

Q3 2008 FINANCIAL AND OPERATING HIGHLIGHTS

	Three months ended September 30		Nine months ended September 30	
	2008	2007	2008	2007
FINANCIAL (\$000's, except per share data)				
Total revenue	33,638	24,916	123,146	67,859
Cash flow from operations before working capital changes ⁽²⁾	21,021	6,268	68,496	11,468
Per common share				
Basic and diluted (\$)	0.11	0.04	0.36	0.08
Net income (loss)	1,926	(13,683)	4,823	(38,536)
Per common share				
Basic and diluted (\$)	0.01	(0.09)	0.03	(0.28)
Capital expenditures	39,480	47,446	74,597	140,787
Total assets	554,956	654,543	554,956	654,543
Total long-term financial liabilities	13,499	14,512	13,499	14,512
Working capital (deficiency)	36,147	(87,588)	36,147	(87,588)
Shareholders' equity	496,400	500,882	496,400	500,882
OPERATIONAL				
Daily Production				
Oil – net production (bbls/d)	4,401	6,973	6,578	5,852
Gas – net production (mcf/d)	8,156	12,608	9,434	12,758
Total net production (boe/d)	5,776	9,093	8,166	7,998
Product Pricing				
Oil – average selling price per bbl (\$/)	95.85	41.94	77.68	40.26
Gas – average selling price per mcf (\$)	8.08	5.01	8.54	6.40
Weighted average sales price per boe (\$)	85.02	39.17	72.78	39.87
Royalties (\$/boe)	22.51	9.43	18.26	8.93
Operating costs (including transportation expenses) (\$/boe)	18.74	15.23	18.99	16.44
Petroleum and Natural Gas (“PNG”) Netback ⁽³⁾ (\$/boe)	43.77	14.51	35.53	14.50
Common Share Information				
Weighted average shares outstanding (basic)	189,241,716	145,615,529	189,241,716	137,389,099
Weighted average shares outstanding (diluted)	189,241,716	145,880,287	189,242,004	137,741,368
Shares outstanding at end of period	189,241,716	147,434,697	189,241,716	147,434,697
Volume traded during the quarter	17,442,292	26,011,475	91,897,535	78,023,421
Share price (\$)				
High	2.48	5.30	2.80	5.93
Low	0.91	3.30	0.91	3.30
Close (end of period)	1.30	3.94	1.30	3.94

(1) Barrel of oil equivalent (or “BOE”) amounts referenced have been calculated using a conversion rate of six thousand cubic feet of natural gas to one barrel of oil. BOEs may be misleading, particularly if used in isolation. A BOE conversion ratio of 6 mcf:1 bbl is based on an energy equivalency.

(2) Cash flow from operations before working capital changes and cash flow per share do not have standardized meanings prescribed by Canadian Generally Accepted Accounting Principles (“GAAP”) and therefore may not be comparable to similar measures used by other companies. Cash flow from operations before working capital changes includes all cash flow from operating activities and is calculated before changes in non-cash working capital. Cash flow from operations before working capital changes is reconciled with net loss on the Consolidated Statement of Cash. Management uses these non-GAAP measurements for its own performance measures and to provide its shareholders and investors with a measurement of the Company's efficiency and its ability to fund a portion of its future growth expenditures.

(3) PNG netback is a non-GAAP measure used by management as a measure of operating efficiency and profitability and may not be comparable to similar measures used by other companies. It is calculated by deducting royalties, operating costs and transportation costs from petroleum and natural gas revenues.

Letter to Shareholders

The third quarter of 2008 represented a major shift in the market conditions impacting the business model of the Company. July saw the highest wellhead pricing and wellhead netbacks in our history, \$94.01 and \$53.08 respectively which declined throughout the period to an average of \$71.32 and \$32.90 in September. These values have continued to decline into the fourth quarter as overall market conditions also continued to deteriorate. This fall was partially offset by a historic weakening of the Canadian dollar which fell from approximately par at the beginning of July to under \$0.80 at times during October. As essentially all of our product sales trade in reference to US dollars, a falling Canadian dollar helps mitigate the impact of falling oil and natural gas prices as the majority of our costs are in Canadian dollars. While our long term outlook on commodity prices and in particular heavy oil prices remains highly positive, we have adjusted our budget and financial outlooks to reflect the difficult pricing environment we are currently experiencing.

The Company remains dedicated to our capital budget philosophy, which is to fund capital programs based on available cash flow from operations and proceeds from non-core asset sales. As such, as a result of the dramatic decrease in current commodity prices we have deferred several of the projects in our recently announced budget to result in a firm budget of approximately \$110 million for 2008. As a result, some anticipated production increases and pilot advancement activities will be delayed. It is the Company's intention to re-instate these deferred projects when the prices for oil and natural gas return to more normal levels.

On the positive front, the Company has a very strong balance sheet and is well positioned to weather the current financial crisis. Due to the sale of \$79 million in non-core producing assets and cash flow from operations of approximately \$68.5 million, to the end of Q3, including a strong quarterly cash flow performance of \$21 million in the third quarter, we find ourselves in the enviable position of having a \$36 million working capital surplus, a \$47 million undrawn credit facility with Alberta Treasury Branch ("ATB") and have no requirements to raise additional financing through either debt or equity, despite an aggressive 2008 capital spending program being undertaken on our four core assets.

We have made good progress on all four core assets with each of them making significant strides down the path to adding value in terms of our core strategy of converting resources first to reserves and then ultimately to production and cash flow. We have production pilots up and running at three of these core assets (Mooney, Onion Lake and San Miguel) and have increased our ownership interests and are working towards pilot implementation on our Blackrod project.

At Mooney, the most significant events were the initiation of the water flood and the commencement of injection of polymer at the pilot project. The water flood includes the drilling of 7 additional wells and will essentially be completed by the end of the year. Implementation of the water flood is critical for maintaining reservoir pressure and should help check the current declines in the field. Polymer injection commenced on October 30th and results are expected to be observed in the next three to six months. Polymer flooding has the potential to significantly increase both production rates and recoveries in the field if successful.

At Onion Lake, the cyclic steam stimulation ("CSS") pilot project continued to produce positive results. The first well (Z1) had sustained flow rates of over 150 barrels of oil per day in the first production cycle, approximately 3 times greater than our modeled expectations. The second well (Z2) encountered some mechanical issues, but still achieved a rate of over 70 barrels of oil per day. Z1 is currently undergoing the second injection cycle with the second production cycle at Z1 expected to commence in mid-November. The Z2 well should begin the second steam injection cycle in the next couple of weeks. Based on the positive results to date, up to 3 additional CSS wells are being planned in order to better quantify the reservoir distribution and performance. It is expected that a decision on whether to go ahead with the first phase of a commercial steam development will be made by mid-year 2009.

At San Miguel, the Chittum Steam Assisted Gravity Drainage (“SAGD”) pilot, in the central portion of the field, was put on full SAGD mode in September and we have seen the first production start to ramp-up in the producing well. It will likely take several months for the steam chamber to build to sufficient size to allow the well to achieve full production rates, but initial results are encouraging. The Saner pilot, in the northern portion of the field, utilizes the Fracture Assisted Steam Technology (“FAST”) used by Conoco in their original pilot and is currently injecting steam in the pre-heating phase. This pilot will use horizontal wells in a portion of the pilot area, as opposed to all vertical wells used by Conoco. In parallel with these pilots, numerous commercial optimization studies including the fuel source selection for steam generation and the marketing of the very heavy oil in this project are being investigated. It is expected that both the pilot and the commercial study results will be completed by mid-year 2009 and thus a commercial development decision can be made at that time.

At Blackrod, we are awaiting approvals from the Alberta and Canadian Federal regulatory agencies for our SAGD pilot project. The winter season in 2008 / 2009 will be used to gather additional essential information including cores, water source and disposal information and oil viscosity data. We are targeting a startup date for the Blackrod pilot in the first quarter of 2010. As previously announced we acquired an additional 30% working interest in the Blackrod project on August 20, 2008. In addition, in September and early October, we acquired approximately net 36 sections of crown lands in the area and very recently we have entered into an agreement with our remaining partner Serrano Energy Ltd. (“Serrano”) to swap our equity interests in Serrano for a 15% increased interest in the Blackrod project and a carried work commitment of \$5 million. We expect to close this transaction prior to year end. We have the right and we intend to become operator of the Blackrod project as soon as reasonably practicable.

Our production averaged 5,776 Boed per day during the third quarter down from 8,246 Boed day in the second quarter. The three primary reasons for this drop were the aforementioned sale of non-core producing properties, the forced shut-in of approximately 700 Boed from our Mooney Field due to CO₂ content in the gas greater than permitted on the pipeline and natural declines. We have solved the CO₂ issues through the installation of an amine plant to remove excess CO₂ from our solution gas. Productive capacity is now over 6000 Boed. We expect to exit the year at between 6000 and 7000 Boed. This production is not only vital to our cash flow for development activities but will also be helpful in our resource to reserves strategy.

Despite the current impact of low oil and natural gas prices on our near term cash flow, we remain very encouraged on the value and viability of our large scale heavy oil fields. Our strong balance sheet will allow us to emerge from this crisis in a very favorable position at a time when reserves will hopefully be at a premium as more and more projects are put on hold or delayed. Existing announced refinery upgrade and heavy oil pipeline projects appear to remain on track and will require significant supplies of heavy oil in the future. Our primary goal is to keep our projects moving forward at the best possible speed without exposing the Company to financial leverage or risk until the market recovers.

Keith Hill
President and CEO

November 13, 2008

**PEARL EXPLORATION AND PRODUCTION LTD.
MANAGEMENT'S DISCUSSION AND ANALYSIS
Three months ended September 30, 2008 and 2007**

Management's discussion and analysis ("MD&A") of Pearl Exploration and Production Ltd.'s (the "Company" or "Pearl") financial condition and results of operations should be read in conjunction with the unaudited consolidated financial statements for the three and nine months ended September 30, 2008 and 2007 as contained in this interim report and the MD&A and audited financial statements for the fifteen months ended December 31, 2007 and twelve months ended September 30, 2006 contained in the Company's 2007 Financial Report. The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP") and are presented in Canadian dollars unless otherwise indicated. The effective date of this MD&A is November 13th, 2008.

Additional information relating to the Company is available on SEDAR at www.sedar.com and on the Company's web-site at www.pearleandp.com.

Forward-Looking Statements

Forward-looking statements: This document contains statements about expected or anticipated future events and financial results that are forward-looking in nature and, as a result, are subject to certain risks and uncertainties, such as general economic, market and business conditions, the regulatory process and actions, technical issues, new legislation, competitive and general economic factors and conditions, the uncertainties resulting from potential delays or changes in plans, the occurrence of unexpected events, and the Company's capability to execute and implement its future plans. Actual results may differ materially from those projected by management. Although the Company has attempted to identify important factors that could cause the actual events or results to differ materially from those described in forward-looking statements, readers are cautioned that the foregoing list of risks and factors is not exhaustive and there may be other factors that cause events or results not to be as anticipated, estimated or intended. Forward-looking statements are based on management's estimates, beliefs and opinions on the date the statements are made. Although the Company believes that the expectations represented by such forward-looking statements and the assumptions of the Company upon which they are based are reasonable, there can be no assurance that such expectations will prove to be correct. The Company assumes no obligation except as outlined by regulatory requirements to update forward-looking statements if circumstances of management's estimates, beliefs or opinions should change. Additional information on these and other potential factors that could affect the Company's financial results are detailed in documents filed from time to time with the Alberta, British Columbia and Ontario Securities Commissions. Accordingly, readers should not place undue reliance on forward-looking statements. For such statements, we claim the safe harbour for forward-looking statements within the meaning of the Private Securities Legislation Reform Act of 1995.

All references to BOEs are based on a 6 to 1 conversion ratio. BOEs may be misleading, particularly if used in isolation. A BOE conversion of 6 Mcf: 1 bbl is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead.

OVERVIEW

Pearl is a Canadian-based oil and gas company whose common shares are traded on the TSX Exchange under the symbol "PXX". Pearl's main focus is large, heavy oil projects in Canada and the USA. The Company also holds interests in a number of natural gas properties.

Pearl's core properties include:

- Onion Lake, Saskatchewan – heavy oil;
- Mooney, Alberta – heavy oil;
- Blackrod, Alberta – heavy oil;
- San Miguel, Texas – heavy oil

OPERATIONS UPDATE

Mooney Heavy Oil Project – Alberta

As of the end Q3 2008 Pearl has drilled ten net horizontal wells in our Mooney area thus far in 2008. Four of the eight wells were drilled as part of the polymer pilot which will consist of two polymer injection wells and two producers. Regulatory approval has been obtained for the polymer pilot and polymer injection began in late October of 2008. Preliminary results from the pilot are expected by Q1 2009. Plans for a field wide polymer flood implementation are expected to be finalized by Q2 2009 with the initiation of full field implementation targeted as early as Q4 2009.

In addition we have continued to advance the conversion of the field to a water flood project. During Q3 an additional 1.5 sections were approved for water flood with water injection expected to commence in late Q4 2008 and early Q1 2009.

In addition, one additional section is awaiting waterflood approval which is expected to commence water injection in Q1 2009. The water flood will ultimately assist in both maintaining production levels and increasing reserves as recoveries are expected to increase with the demonstration of pressure maintenance, a decreasing gas/oil ratio ("GOR") and sustained production. In the event that the polymer pilot is successful the investment in the infrastructure implemented for the water flood will be used as base infrastructure for the polymer flood. While the Company expects that the implementation of the water flood will result in both sustained production and higher reserve recovery, in the short term as the field is converted there will be intermittent production disruption in Mooney.

The Company was successful at a crown land sale acquiring 6 sections (1536 hectares) of land at 100% working interest in the Mooney core area.

The Mooney field produced approximately 1,650 Boed during Q3. Production from Mooney was curtailed significantly for approximately nine weeks, beginning at the end of June by approximately 700 Boed. This shut-in was a result of our pipeline provider, on short notice, terminating our ability to ship solution gas that contained higher than permitted CO2 on their system. To rectify the situation we procured, installed and commissioned an amine plant in less than 10 weeks. As a result we now have the capability to remove excess CO2 from our gas stream which allows us to ship our gas production to market without interruption to service.

Onion Lake Heavy Oil Project – Saskatchewan

In Onion Lake the Cyclic Steam Stimulation (CSS) thermal pilot continues. The first well ("Z1") has completed the first steam and production cycles, with a peak rate of over 150 Bopd being achieved. The Z1 well began its second injection cycle September 21/08. Steam injection on the second well ("Z2") began on June 20th and the first production cycle commenced on August 11, 2008. Mechanical issues were experienced during the steam cycle on the Z2 well resulting in a small amount of steam entering the reservoir. As a result, the first production cycle of the Z2 well was lower than expected. It is anticipated that the Z2 well will perform similarly to the Z1 well when similar amounts of steam have been injected into the reservoir. We are currently preparing to begin the second steam cycle in the Z2 well.

During Q3 production from Onion Lake average approximately 2,300 Boed; this excludes production from the CSS thermal pilot as net revenue from the pilot is captured as an offset to the net capital costs for that project.

Blackrod Heavy Oil Project – Alberta

At Blackrod, as previously announced the Company closed a transaction on August 20th to acquire an additional 30% working interest in the Blackrod project area. The company paid \$4.5 million in cash and, if successful, will be required to make additional payments totaling up to \$11 million, based on pre-set criteria of success. In September and early October the Company was also successful at 2 separate crown land sales and acquired an additional 36 sections (9,216 net hectares) of oil sands leases contiguous to our project area. Subsequent to the end of Q3 the Company entered into an agreement with Serrano to increase our working interest in the original project area from 65% to 80% in return for the disposal of our interests in Serrano and a carried work program of net \$5 mm over the next twelve months.

Pearl intends to continue its plan to drill 10 to 15 stratigraphic core wells in the 2008/2009 winter to further delineate this deposit and gather additional petrophysical and reservoir fluid characteristic data. The application for the required governmental approvals of the thermal SAGD pilot project was submitted in May of 2008 and is expected to be approved in the next 6 to 12 months.

There is currently no production at Blackrod and we do not anticipate any production coming from Blackrod until our pilot project is operational. We currently anticipate the pilot being operational in 2010.

San Miguel Heavy Oil Project – Maverick Basin, South Texas

At San Miguel, Pearl and its 50% partner TXCO continued steam injection at the Steam Assisted Gravity Drainage ("SAGD") pilot located within the Chittim "B" Lease. Production, temperature, and pressure monitoring of the well pair continue to confirm that the well pair has entered SAGD mode with initial oil flows being observed.

At Saner Ranch, the pilot facility construction is proceeding on schedule with mechanical completion still expected to be completed in early December. The Saner Ranch pilot includes a vertical inverted five spot well pattern and a horizontal three well pattern that both utilize a modified Fracture Assisted Steamflood Technology ("FAST") process. Steam injection into the vertical inverted five spot pattern commenced on August 28 as part of the reservoir warm-up phase with initial indications of connectivity being observed within the inverted 5 spot pattern. The three horizontal wells were completed in September and achieved first steam injection / reservoir warm-up phase as scheduled on October 8, 2008. Preliminary performance results from both patterns are anticipated during the first half of 2009.

By the end of the second quarter of 2009, Pearl expects to be in a position to select which of the three recovery techniques will be used to form the basis of a commercial development project, SAGD or one of the two modified FAST techniques. In addition, work continues on the commercial aspects of a successful project in San Miguel including the method in which the JV will generate energy to produce steam and the markets and value of the production from the project.

There is currently no commercial production in San Miguel and we do not anticipate any commercial production originating from San Miguel until the JV moves into a commercial development of this resource. We have begun to see early production in the Chittum pilot in October.

Other Properties – Alberta, Saskatchewan

In order to enhance the value of certain non-core assets, Pearl initiated a 9 well drilling program at Ear Lake, Salt Lake and Druid in Q3, which is now complete. All of these wells will initiate production in Q4. Overall, the production increase from this program is expected to reach between 400 and 500 bopd by year end.

Production from other non-core Canadian properties averaged 1,800 Boe/d in Q3. It is still the intention to sell these properties once market conditions improve.

Other Properties – U.S.

The Company also holds interests in several other areas in the United States, including Queen City gas fields, the West Rozel and Gunnison Wedge in Utah, Promised Land and Fiddler Creek in Montana and Queen City gas field in Texas. There is limited or no production from these areas and there are only minor evaluation plans contemplated for these lands in 2008. However, the Company believes certain of these lands contain large resource potential and may, based upon further evaluation, be developed in the future.

In September, we agreed to dispose of our land and tangible interests in the Palo Duro basin to Tyner Resources Ltd. (“Tyner”) in exchange for an equity interest in Tyner. This transaction is consistent with our strategy to focus on our 4 core areas and is expected to close prior to year-end.

Production

Q3 production averaged 5,776 boed in line with expectations given that volumes were curtailed in Mooney due to the previously discussed CO2 issue. That situation has now been addressed and full production in Mooney has been restored. We maintain our previous guidance of 6,000 to 7,000 boed for the remainder of the year.

RESULTS OF OPERATIONS

Oil and Gas Production, Pricing and Revenue

	Three months ended		Nine months ended	
	September 30		September 30	
	2008	2007	2008	2007
Daily production / sales volumes ⁽¹⁾				
Oil (bbl/d)	4,401	6,973	6,578	5,852
Natural gas (mcf/d)	8,156	12,608	9,434	12,758
Combined ⁽¹⁾ (boe/d)	5,776	9,093	8,166	7,998
Product pricing (\$)				
Crude oil - per bbl	95.85	41.94	77.68	40.26
Natural gas - per mcf	8.08	5.01	8.54	6.40
Combined - per boe	85.02	39.17	72.78	39.87
Revenue (000's)				
PNG revenue - gross	45,180	32,786	162,849	87,052
Royalties	(11,962)	(7,889)	(40,849)	(19,495)
PNG revenue - net	33,218	24,898	122,000	67,557

* gas production converted at 6:1

(1) Includes small amounts of NGLs not separately identified in the table

For the three months ended September 30, 2008 production has decreased from the prior year three-months ended September 30, 2007 due to the company disposing of non-core properties during the prior quarter representing approximately thirty percent of daily production, natural decline and the unscheduled shut-in of approximately 700 Boed of production in Mooney due to the requirement to install and an amine facility to decrease the CO₂ in our associated gas production. In addition during the current quarter, wells were taken offline in order to complete some drilling in Mooney.

The significant increase in revenue for both the three and nine months ended September 30, 2008 is primarily due to the higher market pricing for heavy oil and natural gas in 2008.

Royalties

	Three months ended September 30		Nine months ended September 30	
	2008	2007	2008	2007
Royalties	11,962	7,889	40,849	19,495
as a percentage of PNG revenue	26%	24%	25%	22%

Royalties represent charges against production or revenue by governments and landowners. Royalties for the three and nine months ended September 30, 2008 increased over the comparable periods of 2007. This increase is consistent with the increase in revenues during the period.

As expected royalties as a percentage of revenue are consistent between 2008 and 2007.

PNG Operating Expenses and Netbacks

	Three months ended September 30				Nine months ended September 30			
	2008		2007		2008		2007	
	Total	Per boe	Total	Per boe	Total	Per boe	Total	Per boe
Average daily production	5,776		9,093		8,166		7,998	
Gross PNG revenue	45,180	85.02	32,786	39.17	162,849	72.78	87,052	39.87
Royalties	(11,962)	(22.51)	(7,889)	(9.43)	(40,849)	(18.26)	(19,495)	(8.93)
Net PNG revenue	33,218	62.51	24,897	29.74	122,000	54.52	67,557	30.94
Operating costs	(9,272)	(17.45)	(12,245)	(14.64)	(39,609)	(17.70)	(33,327)	(15.26)
Transportation	(686)	(1.29)	(498)	(0.59)	(2,886)	(1.29)	(2,571)	(1.18)
PNG netback	23,260	43.77	12,154	14.51	79,505	35.53	31,659	14.50

Operating Expenses

Third quarter operating costs on a per boe basis were higher when compared to the same period in 2007, averaging \$17.45 for the three months ended September 30, 2008 in comparison to \$14.64 per boe in 2007. For the nine months ended September 30, 2008 operating costs were \$17.70 per boe as compared to \$15.26 for the nine months ended September 30, 2007. The increase in per unit operating costs for the nine month period is principally due to several factors including: (i) high cost of propane incurred in Q1; (ii) timing of focusing resources on developing efficiencies with regards to operating costs; and (iii) \$2.2 million or \$1.02 per boe of underestimated 3rd party costs that related to prior periods that was recognized in the first quarter. Installation of a fuel gas system has helped to alleviate the high cost of propane in the second and third quarters.

PNG netbacks are significantly higher in both the three and nine months ended September 30, 2008 when compared to 2007 results. The increase is due to the higher price of oil and gas in 2008.

General and Administrative Expenses ("G&A")

General and administrative expenses were \$3.6 million in the third quarter of 2008 compared to \$4.3 million in 2007. On a per unit basis, G&A was \$6.71 per boe compared to \$5.10 per boe in 2007. General and administrative costs have increased by \$1.61 per boe from the same period in 2007 due to a decrease in production. The gross costs have decreased by \$0.7 million due to a corporate focus on decreasing administrative costs and an overall decrease in

corporate acquisition activities but offset slightly by higher exchange related costs associated with moving our shares from the Toronto venture exchange (TSX-V) to the main exchange (TSX).

G&A for the nine months ended September 30, 2008 was \$10.0 million or \$4.46 per boe compared to \$10.8 million or \$4.94 per boe in 2007. The decrease of \$0.48 per boe from 2007 is again principally due to the same reasons noted for the above three months ended September 30, 2008.

Depletion, Depreciation and Accretion (“DD&A”)

DD&A expense was \$13.7 million or \$25.73 per boe for the three months ended September 30, 2008 in comparison to \$23.4 million or \$27.98 per boe for the three months ended September 30, 2007. For the nine months ended September 30, 2008 DD&A expense was \$57.7 million or \$25.79 per boe in comparison to \$63.3 million or \$28.98 for the same period of 2007. The lower rate in 2008 is due to increased proved reserves as a result of the significant drilling and acquisition activity in 2007.

Interest Expense

Interest expense for the three months ended September 30, 2008 was \$0.03 million in comparison to \$1.2 million for the three months ended September 30, 2007. Interest expense relates to the Company's bank debt. The Company had an average debt level of \$0.4 million and an effective interest rate of 6.24% for the three months ended September 30, 2008. Lower interest expense is due to a lower dependence on debt financing during the period.

For the nine months ended September 30, 2008 interest expense was \$0.8 million in comparison to \$2.9 million for the same period in 2007. The Company's average debt balance was \$14.9 million with an effective interest rate of 5.42% for the nine months ended September 30, 2008. Lower interest expense is due to a lower dependence on debt financing during the period.

Change in unrealized loss on gas pricing contracts

The change in unrealized loss on gas pricing contracts for the nine months ended September 30, 2007 relates to gas contracts acquired as part of the Atlas acquisition in December, 2006.

Other items

For the three and nine months ended September 30, 2008 there was a dilution gain of \$2.3 million recorded on the investment in Serrano and a \$2.6 million writedown of the investment in Asset-backed commercial paper (“ABCP”). Both of these items are discussed in more detail in note 5 of the financial statements. For the nine months ended September 30, 2007 a \$13.3 million gain was recorded on the sale of its Gulf of Mexico leases in exchange for shares of Bayou Bend Petroleum Ltd.

Income Taxes

The provision for future income taxes for the quarter ended September 30, 2008 was \$2.6 million compared to a recovery of \$5.4 million for the three months ended September 30, 2007. As at September 30, 2008, the Company has recognized a future tax liability of \$1.9 million due to the decrease of our tax pool balances as a result of our asset sales during 2008 and due to the high revenues we have realized thus far in 2008.

For the nine months ended September 30, 2008, future income taxes were \$2.6 million in comparison to a recovery of \$5.0 million for the comparable period in 2007. Reasons for the significant change year to year are noted above for the three month period.

Current tax of \$1.9 million for the nine months ended September 30, 2008 is comprised of Saskatchewan capital tax and resource surcharge. The \$8.3 million tax expense for the same period of 2007 was a result of the sale of certain assets in the United States

Net Income (Loss)

Net income for the quarter ended September 30, 2008 was \$1.9 million in comparison to a net loss of \$13.7 million for the quarter ended September 30, 2007. Earnings for the nine months ended September 30, 2008 were \$4.8 million, a \$43.4 million improvement over the nine months ended September 30, 2007 reported net loss of \$38.5 million. The significant increase in 2008 net income is principally due to increased revenues caused by the high market price for heavy oil and natural gas in the first nine months of 2008.

LIQUIDITY AND CAPITAL RESOURCES

At September 30, 2008, the Company had \$47.0 million of remaining credit capacity available under its \$37.0 million extendible term credit facility and \$10.0 million demand revolving credit facility.

At September 30, 2008, the Company had working capital surplus of \$36.2 million compared to a working capital deficit of \$34.2 million at December 31, 2007.

Funds from operations were \$21.0 million for the three months ended September 30, 2008 compared to funds from operations of \$6.3 million for the three months ended September 30, 2007. For the nine months ended September 30, 2008 funds from operations were \$68.5 million as compared to \$11.5 million for the nine months ended September 30, 2007. The improvement in funds from operations is principally due to higher commodity prices and to a lesser extent higher average production and lower G&A expenses.

Net cash used in financing activities for the quarter ended September 30, 2008 was \$5.0 million compared to net cash from financing activities of \$44.4 million for the quarter ended September 30, 2007. During the current quarter the Company repaid \$5.0 million on its credit facility. Significant financing activities from the quarter ended September 30, 2007 included (i) the net repayment of \$14.0 million of debt, and (ii) the net proceeds of \$58.4 million from an equity financing.

Net cash from financing activities was \$nil for the nine months ended September 30, 2008 in comparison to net cash from financing activities of \$24.3 million for the nine months ended September 30, 2007. The repayment of \$5.0 million on the Company's bank loan was the only financing activity for the current period. Significant financing activities from the nine months ended September 30, 2007 included (i) a net repayment of \$34.7 million of the Company's debt, and (ii) net proceeds of \$58.4 million from equity financing, and (iii) \$0.6 million from the exercise of stock options.

Net cash used in investing activities was \$22.0 million for the three months ended September 30, 2008 compared to net cash used in investing activities of \$42.8 million for the three months ended September 30, 2007. During the current quarter, the Company sold certain non-core heavy oil producing assets for \$3.8 million and spent \$39.5 million on exploration, development and lease acquisition activities. Investing activities during the quarter ended September 30, 2007 included \$47.4 million spent on exploration, development and lease acquisition activities.

Net cash used in investing activities for the nine months ended September 30, 2008 was \$13.9 million compared to net cash used in investing activities of \$113.4 million in the same period of 2007. In addition to the \$79 million from the sale of assets, the Company spent \$74.6 million on exploration, development and lease acquisition activities during the first nine months of 2008. During the nine months ended September 30, 2007 the Company's exploration, development and lease acquisition activities totaled \$140.8 million, corporate acquisition costs totaled \$11.3 million and the sale of Bayou Bend shares generated \$10.0 million.

During Q3 the Company announced that it had increased its capital budget for 2008 to approximately \$135 million, up from the original budget of \$61.0 million. Since the time of our announcement to expand our budget, the world price of oil and the North American price of natural gas have declined dramatically. In-turn the prices that we receive for our products have also been dramatically impacted by the decreasing broader market values for these commodities.

The Company remains dedicated to our capital budget philosophy; which is to fund capital budgets based on available cash flow from operations, non-core asset sales and to limit the timing of our capital expenditures such that we will only ever use a maximum of 50% of our current borrowing base. As such, as a result of the dramatic decrease in current commodity prices we have deferred several of the projects in our recently announced budget increase to \$135 million to result in a firm budget of approximately \$110 million for 2008. This decreased budget is still principally focused on Mooney: accelerating the polymer pilot, expansion of the water flood and related infrastructure and delineation drilling in the western portion of the eastern field. However, some production increases and pilot advancement activities will be delayed by this capital budget cut. It is the intention of the Company to re-instate these deferred projects when the price of oil and natural gas increase, resulting in increased cash flow from operations that is available for capital investment.

While there are no current plans to raise additional funds in the form of either debt or equity, in the future as our projects move from pilot projects to development projects, the Company may consider additional issuances of common shares or debt instruments to assist with financing these developments to the extent that sufficient cash flow from operations is inadequate. The Company may consider divesting additional non-core oil and gas assets or farming out interests in oil and gas properties to finance its operations. Accordingly, the Company's consolidated financial statements are presented on a going-concern basis.

CAPITAL EXPENDITURES

Capital expenditures for the three and nine months ended September 30, 2008 and 2007 are as follows:

	2008	2007	2008	2007
Land	1,207,620	812,108	2,071,613	1,616,811
Seismic	407,647	218,122	968,861	1,227,589
Drilling and completion	27,830,145	35,186,887	41,335,656	103,390,831
Equipment	5,236,987	5,576,523	24,424,744	23,277,153
Other	-	700,423	561,003	1,967,417
Total exploration and development	34,682,399	42,494,063	69,361,877	131,479,801
Corporate acquisition	-	-	-	8,809,049
Property acquisitions	4,797,608	11,678,057	5,235,356	17,381,053
Property dispositions	(3,760,800)	(6,726,454)	(79,097,031)	(15,573,771)
Total capital expenditures	35,719,207	47,445,666	4,499,798	142,096,132

RELATED PARTY TRANSACTIONS

Tanganyika Oil Company Ltd. ("Tanganyika") provides administrative and technical services to the Company from time to time based upon time and expenses incurred by Tanganyika. For the nine months ended September 30, 2008, Tanganyika charged the Company \$58,643 (2007 - \$127,773). Tanganyika and Pearl have certain directors and officers in common.

Namdo Management Services Ltd. ("Namdo") provides executive and support services to the Company. For the nine months ended September 30, 2008, the Company paid Namdo \$135,000 (2007 - \$78,000). Namdo is a private corporation owned by Lukas H. Lundin, a director of the Company.

RISKS AND UNCERTAINTIES

The Company is exposed to a number of risks and uncertainties inherent in exploring for, developing and producing crude oil and natural gas. These risks and uncertainties include, but are not limited to, the following:

- risk of finding and producing reserves economically;
- uncertainty associated with obtaining drilling licenses and other regulatory consents and approvals;
- production risks associated with sour hydrocarbons;
- marketing reserves at acceptable prices;
- cost of capital risk associated with securing the needed capital to carry out the Company's operations;
- risk of fluctuating oil and natural gas prices;
- risk of fluctuating foreign currency exchange rates;
- risk of governmental policies, social instability or other political, economic or diplomatic developments in its operations;
- market risks associated with investing the Company's cash reserves in interest bearing depository instruments; and
- environmental risks related to its oil and gas properties.

Many of the previously mentioned risks are beyond the Company's control, and it is impossible to ensure that any exploration drilling program or piloting program will ultimately result in commercial operations. The Company does not currently utilize derivative instruments to hedge its commodity price, foreign currency exchange or interest rate risks.

Pearl strives to minimize and manage these risks in a number of ways, including:

- Employing qualified professional and technical staff;
- Communicating openly with members of the public regarding its activities;
- Concentrating in a limited number of areas;
- Utilizing the latest technology for finding and developing reserves;
- Constructing high-quality, environmentally sensitive, safe production facilities; and
- Maximizing operational control of drilling and producing operations.

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 federal, provincial and local laws and regulations. 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. In 2002, the Government of Canada ratified the Kyoto Protocol (the "Protocol"), which calls for Canada to reduce its greenhouse gas emissions to specified levels. There has been much public debate with respect to Canada's ability to meet these targets and the government's strategy or alternative strategies with respect to climate change and the control of greenhouse gases. Implementation of strategies for reducing greenhouse gases, whether to meet the limits required by the Protocol or as otherwise determined, could have a material impact on the nature of oil and natural gas operations, including those of the Company. Given the evolving nature of the debate related to climate change and the control of greenhouse gases and resulting requirements, it is not possible to predict either the nature of those requirements or the impact on the Company and its operations and financial condition.

NEW ACCOUNTING STANDARDS ADOPTED

As disclosed in the December 31, 2007 annual audited consolidated financial statements, on January 1, 2008, the Company adopted the new CICA Handbook Sections 3862 "Financial Instruments – Disclosures", 3863 "Financial Instruments – Presentation", and 1535 "Capital Disclosures". The adoption of these standards has had no material impact on the Company's net income or cash flows. Additional information on the implementation of these new standards can be found in Note 3 to the Interim Consolidated Financial Statements.

RECENT ACCOUNTING PRONOUNCEMENTS

Goodwill and Intangible Assets

As of January 1, 2009, Pearl will be required to adopt Section 3064 "Goodwill and Intangible Assets," which revises the requirement for recognition, measurement, presentation and disclosure of intangible assets and replaces the existing Goodwill and Intangible Asset standard. The adoption of this standard should not have a material impact on the Company's consolidated 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, the Accounting Standards Board confirmed in February, 2008 that International Reporting Standards ("IFRS") will replace Canadian GAAP for profit-oriented Canadian publicly accountable enterprises in 2011. Pearl is assessing the potential impact of this change and developing a plan accordingly.

INTERNAL CONTROLS OVER FINANCIAL REPORTING

The Company has, under the supervision of its chief financial officer, designed a process for internal control over financial reporting, which process has been effected by the Company's board of directors and management. The process was designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP and incorporates policies and procedures as described above. There have been no changes in the Company's systems of internal control over financial reporting that would materially affect, or is reasonably likely to materially affect, the company's internal controls over financial reporting.

It should be noted that a control system, including the Company's disclosure and internal controls and procedures, no matter how well conceived can provide only reasonable, but not absolute, assurance that the objectives of the control system will be met and it should not be expected that the disclosure and internal controls and procedures will prevent all errors or fraud.

OUTLOOK

The Company plans to continue pursuing large North American heavy oil resource opportunities to add to its portfolio, to seek to rationalize non-core assets, and to focus on conversion of resources to reserves and development of its existing interests in the USA and Canada.

BOEs

Throughout this MD&A the calculation of barrels of oil equivalent (boe) is calculated at a conversion rate of six thousand cubic feet (mcf) of natural gas for one barrel of oil and is based on an energy equivalence conversion method. BOEs may

be misleading, particularly if used in isolation. A boe conversion ratio of 6 mcf:1 bbl is based on an energy equivalence conversion method primarily applicable at the burner tip and does not represent a value equivalence at the wellhead.

Non-GAAP Measures

Included in this report are references to terms commonly used in the oil and gas industry, such as, cash flow and funds from operations which represent cash flow from operating activities expressed before changes in non-cash working capital, long-term receivable and asset retirement costs incurred and are used by the Company to analyze operating performance, leverage and liquidity. These terms do not have standardized meanings prescribed by GAAP and therefore may not be comparable with the calculations of similar measures for other entities. Consequently, these are referred to as non-GAAP measures.

PEARL EXPLORATION AND PRODUCTION LTD.

Consolidated Balance Sheet
(unaudited)

	September 30, 2008	December 31, 2007
Assets		
Current assets		
Cash	\$ 52,288,900	\$ 4,799,186
Accounts receivable	24,707,344	25,134,435
Income taxes and capital taxes receivable	2,817,446	2,618,015
Prepaid expenses and deposits	1,390,011	3,195,770
	81,203,701	35,747,406
Investments (note 5)	9,056,027	9,362,895
Petroleum and natural gas properties (note 6)	464,695,831	528,352,540
Future income tax	-	2,402,532
	\$ 554,955,559	\$ 575,865,373
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	45,056,965	69,899,310
	45,056,965	69,899,310
Long-term liabilities		
Asset retirement obligation (note 8)	11,525,869	16,586,030
Future income tax	1,972,876	-
	58,555,710	86,485,340
Shareholders' equity		
Share capital (note 10)	723,121,821	723,121,821
Contributed surplus (note 11)	10,974,502	8,778,124
Deficit	(237,696,474)	(242,519,912)
	496,399,849	489,380,033
	\$ 554,955,559	\$ 575,865,373
Commitments (note 13)		
Contingencies (note 16)		
<i>See accompanying notes to consolidated financial statements</i>		

PEARL EXPLORATION AND PRODUCTION LTD.

Consolidated Statement of Operations and Deficit (unaudited)

	Three months ended September 30		Nine months ended September 30	
	2008	2007	2008	2007
Revenue				
Oil and gas sales	\$ 45,180,194	\$ 32,786,237	162,848,816	\$ 87,051,517
Interest income	420,090	18,802	1,146,227	302,342
Royalties	(11,961,858)	(7,888,734)	(40,848,856)	(19,495,302)
	<u>33,638,426</u>	<u>24,916,305</u>	<u>123,146,187</u>	<u>67,858,557</u>
Expenses				
Production costs	9,272,258	12,245,376	39,609,214	33,326,783
Transportation costs	685,605	497,724	2,886,210	2,570,874
General and administrative	3,566,000	4,268,083	9,979,160	10,779,543
Depletion, depreciation and accretion	13,670,991	23,406,095	57,706,350	63,265,388
Stock-based compensation	775,293	777,877	2,196,377	2,653,273
Interest	27,143	1,246,596	808,868	2,885,179
Change in unrealized loss of gas pricing contracts	-	-	-	487,760
Foreign currency exchange loss (gain)	260,152	118,534	223,441	386,756
	<u>28,257,442</u>	<u>42,560,285</u>	<u>113,409,620</u>	<u>116,355,556</u>
Other items				
Gain on investment	(2,268,028)	-	(2,268,028)	-
Gain on sale of assets	-	-	-	(13,270,044)
Writedown of ABCP	2,574,896	-	2,574,896	-
	<u>306,868</u>	<u>-</u>	<u>306,868</u>	<u>(13,270,044)</u>
Income (loss) before income taxes	<u>5,074,116</u>	<u>(17,643,980)</u>	<u>9,429,699</u>	<u>(35,226,955)</u>
Income taxes				
Future income taxes (recovery)	2,650,137	(5,400,712)	2,663,958	(5,007,942)
Income taxes and capital taxes	498,059	1,439,267	1,942,303	8,316,938
	<u>3,148,196</u>	<u>(3,961,445)</u>	<u>4,606,261</u>	<u>3,308,996</u>
Net income (loss) for the period	<u>1,925,920</u>	<u>(13,682,535)</u>	<u>4,823,438</u>	<u>(38,535,951)</u>
Deficit, beginning of period	<u>(239,622,394)</u>	<u>(45,430,584)</u>	<u>(242,519,912)</u>	<u>(20,577,168)</u>
Deficit, end of period	<u>\$ (237,696,474)</u>	<u>\$ (59,113,119)</u>	<u>(237,696,474)</u>	<u>\$ (59,113,119)</u>
Basic and diluted income (loss) per share	\$ 0.01	\$ (0.09)	0.03	\$ (0.28)
Weighted average number of common shares used in computing earnings per share:				
basic	189,241,716	145,615,529	189,241,716	137,389,099
diluted	189,241,716	145,880,287	189,242,004	137,741,368

See accompanying notes to consolidated financial statements

Consolidated Statement of Comprehensive Income (Loss) and Accumulated Other Comprehensive Income (unaudited)

	Three months ended September 30		Nine months ended September 30	
	2008	2007	2008	2007
Net income (loss)	\$ 1,925,920	\$ (13,682,535)	\$ 4,823,438	\$ (38,535,951)
Other comprehensive income, net of tax				
Items affecting comprehensive income	-	(5,300,000)	-	(4,550,000)
Comprehensive income (loss)	<u>\$ 1,925,920</u>	<u>\$ (18,982,535)</u>	<u>\$ 4,823,438</u>	<u>\$ (43,085,951)</u>
Accumulated other comprehensive income, beginning of period	\$ -	\$ 750,000	\$ -	\$ -
Other comprehensive income, net of taxes	-	(5,300,000)	-	(4,550,000)
Accumulated other comprehensive income, end of period	<u>\$ -</u>	<u>\$ (4,550,000)</u>	<u>\$ -</u>	<u>\$ (4,550,000)</u>

See accompanying notes to consolidated financial statements

PEARL EXPLORATION AND PRODUCTION LTD.

Consolidated Statements of Cash Flows (unaudited)

	Three months ended September 30		Nine months ended September 30	
	2008	2007	2008	2007
Operating activities				
Income (loss)	\$ 1,925,920	\$ (18,982,535)	\$ 4,823,438	\$ (43,085,951)
Items not involving cash:				
Mark to market gain on available-for-sale financial asset	-	5,300,000	-	4,550,000
Writedown of accounts receivable	1,014,252	1,285,098	824,655	2,537,098
Writedown of ABCP	2,574,896	-	2,574,896	-
Gain on sale of assets	-	-	-	(13,270,044)
Gain on investment	(2,268,028)	-	(2,268,028)	-
Depletion, depreciation and accretion	13,670,991	23,406,095	57,706,350	63,265,388
Stock-based compensation	775,293	777,877	2,196,377	2,653,273
Future income tax (recovery)	2,650,137	(5,400,712)	2,663,958	(5,007,942)
Change in unrealized loss of gas pricing contracts	-	-	-	487,760
Foreign exchange loss (gain)	260,152	118,534	223,441	386,756
Abandonment costs	416,904	(236,612)	(249,225)	(1,047,950)
	<u>21,020,517</u>	<u>6,267,745</u>	<u>68,495,862</u>	<u>11,468,388</u>
Changes in non-cash working capital balances related to operations	3,501,052	(3,100,923)	(7,057,885)	(5,246,993)
Long term accounts receivable	-	-	-	1,066,758
	<u>24,521,569</u>	<u>3,166,822</u>	<u>61,437,977</u>	<u>7,288,153</u>
Financing activities				
Advances of bank loan	-	10,000,000	25,000,000	75,000,000
Repayments of bank loan	(5,000,000)	(24,000,000)	(25,000,000)	(109,670,719)
Proceeds from equity financings, net of issue costs	-	58,364,871	-	58,364,870
Exercise of stock options	-	34,100	-	605,325
	<u>(5,000,000)</u>	<u>44,398,971</u>	<u>-</u>	<u>24,299,476</u>
Investing activities				
Acquisition of Cipher Exploration Inc.	-	-	-	(8,809,049)
Acquisition of Serrano shares	-	-	-	(2,500,000)
Proceeds from sale of investments	-	-	-	10,000,000
Proceeds from sale of assets	3,760,800	-	79,097,031	-
Additions to petroleum and natural gas properties	(39,480,007)	(47,445,666)	(74,597,233)	(140,787,082)
Changes in non-cash working capital from investing	13,737,291	4,673,781	(18,448,061)	28,709,600
	<u>(21,981,916)</u>	<u>(42,771,885)</u>	<u>(13,948,263)</u>	<u>(113,386,531)</u>
Net increase (decrease) in cash	(2,460,347)	4,793,908	47,489,714	(81,798,902)
Cash, beginning of period	54,749,247	4,465,393	4,799,186	91,058,203
Cash, end of period	\$ 52,288,900	\$ 9,259,301	\$ 52,288,900	\$ 9,259,301
Supplementary Information				
Interest paid	\$ 27,143	\$ 1,245,596	\$ 808,868	\$ 2,847,956
Capital taxes paid	\$ -	\$ -	\$ 1,009,957	\$ -

See accompanying notes to consolidated financial statements

PEARL EXPLORATION AND PRODUCTION LTD.
Notes to the Consolidated Financial Statements
(unaudited)

1. NATURE OF OPERATIONS

Pearl Exploration and Production Ltd. (collectively with its subsidiaries, the “Company” or “Pearl”) is listed and traded on the TSX Exchange under the trading symbol “PXX”. The Company is engaged in the business of oil and gas exploration and development in North America.

2. BASIS OF PRESENTATION

The interim consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries: Pearl E&P Canada Ltd., CODA Holdings Corp., Pearl Exploration and Production USA Ltd., Pearl Exploration and Production Montana Ltd., Newmex Energy (USA) Inc., Valkyries Texas Corp., and Valkyries Texas Gas Ltd. Both Cipher Exploration Inc. and Watch Resources Ltd. were amalgamated with Pearl E & P Canada Ltd. on January 1, 2008.

The interim consolidated financial statements for the Company have been prepared in accordance with accounting principles generally accepted in Canada, using the same accounting policies and methods of computation as set out in note 3 to the audited consolidated financial statements in the Company’s Financial Report for the fifteen months ended December 31, 2007. The disclosures provided herein are incremental to those included with the audited consolidated financial statements. The interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements for the fifteen months ended December 31, 2007 and the interim consolidated financial statements for the quarters ended March 31 and June 30, 2008.

3. CHANGES IN ACCOUNTING POLICIES

As disclosed in the December 31, 2007 annual audited Consolidated Financial Statements, on January 1, 2008, the Company adopted the following Canadian Institute of Chartered Accountants (“CICA”) Handbook Sections:

- Section 3862 “Financial Instruments – Disclosures” and Section 3863 “Financial Instruments – Presentation,” which replace Section 3861 “Financial Instruments – Disclosure and Presentation.” The new disclosure standard increases the emphasis on the risks associated with financial instruments and how those risks are managed (See Note 14). The new presentation standard carries forward the former presentation requirements.
- Section 1535 “Capital Disclosures,” The new standard requires the Company to disclose its objectives, policies and processes for managing its capital structure (See Note 12).

4. RECENT ACCOUNTING PRONOUNCEMENTS

As of January 1, 2009, the Company will be required to adopt the CICA Handbook Section 3064, “Goodwill and Intangible Assets”, which will replace the existing Goodwill and Intangible Assets standard. The new standard revises the requirement for recognition, measurement, presentation and disclosure of intangible assets. The adoption of this standard should not have a material impact on the Company’s Consolidated Financial Statements.

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 with International Financial Reporting Standards (“IFRS”) for fiscal periods commencing on or after January 1, 2011. The Company is assessing the potential impacts of this changeover and developing a plan for the conversion.

5. INVESTMENTS

	September 30, 2008	December 31, 2007
Investment in Serrano Energy Ltd. (“Serrano”)	\$7,768,028	\$5,500,000
Asset-backed commercial paper (“ABCP”)	1,287,999	3,862,895
	\$9,056,027	\$9,362,895

The Company owns approximately 4.0 million shares of Serrano. On August 20, 2008, a third party participated in a private placement of common shares in Serrano for an amount of \$55.0 million. However, the terms of the placement were such that the Company’s ownership position, formerly 37 percent was reduced to approximately 18 percent. As the shares issued under the placement were sold at a per share price greater than the per share price of the Company’s initial investment, the Company recognized a dilution gain of \$2.3 million. As the Company’s ownership position is now

below the threshold applicable to equity accounting, it accounts for this investment using the cost method; correspondingly, gains or losses will only be recognized upon disposal of the shares held.

The Company holds an investment in ABCP as part of the Watch acquisition on October 19, 2007. Prior to the acquisition of Watch major participants in the third party sponsored ABCP market announced a proposed solution to the liquidity problem in the ABCP market. A restructuring plan was ultimately submitted to the Ontario Superior Court of Justice under the Companies Creditors Arrangement Act (CCAA) which was sanctioned on June 5, 2008. On June 18, 2008 proceedings were taken by a number of corporate noteholders to the Ontario Court of Appeal seeking to challenge the Courts decision that sanctioned the restructuring plan. On August 18, 2008, the Ontario Court of Appeal dismissed the appeal. On September 2, 2008, a number of unsuccessful appellants sought leave to appeal the decision to the Supreme Court of Canada. On September 19, 2008 the Supreme Court announced that it would not grant leave to hear the appeal. The Committee has now commenced the process for implementation of the restructuring with a view of completing implementation by the end of November 2008. The ABCP investment will be converted into notes with maturities matching the underlying assets. The notes will bear interest rates commensurate with the nature of the underlying assets including the cost of a margin funding facility.

At the time of the acquisition of Watch the Company determined that the estimated fair value of the ABCP was \$1.1 million less than the face value. The valuation technique used by the Company to estimate the fair value of its investments in ABCP incorporates probability – weighted discounted cash flows considering the best available public information regarding market conditions and other factors that a market participant would consider for such investments. As at September 30, 2008 the Company determined that a further downward adjustment of \$2.6 million was required at this time. The historical decrease that has affected all the capital markets provides significant uncertainties regarding the value of the assets which underlie the ABCP, the potential development of a liquid market for the replacement notes and as a result the amount and timing of cash flows and the outcome of the restructuring process all give rise to a further decrease in the value of the Company's investment in ABCP.

6. PETROLEUM AND NATURAL GAS PROPERTIES

	September 30, 2008		
	Cost	Accumulated depreciation and depletion	Net book value
Petroleum and natural gas properties	\$616,248,746	\$153,279,238	\$462,969,508
Office equipment	2,401,745	675,422	1,726,323
	<u>\$618,650,491</u>	<u>\$153,954,660</u>	<u>\$464,695,831</u>
	December 31, 2007		
	Cost	Accumulated depreciation and depletion	Net book value
Petroleum and natural gas properties	\$623,916,051	\$96,763,951	\$527,152,100
Office equipment	1,520,287	319,847	1,200,440
	<u>\$625,436,338</u>	<u>\$97,083,798</u>	<u>\$528,352,540</u>

The depletion and ceiling test calculations have excluded the cost of unproved properties of \$66.3 million (December 31, 2007 – \$61.0 million) and included the cost of future development costs of \$82.1 million (December 31, 2007 – \$145.0 million).

7. BANK CREDIT FACILITY

The Company has a credit facility with a Canadian chartered bank which is comprised of a \$37 million revolving 364-day extendible term facility, and a \$10 million demand revolving operating facility. The Company may borrow, repay and re-borrow advances with the aggregated outstanding not to exceed the total credit facility. The facility bears interest at the bank prime rate payable monthly and is secured by a general securities agreement. The facility is subject to annual reviews. The next scheduled review will take place on May 31, 2009.

8. ASSET RETIREMENT OBLIGATION

The total future asset retirement obligation was estimated based on the Company's net ownership interest in all wells and facilities, the estimated costs to abandon and reclaim the wells and facilities and the estimated timing of the costs to be incurred in future periods. The total undiscounted amount of the estimated cash flows required to settle the asset retirement obligations is approximately \$27.6 million which will be incurred over the next 48 years with the majority of costs incurred between 2008 and 2025.

A credit adjusted risk-free rate of 8 percent and an inflation factor of 1.5 percent was used to calculate the fair value of the asset retirement obligation.

Changes to the asset retirement obligation were as follows:

		September 30, 008		December 31, 2007
Asset retirement obligation at beginning of period	\$	16,586,030	\$	3,772,479
Liabilities acquired through acquisitions, net of dispositions		(6,404,132)		9,822,642
Liabilities incurred during the period		757,708		2,987,539
Actual remediation expenses		(249,225)		(1,164,822)
Accretion		835,488		1,168,192
Asset retirement obligation at end of period	\$	11,525,869	\$	16,586,030

9. RELATED PARTY TRANSACTIONS

During the nine months ended September 30, 2008 the Company entered into the following transactions with related parties in the normal course of business, which are recorded at the exchange amount established and agreed to by the related parties:

(a) The Company paid \$58,643 (2007 – \$127,773) to Tanganyika Oil Company Ltd. ("Tanganyika") for administrative and other services. The Company and Tanganyika have certain officers and directors in common.

(b) The Company paid \$135,000 (2007 – \$78,000) to Namdo Management Services Ltd. ("Namdo") for executive and support services pursuant to a services agreement. Namdo is a private corporation owned by Lukas H. Lundin, a director of the Company.

10. SHARE CAPITAL

(a) Authorized:

The Company is authorized to issue an unlimited number of common shares.

(b) Common Shares Issued:

	Number of Shares	Attributed Value
Balance as at September 30, 2008 and December 31, 2007	189,241,716	\$ 723,121,821

(c) Warrants Outstanding:

	Number of whole warrants	Weighted average exercise price per share
Outstanding at December 31, 2007	4,091,800	\$ 0.98
Cancelled	(91,800)	
Outstanding at September 30, 2008	4,000,000	1.00

(i) Four million warrants were issued pursuant to the San Miguel acquisition in November 2005. Each warrant entitles the holder thereof to purchase an additional common share of the Company at a price of \$1.00, exercisable from the date the San Miguel heavy oil project achieves an average daily producing rate of 5,000 barrels of oil per day, averaged over 30 consecutive days, until November 18, 2008.

(ii) In connection with the December, 2005 Palo Duro acquisition, the Company issued 270,000 warrants. This number was subsequently reduced by 66% to 91,800 when the vendor exercised a back-in right on March 3, 2006. Each remaining warrant provides the warrant holder with the right to receive an additional common share of the Company, within 75 days of September 15, 2008, for no additional consideration, if the average production rate per well drilled in

the Palo Duro shale gas project is at least 1.5 million cubic feet equivalent per day, based on the initial 60 days of production. The number of warrants ultimately issued will be reduced pro rata to the actual average production rate if the actual average production rate per well drilled by September 15, 2008 is less than 1.5 million cubic feet equivalent per day. There was no production by September 15, 2008 and the warrants accordingly have now expired.

11. STOCK-BASED COMPENSATION

The Company has a stock option plan (the "plan") for directors, officers, consultants and employees of the Company and its subsidiaries. A total of 18,924,172 stock options are authorized to be issued under the plan. Stock options have terms of two to five years, vest over periods of up to three years and are exercisable at the market prices of the shares on the dates that the options were granted. All of the options are subject to a four-month "hold" period.

The continuity of stock options issued and outstanding is as follows:

	<u>Number of Options</u>	<u>Weighted Average Exercise Price \$</u>
Outstanding December 31, 2007	7,726,357	3.98
Granted	1,460,500	1.77
Cancelled	(1,445,254)	4.22
Expired	(1,401,667)	4.19
Outstanding at September 30, 2008	<u>6,339,936</u>	<u>3.36</u>

The following stock options were outstanding at September 30, 2008:

Range of Exercise Prices (\$)	Options Outstanding			Options Exercisable		
	Number	Weighted-Average Exercise Price (\$)	Weighted-Average Life (Years)	Number	Weighted-Average Exercise Price (\$)	Weighted-Average Life (Years)
1.43 - 3.00	3,228,000	2.19	4.47	-		
3.01 - 4.50	1,250,936	3.83	3.07	634,269	4.14	2.16
4.51 - 5.28	1,861,000	5.09	3.20	663,666	5.08	3.04
	<u>6,339,936</u>	<u>3.37</u>	<u>3.82</u>	<u>1,297,935</u>	<u>4.62</u>	<u>2.61</u>

Compensation expense of \$2,703,818, net of recovery of \$507,440 for cancelled stock options, has been recorded in the Consolidated Statements of Operations and Deficit for the nine months ended September 30, 2008 (2007 – \$2,653,273). The fair value of common share options granted is estimated on the date of grant using the Black-Scholes option pricing model. The weighted average fair value of options granted during 2008 and the assumptions used in their determination are as noted below:

Nine Months Ended September 30, 2008

Weighted average fair value of stock options granted (per option)	\$0.79
Expected life of stock options (years)	3.00
Volatility (weighted average)	64%
Risk free rate of return (weighted average)	3.26%
Expected dividend yield	0%

Contributed surplus continuity	<u>September 30, 2008</u>	<u>December 31, 2007</u>
Balance, beginning of the period	\$ 8,778,124	\$ 4,791,060
Stock-based compensation	2,703,818	4,636,916
Stock-based compensation allocated to contributed surplus as part of Watch acquisition	-	575,448
Recovery of expense on cancelled stock options	(507,440)	(590,137)
Transfer to share capital on exercise of options	-	(635,163)
Balance, end of period	<u>\$ 10,974,502</u>	<u>\$ 8,778,124</u>

12. CAPITAL MANAGEMENT

The Company's capital management strategy is designed to minimize the use of long term debt and maintaining positive working capital. This strategy should provide the financial flexibility to fund the Company's capital program and profitable growth opportunities.

Financial covenants associated with the Company's credit facility are reviewed regularly and controls are in place to maintain compliance with these covenants. The Company complied with all covenants for the nine months ended September 30, 2008.

13. COMMITMENTS AND CONTRACTUAL OBLIGATIONS

The Company enters into commitments and contractual obligations in the normal course of business, including the purchase of services, farm-in agreements, royalty agreements, operating agreements, transportation agreements, processing agreements, right of way agreements and lease agreements for vehicles.

The Company has a nine-year operating lease for office space.

	2008	2009	2010	2011	2012	Subsequent to 2012
Office rent	\$271,190	\$1,084,760	\$1,084,760	\$1,152,557	\$1,220,355	\$4,576,331

The Company has contracted drilling rig services over the next two years. In the event that the Company does not utilize the minimum contracted days, the Company would be obligated to pay the rig operators a variable rate based on days not utilized under the contracts. The maximum commitment at September 30, 2008 related to these contracts is approximately \$3.1 million, which can be reduced by farm-outs to other operators.

14. FINANCIAL INSTRUMENTS

The Company does not utilize derivative instruments to manage risks. The Company is exposed to the following risks related to financial assets and liabilities:

(a) Commodity price risk

The Company is exposed to risks associated with fluctuating commodity prices. At this time, the Company does not use derivative financial instruments to manage its exposure to this risk.

(b) Foreign currency exchange risk

The Company is exposed to risks arising from fluctuations in foreign currency exchange rates and the volatility of those rates. This exposure primarily relates to: (i) certain expenditure commitments, deposits, accounts receivable, and accounts payable which are denominated in US dollars, and (ii) its operations in the United States.

(c) Fair values

The carrying amounts of financial instruments comprising cash, accounts receivable and accounts payable approximate their fair value due to the immediate or short-term nature of these financial instruments.

(d) Credit Risk

The Company's accounts receivable are with customers and joint venture partners in the petroleum and natural gas business and are subject to normal credit risks. Management believes that there is no unusual exposure associated with the collection of the receivables due to the size and reputation of the companies and to the continuing joint venture relationship.

(e) Interest Rate Risk

The Company is exposed to interest rate risk in relation to interest expense on its revolving credit facility.

15. SEGMENTED INFORMATION

The Company presently has one reportable business segment, that being oil and gas exploration and development. The Company's operations are carried on in the following geographic locations:

	Three Months Ended September 30, 2008		
	Canada	USA	Consolidated
Total revenues, net of royalties	33,042,578	595,848	33,638,426
Expenses	27,617,604	379,686	27,997,290
Foreign currency loss (gain)	297,841	(37,689)	260,152
Write-downs	2,574,896	-	2,574,896
Gain on investment	(2,268,028)	-	(2,268,028)
Net income before income taxes	4,820,265	253,851	5,074,116
Income taxes	3,116,269	31,927	3,148,196
Net income	1,703,996	221,924	1,925,920
Segment assets	484,802,365	70,153,194	554,955,559
Segment petroleum and natural gas properties	404,317,798	60,378,033	464,695,831
Capital additions	34,367,037	5,112,970	39,480,007
	Nine Months Ended September 30, 2008		
	Canada	USA	Consolidated
Total revenues, net of royalties	121,887,757	1,258,430	123,146,187
Expenses	112,009,762	1,176,417	113,186,179
Foreign currency loss (gain)	286,553	(63,112)	223,441
Write-downs	2,574,896	-	2,574,896
Gain on investment	(2,268,028)	-	(2,268,028)
Net income before income taxes	9,284,574	145,125	9,429,699
Income taxes	4,557,258	29,003	4,606,261
Net income	4,727,316	116,122	4,823,438
Segment assets	484,802,365	70,153,195	554,955,559
Segment petroleum and natural gas properties	404,317,798	60,378,033	464,695,831
Capital additions	59,475,701	15,121,532	74,597,233
	Three Months Ended September 30, 2007		
	Canada	USA	Consolidated
Total revenues, net of royalties	24,679,954	236,351	24,916,305
Expenses	42,322,872	118,879	42,441,751
Foreign currency loss	(8,623)	127,157	118,534
Gain on sale of assets	-	-	-
Loss before income taxes	(17,634,296)	(9,685)	(17,643,981)
Income taxes (recovery)	(4,796,159)	834,714	(3,961,445)
Net loss	(12,838,137)	(844,399)	(13,682,536)
Segment assets	618,850,780	35,692,662	654,543,442
Goodwill	159,863,578	-	159,863,578
Segment petroleum and natural gas properties	418,180,234	28,163,838	446,344,072
Capital additions	45,640,603	1,805,063	47,445,666

Nine Months Ended September 30, 2007			
	Canada	USA	Consolidated
Total revenues, net of royalties	67,099,849	758,708	67,858,557
Expenses	114,891,668	1,077,132	115,968,800
Foreign currency loss	259,599	127,157	386,756
Gain on sale of assets	-	(13,270,044)	(13,270,044)
Income (loss) before income taxes	(48,051,418)	12,824,463	(35,226,955)
Income taxes (recovery)	(3,977,344)	7,286,340	3,308,996
Net income (loss)	(40,074,074)	5,538,123	(38,535,951)
Segment assets	618,850,780	35,692,662	654,543,442
Goodwill	159,863,578	-	159,863,578
Segment petroleum and natural gas properties	418,180,234	28,163,838	446,344,072
Capital additions	134,493,536	7,602,596	142,096,132

16. CONTINGENCIES

(a) In connection with the November, 2007 property acquisition from PetroHunter, the Company may be required to pay a performance payment of US \$9.8 million in cash at such time as either: (i) production from the assets reaches 5,000 bopd; or (ii) proven reserves from the assets is greater than 50 million barrels of oil, if either condition is met prior to November 6th, 2010. As noted in Q2, the Company did not reach an agreement with a third party and therefore the previously stated performance payment was reduced and the contingent shares were not issued.

(b) Four million warrants were issued pursuant to the San Miguel property acquisition in November 2005. Each warrant entitles the holder thereof to purchase an additional common share of the Company at a price of \$1.00, exercisable from the date the San Miguel heavy oil project achieves an average daily producing rate of 5,000 barrels of oil per day, averaged over 30 consecutive days, until November 18, 2008.

(c) In connection with the August, 2008 Blackrod property acquisition, the Company may be required to pay additional payments of (i) \$4.0 million in cash at such time as the pilot project achieving gross accumulated production of 100,000 barrels of oil and (ii) \$4.0 million in cash at such time as commercial project achieving 5,000 Bbl/d of production for the duration of one month, and (iii) \$3.0 million in cash at such time as commercial project achieving 10,000 Bbl/d of production for the duration of one month.

17. SUBSEQUENT EVENTS

The Company has entered into an agreement with Serrano Energy Ltd. ("Serrano") to swap our equity interests in Serrano for a 15% increased interest in the Blackrod project and a carried work commitment of \$5 million. We expect to close this transaction prior to year end. We have the right and we intend to become operator of the Blackrod project as soon as reasonably practicable.

18. COMPARATIVE FIGURES

Certain comparative figures have been reclassified to conform to the presentation adopted in 2008.

SELECTED QUARTERLY INFORMATION

	2008			2007				2006
	30-Sep	30-Jun	31-Mar	31-Dec	30-Sep	30-Jun	31-Mar	31-Dec
FINANCIAL (\$000's, except per share data)								
Total revenue	33,638	45,493	44,015	27,973	24,916	23,520	19,422	5,318
Cash flow from operations before working capital changes ⁽²⁾	21,021	28,023	19,452	9,609	6,268	973	5,039	569
Per common share								
Basic and diluted (\$)	0.11	0.15	0.1	0.05	0.04	0.01	0.04	0.01
Net and comprehensive income (loss)	1,926	6,688	(3,790)	(183,407)	(18,983)	(7,225)	(17,628)	(5,263)
Per common share								
Basic and diluted (\$)	0.01	0.04	(0.02)	(1.01)	(0.09)	(0.05)	(0.13)	(0.08)
Capital expenditures	39,480	17,605	17,512	61,971	47,446	53,810	50,841	17,680
Total assets	554,956	543,123	584,237	575,865	654,543	620,792	586,276	640,195
Total long-term financial liabilities	13,499	16,128	41,682	16,586	14,512	15,902	16,211	13,433
Working capital surplus (deficiency)	36,147	57,371	(7,177)	(34,152)	(87,588)	(98,510)	(53,633)	(5,836)
Shareholders' equity	496,400	493,699	486,491	489,380	500,882	453,135	458,574	468,106
OPERATIONAL								
Daily Production								
Oil – net production (bbls/d)	4,401	6,660	8,698	7,703	6,973	5,934	4,622	1,238
Gas – net production (mcf/d)	8,156	9,402	10,757	10,734	12,608	11,757	13,923	2,620
Total net production (boe/d)*	5,776	8,246	10,503	9,507	9,093	7,910	6,966	1,674
Product Pricing								
Oil – average selling price per bbl (\$/)	95.85	84.57	63.11	40.73	41.94	41.29	35.89	38.44
Gas – average selling price per mcf (\$)	8.08	9.8	7.79	6.23	5.01	6.81	7.32	6.8
Weighted average sales price per boe (\$)	85.02	7a9.74	60.5	40.3	39.17	41.4	39.02	40.4
Royalties (\$/boe)	22.51	19.93	14.58	8.95	9.43	8.78	8.43	7.6
Operating costs (including transportation expenses) (\$/boe)	18.74	16.6	21.01	17.91	15.23	16.7	17.75	16.47
PNG Netback ⁽³⁾ (\$/boe)	43.77	43.21	24.91	13.44	14.51	15.92	12.84	16.33
Share Information (000's)								
Weighted average shares outstanding (basic)	189,242	189,242	189,242	181,212	145,616	133,935	132,472	62,939
Shares outstanding at end of period	189,242	189,242	189,242	189,242	147,435	133,950	133,920	131,737
Volume traded during the quarter	17,442	37,101	37,354	26,080	26,012	38,105	13,907	9,673
Share price (\$)								
High	2.48	2.73	2.8	4.04	5.3	5.93	5.2	6.2
Low	0.91	1.6	1.43	2.15	3.3	4	3.9	4.4
Close (end of period)	1.30	2.1	1.63	2.6	3.94	5.07	4.15	5.08

(1) Oil equivalent amounts referenced have been calculated using a conversion rate of six thousand cubic feet of natural gas to one barrel of oil. BOEs may be misleading, particularly if used in isolation. A BOE conversion ratio of 6 MCF:1 bbl is based on an energy equivalency.

(2) Cash flow from operations before working capital changes and cash flow per share do not have standardized meanings prescribed by Canadian Generally Accepted Accounting Principles ("GAAP") and therefore may not be comparable to similar measures used by other companies. Cash flow from operations before working capital changes includes all cash flow from operating activities and is calculated before changes in non-cash working capital. Cash flow from operations before working capital changes is reconciled with net loss on the Consolidated Statement of Cash Flows and in the accompanying Management Discussion & Analysis. Management uses these non-GAAP measurements for its own performance measures and to provide its shareholders and investors with a measurement of the Company's efficiency and its ability to fund a portion of its future growth expenditures.

(3) PNG netback is a non-GAAP measure used by management as a measure of operating efficiency and profitability. It is calculated by deducting royalties, operating costs and transportation costs from petroleum and natural gas revenues.

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COMPANY REGISTRATION NUMBER

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CERTIFIED ADVISOR ON FIRST NORTH

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The report for the quarter ending
December 31, 2008 will be published
on or before February 28, 2009.