Frontera Resources Corporation and Subsidiaries

Condensed Consolidated Financial Statements
Three and Nine Months Ended September 30, 2008 and 2007

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Frontera Resources Corporation and Subsidiaries
Condensed Consolidated Balance Sheets *(Unaudited)*

	September 30, 2008	December 31, 2007
Assets		
Current assets		
Cash and cash equivalents	$ 17,512,363	$ 4,945,221
Restricted cash	5,000,000	15,118,786
Short-term investments	12,100,000	25,600,000
Accounts receivable	124,887	73,189
Inventory	8,306,331	9,293,005
Prepaid expenses and other current assets	1,729,689	1,268,503
Total current assets	44,773,270	56,298,704
Property and equipment, net	1,476,209	1,405,957
Oil and gas properties, full cost method		
Properties being depleted	24,767,360	23,750,981
Properties not subject to depletion	81,264,763	55,828,093
Less: Accumulated depletion	(21,727,846)	(21,457,846)
Net oil and gas properties	84,304,277	58,121,228
Other assets	5,531,176	2,431,254
Total assets	$136,084,932	$ 118,257,143
Liabilities and Stockholders' Equity		
Current liabilities		
Accounts payable	$ 1,018,533	$ 3,049,928
Accrued liabilities	3,309,277	7,760,800
Short-term notes payable	9,450,000	-
Total current liabilities	13,777,810	10,810,728
Line of credit	1,978,414	-
Convertible notes payable	93,686,211	68,572,500
Other long-term liabilities	33,792	38,595
Total liabilities	109,476,227	79,421,823
Commitments and contingencies		
Stockholders' equity		
Common stock	2,959	2,821
Additional paid-in capital	160,310,527	153,107,958
Common stock warrants	3,114,055	1,266
Treasury stock, at cost	(567,832)	(567,832)
Accumulated deficit	(135,751,004)	(113,708,893)
Accumulated other comprehensive loss	(500,000)	-
Total stockholders' equity	26,608,705	38,835,320
Total liabilities and stockholders' equity	$136,084,932	$ 118,257,143

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

Frontera Resources Corporation and Subsidiaries

Condensed Consolidated Statements of Operations *(Unaudited)*

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Revenue - crude oil sales	$ -	$ -	$ 2,874,437	$ 1,878,540
Operating expenses				
Field operating and project costs	1,319,119	594,824	4,006,274	3,031,388
General and administrative	6,190,154	4,272,978	14,357,066	10,713,027
Depreciation, depletion and amortization	175,313	133,677	510,114	534,598
Total operating expenses	7,684,586	5,001,479	18,873,454	14,279,013
Loss from operations	(7,684,586)	(5,001,479)	(15,999,017)	(12,400,473)
Other income (expense)				
Interest income	285,205	972,090	968,190	1,791,537
Interest expense	(2,951,385)	(1,830,117)	(6,975,624)	(2,814,541)
Other, net	(42,738)	3,837	(35,660)	36,148
Total other income (expense)	(2,708,918)	(854,190)	(6,043,094)	(986,856)
Net loss	$ (10,393,504)	$ (5,855,669)	$ (22,042,111)	$ (13,387,329)
Loss per share				
Basic and diluted	($0.14)	($0.08)	($0.31)	($0.19)
Number of shares used in calculating loss per share				
Basic and diluted	73,168,765	70,459,278	71,711,170	70,409,783

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

Frontera Resources Corporation and Subsidiaries
Condensed Consolidated Statement of Stockholders' Equity *(Unaudited)*

	Common Stock	Additional Paid-in Capital	Common Stock Warrants	Treasury Stock	Accumulated Deficit	Accumulated Other Comprehensive Loss	Total Stockholders' Equity
Balances at December 31, 2007	$ 2,821	$ 153,107,958	$ 1,266	$ (567,832)	$ (113,708,893)	$ -	$ 38,835,320
Conversion of convertible debt	109	4,539,525	-	-	-	-	4,539,634
Issuance of common stock warrants	-	-	3,114,055	-	-	-	3,114,055
Exercise of common stock warrants	15	1,251	(1,266)	-	-	-	-
Exercise of common stock options	14	347,036	-	-	-	-	347,050
Compensation expense-common stock option	-	2,314,757	-	-	-	-	2,314,757
Unrealized loss on short-term investments	-	-	-	-	-	(500,000)	(500,000)
Net loss	-	-	-	-	(22,042,111)	-	(22,042,111)
Total comprehensive loss for the year					(22,042,111)	(500,000)	(22,542,111)
Balances at September 30, 2008	$ 2,959	$ 160,310,527	$3,114,055	$ (567,832)	$ (135,751,004)	$ (500,000)	$ 26,608,705

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

Frontera Resources Corporation and Subsidiaries

Condensed Consolidated Statements of Cash Flows *(Unaudited)*

	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Cash flows from operating activities		
Net loss	$ (22,042,111)	$ (13,387,329)
Adjustments to reconcile net loss to net cash used in operating activities		
Depreciation, depletion and amortization	510,114	534,598
Interest income–restricted cash	-	(126,728)
Debt issuance cost amortization	657,842	152,725
Noncash interest expense	6,153,345	-
Stock based compensation	2,314,757	1,983,742
Changes in operating assets and liabilities:		
Accounts receivable	(51,698)	21,640
Inventory	986,674	(4,421,279)
Prepaid expenses and other current assets	(461,186)	(3,320,219)
Accounts payable	(2,137,161)	(420,184)
Accrued liabilities	(6,404,784)	6,152,095
Other long-term liabilities	(4,803)	(1,994)
Net cash used in operating activities	(20,479,011)	(12,832,933)
Cash flows from investing activities		
Investment in oil and gas properties	(24,394,022)	(10,889,219)
Investment in property and equipment	(310,366)	(131,953)
Restricted cash	-	(5,000,000)
Net redemption (purchase) of other short-term investments	-	(10,451,556)
Purchase of auction rate securities	-	(33,150,000)
Redemption of auction rate securities	13,000,000	18,225,000
Net cash used in investing activities	(11,704,388)	(41,397,728)
Cash flows from financing activities		
Repayments of borrowings	-	(3,502,038)
Proceeds from convertible debt	23,500,000	66,500,000
Restricted cash	10,118,786	(10,000,000)
Debt issuance costs	(643,709)	(1,537,928)
Proceeds from line of credit	1,978,414	-
Proceeds from short-term notes payable	9,450,000	-
Exercise of common stock options	347,050	18,400
Net cash provided by financing activities	44,750,541	51,478,434
Net increase (decrease) in cash and cash equivalents	12,567,142	(2,752,227)
Cash and cash equivalents		
Beginning of year	4,945,221	9,927,181
End of period	$ 17,512,363	$ 7,174,954
Supplemental disclosure of noncash investing and financing activities		
Issuance of convertible notes in lieu of interest payments	$ 5,673,712	$ -
Noncash debt issuance costs	3,114,055	500,000
Conversion of debt to common stock	4,539,634	100,000

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

1. Nature of Operations

Frontera Resources Corporation, a Delaware corporation, and its subsidiaries (collectively "Frontera" or the "Company") are engaged in the development of oil and gas projects in emerging marketplaces. Frontera was founded in 1996 and is headquartered in Houston, Texas. The Company emphasizes development of reserves in known hydrocarbon-bearing basins, and is attracted to projects that have significant exploration upside. Since 2002, the Company has focused substantially all of its efforts on the exploration and development of oilfields within the Republic of Georgia ("Georgia"), a member of the Former Soviet Union.

In June 1997, the Company entered into a 25 year production sharing agreement with the Ministry of Fuel and Energy of Georgia and State Company Georgian Oil ("Georgian Oil"), which gives the Company the exclusive right to explore, develop and produce crude oil in a 5500 square kilometer area in eastern Georgia known as Block 12, hereafter referred to as the "Block 12 PSA". The Block 12 PSA can be extended if commercial production remains viable upon its expiration in June 2022.

Under the terms of the Block 12 PSA, the Company is entitled to conduct exploration and production activities and is entitled to recover its cumulative costs and expenses from the crude oil produced from Block 12. Following recovery of cumulative costs and expenses from Block 12 production, the remaining crude oil sales, referred to as Profit Oil, are allocated between Georgian Oil and Frontera in the proportion of 51% and 49%, respectively.

Under the terms of the Block 12 PSA, Frontera is exempt from all taxes imposed by the government of Georgia, and any taxes imposed on the Company shall be paid by Georgian Oil on behalf of the Company from Georgian Oil's 51% share of Profit Oil. Taxes are defined by the Block 12 PSA to mean all levies, duties, payments, fees, taxes or contributions payable to or imposed by any government agency, subdivision, municipal or local authorities within the Government of Georgia.

Frontera's future revenues depend on operating results from its operations in the Republic of Georgia. The success of Frontera's operations is subject to various contingencies beyond management control. These contingencies include general and regional economic and political conditions, prices for crude oil, competition and changes in regulation. Frontera is subject to various additional political and economic uncertainties in Georgia which could include restrictions on transfer of funds, import and export duties, quotas and embargoes, domestic and international customs and tariffs, and changing taxation policies, foreign exchange restrictions, political conditions and regulations. The hostilities between Georgia and the Russian Federation over the separatist regions of South Ossetia and Abkhazia in August 2008 temporarily interrupted oil transportation routes within Georgia and operations at key Black Sea ports. Although Russian forces have withdrawn from Georgia, any resumption of hostilities could interrupt and adversely affect the Company's operations and ability to market production from Block 12. Frontera's business units within Block 12 are located approximately 100 miles or more east of South Ossetia.

2. Liquidity and Capital Resources

The following key financial measurements reflect our financial position and capital resources as of September 30, 2008 and December 31, 2007 (dollars in thousands):

	September 30, 2008	December 31, 2007
Cash and cash equivalents	17,512	4,945
Working capital	30,995	45,488
Total debt	105,115	68,573
Debt to debt and equity	80%	64%

Our cash and cash equivalents consist of highly liquid investments in deposits we hold at major financial institutions.

Our operating cash flow is influenced mainly by the prices that we receive for our oil production; the quantity of oil we produce; and the success of our development and exploration activities. Currently we do not generate sufficient operating cash flows to cover our general corporate activities or our planned capital expenditure programs.

We have previously met all capital expenditure requirements under the terms of our production sharing agreement with the Republic of Georgia and as a result, our capital expenditures are entirely discretionary. While we make and expect to continue to make substantial capital expenditures in the exploration, development, and production of natural gas and oil reserves, we are able to adjust our expenditures according to available capital resources. We believe that our cash flows from operations, current cash and investments on hand will be sufficient to meet our non-discretionary capital expenditure budget for the next 12 months.

We estimate that our total capital expenditures for 2008 will be approximately $33.7 million, of which $26.8 million had been spent as of September 30, 2008. Our planned 2008 capital expenditures represent a 16% increase over actual 2007 capital expenditures. Our 2008 capital expenditures have been focused on growing and developing our reserves and production on our existing Block 12 acreage. Of our total $33.7 million planned capital expenditures approximately $33.5 million is directed to exploration and production activities in the Tarabani Field, Basin Edge Play and Shallow Field Production Units.

In order to fund discretionary capital expenditures during 2009, we will require additional outside financing. In recent months there has been extreme volatility and disruption in the global capital and credit markets. While these market conditions persist, our ability to access the capital and credit markets may be adversely affected.

The principal factors that could adversely affect the amount and availability of our internally generated cash flows from operations include:

- Further deterioration in the sales price of crude oil.
- Decline in current production volumes or production volumes of future wells being less than anticipated.
- Inability to attract outside financing to continue discretionary capital expenditures for future drilling.

The principal factors that could adversely affect our ability to obtain financing from external sources include:

- Covenants contained in our 10% convertible notes.
- Volatility in the markets for corporate debt, continued market instability, unavailability of credit or inability to access the capital markets as a result of the global financial crisis.
- Fluctuations in the market price of our common stock.

3. Basis of Presentation and Summary of Significant Accounting Policies

The condensed consolidated balance sheet of the Company at December 31, 2007 was derived from the Company's audited consolidated financial statements as of that date. The condensed consolidated balance sheet at September 30, 2008, the condensed consolidated statements of operations for the three and nine month periods ended September 30, 2008 and 2007, the condensed consolidated statement of changes in stockholders' equity for the nine month period ended September 30, 2008, and the condensed consolidated statements of cash flows for the nine month periods ended September 30, 2008 and 2007 were prepared by the Company.

In the opinion of Company management, all adjustments, consisting of normal recurring adjustments, necessary to state fairly the consolidated financial position, results of operations and cash flows were recorded. The results of operations for the three month period ended September 30, 2008 are not necessarily indicative of the operating results for a full year or of future operations.

Certain information and footnote disclosures normally included in financial statements presented in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. The accompanying condensed consolidated financial statements should be read in conjunction with the financial statements and notes thereto contained in the Company's consolidated financial statements for the year ended December 31, 2007.

For a description of the Company's accounting policies, refer to Note 2 of the 2007 consolidated financial statements.

Use of Estimates
The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent asset and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Estimates of oil and natural gas reserves and their values, future production rates and future costs and expenses are inherently uncertain for numerous reasons, including many factors beyond the Company's control. Reservoir engineering is a subjective process of estimating underground accumulations of oil and natural gas that cannot be measured in an exact manner. The accuracy of any reserve estimate is a function of the quality of data available and of engineering and geological interpretation and judgment. In addition, estimates of reserves may be revised based on actual production, results of subsequent exploitation and development activities, prevailing commodity prices, operating cost and other factors. These revisions may be material and could materially affect the Company's future depletion, depreciation and amortization expenses.

The Company's revenue, profitability, and future growth are substantially dependent upon the prevailing and future prices for oil and natural gas, which are dependent upon numerous factors beyond its control such as economic, regulatory developments and competition from other energy sources. The energy markets have historically been volatile and there can be no assurance that oil and natural gas prices will not be subject to wide fluctuations in the future. A substantial or extended decline in oil and natural gas prices could have a material adverse effect on the Company's financial position, results of operations, cash flows and quantities of oil and natural gas reserves that may be economically produced.

Fair Value Measurements
Effective January 1, 2008, the Company implemented Statement of Financial Accounting Standards ("SFAS") No. 157, *Fair Value Measurements* for its financial assets and liabilities that are being measured on a recurring basis. SFAS No. 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS No. 157 does not require new fair value measurements. SFAS No. 157 did not have an effect on the Company's financial statements other than requiring additional disclosures regarding fair value measurements. See Note 4 for further discussion of the Company's fair value measurement.

Restricted Cash
At September 30, 2008 the Company had approximately $5.0 million of restricted cash. Restricted cash in the amount of $5.0 million serves as collateral for a $5.0 million line of credit that is used from time to time to support letters of credit that provide financial assurance that the Company will fulfill its obligations with respect to service contracts with certain vendors. In July 2008, previously restricted cash (related to the Company's convertible debt) in the amount of $5.0 million was released from escrow due to meeting certain benchmarks.

Short-Term Investments
Short-term investments consist of Municipal Short Term Auction Rate Securities ("M-STARS") and corporate bonds both of which represent funds available for current operations. In accordance with the SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, these M-STARS are classified as available-for-sale and are carried at cost or par value, which approximates the fair market value. These securities have stated maturities beyond three months but are priced and traded as short-term instruments due to the liquidity provided through the interest rate mechanism of 7 to 35 days.

The auction process resets the applicable interest rates at prescribed calendar intervals and is intended to provide liquidity to the holders of auction rate securities by matching buyers and sellers in a market context, enabling the holders to gain immediate liquidity by selling such securities at par, or rolling over their investment. If there is an imbalance between buyers and sellers, there is a risk of a failed auction. Due to recent credit issues experienced by short-term funding markets, some of these securities, including our M-STARS, have failed at auction in 2008; however, we have successfully liquidated $13.0 million of our M-STARS during 2008. An auction failure is not a default, and in some cases it could reset the applicable interest rates to a higher rate as outlined by the security. The Company does not currently intend to liquidate these investments at below par value or prior to a reset date but has recorded a temporary impairment of $0.5 million with regards to these investments (see Note 4). The Company will continue to assess the fair value of these securities at the end of each quarter. Based on the Company's ability to access cash and cash equivalents, expected operating cash flows and other sources of cash, we do not anticipate that any lack of short-term liquidity related to these securities will materially affect the Company's ability to operate its business.

Short-term investments consisted of investments in M-STARS with an estimated fair value of $12.1 million and $25.6 million at September 30, 2008 and December 31, 2007, respectively (see Note 4).

4. Fair Value Measurements

The Company implemented SFAS No. 157 effective January 1, 2008 for its financial assets and liabilities measured on a recurring basis. SFAS No. 157 applies to all financial assets and liabilities that are being measured and reported on a fair value basis. In February 2008, the FASB issued FSP 157-2, which delayed the effective date of SFAS No. 157 by one year for certain nonfinancial assets and liabilities. In October 2008, the FASB issued FSP 157-3, which clarifies the application of SFAS No. 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. It also reaffirms the notion of fair value as an exit price as of the measurement date. This position was effective upon issuance, including prior periods for which financial statements have not been issued. The adoption had no impact on the Company's condensed consolidated financial statements.

As defined in SFAS No. 157, fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. SFAS No. 157 requires disclosure that establishes a framework for measuring fair value and expands disclosure about fair value measurements. The statement requires fair value measurements be classified and disclosed in one of the following categories:

Level 1: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities. The Company considers active markets as those in which transactions for the assets or liabilities occur in sufficient frequency and volume to provide pricing information on an ongoing basis.

Level 2: Quoted prices in markets that are not active, or inputs which are observable, either directly or indirectly, for substantially the full term of the asset or liability.

Level 3: Measured based on prices or valuation models that required inputs that are both significant to the fair value measurement and less observable for objective sources (i.e., supported by little or no market activity).

As required by SFAS No. 157, financial assets and liabilities are classified based on the lowest level of input that is significant to the fair value measurement. The Company's assessment of the significance of a particular input to the fair value measurement requires judgment, and may affect the valuation of the fair value of assets and liabilities and their placement within the fair value hierarchy levels. Per SFAS No. 157, the Company has classified its short-term investments into one of the three levels based upon the data relied upon to determine the fair value.

Liquidity in certain auction rate securities markets was also significantly reduced during the first nine months of 2008, resulting in wide-spread auction failures and increasing rates for auction rate securities. Third-party pricing services are either no longer providing valuations for failed auction rate securities or are valuing such securities at par (which may not necessarily reflect prices that would be obtained in the secondary market for such securities if such a market were to develop). As a result, the Company assigned these securities to level 3 in the fair value hierarchy. In the absence of a secondary market, fair value was estimated based on a number of factors including the credit quality of the obligor, the credit quality of the bond insurer, the coupon, and the likelihood of refinancing by the issuer. Based on this analysis, a temporary impairment of $0.5 million was recorded at September 30, 2008 to accumulated other comprehensive loss on the accompanying condensed consolidated balance sheet.

The following table summarizes the valuation of the Company's financial assets by SFAS No. 157 pricing levels as of September 30, 2008.

	Fair Value Measurement Using:			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**	**Asset at Fair Value**
Short-term investments - M-STARS	$ -	$ -	$ 12,100,000	$ 12,100,000
	$ -	$ -	$ 12,100,000	$ 12,100,000

The table below sets forth a reconciliation for assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the nine months ended September 30, 2008:

Short-term investments - M-STARS as of December 31, 2007	$ 25,600,000
Total unrealized loss	(500,000)
Purchases, issuances and settlements	(13,000,000)
Short-term investments - M-STARS as of September 30, 2008	$ 12,100,000

5. Detail of Certain Balance Sheet Accounts

Inventory consists primarily of materials to be used in the Company’s foreign oilfield operations and crude oil held in stock tanks. Inventory is valued using the first-in, first-out method and is stated at the lower of cost or market. Inventory consists of the following:

	September 30, 2008	**December 31, 2007**
Materials and supplies	$ 6,325,268	$ 7,997,192
Crude oil	1,981,063	1,295,813
	$ 8,306,331	$ 9,293,005

6. Notes Payable

Line of Credit

During 2007 the Company established a $5.0 million line of credit with a commercial bank by agreeing to collateralize $5.0 million of cash and cash equivalents. The line was primarily set up to support letters of credit issued by the Company from time to time in support of its oil and gas operations. The line of credit remains in place during 2008 and approximately $2.0 million had been borrowed against the line at September 30, 2008. No amounts were borrowed at December 31, 2007.

In February 2008, warrant holders exercised warrants to purchase 377,418 shares of common stock in a cashless exercise, pursuant to the warrant agreement.

In April 2008, the Company borrowed approximately $9.5 million under a short term note agreement with a bank, collateralized by its short term investments in M-STARS. The note was due in October 2008 and was subsequently renewed in November for 90 days.

7. Convertible Notes

During May 2007, the Company raised approximately $67.0 million through a private placement of convertible unsecured notes due May 2012. The notes were issued at par and bear interest at 10%, payable quarterly in arrears in cash or in kind at the Company's discretion. The notes are convertible into shares of common stock at conversion price of $1.67 per share. The notes will be automatically converted into common stock at the conversion price if the stock price exceeds two times the conversion price for at least 20 consecutive trading days. As part of the closing of the notes, debt issuance costs of approximately $2.7 million were incurred, of which approximately $1.5 million was paid in cash and $1.2 million of additional convertible notes and stock options were issued for the remainder.

During June 2007, noteholders holding $100,000 of convertible notes elected to convert their notes into 59,880 shares of common stock.

During January 2008, noteholders holding $110,500 of convertible notes elected to convert their notes into 65,906 shares of common stock.

During the second quarter of 2008, noteholders holding $2.6 million of convertible notes elected to convert their notes into 1,556,880 shares of common stock. Noteholders also elected to convert approximately $310,000 of related interest into 135,094 shares of common stock.

During the third quarter of 2008, noteholders holding $1.4 million of convertible notes elected to convert their notes into 814,368 shares of common stock. Noteholders also elected to convert approximately $159,000 of related interest into 134,473 shares of common stock.

On July 3, 2008, the Company raised $23.5 million through a private placement of convertible unsecured notes due July 2013. The notes were issued at par and bear interest at 10%, payable quarterly in arrears in cash or in kind at the Company's discretion. The notes were initially convertible into common stock at a conversion price of $2.14 per share. The conversion price was subsequently reset to $1.71 per share, pursuant to the terms of the notes, since the price of the common stock closed at or below $1.71 per share for 10 out of 20 consecutive trading days. The notes will be automatically converted into common stock at the conversion price if the closing stock price exceeds two times the conversion price for at least 20 consecutive trading days.

The Company solicited consents from holders of its 10% convertible notes due 2012 to amend the note purchase agreements governing such notes to permit the issuance of the new notes and to release the remaining escrowed proceeds of $5.0 million from the May 2007 private placement. In connection with the solicitation, each consenting holder received a warrant exercisable into shares of common stock in an amount equal to 7.5% of the number of shares of common stock into which such consenting holder's existing notes were convertible. The warrants are exercisable for approximately 3,151,000 shares of common stock in the aggregate. Each warrant entitles the holder to purchase one share of common stock at a price of $3.50 per share, and includes a cashless exercise provision. The warrants have a five-year term and contain other customary terms and provisions.

At December 31, 2007, March 31, 2008, and June 30, 2008, the Company elected to pay the quarterly interest payments on the May 2007 convertible notes in kind and issued approximately $1.7 million for each period, respectively, in additional convertible notes in accordance with terms of the note purchase agreement. At September 30, 2008, the Company also elected to pay the quarterly interest payments in kind on both tranches of convertible debt and issued approximately $2.3 million in additional convertible notes.

8. Income Taxes

The Company has incurred losses since inception and, therefore, has not been required to pay federal income taxes. In accordance with applicable generally accepted accounting principles, the Company estimates for each interim reporting period the effective tax rate expected for the full fiscal year and uses that estimated rate in providing income taxes on a current year to date basis. The Company has established a valuation allowance that is primarily attributable to U.S. federal deferred tax assets. Management believes enough uncertainty exists regarding the realization of the deferred items and has recorded a full valuation allowance.

For the nine months ended September 30, 2008 and 2007, no income tax payments were made.

9. Commitments and Contingencies

SOCAR Arbitration
In June 1998, Frontera Resources Azerbaijan Corporation, an indirect wholly owned subsidiary of the Company, entered into a production sharing agreement with the State Oil Company of the Azerbaijan Republic (SOCAR), hereafter referred to as the “Azerbaijan PSA”. The Azerbaijan PSA covered the Kursangi and Karabagli onshore oilfields in an area of Azerbaijan known as the “K&K Block”. The Company and an operating partner undertook an exploration and development program on the K&K Block. The Company’s relationship with SOCAR deteriorated as a result of several disputes under the Azerbaijan PSA and the Company was unsuccessful at reaching a settlement with SOCAR.

Frontera initiated binding arbitration against SOCAR in October 2003 related to claims resulting from SOCAR’s halting of oil exports from the K&K Block during the fourth quarter of 2000. The arbitration was held in Stockholm under the rules of the United Nations Commission on International Trade Law. In January 2006, the arbitral panel found that the halting of exports of crude oil from the K&K Block was in violation of the Azerbaijan PSA and awarded Frontera approximately $1.2 million plus interest from 2000 until payment is made. The arbitral panel rejected all other claims and counterclaims between the parties.

SOCAR has refused to pay the award and filed an action in the Svea Court of Appeals in Stockholm to annul the award. The proceedings are continuing before the appeals court, and a final hearing is scheduled for March 2009. As a result of SOCAR's refusal to pay the award, the Company commenced an action in the United States District Court for the Southern District of New York in February 2006, seeking to enforce the award. In March 2007, the District Court granted SOCAR’s motion to dismiss, and the Company appealed that decision in July 2007 to the United States Court of Appeals for the Second Circuit. The hearing on the appeal occurred in October 2008, and a decision is expected during the first quarter of 2009.

GAC Arbitration
In June 2007, Frontera Resources Georgia Corporation, an indirect wholly owned subsidiary of the Company ("FRGC"), was served a notice of arbitration and claim by GAC Energy Company and an affiliated company (collectively, "GAC"). GAC and Frontera were parties to a farmout agreement dated June 2002 covering Block 12 (the "Farmout Agreement"), pursuant to which GAC would earn a 25% working interest in Block 12 and a 12.5% interest in Frontera Eastern Georgia Limited, an indirect consolidated subsidiary of the Company ("FEGL"), upon the fulfillment of certain financial and work program commitments. In September 2004, GAC reassigned its interest in Block 12 to Frontera as a result of GAC's default on its financial and work program commitments. The notice of arbitration and claim alleged, among other things, that GAC did not default on its obligations under the Farmout Agreement and should be awarded a 25% working interest in Block 12. The

evidentiary hearing was held in July 2008, and the arbitrator's decision was announced in October 2008. The arbitrator found that GAC failed to complete its obligations under the Farmout Agreement and rejected GAC's claims for either an interest in Block 12 or $19 million in restitution and directed GAC to pay Frontera's arbitration costs of approximately $85,000. The arbitration, which is binding on the parties, resolves all claims and counterclaims between Frontera and GAC with respect to the Farmout Agreement.

ARAR Arbitration

In January 2008, FEGL, served a notice of arbitration and claim on ARAR, Inc. (“ARAR"), for breach of contract under a drilling services contract dated May 2007, specifically for, among other things, failure to commence work by the time specified in the contract, failure of the drilling rig to meet required specifications and failure to reconcile advance payments made by FEGL with work actually performed. FEGL terminated the contract after ARAR failed to mobilize the rig to the required location and failed to commence work as otherwise required under the contract. FEGL seeks damages of approximately $7.0 million in the arbitration. ARAR denies FEGL's claims and has filed counterclaims against FEGL, seeking payments of approximately $7.1 million for, among other things, standby charges for the period of time the rig was undergoing inspection and repairs to bring it into contract specification, early termination fees and demobilization fees. Frontera considers the ARAR counterclaims to be without merit and intends to vigorously defend itself. The evidentiary hearing has been scheduled for December 2008.

10. Stockholders’ Equity

Preferred Stock

The Company has the authority to issue up to 10,000,000 shares, par value $.00001, of serial preferred stock. No preferred stock was outstanding at September 30, 2008 and December 31, 2007. The Board of Directors may designate and authorize the issuance of such shares with such voting power and in such classes and series, and with such designation, preferences and relative participation, optional, or other special rights, qualifications, limitations, or restrictions as deemed appropriate by the Company’s Board of Directors.

Common Stock

As of September 30, 2008 and December 31, 2007 the Company was authorized to issue 200,000,000 shares of common stock, par value $.00004 per share. As of September 30, 2008 and December 31, 2007, the Company had 73,904,297 and 70,463,408 shares, respectively, of common stock issued and outstanding. At September 30, 2008 and December 31, 2007, there were an additional 17,571,000 and 15,061,000 shares, respectively, of common stock reserved for the exercise of existing options and warrants.

Treasury Stock

At September 30, 2008 and December 31, 2007, the Company had 5,739,855 shares of treasury stock, all held as common stock.

For the nine months ended September 30, the Company recognized stock-based compensation expense related to common stock options of approximately $2.3 million in 2008 and $2.0 million in 2007. Stock-based compensation expense is reflected in general and administrative expense in the condensed consolidated statements of operations.

Introduction

The following discussion and analysis should be read in conjunction with the accompanying financial statements and related notes thereto. The following discussion contains forward-looking statements that reflect our future plans, estimates, beliefs and expected performance. The forward-looking statements are dependent upon events, risks and uncertainties that may be outside our control. Our actual results could differ materially from those discussed in these forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, market prices for natural gas and oil, economic and competitive conditions, regulatory changes, estimates of proved reserves, potential failure to achieve production from development projects, capital expenditures and other uncertainties, as well as those factors discussed below, particularly in "Risk Factors" and "Cautionary Statement Concerning Forward-Looking Statements," all of which are difficult to predict. In light of these risks, uncertainties and assumptions, the forward-looking events discussed may not occur.

The financial information with respect to the three and nine month periods ended September 30, 2008 and 2007 that is discussed below is unaudited. In the opinion of management, this information contains all adjustments, consisting only of normal recurring accruals, necessary for the fair presentation of the results for such periods. The results of operations for the interim periods are not necessarily indicative of the results of operations for the full fiscal year.

Overview of Our Company

Frontera Resources Corporation, a Delaware corporation, and its subsidiaries (collectively "Frontera" or the "Company") are engaged in the development of oil and gas projects in emerging marketplaces. Frontera was founded in 1996 and is headquartered in Houston, Texas. The Company emphasizes development of reserves in known hydrocarbon-bearing basins, and is attracted to projects that have significant exploration upside. Since 2002, the Company has focused substantially all of its efforts on the exploration and development of oilfields within the Republic of Georgia ("Georgia"), a member of the Former Soviet Union. Prior to 2002, the Company's other significant operating focus was on the exploration and development of an oilfield within the Azerbaijan Republic ("Azerbaijan"), which was sold during 2002 and all operating activities in Azerbaijan ceased at that time.

In accordance with full cost accounting rules, we are subject to a limitation on capitalized costs. The capitalized cost of natural gas and oil properties, net of accumulated depreciation, depletion and amortization, may not exceed the estimated future net cash flows from proved oil and gas reserves discounted at 10%, plus the lower of cost or fair market value of unproved properties as adjusted for related tax effects, which is known as the ceiling limitation. If capitalized costs exceed the ceiling limitation, the excess must be charged to expense. We did not have any adjustment to earnings due to the ceiling limitation for the periods presented herein.

Results of Operations

Nine Months Ended September 30, 2008 Compared to Nine Months Ended September 30, 2007

Revenue. Total revenue increased to $2.9 million for the nine months ended September 30, 2008 from $1.9 million in the same period in 2007. This increase was primarily due to higher commodity prices in the 2008 period.

Operating Costs and Expenses. Total operating costs and expenses increased to $18.9 million for the nine months ended September 30, 2008 compared to $14.3 million for the same period in 2007.

Field operating and project costs includes the costs associated with our exploration and production activities, including, but not limited to, drilling, field operating expense and processing costs.

Field operating and project costs increased $1.0 million primarily due to the cost of oil sold in Q2 2008 versus cost of oil sold in Q1 and Q2 2007 and due to costs of certain drilling personnel being charged to operating expenses in Q3 2008 versus being capitalized to drilling projects in Q3 2007.

DD&A was virtually unchanged during the nine months ended September 30, 2008, as compared to the nine months ended September 30, 2007.

General and administrative expenses increased $3.7 million to $14.4 million for the nine months ended September 30, 2008 from $10.7 million for the comparable period in 2007. Salaries and wages accounted for $1.9 million of the increase. Approximately $1.0 million of the increase was due to the cost of ex-patriate staff in Georgia added in the second half of 2007 and due to charging certain senior drilling staff to general and administrative expense in the 2008 period that had been charged to operating expense in the 2007 period. Approximately $0.4 million increase was due to Georgian national staff salary increases, which are dollar denominated, to adjust for the weakening dollar and covering higher income tax rates, which increased from 12% in the 2007 period to 25% in the 2008 period. The remaining $0.5 million increase in salaries and wages occurred at the corporate level and was primarily attributable to higher stock option compensation expense in the 2008 period versus the 2007 period. Legal expenses increased $2.1 million primarily due to expenses incurred in connection with arbitration proceedings and other general corporate matters during the first nine months of 2008. The remaining $0.3 million decrease was primarily attributable to lower shareholder relations expenses in the nine months ended September 30, 2008 versus the comparable period in 2007.

Other Income (Expense). Total other expense increased to $6.0 million in the nine month period ended September 30, 2008 from other expense of $1.0 million in the nine month period ended September 30, 2008. The $5.0 million increase in other expense is primarily attributable to an increase in interest expense of $4.1 million and a $0.9 million decrease in interest income.

Interest income decreased to $1.0 million for the nine months ended September 30, 2008 from $1.8 million for the same period in 2007. This decrease was due to interest income from excess cash in investment accounts which was higher in 2007 due to the Company's May 2007 $67.0 million convertible debt offering.

Interest expense increased to $7.0 million for the nine months ended September 30, 2008 from $2.8 million for the same period in 2007. This increase was primarily attributable to the Company's $67.0 million convertible debt offering which was outstanding for the full nine months ended September 30, 2008 versus being outstanding for only 82 days in the comparable period in 2007. The increase was also attributable to interest on the July 2008 convertible debt offering of $23.5 million.

Results of Operations

Three Months Ended September 30, 2008 Compared to Three Months Ended September 30, 2007

Revenue. Revenues for the three months ended September 30, 2008 and 2007 were zero as no oil sales were completed in either period.

Operating Costs and Expenses. Total operating costs and expenses increased to $7.7 million for the three months ended September 30, 2008 compared to $5.0 million for the same period in 2007.

Field operating and project costs includes the costs associated with our exploration and production activities, including, but not limited to, drilling, field operating expense and processing costs.

Field operating and project costs increased $0.7 million to $1.3 million during the three months ended September 30, 2008 as compared to $0.6 million for the three months ended September 30, 2007.

Approximately $0.4 million of the increase was due cost of expatriate drilling personnel charged to operating expense in the 2008 period versus capitalized in drilling costs for the 2007 period. The remaining $0.3 million increase is attributable to higher rail transportation costs in the 2008 period versus the 2007 period. Most oil sold in the 2007 period was actually transported to the port for sale in the fourth quarter of 2006.

DD&A was virtually unchanged during the three months ended September 30, 2008 as compared to the three months ended September 30, 2007.

General and administrative expenses increased $1.9 million to $6.2 million for the three months ended September 30, 2008 from $4.3 million for the comparable period in 2007. The increase was partially attributable to a $0.5 million increase in compensation expense related to our Georgian operations due to additional expatriate staff and a change in classification for senior drilling managers from operations expense in the 2007 period to general and administrative expense in the 2008 period. Also national staff salaries, which are dollar denominated, were increased to adjust for a weakening dollar and an income tax increase from 12% in the 2007 period to 25% in the 2008 period. There was also a $0.3 million increase in compensation expense at the corporate level, which was primarily attributable to higher stock option compensation expense in the 2008 period versus the 2007 period. We also had a $1.2 million increase in legal expense, which was primarily attributable to arbitration proceedings and other general corporate matters. These increases in the 2008 period were partially offset by a $0.1 million decrease in other general and administrative expense as compared to the same period in 2007.

Other Income (Expense). Total other expense increased to $2.7 million in the three month period ended September 30, 2008 from other expense of $0.9 million in the three month period ended September 30, 2007. The $1.8 million increase is primarily attributable to an increase in interest expense of $1.1 million and a $0.7 million decrease in interest income.

Interest income decreased to $0.3 million for the three months ended September 30, 2008 from $1.0 million for the same period in 2007. This decrease was due to lower available cash for investment in the 2008 period as compared to the same period in 2007 primarily due to the $67.0 million convertible debt offering which occurred in May 2007.

Interest expense increased to $3.0 million for the three months ended September 30, 2008 from $1.8 million for the same period in 2007. This increase was primarily attributable to interest on the $23.5 million convertible debt offering in July 2008 and to additional debt incurred by making interest payments in kind on the $67.0 million 2007 convertible debt offering.

Liquidity and Capital Resources

Summary

The following key financial measurements reflect our financial position and capital resources as of September 30, 2008 and December 31, 2007 (dollars in thousands):

	September 30, 2008	December 31, 2007
Cash and cash equivalents	17,512	4,945
Working capital	30,995	45,488
Total debt	105,115	68,573
Debt to debt and equity	80%	64%

Our cash and cash equivalents consist of highly liquid investments in deposits we hold at major financial institutions.

Our operating cash flow is influenced mainly by the prices that we receive for our oil production; the quantity of oil we produce; and the success of our development and exploration activities. Currently we do not generate sufficient operating cash flows to cover our general corporate activities or our planned capital expenditure programs. We have met all minimum expenditure requirements under our production sharing contract in the Republic of Georgia as of September 30, 2008 and therefore our planned capital expenditure programs are entirely discretionary.

As of September 30, 2008, our cash and cash equivalents were $17.5 million, our short-term investments were $12.1 million and we had approximately $5.0 million of restricted cash. In July 2008, $5.0 million of previously restricted cash was released in connection with the issuance of new convertible notes. The remaining $5.0 million serves as collateral for a $5.0 million line of credit that is used from time to time to support letters of credit that provide financial assurance that the Company will fulfill its obligations with respect to service contracts with certain vendors. See Notes 3, 6, and 7 of the accompanying notes to the condensed consolidated financial statements for further discussion of the convertible notes, the line of credit, the restricted cash and the new convertible notes. At September 30, 2008 the Company had $93.6 million of convertible long term debt outstanding. The company also had a $9.5 million short term note payable to a bank which was collateralized by $12.1 million in short term investments in M-STARS, and $2.0 million dollars payable pursuant to funds drawn against a $5.0 million dollar line of credit with its primary bank. The Company had no other outstanding debt at September 30, 2008.

In July 2008, the Company received proceeds of $23.5 million pursuant to the private placement of convertible notes due July 2013. In connection with the placement, $5.0 million of restricted cash was released from escrow pursuant to unanimous consent of noteholders from the Company's $67.0 million dollar private placement of convertible debt in May 2007. Also, in July 2008, the $9.5 million short term note payable was renewed for 90 days. In November 2008 the short term note was again renewed for 90 days. See Notes 6 and 7 of the accompanying notes to the condensed consolidated financial statements for further discussion of these transactions.

Liquidity in certain auction rate securities markets was also significantly reduced in the first nine months of 2008, resulting in wide-spread auction failures, including our M-STARS. Third-party pricing services are either no longer providing valuations for failed auction rate securities or are valuing such securities at par (which may not necessarily reflect prices that would be obtained in the secondary market for such securities if such a market were to develop). As a result, the Company assigned these securities to level 3 in the fair value hierarchy, as described in SFAS No. 157. In the absence of a secondary market, fair value was estimated based on a number of factors including the credit quality of the obligor, the credit quality of the bond insurer, the coupon, and the likelihood of refinancing by the issuer. Based on this analysis, a temporary impairment of $0.5 million was recorded to accumulated other comprehensive loss on the accompanying condensed consolidated balance sheet. See Notes 3 and 4 of the accompanying notes to the condensed consolidated financial statements for further discussion.

Capital Expenditures

We have met all capital expenditure requirements under the terms of our production sharing agreement with the Republic of Georgia and as a result, our capital expenditures are now discretionary. While we make and expect to continue to make substantial capital expenditures in the exploration, development, and production of natural gas and oil reserves, we are able to adjust our expenditures according to available capital resources. We believe that our cash flows from operations, current cash and investments on hand will be sufficient to meet our non-discretionary capital expenditure budget for the next 12 months.

We estimate that our total capital expenditures for 2008 will be approximately $33.7 million, of which $26.8 million had been spent as of September 30, 2008. Our planned 2008 capital expenditures represent a 16% increase over actual 2007 capital expenditures. Our 2008 capital expenditures have been focused on growing and developing our reserves and production on our existing Block 12 acreage. Of our total $33.7 million planned capital expenditures, approximately $33.5 million is directed to exploration and production activities in the Tarabani Field, Basin Edge Play and Shallow Fields Production units.

In order to fund discretionary capital expenditures during 2009, we will require additional outside financing. In recent months there has been extreme volatility and disruption in the global capital and credit markets. While these market conditions persist, our ability to access the capital and credit markets may be adversely affected.

The principal factors that could adversely affect the amount and availability of our internally generated cash flows from operations include:

- Further deterioration in the sales price of crude oil.
- Decline in current production volumes or production volumes of future wells being less than anticipated.
- Inability to attract outside financing to continue discretionary capital expenditures for future drilling.

The principal factors that could adversely affect our ability to obtain financing from external sources include:

- Covenants contained in our 10% convertible notes.
- Volatility in the markets for corporate debt, continued market instability, unavailability of credit or inability to access the capital markets as a result of the global financial crisis.
- Fluctuations in the market price of our common stock.

Cash Flow Activity

Operating Activities. Cash flows used in operating activities increased $7.6 million to $20.5 million for the nine months ended September 30, 2008 from $12.8 million for the nine months ended September 30, 2007. The increase was primarily attributable to a higher net loss of $22.0 million for the nine months ended September 30, 2008 as compared to $13.4 million for the comparable period in 2007. This was partially offset by increases in non cash interest and stock option compensation expense of $6.5 million and debt issuance amortization of $0.5 million in the 2008 period. The increase was also attributable to a $6.0 million increase in changes in operating assets and liabilities.

Investing Activities. Cash flows used in investing activities decreased $29.7 million to $11.7 million in the nine month period ended September 30, 2008 from $41.4 million in the 2007 period. The decrease was primarily attributable to a net $25.4 million purchase of short term investments and auction rate securities and a $5.0 million balance in restricted cash in 2007 compared with a $13.0 million redemption in the 2008 period. This was partially offset by a $13.7 million increase in capital expenditures for the nine months ended 2008 as compared to 2007 as the Company's drilling campaign was launched later than originally expected in 2007 versus the substantial drilling campaign that was underway in the Tarabani Field and Basin Edge Play units in the 2008 period.

Financing Activities. Since March 2005, we have used equity issuances, borrowings and, to a lesser extent, our cash flows from oil sales to fund our exploration and production costs and general corporate overhead. Cash provided by financing activities decreased $6.7 million to $44.8 million for the nine months ended September 30, 2008 from $51.5 million for the nine months ended September 30, 2008. Net proceeds from borrowings decreased to $34.3 million for the nine months ended September 30, 2008, from $65.0 million for the nine months ended September 30, 2008. The decrease in 2008 versus the 2007 period was primarily attributable to the net proceeds of the $67.0 million convertible debt offering closed in Q2 2007, which was partially offset by $34.9 million of borrowings in the comparable 2008 period attributable to the July $23.5 million convertible debt offering, short term notes and the Company's line of credit with a bank. Also, during the 2007 period $3.5 million in borrowings were re-paid. During the nine months ended September 30, 2008, $10.1 million of cash was provided by the release of previously escrowed convertible debt proceeds and related interest. During the comparable 2007 period, $10 million of proceeds were restricted as to use and classified as restricted cash. During the nine months ended September 30, 2008, we received $0.3 million from the exercise of stock options and received $0.02 million from stock option exercises in the comparable 2007 period. We used the net proceeds to fund our capital expenditure programs and for general corporate purposes and short term investments.

Contractual Obligations and Commitments

The following table outlines our contractual obligations and commitments by payment due dates as of September 30, 2008 (in millions):

	Payments Due by Period				
	Total	Less than 1 Year	2-3 Years	4-5 Years	After 5 Years
Contractual Obligations and Commitments					
Long-term debt–principal	$ 93.7	$ -	$ -	$ 93.7	$ -
Long-term debt–interest	36.4	9.3	18.6	8.5	-
Lease agreements	1.1	0.6	0.5	-	-
Total contractual obligations and commitments	$ 131.2	$ 9.9	$ 19.1	$102.2	$ -

Critical Accounting Policies and Estimates

The discussion and analysis of our financial condition and results of operations are based upon our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of our financial statements requires us to make assumptions and prepare estimates that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities and revenues and expenses. We base our estimates on historical experience and various other assumptions that we believe are reasonable; however, actual results may differ. See Notes 1 and 3 ("Nature of Operations" and "Summary of Significant Accounting Policies") to our consolidated financial statements for a discussion of our significant accounting policies.

Risk Factors

Risks Related to the Natural Gas and Oil Industry and Our Business

Natural gas and oil prices are volatile, and a decline in natural gas and oil prices can significantly affect our financial results and impede our growth.

Our revenue, profitability and cash flow depend upon the prices and demand for natural gas and oil. The markets for these commodities are very volatile. Even relatively modest drops in prices can significantly affect our financial results and impede our growth. Changes in natural gas and oil prices have a significant impact on the value of our reserves and on our cash flow. Prices for natural gas and oil may fluctuate widely in response to relatively minor changes in the supply of and demand for natural gas and oil and a variety of additional factors that are beyond our control, such as:

- the domestic and foreign supply of natural gas and oil;
- the price of foreign imports;
- worldwide economic conditions;
- political and economic conditions in oil producing countries;
- the ability of members of the Organization of Petroleum Exporting Countries to agree to and maintain oil price and production controls;
- the level of consumer product demand;
- weather conditions;
- technological advances affecting energy consumption;
- availability of pipeline infrastructure, treating, transportation and refining capacity;
- domestic and foreign governmental regulations and taxes;
- the price and availability of alternative fuels;
- the inability to obtain financing on satisfactory terms.

Lower oil and natural gas prices may not only decrease our revenues on a per share basis, but also may reduce the amount of oil and natural gas that we can produce economically. This may result in our having to make substantial downward adjustments to our estimated proved reserves, and could result in a ceiling test writedown.

Our estimated reserves are based on many assumptions that may turn out to be inaccurate. Any significant inaccuracies in these reserve estimates or underlying assumptions will materially affect the quantities and present value of our reserves.

The present value of future net cash flows from our proved reserves will not necessarily be the same as the current market value of our estimated natural gas and oil reserves.

Unless we replace our natural gas and oil reserves, our reserves and production will decline, which would adversely affect our business, financial condition and results of operations.

Our potential drilling location inventories are scheduled over several years, making them susceptible to uncertainties that could materially alter the occurrence or timing of their drilling.

We will not know conclusively prior to drilling whether natural gas or oil will be present in sufficient quantities to be economically viable.

Our use of 2-D and 3-D seismic data is subject to interpretation and may not accurately identify the presence of natural gas and oil, which could adversely affect the results of our drilling operations.
Market conditions or operational impediments may hinder our access to natural gas and oil markets or delay our production.

We have a substantial amount of indebtedness, which may adversely affect our cash flow and our ability to operate our business.

Competition in the natural gas and oil industry is intense, which may adversely affect our ability to succeed.

Our operations expose us to potentially substantial costs and liabilities with respect to environmental, health and safety matters.

The volatility and disruptions in the global capital and credit markets in recent months have created conditions that may adversely affect the financial condition of our insurers, oil and natural gas purchasers and other counterparties with whom we deal. The inability of one or more of our customers or vendors to meet their obligations may adversely affect our financial results.

Our development and exploration operations require substantial capital and we may be unable to obtain needed capital or financing on satisfactory terms, which could lead to a loss of properties and a decline in our natural gas and oil reserves.

We are subject to commodity price risk on our production, and our liquidity may be adversely affected if commodity prices continue to decline. Based on a number of economic indicators, it appears that growth in global economic activity has slowed substantially. At the present time, the rate at which the global economy will slow has become increasingly uncertain. A continued slowing of global economic growth, and, in particular, in the United States, will likely continue to reduce demand for oil and gas. A reduction in the demand for, and the resulting lower prices of, oil and gas could adversely affect our results of operations.

Foreign Operations

Frontera's future revenues depend on operating results from its operations in the Republic of Georgia. The success of Frontera’s operations is subject to various contingencies beyond management control. These contingencies include general and regional economic and political conditions, prices for crude oil, competition and changes in regulation. Frontera is subject to various additional political and economic uncertainties in Georgia which could include restrictions on transfer of funds, import and export duties, quotas and embargoes, domestic and international customs and tariffs, and changing taxation policies, foreign exchange restrictions, political conditions and regulations. The hostilities between Georgia and the Russian Federation over the separatist regions of South Ossetia and Abkhazia in August 2008 temporarily interrupted oil transportation routes within Georgia and operations at key Black Sea ports. Although Russian forces have withdrawn from Georgia, any resumption of hostilities could interrupt and adversely affect the Company's operations and ability to market production from Block 12. Frontera's business units within Block 12 are located approximately 100 miles or more east of South Ossetia.

Cautionary Statement Concerning Forward-Looking Statements

Various statements contained in this management's discussion and analysis (MD&A), including those that express a belief, expectation, or intention, as well as those that are not statements of historical fact, are forward-looking statements. These forward-looking statements may include projections and estimates concerning the timing and success of specific projects and our future production, revenues, income and capital spending. Our forward-looking statements are generally accompanied by words such as "estimate," "project," "predict," "believe," "expect," "anticipate," "potential," "could," "may," "foresee," "plan," "goal" or other words that convey the uncertainty of future events or outcomes. The forward-looking statements in this MD&A speak only as of the date of this MD&A; we disclaim any obligation to update these statements unless required by securities law, and we caution you not to rely on them unduly. We have based these forward-looking statements on our current expectations and assumptions about future events. While our management considers these expectations and assumptions to be reasonable, they are inherently subject to significant business, economic, political, competitive, regulatory and other risks, contingencies and uncertainties relating to, among other matters, the risks discussed under the heading "Risk Factors" and the following:

- the volatility of natural gas and oil prices;
- discovery, estimation, development and replacement of natural gas and oil reserves;
- cash flow and liquidity;
- financial position;
- business strategy;
- amount, nature and timing of capital expenditures, including future development costs;
- availability and terms of capital;
- timing and amount of future production of natural gas and oil;
- availability of drilling and production equipment;
- availability of oil field labor;
- operating costs and other expenses;
- prospect development and property acquisitions;
- availability of pipeline infrastructure to transport natural gas production;
- marketing of natural gas and oil;
- competition in the natural gas and oil industry;
- regional and worldwide political conditions and uncertainties;
- governmental regulation and taxation of the natural gas and oil industry; and
- developments in oil-producing and natural gas-producing countries.