Frontera Resources Corporation and Subsidiaries

Condensed Consolidated Financial Statements
Three and Nine Months Ended September 30, 2007 and 2006

Frontera Resources Corporation and Subsidiaries
Index

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

	September 30, 2007	December 31, 2006
Assets		
Current assets		
Cash and cash equivalents	$ 7,174,954	$ 9,927,181
Restricted cash	15,126,728	-
Short-term investments	40,075,006	14,823,000
Accounts receivable	117,467	139,107
Inventory	7,546,137	3,124,858
Prepaid expenses and other current assets	3,587,939	267,720
Total current assets	73,628,231	28,281,866
Property and equipment, net	939,566	1,081,213
Oil and gas properties, full cost method		
Properties being depleted	23,750,981	23,750,981
Properties not subject to depletion	38,520,726	27,631,505
Less: Accumulated depletion	(21,368,707)	(21,107,707)
Net oil and gas properties	40,903,000	30,274,779
Other assets	1,885,203	-
Total assets	$ 117,356,000	$ 59,637,858
Liabilities and Stockholders' Equity		
Current liabilities		
Accounts payable	$ 146,212	$ 566,396
Accrued liabilities	6,670,099	518,004
Current maturities of notes payable-vendor	-	3,450,941
Current maturities of notes payable-related party	-	51,097
Total current liabilities	6,816,311	4,586,438
Convertible notes payable	66,900,000	-
Other long-term liabilities	39,675	41,669
Total liabilities	73,755,986	4,628,107
Commitments and contingencies		
Stockholders' equity		
Common stock	2,821	2,818
Additional paid-in capital	151,601,316	149,499,177
Common stock warrants	1,266	1,266
Treasury stock, at cost	(567,832)	(567,832)
Accumulated deficit	(107,437,557)	(94,050,228)
Accumulated other comprehensive income	-	124,550
Total stockholders' equity	43,600,014	55,009,751
Total liabilities and stockholders' equity	$ 117,356,000	$ 59,637,858

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,	
	2007	**2006**	**2007**	**2006**
Revenue - crude oil sales	$ -	$ -	$ 1,878,540	$ 758,630
Operating expenses				
Field operating and project costs	594,824	271,831	3,031,388	918,749
General and administrative	4,272,978	2,848,286	10,713,027	8,335,030
Depreciation, depletion and amortization	133,677	214,552	534,598	679,245
Total operating expenses	5,001,479	3,334,669	14,279,013	9,933,024
Loss from operations	(5,001,479)	(3,334,669)	(12,400,473)	(9,174,394)
Other income (expense)				
Forgiveness of debt	-	-	-	11,732
Interest income	972,090	364,882	1,791,537	1,291,263
Interest expense	(1,830,117)	(76,821)	(2,814,541)	(221,600)
Other, net	3,837	16,406	36,148	26,930
Total other income (expense)	(854,190)	304,467	(986,856)	1,108,325
Net loss	$(5,855,669)	$(3,030,202)	$(13,387,329)	$(8,066,069)
Loss per share				
Basic and diluted	$ (0.08)	$ (0.05)	$ (0.19)	$ (0.13)
Number of shares used in calculating loss per share				
Basic and diluted	70,459,278	66,810,763	70,409,783	61,502,366

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 Income	Total Stockholders' Equity
Balances at December 31, 2006	$ 2,818	$ 149,499,177	$ 1,266	$ (567,832)	$ (94,050,228)	$ 124,550	$ 55,009,751
Conversion of convertible debt	2	99,998	-	-	-	-	100,000
Exercise of common stock options	1	18,399	-	-	-	-	18,400
Compensation expense-common stock options	-	1,983,742	-	-	-	-	1,983,742
Unrealized gain on marketable securities	-	-	-	-	-	53,420	53,420
Reclassification adjustment for gains on marketable securities included in net income	-	-	-	-	-	(177,970)	(177,970)
Net loss	-	-	-	-	(13,387,329)	-	(13,387,329)
Total comprehensive loss for the year	-	-	-	-	-	-	(13,511,879)
Balances at September 30, 2007	$ 2,821	$ 151,601,316	$ 1,266	$ (567,832)	$(107,437,557)	$ -	$ 43,600,014

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, 2007	Nine Months Ended September 30, 2006
Cash flows from operating activities		
Net loss	$ (13,387,329)	$ (8,066,069)
Adjustments to reconcile net loss to net cash used in operating activities		
Depreciation, depletion and amortization	534,598	679,245
Gain on sale	-	(85,000)
Interest income–restricted cash	(126,728)	-
Debt issuance cost amortization	152,725	-
Amortization of warrants	-	72,504
Stock based compensation	1,983,742	2,174,287
Forgiveness of debt	-	(11,732)
Changes in operating assets and liabilities:		
Accounts receivable	21,640	(32,755)
Inventory	(4,421,279)	(857,597)
Prepaid expenses and other current assets	(3,320,219)	239,999
Accounts payable	(420,184)	(519,432)
Accrued liabilities	6,152,095	(832,458)
Other long-term liabilities	(1,994)	41,033
Net cash used in operating activities	(12,832,933)	(7,197,975)
Cash flows from investing activities		
Investment in oil and gas properties	(10,889,219)	(21,698,405)
Investment in property and equipment	(131,953)	(71,502)
Restricted cash	(5,000,000)	-
Restricted short-term investments	-	(1,225,000)
Net redemption (purchase) of other short-term investments	(10,451,556)	22,036,511
Purchase of auction rate securities	(33,150,000)	-
Redemption of auction rate securities	18,225,000	-
Proceeds from disposal of property, plant and equipment	-	85,000
Net cash used in investing activities	(41,397,728)	(873,396)
Cash flows from financing activities		
Repayments of borrowings	(3,502,038)	-
Proceeds from convertible debt	66,500,000	-
Restricted cash	(10,000,000)	-
Exercise of common stock warrants	-	3,072,879
Debt issuance costs	(1,537,928)	-
Exercise of common stock options	18,400	525,000
Net cash provided by financing activities	51,478,434	3,597,879
Net decrease in cash and cash equivalents	(2,752,227)	(4,473,492)
Cash and cash equivalents		
Beginning of year	9,927,181	19,586,747
End of period	$ 7,174,954	$ 15,113,255
Supplemental disclosure of noncash investing and financing activities		
Notes payable used to exercise common stock warrants	$ -	$ 212,174
Noncash debt issuance costs	500,000	-
Conversion of debt to common stock	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.

2. Basis of Presentation and Summary of Significant Accounting Policies

The condensed consolidated balance sheet of the Company at December 31, 2006 was derived from the Company's audited consolidated financial statements as of that date. The condensed consolidated balance sheet at September 30, 2007, the condensed consolidated statements of operations for the three and nine month periods ended September 30, 2007 and 2006, the condensed consolidated statement of changes in stockholders' equity for the nine month period ended September 30, 2007, and the condensed consolidated statements of cash flows for the nine month periods ended September 30, 2007 and 2006 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 nine month period ended September 30, 2007 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, 2006.

Certain amounts in the unaudited condensed consolidated financial statements have been reclassified in the prior period to conform with current period presentation. Reclassifications have no impact on the Company's financial position, results of operations, or cash flows.

For a description of the Company's accounting policies, refer to Note 2 of the 2006 consolidated financial statements.

Restricted Cash

At September 30, 2007 the Company had approximately $15,127,000 of restricted cash. Restricted cash in the amount of $5,000,000 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. The remaining $10,127,000 is a portion of the proceeds from the convertible debt issuance in May 2007 of approximately $67.0 million, plus related earned interest, which is being held in escrow until the Company's stock price meets certain agreed benchmarks. Assuming no event of default has occurred, $5,000,000 will be released from escrow after the stock price of the shares of common stock has exceeded the conversion price for 20 consecutive trading days; the balance of the escrow account will be released when the stock price of the shares exceeds two times the conversion price for twenty consecutive trading days. See Note 5 for further discussion of the convertible notes terms. At December 31, 2006, the Company had no cash equivalents restricted as to use or availability.

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 Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities* ("SFAS No. 115"), 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.

At September 30, 2007, short-term investments consist of investments in M-STARS with an estimated fair value of $40,075,006 with no unrealized holding gains or losses. At December 31, 2006, short-term investments consisted of investments in corporate bonds with an estimated fair value of $14,823,000 and net unrealized holding gains in the amount of $124,550 which were included in accumulated other comprehensive income.

3. 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, 2007	December 31, 2006
Materials and supplies	$ 6,722,603	$ 1,405,610
Crude oil	823,534	1,719,248
	$ 7,546,137	$ 3,124,858

Accrued liabilities consist of the following:

	September 30, 2007	December 31, 2006
Accrued payables	$ 4,876,568	$ 331,103
Accrued interest	1,672,500	58,097
Accrued benefits	121,031	128,804
	$ 6,670,099	$ 518,004

4. Notes Payable

Line of Credit

During 2006 the Company established a $10,000,000 line of credit with a commercial bank by agreeing to collateralize $15,000,000 of cash and marketable securities. 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. During 2007, the line was retired and replaced with 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.

Notes Payable–Related Party

Effective December 31, 2001, the Company raised $500,394 through the issuance of a rights offering consisting of 6% notes payable plus warrants which entitled the holders to purchase an aggregate of 15,637,329 shares of common stock of the Company at an exercise price of $0.032 per share. During 2006 the notes became due and were retired in full with the exception of one note holder as the Company was awaiting fund transfer instructions. This note holder was paid in full in early January 2007. Notes payable-related party outstanding as of September 30, 2007 and December 31, 2006 was $0 and $51,097, respectively.

During the first nine months of 2006, warrant holders exercised warrants to purchase 8,907,884 common shares for approximately $72,879.

Notes Payable–Vendor

Effective October 1, 2004, the Company converted a $3,450,941 account payable to Saipem S.p.A. (“Saipem”) into a note payable for the same amount. Under the terms of the Saipem note payable agreement, the Company agreed to pay Saipem quarterly interest-only payments until September 30, 2007, the maturity date, at which date the note was paid in full. The note bears interest at 5% per annum. Notes payable-vendor outstanding as of September 30, 2007 and December 31, 2006 was $0 and $3,450,941, respectively.

During the first nine months of 2006, warrants were exercised to purchase 3,000,000 common shares for $3,000,000 related to a prior senior note.

5. 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 will bear interest at 10%, payable quarterly in arrears in cash or in kind at the Company’s discretion. The notes are convertible into common shares at a conversion price of $1.67 per share. The conversion price will be reset to $1.30 per share if the stock price is at or below $1.30 per share for 10 out of any 20 consecutive trading days at any time in the 12 months following the closing date. The notes will be automatically converted into common shares 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 $1.9 million were incurred, of which approximately $1.4 million was paid in cash and $0.5 million of additional convertible notes were issued for the remainder.

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

For the nine months ended September 30, interest payments were $1,004,866 in 2007 and $258,393 in 2006.

6. 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.

On January 1, 2007, the Company adopted the provisions of FASB Interpretation No. 48 (“FIN48”), *Accounting for Uncertainty in Income Taxes*. 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 September 30, 2007. The Company and its subsidiaries file income tax returns in the US federal jurisdiction. Tax years 2002 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 September 30, 2007.

For the nine months ended September 30, 2007 and 2006, no income tax payments were made.

7. 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 refused to pay the award and filed an action in the Svea Court of Appeals in Stockholm seeking to annul the award. The Company moved to dismiss on procedural grounds, and the Svea Court of Appeals recently ruled in the Company's favor on a majority of the counts. Final disposition is expected in 2008. 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 is expected to occur in the first quarter of 2008.

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 FRGC upon the fulfillment of certain financial and work program commitments. In September 2004, as required under the terms of the Farmout Agreement, 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 alleges that GAC did not default on its obligations under the Farmout Agreement and should be awarded a 25% working interest in Block 12, a 12.5% ownership interest in FRGC and a proportionate share of the revenue from oil sales from July 2002 to August 2003. In August 2007, Frontera filed its statement of defense and counterclaims against GAC, and in October 2007, Frontera initiated arbitration against certain third parties involved with GAC alleging that they fraudulently induced Frontera to enter into the Farmout Agreement with GAC. Frontera considers the GAC claim to be without merit and intends to vigorously defend itself against this claim.

8. 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, 2007 and December 31, 2006. 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, 2007 and December 31, 2006 the Company was authorized to issue 200,000,000 shares of common stock, par value $.00004 per share. As of September 30, 2007 and December 31, 2006, the Company had 70,463,408 and 70,383,528, respectively, of common shares issued and outstanding. At September 30, 2007 and December 31, 2006, there were an additional 13,508,000 and 11,310,000 shares, respectively, of common stock reserved for the exercise of existing options and warrants.

Treasury Stock

At September 30, 2007 and December 31, 2006, the Company had 5,739,855 shares of treasury stock, all held as common shares.

For the nine months ended September 30, the Company recognized stock-based compensation expense related to common stock options of approximately $2.0 million in 2007 and $2.2 million in 2006. Stock-based compensation expense is reflected in general and administrative expense in the consolidated statements of operations.

9. 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 2001 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.

Management's Discussion and Analysis of Financial Condition and Results 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, 2007 and 2006 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, 2007 Compared to Nine Months Ended September 30, 2006

Revenue. Total revenue increased to $1.9 million for the nine months ended September 30, 2007 from $0.8 million in the same period in 2006. This increase was primarily due to a Q1 2007 sale of the Company’s 2006 Q3 and Q4 production.

Operating Costs and Expenses. Total operating costs and expenses increased to $14.3 million for the nine months ended September 30, 2007 compared to $9.9 million for the same period in 2006.

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 $2.1 million primarily due to the cost of oil sold in Q1 2007 which was attributable to Q3 and Q4 2006 production ,and an ex-pat staffing increase and associated costs carried out in support of a ramp up in the company's exploration and development activities in 2007 as compared 2006.

DD&A decreased $0.2 million primarily due to lower depletion expense associated with lower production volumes in 2007, and our oil processing facility becoming fully depreciated during 2007.

General and administrative expenses increased $2.4 million to $10.7 million for the nine months ended September 30, 2007 from $8.3 million for the comparable period in 2006. The increase was principally attributable to an increase in staff as the Company completed staffing the organization in anticipation of a ramp up in exploration and production activity in 2007 as compared with the same period in 2006. Salaries and wages accounted for $1.2 million of the increase. Legal and investor relations expenses increased $0.5 million and travel was up $0.3 million as the company's exploration and production activities increased in 2007 as compared to 2006. The remaining $0.4 million increase was associated with IT infrastructure improvements and other office services which increased with the size of the organization in 2007 as compared to 2006.

Other Income (Expense). Total other expense increased to $1.0 million in the nine month period ended September 30, 2007 from other income of $1.1 million in the nine month period ended September 30, 2006. The $2.1 million increase is primarily attributable to an increase in interest expense of $2.6 million partially offset by a $0.5 million increase in interest income.

Interest income increased to $1.8 million for the nine months ended September 30, 2007 from $1.3 million for the same period in 2006. This increase was due to interest income from excess cash in investment accounts which was higher in 2007 due to the Company's Q2 2007 $67.0 million convertible debt offering.

Interest expense increased to $2.8 million for the nine months ended September 30, 2007 from $0.2 million for the same period in 2006. This increase was attributable to increased average debt balances attributable to the Company's $67.0 million convertible debt offering during Q2 of 2007.

Results of Operations
Three Months Ended September 30, 2007 Compared to Three Months Ended September 30, 2006

Revenue. There were no revenues for the three months ended September 30, 2007 and 2006. The Q3 2007 production is expected to be sold in Q4 2007 and the 2006 production for the same period was sold in early 2007.

Operating Costs and Expenses. Total operating costs and expenses increased to $5.0 million for the three months ended September 30, 2007 compared to $3.3 million for the same period in 2006.

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 $0.3 million to $0.6 million during the three months ended September 30, 2007 as compared to $0.3 million for the three months ended September 30, 2006 primarily due to the cost of an ex-pat staffing increase and associated costs carried out in support of a ramp up in the company's exploration and development activities in 2007 as compared 2006.

DD&A decreased $0.1 million during the three months ended September 30, 2007 as compared to the three months ended September 30, 2006 primarily due to lower depletion expense associated with lower production volumes in 2007, and our oil processing facility becoming fully depreciated during 2007.

General and administrative expenses increased $1.5 million to $4.3 million for the nine months ended September 30, 2007 from $2.8 million for the comparable period in 2006. The increase was attributable to an increase in compensation expense of $0.6 million of which $0.2 million related to a non-cash charge for stock option compensation expense under the provisions of SFAS 123R. The remaining $0.4 million increase in compensation expense was attributable to the timing and amount of bonuses in 2007 versus 2006. Legal and investor relations expenses increased $0.2 million and travel was up $0.2 million as the company's exploration and production activities increased in 2007 as compared to 2006. The remaining $0.5 million increase was associated with IT infrastructure improvements and other office services which increased with the size of the organization in 2007 as compared to 2006.

Other Income (Expense). Total other expense increased to $0.9 million in the three month period ended September 30, 2007 from other income of $0.3 million in the three month period ended September 30, 2006. The $1.2 million increase is primarily attributable to an increase in interest expense of $1.8 million partially offset by a $0.6 million increase in interest income.

Interest income increased to $1.0 million for the three months ended September 30, 2007 from $0.4 million for the same period in 2006. This increase was due to interest income from excess cash in investment accounts which was higher in 2007 due to the Company's Q2 2007 $67.0 million convertible debt offering.

Interest expense increased to $1.8 million for the three months ended September 30, 2007 from $0.1 million for the same period in 2006. This increase was attributable to increased average debt balances in the 2007 period attributable to the Company's $67.0 million convertible debt offering during Q2 of 2007.

Liquidity and Capital Resources

Summary

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.

During the second quarter of 2007, we sold in a private placement approximately $67 million principal amount of our 10% convertible notes due 2012 to fund our 2007 planned capital expenditure program and general corporate activities through the end of this year and into early 2008. As of September 30, 2007, our cash and cash equivalents were $7.2 million, our short term investments were $40.1 million and we had approximately $15.1 million of restricted cash. Up to $5.0 million of the restricted cash will be released if the Company's stock price exceeds $1.67 for twenty consecutive trading days, an additional $5.0 million of the restricted cash will be released if the Company's stock price exceeds $3.34 for 20 consecutive trading days. At September 30, 2007, the Company's stock was trading at $1.45. 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 4 and 5 of the attached financial statements for further discussion of the convertible notes, the line of credit and the restricted cash. At September 30, 2007 the company had $66.9 million of convertible long term debt outstanding. The company had no other outstanding debt at September 30, 2007.

During the third quarter of 2007, the Company retired a $3.5 million vendor note payable upon its maturity from available cash on hand.

Capital Expenditures

We make and expect to continue to make substantial capital expenditures in the exploration, development, and production of natural gas and oil reserves. We believe that our cash flows from operations, current cash and investments on hand will be sufficient to meet our capital expenditure budget for the next twelve months.

We estimate that our total capital expenditures for 2007 will be approximately $37.9 million, of which $11.0 million had been spent as of September 30, 2007. Our planned 2007 capital expenditures represent a 74% increase over 2006.

Our 2007 capital expenditures are focused on growing and developing our reserves and production on our existing Block 12 acreage. Of our total $37.9 million capital expenditure budget, approximately $37.0 million is budgeted for exploration and production activities. We plan to drill three wells in the Tarabani unit, and one well in Basin Edge Unit and one shallow well in the Mirzaani Field Area Shallow Production Unit.

The 2008 capital expenditure program is estimated to be $20 million. It is envisaged that these capital expenditures, all of which are discretionary, would be used to drill a new well on the Basin Edge Unit, a new well in the Tarabani Unit, and one shallow well in the Mirzaani Field Area Shallow Production Unit.

There could be significant additional capital expenditures associated with drilling in 2008, depending on the results of the 2007 program and the availability of financing on acceptable terms.

Cash Flow Activity

Operating Activities. Cash flows used in operating activities increased $5.6 million to $12.8 million for the nine months ended September 30, 2007 from $7.2 million for the nine months ended September 30, 2006. The increase was primarily attributable to a higher net loss of $13.4 million for the nine months ended September 30, 2007 as compared to $8.0 million for the comparable period in 2006. The higher net loss was primarily attributable to increased general and administrative costs and field operating costs due to a ramp up in activity during 2007 as compared to 2006.

Investing Activities. Cash flows used in investing activities increased to $41.4 million in the nine month period ended September 30, 2007 from $0.9 million in the 2006 period. The increase was primarily attributable to a net $25.4 million purchase of short term investments and auction rate securities in 2007 compared with a $22.0 million redemption in short term investments for the 2006 period. This was partially offset by an $10.8 million decrease in capital expenditures for the nine months ended 2007 as compared to 2006 as the Company's drilling campaign was launched later than originally expected in 2007 and there were substantially less seismic and geophysical expenses in 2007 as the 3D program was completed during the first nine months of 2006.

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. Proceeds from borrowings increased to $66.5 million for the nine months ended September 30, 2007, and we repaid approximately $3.5 million leaving net borrowings during the period of approximately $63.0 million. Of this amount, approximately $10.1 million is restricted as to use by the terms of the convertible debt agreements discussed at note 4 in the attached condensed consolidated financial statements. We used the net proceeds to fund our capital expenditure programs and for general corporate purposes and short term investments. Our financing activities provided $51.4 million in cash for the nine month period ended September 30, 2007 compared to $3.6 million in the comparable period in 2006.

Contractual Obligations and Commitments

The following table outlines our contractual obligations and commitments by payment due dates as of September 30, 2007 (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	$ 66.9	$ -	$ -	$ 66.9	$ -
Long-term debt–interest	30.8	6.7	13.4	10.7	-
Lease agreements	0.9	0.3	0.4	0.2	-
Total contractual obligations and commitments	$ 98.6	$ 7.0	$ 13.8	$ 77.8	$ -

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 2 ("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.

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.

Our development and exploration operations require substantial capital and we may be unable to obtain needed capital or financing on satisfactory terms.

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 inability of one or more of our customers 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.

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.

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. The 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, 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;
- governmental regulation and taxation of the natural gas and oil industry; and
- developments in oil-producing and natural gas-producing countries.