

// management's report

Management has prepared the consolidated financial statements in accordance with accounting principles generally accepted in Canada. If alternative accounting methods exist, management has chosen those methods it deems most appropriate in the circumstances. Financial statements are not precise as they include certain amounts based on estimates and judgments. Management believes such estimates have been based on careful judgments and have been properly reflected in the accompanying consolidated financial statements. Management has also prepared the financial information presented elsewhere in the annual report and ensured that it is consistent with information in the consolidated financial statements.

ProspEx Resources Ltd. maintains internal accounting and administrative controls designed to provide reasonable assurance that the financial information is relevant, reliable and accurate and that assets are appropriately accounted for and adequately safeguarded.

The Board of Directors is responsible for reviewing and approving the consolidated financial statements and Management's Discussion and Analysis and, primarily through its Audit Committee, ensures that management fulfills its responsibilities for financial reporting.

The Audit Committee is appointed by the Board and is composed of Directors who are not employees of the Company. The Audit Committee meets periodically with management and with the external auditors to satisfy themselves that management responsibilities are being properly discharged, to review the consolidated financial statements and to recommend approval of the consolidated financial statements to the Board. The Audit Committee also considers, for review by the Board and approval by the shareholders, the engagement or reappointment of external auditors.

KPMG LLP, the external auditors, has audited the consolidated financial statements in accordance with the auditing standards generally accepted in Canada on behalf of the shareholders. KPMG LLP has full and free access to the Audit Committee.



John W. Rossall
President and Chief Executive Officer
Calgary, Alberta
March 16, 2009



George D.K. Yee
Vice President, Finance & Chief Financial Officer

// auditors' report

TO THE SHAREHOLDERS OF PROSPEX RESOURCES LTD.

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

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

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

KPMG LLP

KPMG LLP
Chartered Accountants
Calgary, Alberta
March 16, 2009

ProspEx Resources

// consolidated balance sheets

(STATED IN THOUSANDS OF DOLLARS)
AS AT DECEMBER 31,

	2008	2007
Assets		
Current assets		
Accounts receivable	\$ 10,770	\$ 12,900
Prepaid expenses	693	988
Unrealized financial instrument gain	828	214
	12,291	14,102
Property, plant and equipment, net (NOTE 3)	190,693	161,663
Total assets	\$ 202,984	\$ 175,765
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	\$ 22,078	\$ 22,761
Future income tax liability (NOTE 4)	240	69
	22,318	22,830
Long-term debt (NOTE 5)	40,807	28,846
Asset retirement obligation (NOTE 6)	6,462	5,201
Future income tax liability (NOTE 4)	9,119	3,145
Total liabilities	78,706	60,022
Shareholders' Equity		
Common shares (NOTE 7)	90,802	90,543
Common share performance warrants (NOTE 7)	1,233	1,661
Contributed surplus (NOTE 7)	6,758	5,614
Retained earnings	25,485	17,925
Total shareholders' equity	124,278	115,743
	\$ 202,984	\$ 175,765

Subsequent event (NOTE 11)

See accompanying notes to consolidated financial statements.

On Behalf of the Board of Directors:


John W. Rossall
Director

Kyle D. Kitagawa
Director

// consolidated statements of earnings (loss), comprehensive earnings (loss) and retained earnings

(STATED IN THOUSANDS OF DOLLARS, EXCEPT PER SHARE AMOUNTS)
FOR THE YEARS ENDED DECEMBER 31,

	2008	2007
Revenue		
Oil and gas	\$ 76,705	\$ 63,534
Unrealized financial instrument gain (loss)	614	(2,867)
Royalties	(14,916)	(9,343)
	62,403	51,324
Expenses		
Operating	11,034	11,341
Transportation	1,373	1,343
Depletion, depreciation and accretion	33,084	33,889
General and administrative	3,032	3,080
Interest and bank charges	1,913	2,047
Stock-based compensation	750	1,156
	51,186	52,856
Earnings (loss) before income taxes	11,217	(1,532)
Income taxes (NOTE 4)		
Future (reduction)	3,657	(441)
Net earnings (loss) and comprehensive earnings (loss) for the year	7,560	(1,091)
Retained earnings, beginning of year	17,925	19,016
Retained earnings, end of year	\$ 25,485	\$ 17,925
Net earnings (loss) per share		
Basic	\$ 0.13	\$ (0.02)
Diluted	\$ 0.13	\$ (0.02)

See accompanying notes to consolidated financial statements.

// consolidated statements of cash flows

(STATED IN THOUSANDS OF DOLLARS)
FOR THE YEARS ENDED DECEMBER 31,

	2008	2007
Operations		
Net earnings (loss) for the year	\$ 7,560	\$ (1,091)
Items not involving cash		
Depletion, depreciation and accretion	33,084	33,889
Stock-based compensation	750	1,156
Future income taxes (reduction)	3,657	(441)
Unrealized financial instrument (gain) loss	(614)	2,867
Asset retirement expenditures	(111)	(383)
	44,326	35,997
Changes in non-cash working capital	3,576	(901)
	47,902	35,096
Financing		
Issuance of shares	1,678	8,020
Increase in long-term debt	11,962	12,080
	13,640	20,100
Investing		
Exploration and development expenditures	(51,488)	(48,550)
Property acquisitions	(9,226)	-
Deposit on property acquisition	1,175	(1,175)
Expenditure on asset held for resale	-	937
Other capital expenditures	(168)	(160)
	(59,707)	(48,948)
Changes in non-cash working capital	(1,835)	(6,248)
	(61,542)	(55,196)
Change in cash	-	-
Cash, beginning of year	-	-
Cash, end of year	\$ -	\$ -

See accompanying notes to consolidated financial statements.

// notes to consolidated financial statements

FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

1. SIGNIFICANT ACCOUNTING POLICIES

ProspEx Resources Ltd. (“ProspEx” or the “Company”) is engaged in the acquisition, exploration, development and production of oil and natural gas in Canada. ProspEx was incorporated on August 13, 2004 and commenced operations on October 1, 2004 when certain assets of Esprit Exploration Ltd. were transferred to ProspEx under a Plan of Arrangement.

These financial statements have been prepared in accordance with Canadian generally accepted accounting principles. The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reported period. Actual results may differ from these estimates.

(a) Consolidation

The consolidated financial statements include the accounts of the Company and its subsidiary. A substantial portion of the Company’s activities are conducted jointly with others and the consolidated financial statements reflect only the Company’s proportionate interest in such activities.

(b) Property, Plant and Equipment

The Company follows the full cost method of accounting for exploration and development expenditures whereby all costs relating to the acquisition of, exploration for and development of oil and gas reserves, including asset retirement costs, are capitalized. Such costs include lease acquisition, geological and geophysical analysis, lease rentals on undeveloped properties, drilling both productive and non-productive wells, production equipment and overhead charges directly related to acquisition, exploration and development activities. Proceeds received from disposals of properties and equipment are credited against capitalized costs unless the disposal would alter the rate of depletion and depreciation by more than 20 percent, in which case a gain or loss on disposal is recorded.

Capitalized costs and estimated costs of future development of proved undeveloped reserves are depleted and depreciated by the unit of production method based on estimated gross proved reserves before royalties as determined by independent engineers. The costs of undeveloped properties are excluded from costs subject to depletion until it is determined whether or not proved reserves are attributable to the properties or impairment has occurred. Oil and gas reserves are converted to equivalent units using their relative energy content.

Oil and gas assets are evaluated in each reporting period to confirm that the costs are recoverable and do not exceed the fair value of the properties. The costs are assessed to be recoverable if the sum of the undiscounted cash flows expected from the production of proved reserves and the lower of cost and market of unproved properties exceed the carrying value of the oil and gas assets. If the carrying value of the oil and gas assets is not assessed to be recoverable, an impairment loss is recognized to the extent that the carrying value exceeds the sum of the discounted cash flows expected from the production of proved and probable reserves and the lower of cost and market of unproved properties. The cash flows are estimated using future product prices and costs and are discounted using the risk-free rate.

Amortization of capital assets not related to oil and gas assets is provided using the declining balance method at a rate from 20 to 50 percent per annum. Leasehold improvements are amortized using the straight-line method over the terms of the respective leases.

(c) Asset Retirement Obligation

The Company records the fair value of legal obligations associated with the retirement of long-lived tangible assets, such as producing well sites, in the period in which they are incurred and a corresponding increase in the carrying amount of the related long-lived asset. The liability accretes until the Company expects to settle the retirement obligation. The asset retirement costs are depleted using the unit of production method. Actual costs to retire tangible assets are deducted from the liability as incurred.

(d) Income Taxes

The Company follows the asset and liability method of accounting for future income taxes. Under this method, future income tax assets and liabilities are determined based on differences between the amounts reported in the financial statements and the tax basis of the assets and liabilities, and are measured using the currently enacted, or substantively enacted, tax rates and laws expected to apply when these differences reverse.

(e) Stock-based Compensation

Stock options and special performance units granted have been accounted for based on the fair value method. The fair value is measured at the grant date and charged to earnings or capital assets over the vesting period with a corresponding increase in contributed surplus. For awards that vest on a graded basis, compensation cost is recognized on a pro-rata basis over the vesting period. Consideration paid to the Company on exercise of all options is credited to share capital. When stock options and special performance units are exercised, contributed surplus is reduced by the fair value originally attributed to them.

(f) Financial Instruments

A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument to another entity. Upon initial recognition all financial instruments, including derivatives, are recognized on the balance sheet at fair value. Subsequent measurement is then based on the financial instruments being classified into one of five categories: held for trading, held to maturity, loans and receivables, available for sale and other liabilities. The Company has designated its financial instruments into the following categories applying the indicated measurement methods:

Financial Instrument	Category	Measurement Method
Accounts receivable	Loans and receivables	Amortized cost
Accounts payable and accrued liabilities	Other liabilities	Amortized cost
Long-term debt	Other liabilities	Amortized cost
Unrealized financial instrument gains/losses	Other liabilities or receivables as applicable	Fair value

The Company uses derivative financial instruments and commodity price hedges to manage its exposure to volatility in commodity prices. These financial instruments are not used for trading or other speculative purposes.

Gains or losses on commodity price financial instruments designated as hedges are reflected as adjustments to the related revenue when the gain or loss is realized.

Commodity price financial instruments that do not qualify as hedges, or have not been designated as such, are recorded at fair value on inception. Realized gains or losses on these financial instruments are reflected as adjustments to the related revenue when the gain or loss is realized; unrealized gains and losses on these instruments are

recognized as adjustments to the related revenue at the end of each reporting period. The estimated fair value of these instruments is based on quoted market prices, or if quotes are not available, third-party market indications and forecasts are used.

(g) Earnings Per Share

The Company uses the treasury stock method to determine the dilutive effect of outstanding stock options, special performance units and warrants. Basic and diluted earnings per share are calculated using the weighted average number of common shares outstanding during the period. Diluted per share amounts reflect the potential dilution that could occur if securities or other contracts to issue common shares were exercised or converted to common shares. Anti-dilutive options and warrants are excluded from the calculation.

(h) Revenue Recognition

Revenue from the sale of crude oil, natural gas and natural gas liquids is recorded when title passes.

(i) Environmental Liabilities

The Company records liabilities on an undiscounted basis for environmental remediation efforts that are likely to occur and where the cost can be reasonably estimated. The estimates, including associated legal costs, are based on available information using existing technology and enacted laws and regulations. The estimates are subject to revision in future periods based on actual costs incurred or new circumstances. Any amounts expected to be recovered from other parties, including insurers, are recorded as an asset separate from the associated liability.

2. CHANGES IN ACCOUNTING POLICIES

(a) Financial Instruments – disclosures

On January 1, 2008, the Company adopted the new accounting standard for financial instruments – disclosures, which applies to both recognized and unrecognized financial instruments. The standards require that disclosure be made of the nature and extent of risks arising from financial instruments and how the Company manages those risks. This adoption did not have any impact on the results of operations or net financial position, as it is a disclosure related standard. These disclosures are included in note 8.

(b) Capital Disclosures

On January 1, 2008, the Company adopted the new accounting standard for disclosure of the Company's objectives, policies and processes for managing capital. This new adoption did not have any impact on the results of operations or net financial position, as it is a disclosure related standard. These disclosures are included in note 8.

3. PROPERTY, PLANT & EQUIPMENT

<i>(\$000s)</i>	2008	2007
Exploration and development properties	\$ 290,757	\$ 229,213
Other	1,046	878
	291,803	230,091
Less accumulated depletion, depreciation and amortization	(101,110)	(68,428)
Total property, plant and equipment	\$ 190,693	\$ 161,663

At December 31, 2008 oil and gas properties included \$24.3 million (2007 – \$19.6 million) of unproved properties that have been excluded from the depletion calculation. Future development costs related to proved undeveloped reserves of \$20.6 million (2007 – \$22.1 million) are included in the depletion calculation.

During 2008 the Company capitalized \$3.6 million (2007 – \$4.2 million) of overhead and stock-based compensation directly related to acquisition, exploration and development activities.

The Company performed a ceiling test calculation at December 31, 2008 resulting in the undiscounted cash flows from proved reserves and the lower of cost and market of unproved properties exceeding the carrying value of oil and gas assets. The prices used in the ceiling test evaluation of the Company's oil and gas assets are summarized below:

	Gas (\$ per thousand cubic feet) ¹	Natural gas liquids (\$ per barrel) ¹	Oil (\$ per barrel) ²
2009	6.69	52.07	66.15
2010	7.73	60.55	77.11
2011	8.04	64.43	82.33
2012	7.79	65.71	84.07
2013	7.67	66.96	85.75
2014	9.14	73.98	97.84
2015	9.34	75.49	99.82
2016	9.54	77.02	101.83
2017	9.75	78.58	103.89
2018	9.95	80.17	105.99
2019	10.15	81.78	108.11
2020	+2%	+2%	+2%

¹ Weighted average plantgate price.

² Weighted average wellhead price.

4. FUTURE INCOME TAXES

The provision for future income taxes differs from the amount computed by applying the combined expected Canadian Federal and Provincial tax rates to earnings (loss) before income taxes. The reasons for these differences are as follows:

(\$000s)	2008	2007
Earnings (loss) before income taxes	\$ 11,217	\$ (1,532)
Rate (%)	29.50%	32.12%
Computed expected provision (reduction) for future income taxes	3,309	(492)
Increase (decrease) in taxes resulting from:		
Stock-based compensation expensed	221	371
Effect of change in tax rate	(206)	(458)
Other	333	138
Income tax expense (reduction)	\$ 3,657	\$ (441)

The current future income tax liability at December 31, 2008 of \$0.2 million (2007 – \$0.1 million) results from the future tax impact of the unrealized financial instrument gain.

The components of the long term future income tax liability at December 31 are as follows:

<i>(\$000s)</i>	2008	2007
Property, plant and equipment	\$ (10,697)	\$ (3,744)
Asset retirement obligation	1,773	509
Share issue costs	305	590
	(8,619)	(2,645)
Valuation allowance	(500)	(500)
Future income tax liability	\$ (9,119)	\$ (3,145)

At December 31, 2008 the Company had estimated tax pools available to reduce future taxable income of \$154.6 million (2007 – \$147.0 million). ProspEx has met its commitment to incur \$8.0 million in qualifying Canadian exploration expenditures related to the December 2007 flow-through share financing.

Capitalized stock based compensation resulted in an increase to future tax liabilities of \$0.3 million during the year ended December 31, 2008 (2007 – \$0.4 million).

During the first quarter of 2008, the renoucement of flow-through shares resulted in an increase of future tax liability of \$2.2 million (2007 – \$4.5 million).

5. LONG-TERM DEBT

At December 31, 2008 the Company had a \$65.0 million credit facility with a Canadian chartered bank. The facility is available by way of Canadian dollar prime and US dollar base rate loans, LIBOR advances, bankers' acceptances and letters of credit. Canadian prime rate loans, US base rate loans, and LIBOR advances bear interest at Canadian prime, US base rate or LIBOR, as applicable, plus a margin dependant upon the Company's debt/cash flow ratio as calculated in the previous quarter. Stamping fees for bankers' acceptances are based on a rate adjusted over the term to maturity plus a margin as described above. The margins and stamping fees varied from 3.01 percent to 5.88 percent in 2008 compared to 5.39 percent to 6.12 percent in 2007. The credit facility is fully revolving until June 30, 2009 and may be extended at the mutual agreement of ProspEx and its lender for an additional year. If the credit facility is not extended, a repayment is required on July 1, 2010. This facility is secured by a \$200 million demand debenture and a first floating charge on all petroleum and natural gas assets of ProspEx.

Subsequent to the year end the semi-annual review of the credit facility was completed, which resulted in no changes to the \$65.0 million credit facility limit.

6. ASSET RETIREMENT OBLIGATION

The Company has estimated the net present value of its total asset retirement obligation at December 31, 2008 to be \$6.5 million (2007 – \$5.2 million) based on a total future liability of \$22.2 million (2007 – \$19.0 million). The total future liability was estimated based on the Company's net ownership interest in all wells and facilities, estimated costs to reclaim and abandon the wells and facilities and the estimated timing of when the costs will be incurred. These payments are expected to be made over the next 33 years with the majority of costs incurred between 2029 and 2042. A seven percent discount rate and two percent inflation rate were used to calculate the present value of the asset retirement obligation.

ProspEx Resources

(\$000s)	2008		2007	
Balance at the beginning of the year	\$	5,201	\$	4,157
Liabilities incurred		814		560
Change in assumptions		157		567
Accretion expense		401		300
Liabilities settled		(111)		(383)
Balance at the end of the year	\$	6,462	\$	5,201

7. SHAREHOLDERS' EQUITY**(a) Shares authorized**

An unlimited number of common shares and non-voting common shares and an unlimited number of preferred shares are authorized for issuance.

(b) Common Shares & Common Share Performance Warrants Issued

	2008		2007	
	Number of Shares/Warrants (000s)	Amount (\$000s)	Number of Shares/Warrants (000s)	Amount (\$000s)
Common shares				
Balance at the beginning of the year	56,453	\$ 90,543	53,790	\$ 85,681
Issued on exercise of options	232	747	72	243
Shares issued on exercise of warrants	700	1,407	169	353
Flow-through shares issued – December 13, 2007	–	–	2,170	8,029
Flow-through shares tax adjustment	–	(2,218)	–	(4,461)
Issue costs, net of future tax reduction of \$14 (2007 – \$140)	–	(34)	–	(351)
Shares issued under special performance unit plan	–	–	252	3
Adjustment to contributed surplus for options exercised	–	357	–	1,046
Balance at the end of the year	57,385	\$ 90,802	56,453	\$ 90,543
Common share performance warrants				
Balance at the beginning of the year	2,716	\$ 1,661	2,908	\$ 1,778
Exercised	(700)	(428)	(169)	(104)
Cancelled	–	–	(23)	(13)
Balance at the end of the year	2,016	\$ 1,233	2,716	\$ 1,661

All outstanding performance warrants entitle the holder to acquire a common share at a price of \$1.40 and expire no later than October 1, 2009.

The estimated fair value of the common share performance warrants was recognized as a reduction of the common share capital with a corresponding increase to common share performance warrants.

On December 13, 2007 ProspEx issued 2,170,000 common shares on a flow-through basis at a price of \$3.70 per share for total gross proceeds of \$8.0 million.

(c) Contributed Surplus

<i>(\$000s)</i>	2008	2007
Balance at the beginning of the year	\$ 5,614	\$ 4,348
Stock-based compensation	1,501	2,312
Exercise of stock options and special performance units	(357)	(1,046)
Balance at the end of the year	\$ 6,758	\$ 5,614

(d) Stock Options and special performance units

ProspEx has a stock option plan for directors, officers and employees that provides for the granting of options to acquire common shares. Under the terms of the plan, options normally vest equally over a three-year period, and expire five years after the date of grant. At December 31, 2008, options to acquire 5.2 million (2007 – 5.6 million) common shares were authorized for issuance under the stock option plan. Changes in outstanding options during the year ended December 31, 2008 and 2007 are summarized below:

	2008		2007	
	Options (000s)	Weighted Average Exercise Price	Options (000s)	Weighted Average Exercise Price
Outstanding at beginning of year	4,656	\$ 3.62	3,354	\$ 3.49
Granted	907	2.64	1,725	3.96
Exercised	(232)	3.22	(72)	3.38
Forfeited	(171)	4.29	(351)	4.06
Outstanding at end of year	5,160	\$ 3.44	4,656	\$ 3.62

ProspEx had a special performance unit (“SPU”) plan for directors, officers and employees. At December 31, 2007 there were no SPU outstanding, and there was no further activity in 2008 relating to these SPU. Changes in SPU during the year ended December 31, 2007 were as follows:

<i>(000s)</i>	2008	2007
Outstanding at beginning of year	–	436
Exercised	–	(406)
Forfeited	–	(30)
Outstanding at end of year	–	–

The following table summarizes stock options outstanding and exercisable at December 31, 2008:

Range of exercise price	Options outstanding		Options exercisable		
	Number of outstanding at year end (000s)	Weighted average remaining contractual life (years)	Weighted average exercise price	Number exercisable at year end (000s)	Weighted average exercise price
\$1.25 – 2.32	296	4.9	\$ 1.25	–	\$ –
\$2.33 – 3.39	2,308	1.6	3.21	1,801	3.22
\$3.40 – 4.46	2,556	2.9	3.91	1,176	3.90
	5,160	2.2	\$ 3.45	2,977	\$ 3.49

The fair value of each stock option and SPU granted is estimated on the date of the grant using the Black-Scholes option pricing model with the following weighted average assumptions for grants as follows:

	2008	2007
Risk-free interest rate	3%	4%
Expected life	5 years	5 years
Expected volatility	56%	44%
Expected dividend yield	Nil	Nil

The estimated fair value of stock options granted in 2008 was \$1.0 million (2007 – \$2.7 million). This estimated fair value is being amortized to earnings and capitalized to property, plant and equipment over the vesting period. A total of \$0.8 million (2007 – \$1.2 million) of stock and unit-based compensation was recorded against income in 2008 and \$0.8 million (2007 – \$1.2 million) was capitalized.

(e) Per Share Amounts

Basic per share amounts are calculated using the weighted average number of common shares outstanding during the year. Diluted per share amounts are calculated based on the treasury stock method, which assumes that any proceeds obtained on exercise of options would be used to purchase common shares at the average price during the year. The weighted average number of shares outstanding is then adjusted by this amount.

	2008	2007
Weighted average common shares basic	57,054,424	54,094,873
Dilutive securities:		
Stock options	100,413	288,204
Performance warrants	946,482	1,747,150
Special performance units	–	188,075
Diluted	58,101,319	56,318,302

For the year ended December 31, 2008, a weighted total of 4,615,261 (December 31, 2007 – 2,871,729) options and warrants were excluded from the diluted calculations as they were anti-dilutive.

8. FINANCIAL INSTRUMENTS, RISK MANAGEMENT AND CAPITAL MANAGEMENT STRATEGY

Overview

The Company has exposure to a number of risks from its use of financial instruments including, without limitation:

- Credit risk
- Liquidity risk
- Market risk
- Foreign currency exchange risk

This note presents information about the Company's exposure to each of the credit, liquidity and market risks and the Company's objectives, policies and processes for measuring and managing risk, and the Company's management of capital. Further quantitative disclosures are included throughout these financial statements.

The Board of Directors has overall responsibility for the establishment and oversight of the Company's risk management framework. The Board has implemented and monitors compliance with risk management policies.

The Company's risk management policies are established to identify and analyze the risks faced by the Company, to set appropriate risk limits and controls, and to monitor risks and adherence to market conditions and the Company's activities.

Credit Risk

Credit risk relates to the Company's receivables from joint venture partners and petroleum and natural gas marketers and the risk of financial loss if a customer, partner or counterparty to a financial instrument fails to meet its contractual obligations. A substantial portion of the Company's accounts receivable are with customers in the energy industry and are subject to normal industry credit risk. The Company generally grants unsecured credit but routinely assesses the financial strength of its partners and marketers.

Receivables from petroleum and natural gas marketers are normally collected on the 25th day of the month following production. The Company sells the majority of its production to two petroleum and natural gas marketers therefore is subject to concentration risk. To date the Company has not experienced any collection issues with its petroleum and natural gas marketers. Joint venture receivables are typically collected within one to three months of the joint venture bill being issued to the partner. The Company attempts to mitigate the risk from joint venture receivables by obtaining joint venturer approval of significant capital expenditures prior to expenditure. The Company does not typically obtain collateral from petroleum and natural gas marketers or joint venturers; however in certain circumstances, it may elect to cash call a joint venturer in advance of the work.

As at December 31, 2008 the Company's receivables consisted of \$4.3 million (2007 – \$5.3 million) from joint venture partners, \$4.2 million (2007 – \$5.1 million) of receivables from petroleum and natural gas marketers and \$2.3 million (2007 – \$2.5 million) of other receivables.

The carrying amount of accounts receivable represents the maximum credit exposure. The Company does not have an allowance for doubtful accounts as at December 31, 2008 or 2007 and did not provide for any doubtful accounts nor was it required to write-off any receivables during the year ended December 31, 2008 or 2007.

Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they are due. The Company's approach to managing liquidity is to ensure, as far as practicable, that it will have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions without incurring unacceptable losses or risking harm to the Company's reputation.

The Company prepares annual capital expenditure budgets, which are regularly monitored and updated as considered necessary. Further, the Company utilizes authorizations for expenditures on both operated and non-operated projects to further manage capital expenditures. To facilitate the capital expenditure program, the Company has a revolving reserve based credit facility, as outlined in note 5. The Company also attempts to match its payment cycle with collection of petroleum and natural gas revenues on the 25th of each month.

The following are the contractual maturities of financial liabilities and associated interest payments due as at December 31, 2008:

Financial Liability (\$000s)	< 1 year	1 – 2 years	2 – 5 years	Thereafter
Accounts payable and accrued liabilities	\$ 22,078	–	–	–
Long-term debt	–	40,807	–	–
Total	\$ 22,078	40,807	–	–

Market risk

Market risk is the risk that changes in market prices, such as foreign exchange rates, commodity prices, and interest rates will affect the Company's net earnings or the value of financial instruments. The objective of market risk management is to manage and control market risk exposures within acceptable limits, while maximizing returns.

The Company utilizes both financial derivatives and physical delivery sales contracts to manage commodity price risks. All such transactions are conducted in accordance with the risk management policy that has been approved by the Board of Directors.

(a) Foreign Currency Exchange Risk

Foreign currency exchange rate risk is the risk that the fair value of financial instruments or future cash flows will fluctuate as a result of changes in foreign exchange rates. Although substantially all of the Company's petroleum and natural gas sales are denominated in Canadian dollars, the underlying market prices in Canada for petroleum and natural gas are impacted by changes in the exchange rate between the Canadian and United States dollars. Given that changes in exchange rate have an indirect influence, the impact of changing exchange rates can not be accurately quantified. The Company had no foreign exchange rate contracts in place as at December 31, 2008.

(b) Commodity Price Risk

Commodity price risk is the risk that the fair value of financial instruments or future cash flows will fluctuate as a result of changes in commodity prices. Commodity prices for petroleum and natural gas are impacted by world economic events that dictate the levels of supply and demand. The Company has attempted to mitigate commodity price risk through the use of financial derivative sales contracts. The Company's contracts in place as of December 31, 2008 are as follows:

Type	Amount (GJ/d)	Term	Price (\$/GJ) at AECO	Type
Collar	2,000	November 1, 2008 – March 31, 2009	\$7.00 – \$8.80	Financial
Collar	2,000	November 1, 2008 – March 31, 2009	\$7.00 – \$9.15	Financial
Put	2,000	November 1, 2008 – March 31, 2009	\$10.00	Financial

During the year ended December 31, 2008 the contracts in place resulted in an unrealized gain of \$0.6 million (2007 – \$2.9 million loss) and a realized loss of \$2.2 million (2007 – \$3.1 million gain).

With respect to commodity prices, during the year ended December 31, 2008, a one dollar increase in the price per GJ of natural gas relevant only to the Company's production dedicated to derivative financial instruments would have resulted in a net earnings increase of \$0.5 million (2007 – \$1.0 million). A one dollar decrease in the price per GJ of natural gas on the same production would have decreased net earnings for the year ended December 31, 2008 by \$0.3 million (2007 – \$0.1 million).

(c) Interest Rate Risk

Interest rate risk is the risk that future cash flows will fluctuate as a result of changes in market interest rates. The Company is exposed to interest rate fluctuations on its credit facility which bears a floating rate of interest. The Company had no interest rate swaps or financial contracts in place as at or during the year ended December 31, 2008. For the year ended December 31, 2008, a difference in the interest rate of one percent would change net earnings by an estimated \$0.3 million (2007 – \$0.2 million), assuming all other variables are constant.

Capital Management Strategy

The Company's policy on capital management is to attempt to maintain a prudent capital structure to allow the Company to fund future development. The Company considers its capital structure to include shareholders' equity, bank debt, and working capital.

(\$000s)	2008	2007
Shareholders' equity	\$ 124,278	\$ 115,743
Bank debt	40,807	28,846
Working capital deficiency excluding unrealized financial instrument gain or losses and associated future tax assets or liabilities	10,615	8,873

The Company manages its capital programs in order to maintain a prudent capital structure as changes in economic conditions occur. The Company may and has from time to time issued shares and adjusted spending to manage current or projected operating cash flows and debt levels.

The Company monitors its capital base using the ratio of net debt to annual operating cash flow. This ratio is calculated as net debt, as defined as long term debt less working capital (or plus working capital deficiency) excluding unrealized financial instrument gain (loss) and associated future tax assets (liabilities), divided by annual cash flow from operations before changes in non-cash working capital. The Company's guideline is to maintain a ratio of approximately 1.0 to 1.0, not exceeding 2.0 to 1.0. This ratio will fluctuate depending on fluctuations of the commodity and business cycles. The Company prepares annual capital expenditure budgets which are updated periodically to monitor this ratio. The annual budget is approved by the Board of Directors with updates reviewed by the Board throughout the year.

As at December 31, 2008 the Company's ratio of net debt to annual operating cash flow was 1.2 to 1.0 (2007 – 1.0 to 1.0).

The Company's share capital is not subject to any external restrictions. The bank debt facility has no restrictions other than the limitation of borrowing under the facility. As at December 31, 2008, the Company is in compliance with all flow-through share expenditure requirements as well as all bank facility requirements.

There have been no changes to the Company's capital management strategy during the year ended December 31, 2008.

9. ADDITIONAL DISCLOSURE

Net cash interest paid during the year was \$1.3 million (2007 – \$2.5 million). Cash taxes paid during the year was \$nil (2007 – \$nil).

10. COMMITMENTS

The Company has committed to certain payments over the next five years as follows:

Payments due (\$000s)	2009	2010	2011	2012	2013	Thereafter
Long-term debt	\$ –	\$ 40,807	\$ –	\$ –	\$ –	\$ –
Building lease	973	1,212	1,230	1,235	1,235	309
Processing fees	400	379	63	–	–	–
Transportation	673	79	–	–	–	–
Other	16	7	–	–	–	–
Total	\$ 2,062	\$ 42,484	\$ 1,293	\$ 1,235	\$ 1,235	\$ 309

ProspEx has met its commitment to incur \$8.0 million in qualifying Canadian exploration expenditures related to the December 2007 flow-through share financing.

11. SUBSEQUENT EVENT

Effective February 1, 2009 the Company disposed of certain non core properties in the Wapiti area of Alberta. These properties consist of 4 (2.0 net) producing wells, with current net production of approximately 30 boe per day and 3,160 net acres of undeveloped land. The consideration paid to the Company was \$2.1 million subject to normal closing adjustments.

12. RECLASSIFICATION

Certain amounts disclosed for prior years have been reclassified to conform to current period presentation.