

# **Frontera Resources Corporation and Subsidiaries**

**Condensed Consolidated Financial Statements  
Three and Six Months Ended June 30, 2010 and  
2009**

# **Frontera Resources Corporation and Subsidiaries**

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**June 30, 2010 and 2009**

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

	<b>June 30, 2010</b>	<b>December 31, 2009</b>
<b>Assets</b>		
Current assets		
Cash and cash equivalents	\$ 1,154,179	\$ 813,500
Restricted cash	—	594,356
Investments	—	8,080,000
Accounts receivable	563,239	587,479
Inventory	6,901,566	7,382,555
Prepaid expenses and other current assets	308,997	342,418
Total current assets	<u>8,927,981</u>	<u>17,800,308</u>
Property and equipment, net	1,386,117	1,570,619
Oil and gas properties, full cost method		
Properties being depleted	72,092,568	71,779,778
Properties not subject to depletion	49,858,773	47,583,794
Less: Accumulated depletion	<u>(71,395,068)</u>	<u>(71,313,732)</u>
Net oil and gas properties	50,556,273	48,049,840
Other assets	<u>2,930,873</u>	<u>3,673,817</u>
Total assets	<u>\$ 63,801,244</u>	<u>\$ 71,094,584</u>
<b>Liabilities and Stockholders' Deficit</b>		
Current liabilities		
Accounts payable	\$ 2,713,673	\$ 755,931
Accrued liabilities	6,388,772	2,210,923
Current maturities of notes payable	—	9,450,000
Advances from Related Party	<u>1,865,000</u>	<u>—</u>
Total current liabilities	10,967,445	12,416,854
Convertible notes payable	109,405,721	104,133,940
Derivative stock warrant liabilities	474,405	3,229,872
Other long-term liabilities	<u>12,546</u>	<u>20,654</u>
Total liabilities	<u>120,860,117</u>	<u>119,801,320</u>
Commitments and contingencies		
Stockholders' deficit		
Common stock	5,225	5,225
Additional paid-in capital	171,522,760	170,691,064
Treasury stock, at cost	(567,832)	(567,832)
Accumulated deficit	<u>(228,019,026)</u>	<u>(218,835,193)</u>
Total stockholders' deficit	<u>(57,058,873)</u>	<u>(48,706,736)</u>
Total liabilities and stockholders' deficit	<u>\$ 63,801,244</u>	<u>\$ 71,094,584</u>

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 June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
<b>Revenue - crude oil sales</b>	\$ 1,578,357	\$ -	\$ 2,304,467	\$ 1,695,503
<b>Operating expenses</b>				
Field operating and project costs	1,301,407	1,056,113	2,341,800	3,360,988
General and administrative	2,536,092	2,795,592	5,476,254	6,560,324
Depreciation, depletion and amortization	146,890	190,342	285,815	281,417
Impairment of oil and gas properties	-	125,076	-	858,947
Total operating expenses	<u>3,984,389</u>	<u>4,167,123</u>	<u>8,103,869</u>	<u>11,061,676</u>
Loss from operations	<u>(2,406,032)</u>	<u>(4,167,123)</u>	<u>(5,799,402)</u>	<u>(9,366,173)</u>
<b>Other income (expense)</b>				
Interest income	3,380	101,478	18,079	221,305
Interest expense	(3,097,844)	(2,908,606)	(6,154,436)	(5,676,980)
Derivative income	1,673,460	-	2,755,467	-
Other, net	12,703	1,654,488	(3,541)	1,635,204
Total other income (expense)	<u>(1,408,301)</u>	<u>(1,152,640)</u>	<u>(3,384,431)</u>	<u>(3,820,471)</u>
Net loss	<u>\$ (3,814,333)</u>	<u>\$ (5,319,763)</u>	<u>\$ (9,183,833)</u>	<u>\$ (13,186,644)</u>
<b>Loss per share</b>				
Basic and diluted	\$ (0.03)	\$ (0.07)	\$ (0.07)	\$ (0.18)
<b>Number of shares used in calculating loss per share</b>				
Basic and diluted	131,793,282	74,900,928	131,793,282	74,891,842

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

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

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	Common Stock	Additional Paid-in Capital	Treasury Stock	Accumulated Deficit	Total Stockholders' Deficit
<b>Balances at December 31, 2009</b>	\$ 5,225	\$170,691,064	\$ (567,832)	\$ (218,835,193)	\$(48,706,736)
Compensation expense-common stock option	—	831,696	—	—	831,696
Net loss	—	—	—	(9,183,833)	(9,183,833)
<b>Balances at June 30, 2010</b>	<u>\$ 5,225</u>	<u>\$171,522,760</u>	<u>\$ (567,832)</u>	<u>\$(228,019,026)</u>	<u>\$(57,058,873)</u>

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)*

	Six Months Ended June 30,	
	2010	2009
<b>Cash flows from operating activities</b>		
Net loss	\$ (9,183,833)	\$ (13,186,644)
Adjustments to reconcile net loss to net cash used in operating activities		
Depreciation, depletion and amortization	285,815	281,417
Impairment	—	858,947
Debt issuance cost amortization	742,944	742,944
Realized loss on sale of investments	—	300,000
Noncash interest expense	5,271,781	4,776,723
Stock based compensation	831,696	1,432,725
Derivative income	(2,755,467)	—
Changes in operating assets and liabilities:		
Accounts receivable	24,240	217,956
Inventory	480,989	80,611
Prepaid expenses and other current assets	33,421	346,745
Accounts payable	1,021,235	702,408
Accrued liabilities	3,336,016	(3,161,085)
Other long-term liabilities	(8,108)	(5,654)
Net cash provided by (used in) operating activities	<u>80,729</u>	<u>(6,612,907)</u>
<b>Cash flows from investing activities</b>		
Investment in oil and gas properties	(1,561,180)	(1,871,763)
Investment in property and equipment	(19,977)	(140,710)
Redemption of auction rate securities	8,080,000	700,000
Net cash provided by (used in) investing activities	<u>6,498,843</u>	<u>(1,312,473)</u>
<b>Cash flows from financing activities</b>		
Restricted cash	594,356	5,000,000
Repayment of borrowings	(8,698,249)	(4,978,414)
Advances from related party	1,865,000	—
Proceeds from line of credit	—	3,000,000
Net cash provided by (used in) financing activities	<u>(6,238,893)</u>	<u>3,021,586</u>
Net increase (decrease) in cash and cash equivalents	340,679	(4,903,794)
<b>Cash and cash equivalents</b>		
Beginning of year	813,500	7,662,891
End of period	<u>\$ 1,154,179</u>	<u>\$ 2,759,097</u>
<b>Supplemental cash flow information</b>		
Cash paid for interest	1,256	157,313
<b>Noncash investing and financing activities</b>		
Issuance of convertible notes in lieu of interest payments	\$ 5,271,781	\$ 4,775,983
Accrued investment in oil and gas properties	1,026,589	1,643,261
Accrued interest	138,455	—
Conversion of debt to common stock	—	53,283
Issuance of common stock in lieu of interest payments	—	740

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

# **Frontera Resources Corporation and Subsidiaries**

## **Notes to Condensed Consolidated Financial Statements** *(Unaudited)*

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### **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 country of Georgia (“Georgia”), an independent country that was 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 5,500 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 for five years 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 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, relations with neighboring countries including the Russian Federation, and changing taxation policies, foreign exchange restrictions, political conditions and regulations.

### **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, 2010 without additional sources of financing. Management plans to continue to reduce costs and raise additional financing to meet its cash needs for 2010 and has engaged in discussions with various financial institutions to seek additional financing in order to facilitate the Company's 2010 operating plan. It should be noted, however, there can be no assurance that the Company will be successful in obtaining additional sources of financing.

# **Frontera Resources Corporation and Subsidiaries**

## **Notes to Condensed Consolidated Financial Statements** *(Unaudited)*

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Since 2008, 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 is likely to be adversely affected.

Failure to generate sufficient operating cash flows, raise additional capital or further reduce spending will 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 or 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 its 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 June 30, 2010 and December 31, 2009 (dollars in thousands):

	<u>June 30, 2010</u>	<u>December 31, 2009</u>
Cash and cash equivalents	\$ 1,154	\$ 814
Working capital	(2,039)	5,383
Total debt	111,271	113,584
Debt to debt and equity	205%	175%

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:

- Decline 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.

# **Frontera Resources Corporation and Subsidiaries**

## **Notes to Condensed Consolidated Financial Statements** *(Unaudited)*

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### **3. Basis of Presentation and Summary of Significant Accounting Policies**

The condensed consolidated balance sheet of the Company at December 31, 2009 was derived from the Company's audited consolidated financial statements as of that date, but does not include all disclosures required by accounting principles generally accepted in the United States of America. The condensed consolidated balance sheet at June 30, 2010, the condensed consolidated statements of operations for the three and six month periods ended June 30, 2010, and 2009, the condensed consolidated statement of changes in stockholders' deficit for the six month period ended June 30, 2010, and the condensed consolidated statements of cash flows for the six month periods ended June 30, 2010 and 2009 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 six month period ended June 30, 2010 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, 2009.

For a description of the Company's accounting policies, refer to Note 3 of the 2009 consolidated financial statements.

#### **Use of Estimates**

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

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

# **Frontera Resources Corporation and Subsidiaries**

## **Notes to Condensed Consolidated Financial Statements (Unaudited)**

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### **Impairment**

Under the full cost method of accounting, the net book value of natural gas and crude oil properties may not exceed a calculated "ceiling." The ceiling limitation is the discounted estimated future net revenue from proved natural gas and crude oil properties plus the cost of properties not subject to amortization. In calculating future net revenues, prices and costs used are those as of the end of the appropriate period. These prices are not changed except where different prices are fixed and determinable from applicable contracts for the remaining term of those contracts.

The net book value is compared to the ceiling limitation on both a quarterly and annual basis. Any excess of the net book value is written off as impairment expense. Impairment expense recorded in one period may not be reversed in a subsequent period even though higher natural gas and crude oil prices may have increased the ceiling limitation in the subsequent period. For the six months ended June 30, 2009, the Company reduced the carrying value of its natural gas and crude oil properties by approximately \$0.9 million due to the full cost ceiling limitation. As the full cost ceiling exceeded the net capitalized costs at March 31, 2010 and June 30, 2010, there was no such reduction of the Company's carrying value of its natural gas and crude oil properties during 2010.

### **Fair Value Measurements**

The Company's financial instruments consist primarily of cash and cash equivalents, trade receivables, trade payables, long-term debt and derivative stock warrant liabilities. Management considers the carrying values of cash and cash equivalents, trade receivables, trade payables and long-term debt to be representative of their respective fair values. Additionally, the derivative warrant liabilities are recorded at fair value in the accompanying balance sheets.

The authoritative guidance related to fair value defines a hierarchy of inputs to valuation techniques based upon whether those inputs reflect assumptions other market participants would use based upon market data obtained from independent sources (observable inputs). The Company performed an analysis on its derivative warrant liabilities as of the balance sheet date. The fair value of the combined derivative stock warrant liabilities on June 30, 2010 was \$474,405, within Level 2 of the fair value hierarchy. The Company does not have any assets or liabilities classified within Level 3 of the fair value hierarchy.

## **4. Detail of Certain Balance Sheet Accounts**

### **Accounts Receivable**

Accounts receivable consists of the following:

	<b>June 30, 2010</b>	<b>December 31, 2009</b>
Trade receivables	\$ —	\$ —
Other receivables	563,239	587,479
Total accounts receivable	<u>\$ 563,239</u>	<u>\$ 587,479</u>

# Frontera Resources Corporation and Subsidiaries

## Notes to Condensed Consolidated Financial Statements *(Unaudited)*

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### Inventory

Inventory consists of the following:

	<b>June 30, 2010</b>	<b>December 31, 2009</b>
Materials and supplies	\$ 4,897,200	\$ 5,626,387
Crude oil	2,004,366	1,756,168
Total inventory	\$ 6,901,566	\$ 7,382,555

### Accrued Liabilities

Accrued liabilities consist of the following:

	<b>June 30, 2010</b>	<b>December 31, 2009</b>
Accrued payables	\$ 1,154,133	\$ 1,351,784
Deferred oil sales	4,164,953	678,935
Accrued benefits	147,216	147,940
Accrued interest	170,719	32,264
Other accruals	751,751	-
Total accrued liabilities	\$ 6,388,772	\$ 2,210,923

## 5. Notes Payable

In February 2010, the Company repaid \$8.7 million of a \$9.5 million note under an agreement with a bank. The remainder of the note was extinguished under a settlement with the bank in August 2010. See Note 8 for further discussion of the settlement. During the first six months of 2010, an affiliate of a director of the Company issued a series of unsecured short-term notes payable totaling \$1.9 million, which accrue interest at 15% per annum.

## 6. Convertible Notes

During May 2007, the Company raised approximately \$67.0 million through a private placement of convertible unsecured notes due May 2012 ("May 2007 Notes"). 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 note placement, debt issuance costs of approximately \$2.7 million were incurred, of which approximately \$1.5 million was paid in cash and \$1.2 million was paid in additional convertible notes and stock options.

During July 2008, the Company raised \$23.5 million through a private placement of convertible unsecured notes due July 2013 ("July 2008 Notes"). 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

# **Frontera Resources Corporation and Subsidiaries**

## **Notes to Condensed Consolidated Financial Statements** *(Unaudited)*

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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.

In connection with the issuance of the July 2008 Notes, each holder of the May 2007 Notes 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 were initially exercisable for approximately 3,151,000 shares of common stock in the aggregate at an exercise price of \$3.50 per share, and include a cashless exercise provision. The warrants have a five-year term and contain other customary terms and provisions. During 2009, in accordance with the anti-dilution provisions of the warrants, the number of shares of common stock issuable upon exercise of the warrants increased to 6,528,000 and the exercise price decreased to \$1.69 per share.

During 2009, noteholders of the Company's convertible notes elected to convert approximately \$50,000 of convertible notes into 31,906 shares of common stock and also elected to convert approximately \$1,000 of related interest into 443 shares of common stock. No such elections were made in 2010.

During the six month periods ended June 30, 2010 and 2009, the Company elected to pay the quarterly interest payments in kind and issued approximately \$5.3 million and \$4.8 million, respectively, in additional convertible notes in accordance with terms of the note purchase agreements.

### **7. Commitments and Contingencies**

#### **ARAR Arbitration**

In January 2008, Frontera Eastern Georgia Limited, an indirect consolidated subsidiary of the Company ("FEGFL") 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 FEGFL with work actually performed. FEGFL 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. FEGFL claimed damages of approximately \$7.0 million in the arbitration. ARAR denied FEGFL's claims and filed counterclaims against FEGFL, 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 was required to make a series of payments to FEGFL through December 2009. The settlement resolved all outstanding claims and counterclaims between Frontera and ARAR arising out of the drilling services contract. Beginning in August 2009, ARAR defaulted on its monthly payments and remains in default on payments due August–December 2009. The Company applied to the arbitration panel for entry of an agreed award pursuant to the settlement agreement. The panel held a hearing on the Company's application in March 2010, and in April 2010, entered a final, binding award in the amount of \$1.4 million in favor of FEGFL. The Company intends to pursue payment of the full amount of the award and to enforce the award in any jurisdiction in which the assets of ARAR may be found.

In April 2010, FEGFL filed an action in the U.S. District Court for the Southern District of Texas seeking confirmation of the final arbitration award pursuant to the Convention on Recognition and Enforcement of Foreign Arbitral Awards of June 10, 1958 as a precursor to further enforcement

## **Frontera Resources Corporation and Subsidiaries**

### **Notes to Condensed Consolidated Financial Statements** *(Unaudited)*

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action in the U.S. Service of process has been effected on ARAR and is being effected on certain affiliates of ARAR in Turkey that are subject to the final award. In May 2010, ARAR filed a counterclaim in the district court seeking to deny confirmation and to vacate the award. In July 2010, FEGL filed an enforcement action in the 4<sup>th</sup> Commercial Court in Ankara, Turkey, seeking to enforce its \$1.4 million final award against assets of ARAR located in Turkey. An affiliate of ARAR initiated a lawsuit against FEGL in the 7th Commercial Court in Ankara, Turkey in July 2010 claiming damages of \$0.3 million in connection with the exportation of the rig from Georgia. The Company believes the claims made by ARAR in the Turkish lawsuit are subject to the arbitration clause of the contract, were resolved by the December 2008 settlement, and in any event are completely without merit.

#### **8. Subsequent Events**

Events occurring after June 30, 2010, were evaluated as of August 27, 2010, the date this Quarterly Report was issued, to ensure that any subsequent events that met the criteria for recognition and/or disclosure in this report have been included.

The Company liquidated \$2.6 million par value of investments in Municipal Short Term Auction Rate Securities ("M-STARS") in 2009 and \$10.0 par value of M-STARS in the first quarter of 2010. These M-STARS were sold at approximately \$2.6 million below par on the secondary market due to widespread failure of the auction rate securities market since 2008. In June 2010, the Company initiated an arbitration against the broker and bank from which it had purchased the M-STARS seeking damages for, among other things, violations of federal and state securities laws and common law fraud in connection with the Company's original purchase of the M-STARS. In August 2010, the arbitration was settled releasing approximately \$0.9 million in accrued liabilities and payment of \$0.9 million.

# **Frontera Resources Corporation and Subsidiaries**

## **Management's Discussion and Analysis of Financial Condition and Results of Operations**

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### **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 country 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 2010 periods presented herein. For the six months ended June 30, 2009 we recorded an impairment provision of \$0.9 million related to the Company's fields in Georgia.

### **Results of Operations**

#### ***Six Months Ended June 30, 2010 Compared to Six Months Ended June 30, 2009***

*Revenue.* Revenues for the six months ended June 30, 2010 increased \$0.6 million to \$2.3 million from \$1.7 million for the comparable 2009 period. The increase was mainly attributable to increase in sales volumes in the 2010 period.

*Operating Costs and Expenses.* Total operating costs and expenses decreased to \$8.1 million for the six months ended June 30, 2010 compared to \$11.1 million for the same period in 2009.

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. These costs decreased \$1.1 million to \$2.3 million during the six months ended June 30, 2010 as compared to \$3.4 million for the six months ended June 30, 2009. Substantially all of the decrease was due to lower personnel costs as drilling personnel on standby in the 2009 period were released in Q3 and Q4 2009. The decrease is also attributable to a \$0.4 million write-off of obsolete inventory in the 2009 period with no like adjustment in the 2010 period.

## **Frontera Resources Corporation and Subsidiaries**

### **Management's Discussion and Analysis of Financial Condition and Results of Operations**

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Depreciation, depletion and amortization and impairment expense decreased \$0.8 million during the six months ended June 30, 2010 to \$0.3 million as compared to \$1.1 million for the six months ended June 30, 2009. The decrease was primarily attributable to their being no ceiling test write-down in the 2010 period versus a \$0.9 million ceiling test write-down during the same period in 2009.

General and administrative expenses decreased \$1.1 million to \$5.5 million for the six months ended June 30, 2010 from \$6.6 million for the comparable period in 2009. The decrease was generally attributable to a series of cost cutting measures instituted in 2009 and 2010, primarily related to headcount reductions in Georgia and Houston.

*Other Income (Expense).* Total other expense decreased to \$3.4 million in the six month period ended June 30, 2010 from \$3.8 million in the six month period ended June 30, 2009. The \$0.4 million decrease is primarily attributable to an increase in interest expense of \$0.5 million, and a decrease in interest income of \$0.2 million. These changes were more than offset by a \$2.8 million increase in derivative income which was partially offset by a \$1.6 million decrease in other net income.

Interest income decreased to \$0.02 million for the six months ended June 30, 2010 from \$0.2 million for the same period in 2009. This decrease was due to lower cash available for investment in the 2010 period as compared to the same period in 2009.

Interest expense increased to \$6.2 million for the six months ended June 30, 2010 from \$5.7 million for the same period in 2009. This increase was primarily attributable to interest on additional debt incurred by making interest payments in kind on the 2007 and 2008 convertible debt offerings.

Derivative income increased to \$2.8 million for the six months ended June 30, 2010 from zero for the same period in 2009 as a result of a mark to market adjustment of the Company's 46.5 million warrants issued as part of the Company's \$7.6 million September 2009 equity financing.

Other net income decreased \$1.6 million for the six months ended June 30, 2010 primarily due to an arbitral award received in the 2009 period with no such award received in the 2010 period.

#### ***Three Months Ended June 30, 2010 Compared to Three Months Ended June 30, 2009***

*Revenue.* Revenues for the three months ended June 30, 2010 increased \$1.6 million to \$1.6 million from zero for the comparable 2009 period. The increase was mainly attributable to increase in sales volumes in the 2010 period.

*Operating Costs and Expenses.* Total operating costs and expenses decreased to \$4.0 million for the three months ended June 30, 2010 compared to \$4.2 million for the same period in 2009.

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. These costs increased \$0.2 million to \$1.3 million during the three months ended June 30, 2010 as compared to \$1.1 million for the three months ended June 30, 2009. Substantially all of the increase was due to the higher cost of oil sold in the 2010 period as larger volumes of oil were sold in the 2010 period versus the 2009 period. This was partially offset by lower cost of ex-pat drilling personnel that were released in Q3 and Q4 2009, and a \$0.4 million write-off of obsolete inventory in the 2009 period with no like adjustment in the 2010 period.

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Depreciation, depletion and amortization and impairment expense decreased \$0.2 million during the three months ended June 30, 2010 to \$0.1 million as compared to \$0.3 million for the three months ended June 30, 2009. The decrease was primarily attributable to their being no ceiling test write-down in the 2010 period versus a \$0.1 million ceiling test write-down during the same period in 2009.

General and administrative expenses decreased \$0.3 million to \$2.5 million for the three months ended June 30, 2010 from \$2.8 million for the comparable period in 2009. The decrease was generally attributable to a series of cost cutting measures instituted in 2009 and 2010, primarily related to headcount reductions in Georgia and Houston.

*Other Income (Expense).* Total other expense increased to \$1.4 million in the three month period ended June 30, 2010 from \$1.2 million in the three month period ended June 30, 2009. The \$0.2 million increase is primarily attributable to an increase in interest expense of \$0.2 million, and a decrease in interest income of \$0.1 million. These changes were offset by a \$1.7 million increase in derivative income and a \$1.6 million decrease in other net income.

Interest income decreased to \$0.01 million for the three months ended June 30, 2010 from \$0.1 million for the same period in 2009. This decrease was due to lower cash available for investment in the 2010 period as compared to the same period in 2009.

Interest expense increased to \$3.1 million for the three months ended June 30, 2010 from \$2.9 million for the same period in 2009. This increase was primarily attributable to interest on additional debt incurred by making interest payments in kind on the 2007 and 2008 convertible debt offerings.

Derivative income increased to \$1.7 million for the three months ended June 30, 2010 from zero for the same period in 2009 as a result of a mark to market adjustment of the Company's 46.5 million warrants issued as part of the Company's \$7.6 million September 2009 equity financing.

Other net income decreased \$1.6 million for the three months ended June 30, 2010 primarily due to an arbitral award collected in the 2009 period with no such award in the 2010 period.

### **Liquidity and Capital Resources**

#### ***Summary***

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, 2010 without additional sources of financing. Management plans to continue to reduce costs and raise additional financing to meet its cash needs for 2010 and has engaged in discussions with various financial institutions to seek additional financing in order to facilitate the Company's 2010 operating plan. It should be noted, however, there can be no assurance that the Company will be successful in obtaining additional sources of financing.

Since 2008, 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 is likely to be adversely affected.

Failure to generate sufficient operating cash flows, raise additional capital or further reduce spending will 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.

# **Frontera Resources Corporation and Subsidiaries**

## **Management's Discussion and Analysis of Financial Condition and Results of Operations**

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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 or 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 its 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 June 30, 2010 and December 31, 2009 (dollars in thousands):

	<u>June 30, 2010</u>	<u>December 31, 2009</u>
Cash and cash equivalents	\$ 1,154	\$ 814
Working capital	(2,039)	5,383
Total debt	111,271	113,584
Debt to debt and equity	205%	175%

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:

- Decline 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.

As of June 30, 2010, our cash and cash equivalents were \$1.2 million. At June 30, 2010 the Company had \$109.4 million of convertible long-term debt outstanding. The Company also had \$1.9 million in unsecured short-term notes payable to an affiliate of a director of the Company.

During the first quarter of 2010 the Company liquidated \$10.0 million par value of investments for \$8.1 million. The sale resulted in another-than-temporary loss of \$1.9 million at December 31, 2009, and as such the investments were classified as short-term at December 31, 2009 and are fully liquidated at June 30, 2010.

### ***Capital Expenditures***

We have met all capital expenditure requirements under the terms of our production sharing agreement with 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.

# **Frontera Resources Corporation and Subsidiaries**

## **Management's Discussion and Analysis of Financial Condition and Results of Operations**

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Our total capital expenditures for the six months ended June 30, 2010 were approximately \$2.6 million. Our 2010 capital expenditures represent a 26% decrease over actual 2009 capital expenditures during the same period. Our 2010 capital expenditures have been focused on growing and developing our Shallow Fields Production Unit. Of our total \$2.6 million of 2010 capital expenditures, substantially all was directed to exploration and production activities in the Shallow Fields Production units.

In order to fund discretionary capital expenditures planned for 2010, we will require additional outside financing. In recent months there has been extreme volatility and disruption in the global capital and credit markets. While these market conditions persist, our ability to access the capital and credit markets may be adversely affected.

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

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

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

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

### ***Cash Flow Activity***

*Operating Activities.* Cash flows provided by operating activities increased \$6.7 million to \$0.1 million for the six months ended June 30, 2010 compared to cash flows used of \$6.6 million for the six months ended June 30, 2009. The increase was primarily attributable to a lower net loss and lower changes in operating assets and liabilities for the six months ended June 30, 2010 as compared to the same period in 2009. The lower changes in operating assets and liabilities was primarily attributable to a \$4.2 million advance payment against oil inventory recorded in accrued liabilities. The oil is expected to be sold and the advance re-paid from proceeds received in the third quarter of 2010.

*Investing Activities.* Cash flows provided by investing activities increased \$7.8 million to \$6.5 million in the six month period ended June 30, 2010 compared to cash flows used of \$1.3 million in the 2009 period. The increase was primarily attributable to a net increase of \$7.4 million in investment redemptions and a decrease in investment in oil and gas properties of \$0.3 million in the 2010 period versus the 2009 period.

*Financing Activities.* Since March 2005, we have used equity issuances, borrowings and, to a lesser extent, our cash flows from oil sales to fund our exploration and production costs and general corporate overhead. Cash used by financing activities increased \$9.2 million to \$6.2 million for the six months ended June 30, 2010 from cash provided of \$3.0 million for the six months ended June 30, 2009. Our primary financing activities for the 2010 period included \$8.7 million of repayments of borrowings and \$1.9 million of proceeds from short-term notes payable.

# Frontera Resources Corporation and Subsidiaries

## Management's Discussion and Analysis of Financial Condition and Results of Operations

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### Contractual Obligations and Commitments–

The following table outlines our contractual obligations and commitments by payment due dates as of June 30, 2010 (in millions):

	Payments Due by Period				
	Total	Less than 1 Year	2–3 Years	4–5 Years	After 5 Years
<b>Contractual Obligations and Commitments</b>					
Long-term debt–principal	\$ 109.4	\$ –	\$ 80.7	\$ 28.7	\$ –
Long-term debt–interest	23.7	10.2	13.4	0.1	–
Lease agreements	0.8	0.8	–	–	–
Total contractual obligations and commitments	<u>\$ 133.9</u>	<u>\$ 11.0</u>	<u>\$ 94.1</u>	<u>\$ 28.8</u>	<u>\$ –</u>

### 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

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;

## **Frontera Resources Corporation and Subsidiaries**

### **Management's Discussion and Analysis of Financial Condition and Results of Operations**

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- 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.

# **Frontera Resources Corporation and Subsidiaries**

## **Management's Discussion and Analysis of Financial Condition and Results of Operations**

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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 decline. A slowing of global economic growth, and, in particular, in the United States, will likely 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, relations with neighboring countries including the Russian Federation, 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. 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;

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### **Management's Discussion and Analysis of Financial Condition and Results of Operations**

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- 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.