PRICEWATERHOUSECOOPERS

Frontera Resources Corporation and Subsidiaries

Consolidated Financial Statements
December 31, 2008 and 2007

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PRICEWATERHOUSECOOPERS

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Report of Independent Auditors

To the Board of Directors of
Frontera Resources Corporation:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, stockholders' equity and cash flows present fairly, in all material respects, the financial position of Frontera Resources Corporation and its subsidiaries (the "Company") at December 31, 2008 and 2007, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. 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 of these statements in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about 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, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 2 to the consolidated financial statements, the Company has suffered recurring losses from operations and has limited available funds as of December 31, 2008, which raises substantial doubt about its ability to continue as a going concern. Management's plans in regard to this matter are also described in Note 2. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

PricewaterhouseCoopers LLP

March 31, 2009

Frontera Resources Corporation and Subsidiaries
Consolidated Balance Sheets
December 31, 2008 and 2007

	2008	2007
Assets		
Current assets		
Cash and cash equivalents	$ 7,662,891	$ 4,945,221
Restricted cash	5,000,000	15,118,786
Investments	-	25,600,000
Accounts receivable	976,695	73,189
Inventory	7,454,584	9,293,005
Prepaid expenses and other current assets	774,311	1,268,503
Total current assets	21,868,481	56,298,704
Property and equipment, net	1,612,869	1,405,957
Oil and natural gas properties, full cost method		
Properties being depleted	69,718,752	23,750,981
Properties not subject to depletion	40,664,094	55,828,093
Less: Accumulated depletion	(69,718,752)	(21,457,846)
Net oil and gas properties	40,664,094	58,121,228
Investments	11,500,000	-
Other assets	5,159,704	2,431,254
Total assets	$ 80,805,148	$ 118,257,143
Liabilities and Stockholders' Equity		
Current liabilities		
Accounts payable	$ 304,992	$ 3,049,928
Accrued liabilities	3,128,288	7,760,800
Line of credit	1,978,414	-
Current maturities of notes payable	9,450,000	-
Total current liabilities	14,861,694	10,810,728
Convertible notes payable	94,393,483	68,572,500
Other long-term liabilities	32,037	38,595
Total liabilities	109,287,214	79,421,823
Commitments and contingencies		
Stockholders' equity		
Common stock	2,997	2,821
Additional paid-in capital	162,599,116	153,107,958
Common stock warrants	3,114,055	1,266
Treasury stock, at cost	(567,832)	(567,832)
Accumulated deficit	(192,530,402)	(113,708,893)
Accumulated other comprehensive loss	(1,100,000)	
Total stockholders' equity	(28,482,066)	38,835,320
Total liabilities and stockholders' equity	$ 80,805,148	$ 118,257,143

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

Frontera Resources Corporation and Subsidiaries
Consolidated Statements of Operations
Years Ended December 31, 2008 and 2007

	2008	2007
Revenue - crude oil sales	$ 4,839,625	$ 1,878,540
Operating expenses		
Field operating and project costs	7,476,082	3,838,444
General and administrative	18,519,483	14,916,927
Depreciation, depletion and amortization	694,665	703,815
Impairment	47,900,906	-
Total operating expenses	74,591,136	19,459,186
Loss from operations	(69,751,511)	(17,580,646)
Other income (expense)		
Forgiveness of debt	-	6,000
Interest income	1,110,246	2,507,173
Interest expense	(9,912,980)	(4,619,709)
Other, net	(267,264)	28,517
Total other income (expense)	(9,069,998)	(2,078,019)
Net loss	$ (78,821,509)	$ (19,658,665)
Loss per share		
Basic and diluted	$ (1.09)	$ (0.28)
Number of shares used in calculating loss per share		
Basic and diluted	72,407,650	70,423,083

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

Frontera Resources Corporation and Subsidiaries
Consolidated Statements of Stockholders' Equity
Years Ended December 31, 2008 and 2007

	Common Stock	Additional Paid-In Capital	Common Stock Warrants	Treasury Stock	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
Balance at December 31, 2006	**$ 2,818**	**$149,499,177**	**$ 1,266**	**$ (567,832)**	**$ (94,050,228)**	**$ 124,550**	**$ 55,009,751**
Exercise of common stock options	1	18,399	-	-	-	-	18,400
Conversion of convertible debt	2	99,998	-	-	-	-	100,000
Compensation expense-common stock options	-	3,490,384	-	-	-	-	3,490,384
Unrealized gain on marketable securities	-	-	-	-	-	53,420	53,420
Reclassification adjustment for gains on marketable securities included in net loss	-	-	-	-	-	(177,970)	(177,970)
Net loss	-	-	-	-	(19,658,665)	-	(19,658,665)
Total comprehensive loss for the year	-	-	-	-	(19,658,665)	(124,550)	(19,783,215)
Balance at December 31, 2007	**2,821**	**153,107,958**	**1,266**	**(567,832)**	**(113,708,893)**	**-**	**38,835,320**
Exercise of common stock options	14	347,036	-	-	-	-	347,050
Conversion of convertible debt	147	6,149,890	-	-	-	-	6,150,037
Issuance of common stock warrants	-	-	3,114,055	-	-	-	3,114,055
Exercise of common stock warrants	15	1,251	(1,266)	-	-	-	-
Compensation expense-common stock options	-	2,992,981	-	-	-	-	2,992,981
Unrealized loss on investments	-	-	-	-	-	(1,100,000)	(1,100,000)
Net loss	-	-	-	-	(78,821,509)	-	(78,821,509)
Total comprehensive loss for the year	-	-	-	-	(78,821,509)	(1,100,000)	(79,921,509)
Balances at December 31, 2008	**$ 2,997**	**$162,599,116**	**$ 3,114,055**	**$ (567,832)**	**$ (192,530,402)**	**$ (1,100,000)**	**$ (28,482,066)**

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

Frontera Resources Corporation and Subsidiaries
Consolidated Statements of Cash Flows
Years Ended December 31, 2008 and 2007

	2008	2007
Cash flows from operating activities		
Net loss	$ (78,821,509)	$ (19,658,665)
Adjustments to reconcile net loss to net cash used in operating activities		
Depreciation, depletion and amortization	694,665	703,815
Impairment	47,900,906	-
Gain on sale of asset	-	(19,072)
Interest income - restricted cash	-	(118,786)
Noncash interest expense	8,471,020	1,672,500
Debt issuance cost amortization	1,029,314	285,391
Stock based compensation	2,992,981	2,811,649
Forgiveness of debt	-	(6,000)
Changes in operating assets and liabilities:		
Accounts receivable	(903,506)	65,918
Inventory	1,838,421	(6,168,147)
Prepaid expenses and other current assets	494,192	(1,000,783)
Accounts payable	(2,744,936)	2,489,532
Accrued liabilities	(6,816,683)	7,242,796
Other long-term liabilities	(6,558)	(3,074)
Net cash used in operating activities	(25,871,693)	(11,702,926)
Cash flows from investing activities		
Investment in oil and gas properties	(28,619,599)	(28,196,588)
Investment in property and equipment	(541,579)	(678,420)
Restricted cash	-	(5,000,000)
Net redemption (purchase) of short-term investments	-	14,698,450
Purchase of auction rate securities	-	(51,375,000)
Redemption of auction rate securities	13,000,000	25,775,000
Proceeds from disposal of property, plant and equipment	-	19,072
Net cash used in investing activities	(16,161,178)	(44,757,486)
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)
Proceeds from line of credit	1,978,414	-
Proceeds from short-term notes payable	9,450,000	-
Debt issuance costs	(643,709)	(1,537,910)
Exercise of common stock options	347,050	18,400
Net cash provided by financing activities	44,750,541	51,478,452
Net increase (decrease) in cash and cash equivalents	2,717,670	(4,981,960)
Cash and cash equivalents		
Beginning of year	4,945,221	9,927,181
End of year	$ 7,662,891	$ 4,945,221
Supplemental cash flow information		
Cash paid for interest	$ 376,579	$ 2,677,367
Noncash debt issuance costs - convertible notes payable	-	500,000
Noncash debt issuance costs-common stock warrants	3,114,055	-
Noncash debt issuance costs - stock options	-	678,735
Conversion of debt to common stock	5,655,000	100,000
Issuance of common stock in lieu of interest payments	495,035	-
Issuance of convertible notes payable in lieu of interest payments	7,975,985	1,672,500

The accompanying notes are an integral part of these 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 are 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 Company has incurred net losses and negative cash flows from operations in most fiscal periods since inception. Based on the Company's current operating plan, its existing working capital will not be sufficient to meet the cash requirements to fund the Company's planned operating expenses and capital expenditures through December 31, 2009 without additional sources of financing. Management plans to reduce costs and raise additional financing to meet its cash needs for 2009 and has commenced discussions with various financial institutions to seek additional financing in order to facilitate the Company's 2009 operating plan. In recent months, however, there has been extreme volatility and disruption in the global capital and credit markets. While these market conditions persist, the Company's ability to access the capital and credit markets may be adversely affected. Although the Company is encouraged about the prospects of raising capital, discussions are still preliminary and may not result in a successful financing.

Failure to generate sufficient operating cash flows, raise additional capital or further reduce spending could have a material adverse effect on the Company's ability to continue as a going concern and to achieve its intended business objectives. There can be no assurance that sufficient revenues will be generated in the future to sustain the Company's operations. These consolidated financial statements do not include any adjustments related to the outcome of this uncertainty.

Notwithstanding management's plan to reduce costs and raise additional financing, the Company's viability is dependent upon producing oil and gas in sufficient quantities and marketing such oil and gas at sufficient prices to provide positive operating cash flow to the Company. The Company is solely responsible for providing all of the funding for the development of Block 12 in Georgia and will require additional funding in order to obtain certain levels of production and generate sufficient cash flows to meet future capital and operating spending requirements. This is dependent upon, among other factors, achieving significant increases in production, production of oil and gas at costs that provide acceptable margins, reasonable levels of taxation from local authorities, and the ability to market the oil and gas produced at our near world prices.

Management's plan for addressing the above uncertainties is partially based on forward looking events which have yet to occur, including the successful completion of a successful development program, and accordingly, there is no assurance that those events will transpire as initially contemplated.

The following key financial measurements reflect the Company's financial position and capital resources as of December 31, 2008 and December 31, 2007 (dollars in thousands):

	December 31, 2008	December 31, 2007
Cash and cash equivalents	$ 7,663	$ 4,945
Working capital	$ 7,007	$ 45,488
Total debt	$105,822	$ 68,573
Debt to debt and equity	137%	64%

Cash and cash equivalents consist of highly liquid investments in deposits held at major financial institutions.

Operating cash flow is influenced mainly by the prices received for the Company's oil production; the quantity of oil produced and the success of the Company's development and exploration activities. Currently the Company does not generate sufficient operating cash flows to cover general corporate activities or planned capital expenditure programs. The principal factors that could adversely affect the amount and availability of 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.

3. Summary of Significant Accounting Policies

Principles of Consolidation

The consolidated financial statements include the accounts of Frontera Resources Corporation and its wholly and majority owned subsidiaries. All significant intercompany transactions and accounts have been eliminated in consolidation.

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 assets 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 costs 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 and 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.

Cash and Cash Equivalents

Cash and cash equivalents include all cash balances, money market accounts and certificates of deposit, all of which have original maturities of three months or less.

Restricted Cash

At December 31, 2008 the Company had $5,000,000 of restricted cash which serves as collateral for a $5,000,000 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.

Investments

Investments consist of Municipal Short Term Auction Rate Securities ("M-STARS") and corporate bonds. 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 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 $1.1 million with regards to these investments (see Fair Value Measurements). The Company will continue to assess the fair value of these securities at the end of each quarter. Based on the Company's inability to currently liquidate the remaining M-STARS, these investments have been reclassified as noncurrent investments at December 31, 2008.

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 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 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 $1.1 million was recorded at December 31, 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 December 31, 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
Investments - M-STARS	$ -	$ -	$ 11,500,000	$ 11,500,000
	$ -	$ -	$ 11,500,000	$ 11,500,000

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 December 31, 2008:

Investments - M-STARS as of December 31, 2007	$ 25,600,000
Total unrealized loss	(1,100,000)
Purchases, issuances and settlements	(13,000,000)
Investments - M-STARS as of December 31, 2008	$ 11,500,000

Inventory

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:

	December 31,	
	2008	2007
Materials and supplies	$ 6,552,599	$ 7,997,192
Crude oil	901,985	1,295,813
	$ 7,454,584	$ 9,293,005

Property and Equipment

Property and equipment are stated at cost. Expenditures for major renewals and betterments, which extend the original estimated economic useful lives of applicable assets, are capitalized. Expenditures for normal repairs and maintenance are charged to expense as incurred. The costs and related accumulated depreciation of assets sold or retired are removed from the accounts, and any gain or loss thereon is reflected in operations. Depreciation of property and equipment is computed using the straight-line method over the estimated useful lives of the assets, ranging from three to seven years.

Oil and Gas Properties

The Company follows the full cost method of accounting for oil and gas properties. Accordingly, all costs associated with acquisition, exploration and development of oil and gas reserves, including directly related overhead costs, are capitalized.

All capitalized costs of oil and gas properties, including the estimated future costs to develop proved reserves, are depleted on the unit-of-production method using estimates of proved reserves. Investments in unproved properties and major development projects are not depleted until proved reserves associated with the projects can be determined or until impairment occurs. In addition, the capitalized costs are subject to a “ceiling test,” which limits such costs to the aggregate of the future net revenues from proved reserves, based on current economic and operating conditions, discounted at a 10% interest rate, plus the lower of cost or fair market value of unproved properties. A ceiling test calculation is performed at each year-end. No impairment write down was necessary for the year ended December 31, 2007. For the year ended December 31, 2008, the Company recorded an impairment provision at $47.9 million related to its fields in Georgia.

Sales or other dispositions of oil and gas properties are accounted for as adjustments of capitalized costs with no gain or loss recognized, unless such adjustments would significantly alter the relationship between capitalized costs and proved reserves of oil and gas, in which case the gain or loss is recognized in earnings.

Costs Excluded

Costs associated with unproved properties related to continuing operations of $40.7 million as of December 31, 2008 are excluded from amounts subject to amortization. The majority of the evaluation activities are expected to be completed within a three-year period. In addition, the Company's internal engineers evaluate all properties on an annual basis.

Costs Excluded by Year Incurred

	Year Cost Incurred				Excluded Costs at December 31, 2008
	Prior Years	2006	2007	2008	
Property acquisition	$ -	$ -	$ -	$ -	$ -
Exploration	4,063,966	5,776,569	14,439,044	16,384,515	40,664,094
Development	-	-	-	-	-
Total costs incurred	$ 4,063,966	$ 5,776,569	$14,439,044	$ 16,384,515	$ 40,664,094

Income Taxes

The Company follows the provisions of SFAS No. 109, *Accounting for Income Taxes,* which requires the recognition of deferred tax liabilities and assets for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred tax liabilities and assets are determined based on the difference between the financial statements and the tax basis of assets and liabilities using enacted rates in effect for the years in which the differences are expected to reverse. Valuation allowances are established, when appropriate, to reduce deferred tax assets to the amount expected to be realized.

The Company accounts for uncertain tax positions in accordance with FASB Interpretation No. 48 ("FIN 48"), *Accounting for Uncertainty in Income Taxes*. Accordingly, the Company reports a liability for unrecognized tax benefits resulting from uncertain tax positions taken or expected to be taken in a tax return. The Company recognizes interest and penalties, if any, related to unrecognized tax benefits in income tax expense.

Revenue Recognition
Oil and natural gas revenues are recorded when title passes to the customer, net of royalties, discounts and allowances, as applicable. Oil and natural gas sold is not significantly different from the Company's share of production.

Foreign Currency Transactions
The financial statements of the foreign subsidiaries are prepared in United States dollars, and the majority of transactions are denominated in United States dollars. Gains and losses on foreign currency transactions are the result of changes in the exchange rate between the time a foreign currency-denominated invoice is recorded and when it is ultimately paid and are included in operations. Foreign currency transaction gains and losses were not material for the years ended December 31, 2008 and 2007.

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 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.

Concentrations of Credit Risk
Financial instruments which potentially subject the Company to concentrations of credit risk consist principally of cash, investments and accounts receivable. The Company maintains its cash in bank deposits with various major financial institutions. These accounts, at times, may exceed federally insured limits. Deposits in the United States are guaranteed by the Federal Deposit Insurance Corporation up to $250,000. The Company monitors the financial condition of the financial institutions and does not anticipate any losses on such accounts.

Investments consist of auction rate securities. 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 have failed at auction subsequent to December 31, 2008 and 2007. 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. The fair value of these securities is assessed at the end of each quarter.

For the year ended December 31, 2007, 100% of the Company's crude oil sales were to one unrelated customer.

Fair Value of Financial Instruments
Frontera's financial instruments consist of cash, accounts receivable, accounts payable, a line of credit and notes payable. The fair value of cash, accounts receivable and accounts payable are estimated to approximate the carrying value due to the liquid nature of these instruments. The fair value of the line of credit and notes payable was determined based upon discount rates which approximate variable interest rates for borrowings of a similar nature. The fair values of the debt instruments at December 31, 2008 and 2007 were approximately $66,010,000 and $44,589,000, respectively.

Loss Per Share
Basic loss per share amounts are calculated based on the weighted average number of common stock outstanding during the year. Diluted loss per share are calculated using the weighted average number of shares of common stock outstanding during the year, including the dilutive effect of stock options, warrants and convertible notes. Basic and diluted loss per share for the years ended December 31, 2008 and 2007 are the same since the effect of all common stock equivalents is antidilutive to the Company's net loss per share under SFAS No. 128.

Stock-Based Compensation
The Company adopted SFAS No. 123R, *Share-Based Payment*, effective January 1, 2006. This statement requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their grant-date fair values. Compensation costs for awards granted prior to, but not vested, as of January 1, 2006 were based on the grant date attributes originally used to value those awards for pro forma purposes under SFAS No. 123. The Company records compensation cost related to unvested stock awards by recognizing the unamortized grant date fair value of these awards over the remaining vesting periods of those awards with no change in historical reported earnings. The Company estimated forfeiture rates for the year based on our historical experience of approximately 3%. At December 31, 2008 and 2007, there was $2,323,068 and $2,735,646, respectively, of total unrecognized compensation cost related to non-vested stock options. This compensation cost is expected to be recognized over a weighted-average period of approximately 0.6 and 0.7 years, respectively.

The Black-Scholes model incorporates assumptions to value stock-based awards. The risk-free rate of interest is the related U.S. Treasury yield curve for periods within the expected term of the option at the time of grant. The dividend yield on our common stock is assumed to be zero as we have historically not paid dividends and have no current plans to do so in the future. The expected volatility is based on historical volatility of the Company's common stock.

Due to the Company's net operating loss position; there are no anticipated windfall tax benefits upon exercise of options.

4. Accrued Liabilities

Accrued liabilities consist of the following:

	December 31, 2008	December 31, 2007
Accrued payables	$ 2,938,654	$ 7,587,780
Accrued interest	36,068	-
Accrued benefits	153,566	173,020
	$ 3,128,288	$ 7,760,800

5. Notes Payable

During 2007, the Company established a $5,000,000 line of credit collateralized by $5,000,000 of cash and cash equivalents. The line is primarily used to support letters of credit issued by the Company from time to time in support of its oil and gas operations. During 2008 the Company drew $1,978,414 against the line, which remained outstanding at December 31, 2008.

In February 2008, warrants were exercised to purchase 377,419 shares of common stock in a cashless exercise, pursuant to the warrant agreement. At December 31, 2008, no warrants in conjunction with the line of credit remain outstanding.

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 February 2009 and was subsequently renewed in February for 90 days.

6. 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% per annum, 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.

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% per annum, 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.

During 2007 and 2008, noteholders of the Company's convertible notes elected to convert $0.1 million and $5.7 million of convertible notes into 59,880 and 3,392,240 shares of common stock, respectively. During 2008, noteholders also elected to convert approximately $0.5 million of related interest into 278,792 shares of common stock.

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 and December 31, 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 for each period.

7. Income Taxes

The Company has incurred losses since inception and, therefore, has not been required to pay federal income taxes. As of December 31, 2008, the Company has generated net operating loss (“NOL”) carryforwards of approximately $70.4 million that may be available to reduce future income taxes. These carryforwards begin to expire in 2012 with a limited annual utilization. Several factors may further limit the Company’s ability to utilize these carryforwards, including a lack of future taxable income, a change of Company ownership (as defined by federal income tax regulations) or the expiration of the utilization period allowed by federal income tax regulations.

During 2008 and 2007, the valuation allowance increased $26,656,407 and $6,695,139, respectively, primarily due to the Company’s losses. The effective tax rate for 2008 and 2007 differs from the statutory tax rate due primarily to the valuation allowance. The components of the Company’s deferred tax liabilities and assets at December 31, 2008 and 2007, are as follows:

	2008	2007
Deferred tax liabilities		
Geological & geophysical	$ (655,305)	$ (2,097,343)
Other	(244,852)	(244,852)
Deferred tax assets		
Net operating losses - U.S.	23,935,496	18,488,940
Net operating losses - foreign	36,703,613	17,891,823
Depreciation and amortization	327,834	330,127
Accrued salaries	18,066	19,367
Other	13,306	5,973
Stock compensation	1,866,765	914,481
	61,964,923	35,308,516
Valuation allowance	(61,964,923)	(35,308,516)
Net deferred tax assets	$ -	$ -

The valuation allowance is primarily attributed to U.S. federal deferred tax assets. Management believes enough uncertainty exists regarding the realization of these items and has recorded a full valuation allowance.

Profits derived from oil and gas operating activities are subject to a profits tax on taxable income as defined by Georgian law. However, under the terms of the Block 12 PSA, Georgian Oil is responsible for paying the Company's profit tax liabilities with respect to income derived from these activities. Although the Company has incurred operating losses in Georgia, no adjustment with respect to deferred tax assets or a potentially related valuation allowance has been made, as any future benefit related to these operating losses would serve to reduce Georgian Oil's liability.

On January 1, 2007, the Company adopted the provisions of FIN 48. The Company has determined that no uncertain tax positions exist where the Company would be required to make additional tax payments. As a result, the Company has not recorded any additional liabilities for any unrecognized tax benefits as of December 31, 2008. The Company and its subsidiaries file income tax returns in the US federal jurisdiction. Tax years 2004 to present remain open for these taxing authorities. The Company's accounting policy is to recognize penalties and interest related to unrecognized tax benefits as income tax expense. The Company does not have an accrued liability for the payment of penalties and interest at December 31, 2008.

8. Commitments and Contingencies

Operating Leases

The Company has noncancelable operating leases for office facilities and lodging. Approximate future minimum annual rental commitments under these operating leases are as follows:

Years Ending December 31,	
2009	$ 603,433
2010	247,859
2011	52,730
2012	-
2013	-
	$ 904,022

Rental expense for the years ended December 31, 2008 and 2007 was approximately $588,000 and $452,000, respectively.

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 and seizure of oil 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 seizure 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 January 2001 until payment is made. Including interest, the amount of the award is approximately $2.0 million. The arbitral panel directed Frontera to pay approximately $0.3 million of SOCAR's costs and rejected all other claims and counterclaims between the parties. SOCAR refused to pay the award and filed an action in the Svea Court of Appeals in Stockholm to annul the award. A final hearing was held in March 2009, and in May 2009, the court upheld the original award and directed SOCAR to pay Frontera additional costs of approximately $0.3 million. The court's decision states that it is not subject to appeal.

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 second quarter of 2009. Should SOCAR continue to refuse to pay, the Company intends to vigorously pursue enforcement action.

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 $19.0 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 claimed damages of approximately $7.0 million in the arbitration. ARAR denied FEGL's claims and 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. The parties entered into a settlement agreement in December 2008 pursuant to which ARAR is required to make a series of payments to FEGL through December 2009. The settlement resolves all outstanding claims and counterclaims between Frontera and ARAR arising out of the drilling services contract.

9. 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 is outstanding at December 31, 2008 and 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 December 31, 2008, the Company is authorized to issue 200,000,000 shares of common stock, par value $.00004 per share. As of December 31, 2008 and 2007, the Company had 74,868,608 and 70,463,408 shares of common stock issued and outstanding, respectively. At December 31, 2008 and 2007, additional shares in the amount of 17,999,000 and 15,061,000, respectively, of common stock were reserved for the exercise of existing options and warrants.

Treasury Stock

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

1998 Employee Stock Incentive Plan

In 1998, the Company's stockholders approved the 1998 Employee Stock Incentive Plan (the "Plan"), pursuant to which options may be granted to purchase up to 15% of the Company's common stock authorized to be issued by the Company, reduced by the total number of shares of stock subject to stock options and stock awards that have been granted under the Plan and the Frontera Resources Corporation 2000 Nonqualified Stock Option and Stock Award Plan at any given time. The Board of Directors has appointed Frontera's chief executive officer as administrator (the "Administrator") of the Plan. In this capacity, the Administrator determines which employees will receive options, the number of shares covered by any option agreement, and the exercise price and other terms of each such option. The Board of Directors is responsible for administering the Plan as it relates to options granted to the chief executive officer.

Under the terms of the Plan, any issued options expire ten years after the date of grant, with the exception of options granted to 10% stockholders which expire five years after the date of grant, or upon earlier termination of employment. Options granted vest over periods ranging from immediate vesting to vesting in equal increments over three years from the date of grant.

2000 Nonqualified Stock Option and Stock Award Plan

In 2000, the Company's Board of Directors approved the 2000 Nonqualified Stock Option and Stock Award Plan (the "Stock Award Plan"), pursuant to which options may be granted to purchase up to 15% of the Company's common stock authorized to be issued by the Company, reduced by the total number of shares of stock subject to stock options and stock awards that have been granted under the Stock Award Plan and the Frontera Resources Corporation 1998 Employee Stock Incentive Plan. The Board of Directors has appointed Frontera's chief executive officer as administrator (the "Administrator") of the Stock Award Plan. In this capacity, the Administrator determines which employees will receive options, the number of shares covered by any option agreement, and the exercise price and other terms of each such option. The Board of Directors is responsible for administering the Stock Award Plan as it relates to options granted to the chief executive officer.

Under the terms of the Stock Award Plan, any issued options expire ten years after the date of grant or upon earlier of termination of employment or affiliation relationship between the grantee and the Company. Options granted vest over periods ranging from immediate vesting to vesting in equal increments over three years from the date of grant.

A summary of the Company's stock option activity and related information is as follows:

	Options	Weighted-Average Exercise Price
Options outstanding at December 31, 2007	13,111,763	$ 2.16
Granted	2,965,000	1.96
Exercised	(356,750)	0.97
Surrendered	(870,429)	2.14
Options outstanding at December 31, 2008	14,849,584	$ 2.15
Options exercisable at December 31, 2008	11,028,757	$ 2.15

At December 31, 2008, the total intrinsic value and weighted average life for stock options outstanding was $0 and 6.98 years, respectively. At December 31, 2007, the total intrinsic value and weighted average life for stock options exercisable was $0 and 7.01 years, respectively.

The following table summarizes information about stock options outstanding at December 31, 2008:

Range of Exercise Prices	Number Outstanding at December 31, 2008	Weighted-Average Remaining Contractual Life (Years)	Weighted-Average Exercise Price	Number Exercisable at December 31, 2008	Weighted-Average Exercise Price
$0.37-1.00	4,702,500	5.64	$ 0.86	3,627,500	$ 1.00
2.00-2.87	10,142,084	7.61	2.75	7,396,257	2.70
5.28-8.85	5,000	1.49	8.84	5,000	8.84
	14,849,584	6.98	$ 2.15	11,028,757	$ 2.15

Stock option information related to the nonvested options for the year ended December 31, 2008, was as follows:

	Number of Shares Underlying Options	Weighted-Average Grant Date Fair Value
Nonvested options outstanding at December 31, 2007	3,690,666	$ 1.41
Granted	2,965,000	0.91
Vested	(2,834,839)	1.47
Canceled	-	-
Nonvested options outstanding at December 31, 2008	3,820,827	$ 0.98

The Company granted 2,965,000 options to employees during 2008 with exercise prices ranging from $0.37 to $2.87, which was at or above the market value of the Company's common stock at the time of grant. The weighted average fair value of the options granted in 2008 was $0.91. The fair value of the option grants were calculated using a Black-Scholes option pricing model, with the following weighted average assumptions: risk free interest rate of 2.99%; no dividend yield; volatility factor of 127%; and an expected option life of 9.71 years.

10. Related Party

In conjunction with the Company's private placement of approximately $67.0 million of convertible unsecured notes in May 2007, a director of the Company was paid a fee pursuant to a consulting and advisory agreement with Frontera. The fee was approximately $0.8 million and was comprised of approximately $0.3 million in cash and $0.5 million of additional convertible unsecured notes. Also, as part of the fee, the director received 600,000 stock options with a strike price of $2.87 vesting immediately. Due to regulatory requirements, these options were not issued until October 2007. In conjunction with the Company's private placement of approximately $23.5 million of convertible unsecured notes in July 2008, the same director was paid a fee pursuant to the consulting agreement of approximately $0.5 million in cash. In addition to the fees noted above, this same director received consulting fees for the years ended December 31, 2008 and 2007 of $301,500 and $261,500, respectively, pursuant to the consulting agreement.

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.

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.

The Company has incurred net losses and negative cash flows from operations in most fiscal periods since inception. Based on the Company's current operating plan, its existing working capital will not be sufficient to meet the cash requirements to fund the Company's planned operating expenses and capital expenditures through December 31, 2009 without additional sources of financing. Management plans to reduce costs and raise additional financing to meet its cash needs for 2009 and has commenced discussions with various financial institutions to seek additional financing in order to facilitate the Company's 2009 operating plan. In recent months, however, there has been extreme volatility and disruption in the global capital and credit markets. While these market conditions persist, the Company's ability to access the capital and credit markets may be adversely affected. Although the Company is encouraged about the prospects of raising capital, discussions are still preliminary and may not result in a successful financing.

Failure to generate sufficient operating cash flows, raise additional capital or further reduce spending could have a material adverse effect on the Company's ability to continue as a going concern and to achieve its intended business objectives. There can be no assurance that sufficient revenues will be generated in the future to sustain the Company's operations. These consolidated financial statements do not include any adjustments related to the outcome of this uncertainty.

Notwithstanding management's plan to reduce costs and raise additional financing, the Company's viability is dependent upon producing oil and gas in sufficient quantities and marketing such oil and gas at sufficient prices to provide positive operating cash flow to the Company. The Company is solely responsible for providing all of the funding for the development of Block 12 in Georgia and will require additional funding in order to obtain certain levels of production and generate sufficient cash flows to meet future capital and operating spending requirements. This is dependent upon, among other factors, achieving significant increases in production, production of oil and gas at costs that provide acceptable margins, reasonable levels of taxation from local authorities, and the ability to market the oil and gas produced at our near world prices.

Management's plan for addressing the above uncertainties is partially based on forward looking events which have yet to occur, including the successful completion of a successful development program, and accordingly, there is no assurance that those events will transpire as initially contemplated.

Results of Operations
Twelve Months Ended December 31, 2008 Compared to Twelve Months Ended December 31, 2007

Revenue. Total revenue increased to $4.8 million for the twelve months ended December 31, 2008 from $1.9 million in the same period in 2007. This increase was primarily due to higher commodity prices and sales volumes in the 2008 period.

Operating Costs and Expenses. Total operating costs and expenses increased to $74.6 million for the twelve months ended December 31, 2008 compared to $19.5 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 $3.7 million primarily due to the higher cost and volumes of oil sold in Q2 2008 and Q4 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 and Q4 2008 versus being capitalized to drilling projects in the 2007 period.

DD&A increased $47.9 million during the twelve months ended December 31, 2008, as compared to the twelve months ended December 31, 2007. The increase was primarily attributable to an impairment provision due to the ceiling test write-down discussed below.

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 2007 periods presented herein. For the 2008 periods presented herein we recorded an impairment provision of $47.9 million related to the Company's fields in Georgia.

General and administrative expenses increased $3.6 million to $18.5 million for the twelve months ended December 31, 2008 from $14.9 million for the comparable period in 2007. Salaries and wages accounted for $1.6 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 $0.5 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 $0.1 million increase in salaries and wages occurred at the corporate level. Legal expenses increased $1.8 million primarily due to expenses incurred in connection with arbitration proceedings and other general corporate matters during the twelve months ended December 31, 2008. The remaining $0.2 million increase was primarily attributable to higher travel expenses associated with financing and operating the Georgia field work programs.

Other Income (Expense). Total other expense increased to $9.1 million in the twelve month period ended December 31, 2008 from other expense of $2.1 million in the twelve month period ended December 31, 2007. The $7.0 million increase in other expense is primarily attributable to an increase in interest expense of $5.3 million and a $1.4 million decrease in interest income. The remaining $0.3 million increase was due to other net expense which was mainly attributable to foreign currency conversion losses due to the strengthening dollar against the Georgian lari.

Interest income decreased to $1.1 million for the twelve months ended December 31, 2008 from $2.5 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 $9.9 million for the twelve months ended December 31, 2008 from $4.6 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 twelve months ended December 31, 2008 versus being outstanding for approximately 8 months 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 December 31, 2008 Compared to Three Months Ended December 31, 2007

Revenue. Revenues for the three months ended December 31, 2008 increased to $1.9 million from zero in the comparable 2007 period. The increase was due to increased sales volumes and commodity prices in the 2008 period.

Operating Costs and Expenses. Total operating costs and expenses increased to $55.7 million for the three months ended December 31, 2008 compared to $5.2 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 $2.7 million to $3.5 million during the three months ended December 31, 2008 as compared to $0.8 million for the three months ended December 31, 2007. Approximately $0.5 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. Approximately $1.6 million of the increase is attributable to the cost of oil sold in Q4 2008 with no like sale in the 2007 period. Approximately $0.3 million of the increase is a lower of cost or market valuation adjustment to crude oil inventory in the 2008 period due to low year end commodity prices and the remaining $0.3 million increase is primarily attributable to expensed HSE projects in the 2008 period with no like charges in the 2007 period.

DD&A increased $47.9 million during the three months ended December 31, 2008 to $48.1 million as compared to $0.2 million for the three months ended December 31, 2007. The increase was primarily attributable to the $47.9 million ceiling test write-down during Q4 2008 with no like adjustment required in the 2007 period.

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 2007 periods presented herein. For the 2008 periods presented herein we recorded an impairment provision of $47.9 million related to the Company's fields in Georgia.

General and administrative expenses decreased $0.1 million to $4.1 million for the three months ended December 31, 2008 from $4.2 million for the comparable period in 2007. The decrease was partially attributable to a $0.1 million increase in compensation expense related to our Georgian operations due to the fact that 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. These increases in the 2008 period were partially offset by a $0.2 million decrease in other general and administrative expense as compared to the same period in 2007.

Other Income (Expense). Total other expense increased to $3.0 million in the three month period ended December 31, 2008 from other expense of $1.1 million in the three month period ended December 31, 2007. The $1.9 million increase is primarily attributable to an increase in interest expense of $1.1 million and a $0.6 million decrease in interest income. The remaining $0.2 million increase in other expense is primarily attributable to foreign currency conversion losses due to the strengthening US dollar against the Georgian lari.

Interest income decreased to $0.1 million for the three months ended December 31, 2008 from $0.7 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 $2.9 million for the three months ended December 31, 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 December 31, 2008 and December 31, 2007 (dollars in thousands):

	December 31, 2008	December 31, 2007
Cash and cash equivalents	$ 7,663	$ 4,945
Unrestricted working capital	$ 7,007	$ 45,488
Total debt	$105,822	$ 68,573
Debt to debt and equity	137%	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. 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.

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 December 31, 2008 and therefore our planned capital expenditure programs are entirely discretionary.

As of December 31, 2008, our cash and cash equivalents were $7.7 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, 5, and 6 of the accompanying notes to the consolidated financial statements for further discussion of the convertible notes, the line of credit, the restricted cash and the new convertible notes. At December 31, 2008 the Company had $94.4 million of convertible long term debt outstanding (discussed further below). The Company also had a $9.5 million note payable to a bank which was collateralized by $11.5 million in investments in M-STARS, and $2.0 million payable pursuant to funds drawn against a $5.0 million line of credit with its primary bank. The Company had no other outstanding debt at December 31, 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 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 and February 2009 the short term note was again renewed for 90 days. See Notes 5 and 6 of the accompanying notes to the consolidated financial statements for further discussion of these transactions.

Liquidity in certain auction rate securities markets was also significantly reduced in the twelve months ended December 31, 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, and the current lack of liquidity, a temporary impairment of $1.1 million was recorded to accumulated other comprehensive loss and the resulting $11.5 million balance was reclassified to non current investments on the Company's balance sheet at December 31, 2008. See Notes 2 and 3 of the notes to the 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.

Our total capital expenditures for 2008 were approximately $31.3 million. Our 2008 capital expenditures represent a 8% 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 $31.3 million of 2008 capital expenditures, approximately $30.8 million was directed to exploration and production activities in the Taribani 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 and equity securities, 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 $14.2 million to $25.9 million for the twelve months ended December 31, 2008 from $11.7 million for the twelve months ended December 31, 2007. The increased use of cash was primarily attributable to a higher net loss of $78.8 million for the twelve months ended December 31, 2008 as compared to $19.7 million for the comparable period in 2007. This was partially offset by increases in DD&A of $ 47.9 million, non cash interest and stock option compensation expense of $7.0 million and debt issuance amortization of $0.7 million in the 2008 period. The increase was also attributable to a $10.8 million increase in changes in operating assets and liabilities.

Investing Activities. Cash flows used in investing activities decreased $28.6 million to $16.2 million in the twelve month period ended December 31, 2008 from $44.8 million in the 2007 period. The cash used in investing activities was primarily attributable to approximately $29.2 million in capital expenditures offset by approximately $13.0 million in redemptions in auction rate securities.

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 twelve months ended December 31, 2008 from $51.5 million for the twelve months ended December 31, 2007. Net proceeds from borrowings decreased to $34.3 million for the twelve months ended December 31, 2008, from $65.0 million for the twelve months ended December 31, 2007. 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 twelve months ended December 31, 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,

$10.0 million of proceeds were restricted as to use and classified as restricted cash. During the twelve months ended December 31, 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 December 31, 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	$ 94.4	$ -	$ -	$ 94.4	$ -
Long-term debt–interest	34.6	9.4	18.9	6.3	-
Lease agreements	0.9	0.6	0.2	0.1	-
Total contractual obligations and commitments	$ 129.9	$ 10.0	$ 19.1	$100.8	$ -

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.