energy and its operations and financial condition at this time.