



**2008 CONSOLIDATED FINANCIAL STATEMENTS**

## CONSOLIDATED FINANCIAL STATEMENTS

### MANAGEMENT'S RESPONSIBILITY STATEMENT

The consolidated financial statements of Midnight Oil Exploration Ltd. and all information in this report are the responsibility of management and have been approved by the Board of Directors. The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles. The consolidated financial statements include amounts that are based on estimates, which have been objectively developed by management using all relevant information. All financial and operating data in this report is consistent with the information in the consolidated financial statements.

Midnight Oil Exploration Ltd. maintains appropriate systems of internal control to give reasonable assurance that transactions are appropriately authorized, assets are safeguarded from loss or misuse and financial records are properly maintained to provide reliable information for the preparation of financial statements. Midnight Oil Exploration Ltd. has effective disclosure controls and procedures to ensure timely and accurate disclosure of material information relating to the Company which complies with the current requirements of Canadian securities legislation.

KPMG LLP, an independent firm of chartered accountants, has been engaged to examine the financial statements and provide their auditor's report. Their report is presented with the consolidated financial statements.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal control. The Board of Directors carries out this responsibility principally through its Audit Committee. The Audit Committee is comprised entirely of independent directors and meets regularly with management and with the Company's external auditors to discuss the results of their audit examination and to review issues related thereto. The external auditors have full access to the Audit Committee with and without the presence of management. The Audit Committee reviews the consolidated financial statements and Management's Discussion and Analysis and recommends their approval to the Board of Directors.

Signed "*Fred Woods*"

Fred Woods  
President and CEO

Calgary, Alberta  
March 18, 2009

Signed "*Judy Stripling*"

Judy Stripling  
Executive Vice President and CFO

### AUDITORS' REPORT TO THE SHAREHOLDERS

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

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

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

Signed "*KPMG LLP*"

Chartered Accountants

Calgary, Canada  
March 18, 2009

# Consolidated Balance Sheets

As at December 31,

(000's)

	2008	2007
<b>Assets</b>		
Current assets:		
Accounts receivable	\$ 18,527	\$ 13,213
Investments (note 4)	21,010	-
Deposits and prepaid expenses	709	695
	<b>40,246</b>	13,908
Petroleum and natural gas assets (note 3)	<b>136,810</b>	150,773
	<b>\$ 177,056</b>	\$ 164,681
<b>Liabilities and Shareholders' Equity</b>		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 30,132	\$ 13,348
Long-term debt (note 5)	<b>18,844</b>	28,934
Future taxes (note 8)	<b>5,831</b>	4,273
Asset retirement obligations (note 6)	<b>1,883</b>	2,102
Shareholders' equity:		
Share capital (note 7)	<b>109,660</b>	113,032
Warrants (note 7)	-	40
Contributed surplus (note 7)	<b>5,607</b>	2,442
Retained earnings	<b>5,099</b>	510
	<b>120,366</b>	116,024
Commitments (note 10)		
	<b>\$ 177,056</b>	\$ 164,681

See accompanying notes to consolidated financial statements.

## On behalf of the Board:

Signed *"Tom Medvedic"*  
Director

Signed *"Peter Harrison"*  
Director

## Consolidated Statements of Income (Loss), Comprehensive Income (Loss) and Retained Earnings

Years ended December 31,

(000's, except per share amounts)

	2008	2007
<b>Revenues:</b>		
Petroleum and natural gas sales	\$ 49,577	\$ 43,153
Royalties	(10,794)	(6,854)
Gain on investments (note 4)	2,037	-
Other income (note 4)	1,527	179
	42,347	36,478
<b>Expenses:</b>		
Operating and transportation	8,119	9,886
Interest	1,372	1,573
General and administration	4,844	4,210
Depletion, depreciation and accretion	21,468	23,709
	35,803	39,378
Income (loss) before taxes	6,544	(2,900)
Future taxes (reduction) (note 8)	1,955	(1,681)
Net income (loss) and comprehensive income (loss)	4,589	(1,219)
Retained earnings, beginning of year	510	1,729
<b>Retained earnings, end of year</b>	<b>\$ 5,099</b>	<b>\$ 510</b>
Income (loss) per share: (note 7)		
Basic	\$ 0.10	\$ (0.03)
Diluted	\$ 0.10	\$ (0.03)

See accompanying notes to consolidated financial statements.

## Consolidated Statements of Cash Flows

Years Ended December 31,

(000's)

	2008	2007
<b>Cash provided by (used in):</b>		
<b>Operations:</b>		
Net income (loss)	\$ 4,589	\$ (1,219)
Items not involving cash:		
Depletion, depreciation and accretion	21,468	23,709
Stock-based compensation	551	565
Gain on investments (note 4)	(2,037)	-
Future taxes (reduction)	1,955	(1,681)
Abandonment expenditures	(554)	(167)
Changes in non-cash working capital	881	206
Cash flow from operations	26,853	21,413
<b>Financing:</b>		
Increase (decrease) in long-term debt	(10,090)	10,996
Repurchase of common shares	(1,209)	(277)
Changes in non-cash working capital	-	(162)
Cash flow from (used in) financing	(11,299)	10,557
<b>Investing:</b>		
Petroleum and natural gas additions	(36,167)	(27,330)
Property disposition (note 3)	1,930	-
Proceeds from disposition of investments (note 4)	8,108	-
Changes in non-cash working capital	10,575	(4,640)
Cash flow used in investing	(15,554)	(31,970)
Changes in cash	-	-
Cash, beginning of year	-	-
<b>Cash, end of year</b>	<b>\$ -</b>	<b>\$ -</b>
Interest paid	\$ 1,337	\$ 1,380

Cash is defined as cash and cash equivalents.

See accompanying notes to consolidated financial statements.

# Notes to Consolidated Financial Statements

For the years ended December 31, 2008 and 2007  
(Tabular amounts are stated in thousands of dollars except share and per share amounts)

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## Nature of operations

The principal business of the Company is the exploration, exploitation, development and production of oil and natural gas reserves. All activity is conducted in Western Canada and comprises a single business segment.

### 1. Significant accounting policies

The consolidated financial statements of the Company have been prepared in accordance with Canadian generally accepted accounting principles. The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and revenues and expenses during the reporting period. Actual results could differ from those estimated.

Specifically, the amounts recorded for depletion and depreciation of petroleum and natural gas assets and accretion of asset retirement obligations are based on estimates. The ceiling test is based on estimates of reserves, production rates, oil and gas prices, future costs and other relevant assumptions. The amounts for stock-based compensation are based on estimates of risk-free rates, expected option life and volatility. Future income taxes are based on estimates as to the timing of the reversal of temporary differences and tax rates currently substantively enacted. By their nature, these estimates are subject to measurement uncertainty and the effect on the financial statements of changes in such estimates in future periods could be significant.

(a) Consolidation:

The consolidated financial statements include the accounts of Midnight Oil Exploration Ltd. and its wholly owned subsidiary, Midnight Oil Resources Ltd. and a partnership, Midnight Oil Exploration Partnership. All inter-entity transactions and balances have been eliminated.

(b) Cash and cash equivalents:

Cash and cash equivalents are comprised of cash and all investments with a maturity date of three months or less.

(c) Investments:

Investments are comprised of units of a publicly traded royalty trust. Investments are classified as financial assets held for trading. Financial assets held for trading are initially recorded at their fair value with changes in their fair value recognized in net income.

(d) Petroleum and natural gas assets:

(i) Capitalized costs:

The Company follows the full cost method of accounting for petroleum and natural gas assets. Under this method, all costs related to the acquisition of, exploration for and development of petroleum and natural gas reserves are capitalized. These costs include land acquisition costs, geological and geophysical expenditures, rentals and other carrying charges on undeveloped properties, costs of drilling both productive and non-productive wells, oil and gas production equipment and facilities, asset retirement costs and administration expenses directly related to the acquisition, exploration and development activities. Proceeds from the disposition of oil and natural gas properties are accounted for as a reduction of capitalized costs, with no gain or loss recognized, unless such disposition would result in a change greater than 20% in the depletion or depreciation.

(ii) Depletion and depreciation:

Depletion of petroleum and natural gas assets and depreciation of production equipment are calculated using the unit-of-production method, based on production volumes before royalties in relation to estimated proven reserves as determined by an independent petroleum engineering firm. Natural gas reserves and production are converted to equivalent barrels of oil based upon the relative energy content of six thousand cubic feet of gas to one barrel of oil.

The cost of acquisition and evaluation of unproved properties are initially excluded from the depletion calculation. A separate impairment test is performed on these assets to determine whether the carrying value exceeds the fair value. Any excess in carrying value over fair value is an impairment. When proved reserves are assigned or a property is considered to be impaired, the cost of the property or the amount of the impairment will be added to the capitalized costs for the calculation of depletion.

Other assets are depreciated on a declining balance basis at rates ranging from 20% to 35%.

(iii) Ceiling test:

Petroleum and natural gas assets are evaluated in each reporting period to determine that the carrying amount is recoverable and does not exceed the fair value of the properties.

The carrying amounts are assessed to be recoverable when the sum of the undiscounted cash flows expected from the production of proved reserves, the lower of cost and market of unproved properties and the cost of major development projects exceeds the carrying amount of the cost centre. When the carrying amount is not assessed to be recoverable, an impairment loss is recognized to the extent that the carrying amount of the cost centre exceeds the sum of the discounted cash flows expected from the production of proved and probable reserves, the lower of cost and market of unproved properties and the cost of major development projects of the cost centre. The cash flows are estimated using expected future product prices and costs and are discounted using a risk-free interest rate.

(e) Asset retirement obligations:

The Company recognizes the asset retirement obligations for the future cost associated with removal, site restoration and asset retirement costs. The fair value of the liability for the Company's asset retirement obligation is recorded in the period in which it is incurred, discounted to its present value using the Company's credit adjusted risk-free interest rate and the corresponding amount recognized by increasing the carrying amount of petroleum and natural gas assets. The asset recorded is depleted on a unit of production basis over the life of the reserves. The liability amount is increased each reporting period due to the passage of time and the amount of accretion is charged to earnings in the period. Revisions to the estimated timing of cash flows or to the original estimated undiscounted cost could also result in an increase or decrease to the obligation. Actual costs incurred upon settlement of the retirement obligation are charged against the obligation to the extent of the liability recorded.

(f) Joint interest operations:

Substantially all of the Company's exploration, development and production activities related to oil and gas operations are conducted jointly with others and accordingly the accounts reflect only the Company's proportionate interest in such activities.

(g) Revenue recognition:

Revenue from the sale of petroleum and natural gas is recognized during the month when title passes to a third party.

(h) Income taxes:

The Company uses the asset and liability method of tax allocation accounting. Under this method, future tax assets and liabilities are determined based on differences between the financial reporting and tax bases of assets and liabilities, and measured using the substantially enacted tax rates and laws that will be in effect when the differences are expected to reverse.

(i) Flow-through shares:

The resource expenditure deductions for income tax purposes related to exploratory activities funded by flow-through shares are renounced to investors in accordance with tax legislation. Future tax liabilities and share capital are adjusted by the estimated cost of the renounced tax deductions when the expenditures are renounced.

(j) Stock-based compensation plans:

The Company applies the fair value method for valuing stock option grants and warrants. Under this method, compensation cost attributable to all share options granted and warrants issued are measured at fair value at the grant and issuance date and expensed over the vesting period with a corresponding increase to contributed surplus. Upon the exercise of the stock options and warrants, consideration received together with the amount previously recognized in contributed surplus is recorded as an increase to share capital.

(k) Per share information:

Basic per share information is computed by dividing income by the weighted average number of common shares outstanding for the period. The treasury stock method is used to determine the diluted per share amounts, whereby any proceeds from the stock options, warrants or other dilutive instruments are assumed to be used to purchase common shares at the average market price during the period. The weighted average number of shares outstanding is then adjusted by the net change.

(l) Financial instruments:

A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument to another entity. Upon initial recognition all financial instruments, including all derivatives, are recognized on the balance sheet at fair value. Subsequent measurement is then based on the financial instruments being classified into one of five categories: held for trading, held to maturity, loans and receivables, available for sale and other liabilities. The Company has designated its cash and cash equivalents and its investments as held for trading which are measured at fair value. Accounts receivable are classified as loans and receivables which are measured at amortized cost. Accounts payable and accrued liabilities and long term debt are classified as other liabilities which are measured at amortized cost, which is determined using the effective interest method.

The Company will assess at each reporting period whether a financial asset is impaired with any impairment recorded in net income.

The Company is exposed to market risks resulting from fluctuations in commodity prices, foreign exchange rates and interest rates in the normal course of operations. A variety of derivative instruments may be used by the Company to reduce its exposure to fluctuations in commodity prices, foreign exchange rates, and interest rates. The Company does not use these derivative instruments for trading or speculative purposes. The Company considers all of these transactions to be economic hedges, however, the majority of the Company's contracts do not qualify or have not been designated as hedges for accounting purposes. As a result, all derivative contracts are classified as held for trading and are recorded on the balance sheet at fair value, with changes in the fair value recognized in net income, unless specific hedge criteria are met. The fair values of these derivative instruments are based on an estimate of the amounts that would have been received or paid to settle these instruments prior to maturity given future market prices and other relevant factors. Proceeds and costs realized from holding the derivative contracts are recognized in net income at the time each transaction under a contract is settled.

The Company has elected to account for its physical delivery sales contracts, which were entered into and continue to be held for the purpose of receipt or delivery of non-financial items in accordance with its expected purchase, sale or usage requirements as executory contracts on an accrual basis rather than as non-financial derivatives.

The Company measures and recognizes embedded derivatives separately from the host contracts when the economic characteristics and risks of the embedded derivative are not closely related to those of the host contract, when it meets the definition of a derivative and when the entire contract is not measured at fair value. Embedded derivatives are recorded at fair value.

The Company immediately expenses all transaction costs incurred in relation to the acquisition of a financial asset or liability. Long-term debt is presented net of deferred interest payments with interest recognized in net income on an effective interest basis.

The Company applies trade-date accounting for the recognition of a purchase or sale of cash equivalents, investments and derivative contracts.

## **2. Changes in accounting policy**

Effective January 1, 2008, the Company adopted three new accounting standards: Section 1535, Capital Disclosures, Section 3862, Financial Instruments – Disclosures and Section 3863, Financial Instruments – Presentation. Section 1535, requires disclosure of objectives, policies and processes for managing capital, including: quantitative data about the components of capital, whether the Company has complied with all capital requirements and the consequences of non-compliance if the Company has not complied. Sections 3862 and 3863 specify standards of presentation and enhanced disclosures on financial instruments. The adoption of these policies did not impact the measurement of the amounts reported in the Company's financial statements as they primarily relate to disclosures.

### **Future Accounting Changes**

#### **(a) International Financial Reporting Standards ("IFRS"):**

In February 2008, the CICA Accounting Standards Board ("AcSB") confirmed the changeover to IFRS from Canadian GAAP will be required for publicly accountable enterprises for interim and annual financial statements effective for fiscal years beginning on or after January 1, 2011, including comparatives for 2010.

The International Accounting Standards Board ("IASB") has also issued an exposure draft relating to certain amendments and exemptions to IFRS 1. It is anticipated that this exposure draft will not result in an amended IFRS 1 standard until late 2009. The amendment, if implemented, will permit the Company to apply IFRS prospectively by utilizing its current reserves at the transition date to allocate the Company's full cost pool, with the provision that a ceiling test, under IFRS standards, be conducted at the transition date. The eventual changeover to IFRS represents a change due to new accounting standards. The transition from current Canadian GAAP to IFRS is a significant undertaking that may materially affect the Company's reported financial position and results of operations.

In response, the Company has completed a high-level IFRS transition plan and has established a preliminary timeline for its execution and completion. The Company has performed a preliminary review of the accounting policies of the Company under Canadian GAAP and compared them to IFRS. In 2009, the Company will perform the next phase of the project conducting an in-depth review of the significant areas of difference identified during the preliminary assessment in order to identify all specific Canadian GAAP and IFRS differences and select ongoing IFRS policies. Key areas addressed will also be reviewed to determine any information technology issues, the impact on internal controls over financial reporting and the impact on other business activities including compensation arrangements. Staff training programs have commenced in 2008 and will be ongoing as the project unfolds.

The Company will also continue to monitor standards development as issued by the IASB and the AcSB as well as regulatory developments as issued by the Canadian Securities Administrators, which may affect the timing, nature or disclosure of its adoption of IFRS.

(b) Business combinations:

In December 2008, the CICA issued Section 1582, Business Combinations. This section is effective January 1, 2011 and applies prospectively to business combinations for which the acquisition date is on or after the first annual reporting period beginning on or after January 1, 2011 for the Company. Early adoption is permitted. This section replaces Section 1581, Business Combination and harmonizes the Canadian standards with IFRS.

### 3. Petroleum and natural gas assets

	2008	2007
Cost	\$ 211,857	\$ 204,555
Accumulated depletion and depreciation	(75,047)	(53,782)
	\$ 136,810	\$ 150,773

During the year ended December 31, 2008, the Company capitalized \$3,108,000 (2007 – \$2,953,000) of general and administration expenses related to exploration and development activities. Included in this amount is the non-cash related stock-based compensation of \$411,000 (2007 - \$365,000). In addition, the future tax liability of \$139,000 (2007 - \$123,000) associated with the capitalized stock-based compensation has been capitalized.

The cost of unproven properties at December 31, 2008 of \$23,083,000 (2007 - \$24,095,000) has been excluded from the depletion and depreciation calculation. Future development costs of proven reserves of \$13,741,000 (2007 - \$12,321,000) have been included in the depletion and depreciation calculation.

On October 31, 2008, the Company disposed of interests in certain petroleum and natural gas assets to Daylight Resources Trust, a publicly traded oil and gas royalty trust and a related party, in exchange for \$1,930,000, net of purchase price adjustments, and 3,750,000 Daylight Resources Trust Units. The Trust Units were valued at \$7.22 per unit, considered to be the exchange value at the date of the transaction. The disposition also resulted in the removal of \$824,000 of asset retirement obligations and a decrease to the future tax liability of \$536,000. The total reduction to petroleum and natural gas assets was \$30,371,000. The disposition of assets did not result in a change of greater than 20% in the depletion and depreciation rate, and, as a result, no gain or loss has been recorded on the disposition.

At December 31, 2008, the Company applied a ceiling test to its petroleum and natural gas assets and determined that no impairment has occurred. The ceiling test was calculated using the following expected future market prices of:

Year	WTI Oil (\$US/bbl)	AECO Gas (CDN\$/mmbtu)	Cdn\$/US\$ Exchange Rates
2009	57.50	7.58	1.21
2010	68.00	7.94	1.18
2011	74.00	8.34	1.14
2012	85.00	8.70	1.08
2013	92.01	8.95	1.05
2014	93.85	9.14	1.05
2015	95.73	9.34	1.05
2016	97.64	9.54	1.05
2017	99.59	9.75	1.05
2018	101.59	9.95	1.05
2019	103.62	10.15	1.05
Thereafter	+2.0%	+2.0%	1.05

#### 4. Investments

Investments are comprised of the Trust Units received from the disposition of interests in certain petroleum and natural gas assets to Daylight Resources Trust, a publicly traded oil and gas royalty trust and a related party. Midnight considers the units to be financial assets and accounts for them as held for trading determining fair values based on quoted market prices. At December 31, 2008 Midnight held 2,690,200 Trust Units with a fair value of \$21,010,000. The Company disposed of 1,059,800 Trust Units during the year ended December 31, 2008 for proceeds of \$8,108,000 of which \$2,505,000 is outstanding in accounts receivable at year end. A gain of \$454,000 was realized on the disposition. The Company also recognized an unrealized gain of \$1,583,000 based on the fair value of the Trust Units at December 31, 2008. During the year ended December 31, 2008, the Company recorded \$1,360,000 of distribution income from the Trust Units in other income.

In January 2009, the Company disposed of the remaining Trust Units for \$21,489,000 and used the proceeds to reduce long-term debt.

#### 5. Long-term debt

Midnight has a revolving term credit facility available up to \$28.0 million with a Canadian chartered bank. The facility is available on a revolving basis until May 31, 2009. On May 31, 2009, at the Company's discretion, the facility is available on a non-revolving basis for a period of 366 days, at which time the facility would be due and payable. Alternatively, the facility may be extended for a further 364-day period at the request of the Company and subject to approval by the bank. The credit facility bears interest at the bank's prime rate or Bankers' Acceptance rates plus stamping fees based on the Company's debt to cash flow ratio, calculated using the two most recent fiscal quarters. The facility is secured by a \$50 million first floating charge debenture and a general securities agreement. At December 31, 2008, \$18,844,000 (2007 - \$28,934,000) was drawn on this facility. The effective interest rate for the bank debt was 4.9% (2007 - 5.8%) for the year ended December 31, 2008. The \$28.0 million borrowing base is subject to a semi-annual and annual review by the bank. These reviews are based primarily on the reserves and using commodity prices estimated by the bank, as well as other factors and therefore there can be no assurance that the credit facility available upon the next scheduled review will not be reduced. The last review was performed on November 7, 2008 with the next one scheduled for on or prior to May 31, 2009.

#### 6. Asset retirement obligations

The Company's asset retirement obligations result from net ownership interests in petroleum and natural gas assets including well sites, gathering systems and processing facilities. The Company estimates the total undiscounted amount of cash flow required to settle its asset retirement obligations is approximately \$4,658,000 (2007 - \$5,790,000) which will be incurred from 2009 to 2054. The majority of the costs will be incurred between 2015 and 2030. An inflation factor of 2% has been applied to the estimated asset retirement cost at December 31, 2008 and 2007. A credit-adjusted risk-free rate of between 8% and 10% was used to calculate the fair value of the asset retirement obligations at December 31, 2008 (2007 - 8%).

A reconciliation of the asset retirement obligations is provided below:

	2008	2007
Balance, beginning of year	\$ 2,102	\$ 1,930
Liabilities incurred	119	143
Change in estimates	837	-
Liabilities settled	(554)	(167)
Liabilities transferred on disposal (note 3)	(824)	-
Accretion expense	203	196
Balance, end of year	\$ 1,883	\$ 2,102

## 7. Share capital

(a) Authorized:

The authorized share capital consists of an unlimited number of common shares without par value.

(b) Issued and outstanding:

	Number of Shares	Amount
Common shares:		
Balance, December 31, 2006	47,827,829	\$ 119,807
Tax effect of flow-through shares issued in 2006	-	(6,222)
Shares repurchased	(232,700)	(553)
Balance, December 31, 2007	47,595,129	\$ 113,032
Shares repurchased	(1,420,000)	(3,372)
Balance, December 31, 2008	46,175,129	\$ 109,660

On November 7, 2008, Midnight filed notice with the Toronto Stock Exchange (the "TSX") to make a normal course issuer bid to purchase its outstanding common shares on the open market. The TSX has authorized Midnight to purchase up to 4,081,619 common shares during the period from November 12, 2008 to November 11, 2009. The bid replaces Midnight's prior normal course issuer bid which commenced on October 17, 2007 and expired on October 16, 2008. During 2008, Midnight purchased and cancelled 1,420,000 (2007 - 232,700) common shares for total consideration of \$1,209,000 (2007 - \$277,000). The excess of the average book value over the market price paid is recorded as contributed surplus.

(c) Per share amounts:

The following summarizes the common shares used in calculating per share amounts:

	2008	2007
Weighted average shares outstanding:		
Basic	47,290,818	47,809,160
Diluted	47,291,106	47,809,160

The reconciling items between basic and diluted average common shares outstanding are stock options and warrants. At December 31, 2008 there were 4,140,000 (2007-2,992,000) options that were anti-dilutive and at December 31, 2007 there were also 2,013,333 warrants that were anti-dilutive. There were no warrants outstanding at December 31, 2008.

(d) Stock options:

The Company has a stock option plan whereby up to 10% of the issued and outstanding common shares may be granted under option to employees, directors and other persons who provide ongoing management or consulting services to the Company. Stock options are normally granted for a term up to five years and vest over three years from the date granted. The exercise price of each option equals the market price of the Company's common shares on the date of the grant.

The summary of stock option activity is presented below:

	Number of options	Weighted average exercise price
Balance, December 31, 2006	3,636,800	\$ 2.83
Granted	309,500	1.87
Forfeited	(954,300)	3.38
Balance, December 31, 2007	2,992,000	\$ 2.56
Granted	1,218,000	1.28
Forfeited	(67,500)	1.01
Balance, December 31, 2008	4,142,500	\$ 2.21
Exercisable at December 31, 2008	1,981,499	\$ 2.63

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

Range of exercise price	Options Outstanding			Options Exercisable	
	Number outstanding	Weighted average exercise price	Weighted average remaining contractual life (years)	Number exercisable	Weighted average exercise price
\$ 1.00-1.99	1,390,000	\$ 1.39	4.2	78,166	\$ 1.81
\$ 2.00-2.99	2,097,500	2.36	2.9	1,381,667	2.36
\$ 3.00-3.99	655,000	3.45	2.0	521,666	3.45
	4,142,500	\$ 2.21	3.2	1,981,499	\$ 2.63

(e) Warrants:

	Number of Warrants	Amount
Warrants:		
Balance, December 31, 2006	2,083,333	\$ 42
Forfeited	(70,000)	(2)
Balance, December 31, 2007	2,013,333	\$ 40
Expired	(2,013,333)	(40)
Balance, December 31, 2008	-	\$ -

(f) Stock-based compensation:

Midnight accounts for its stock-based compensation plan using the fair value method. Under this method, a compensation cost is charged over the vesting period for warrants and options granted to employees, officers, and directors.

Midnight has not incorporated an estimated forfeiture rate for stock options that will not vest, rather the Company accounts for actual forfeitures as they occur.

The fair value of options granted were estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions and resulting values:

	2008	2007
Fair value of options granted	\$ 0.46	\$ 0.69
Risk free interest	3.1%	4.1%
Estimated hold period prior to exercise	4 years	4 years
Expected volatility	40%	40%
Dividend per share	\$ 0.00	\$ 0.00

(g) Contributed surplus:

The following table reconciles Midnight's contributed surplus:

	2008	2007
Balance, beginning of year	\$ 2,442	\$ 1,234
Stock-based compensation	962	930
Forfeiture and expiration of warrants	40	2
Repurchase of common shares	2,163	276
Balance, end of year	\$ 5,607	\$ 2,442

## 8. Taxes

The provision for taxes in the consolidated statements of income (loss) differs from the result that would have been obtained by applying the combined federal and provincial tax rate to the Company's income (loss) before taxes. The difference results from the following items:

	2008	2007
Income (loss) before taxes	\$ 6,544	\$ (2,900)
Combined federal and provincial tax rate	29.5%	32.1%
Computed "expected" tax expense (recovery)	\$ 1,930	\$ (931)
Increase (decrease) in taxes resulting from:		
Stock-based compensation	163	181
Capital gain on property dispositions	392	-
Effect of change in tax rate	(554)	(962)
Other	24	31
Future taxes (reduction)	\$ 1,955	\$ (1,681)

The future tax liability at December 31 is comprised of the tax effect of temporary differences as follows:

	2008	2007
Petroleum and natural gas assets	\$ 6,866	\$ 5,649
Asset retirement obligations	(471)	(525)
Attributed Canadian Royalty Income	(79)	(79)
Investments	(35)	-
Share issue costs	(450)	(772)
Balance, end of year	\$ 5,831	\$ 4,273

## 9. Financial risk management

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

The Board of Directors has overall responsibility for identifying the principal risks of the Company and ensuring the policies and procedures are in place to appropriately manage these risks. Midnight's management identifies, analyze and monitors risks and considers the implication of the market condition in relation to the Company's activities.

(a) Fair value of financial instruments:

Financial instruments comprise cash and cash equivalents, accounts receivable, investments, accounts payable and accrued liabilities and long-term debt. The fair values of cash and cash equivalents, accounts receivable and accounts payable and accrued liabilities approximate their carrying amounts due to their short-term maturities. The Company's investments held for trading have a fair value based on quoted market price of \$21,010,000. The Company's long-term debt bears interest at a floating market rate and accordingly the fair market value approximates the carrying value.

(b) Credit risk:

Credit risk is the risk of financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligations, and arises principally from Midnight's investment in Daylight Resources Trust (note 4) and from its receivables from joint venture partners and petroleum and natural gas marketers. At December 31, 2008, Midnight had 2,690,200 Daylight Resources Trust Units with a fair value of \$21,010,000 and

subsequent to year end, the Company disposed of its remaining investment for \$21,489,000. As at December 31, 2008 Midnight's receivables consisted of \$10,432,000 (2007 - \$6,823,000) from joint venture partners, \$5,345,000 (2007 - \$6,121,000) from petroleum and natural gas marketers, \$2,505,000 from a brokerage house for the disposition of Trust Units (2007 - nil) and \$245,000 (2007 - \$269,000) of other trade receivables.

Receivables from petroleum and natural gas marketers are normally collected on the 25th day of the month following production. Midnight markets the majority of its petroleum and natural gas through Daylight Resources Trust ("Daylight"), with payment to be received 5 business days after Daylight receives the revenue. Historically, Midnight has not experienced any collection issues with its petroleum and natural gas marketers. Joint venture receivables are typically collected within two to three months of the joint venture bill being issued to the partner. Midnight attempts to mitigate the risk from joint venture receivables by obtaining partner approval of significant capital and operating expenditures prior to expenditure and in certain circumstances may require cash deposits in advance of incurring financial obligations on behalf of joint venture partners. Joint venture receivables are from partners in the petroleum and natural gas industry who are subject to the risks and conditions of the industry. Significant changes in industry conditions and risks that negatively impact partners' ability to generate cash flow will increase the risk of not collecting receivables. Midnight does not typically obtain collateral from petroleum and natural gas marketers or joint venture partners; however the Company does have the ability to withhold production from joint venture partners in the event of non-payment or may be able to register security on the assets of joint venture partners. At December 31, 2008, the Company had \$1.0 million of receivables that were considered past due. The majority of these amounts are due from large well established joint venture partners.

Cash and cash equivalents, when held, consist of cash bank balances and short-term deposits maturing in less than 90 days. Midnight manages the credit exposure related to short-term investments by selecting counterparties based on credit ratings and monitors all investments to ensure a stable return, avoiding complex investment vehicles with higher risk such as asset backed commercial paper.

Midnight establishes an allowance for doubtful accounts as determined by management based on their assessment of collection, therefore the carrying amount of accounts receivable and cash and cash equivalents represents the maximum credit exposure. During the year ended December 31, 2008, Midnight provided an allowance of \$83,000 for doubtful accounts (2007 - nil) that has been recorded in general and administration expenses in the statement of income. Although an allowance has been provided Midnight will continue to pursue collection of this balance. The allowance may be adjusted if circumstances or events change

(c) Liquidity risk:

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they are due. Midnight prepares an annual budget and updates forecasts for operating, financing and investing activities on an ongoing basis to ensure it will have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions without incurring unacceptable losses or risking harm to the Company's reputation. Midnight's financial liabilities consist of its long-term debt, as outlined in note 5, and its accounts payable and accrued liabilities.

The following are the contractual maturities of financial liabilities at December 31, 2008.

Financial Liability	Total	Less than 1 Year	1-2 Years	2-5 Years
Account payable and accrued liabilities	\$ 30,132	\$ 30,132	\$ -	\$ -
Long-term debt	18,844	-	18,844	-
Total	\$ 48,976	\$ 30,132	\$ 18,844	\$ -

(d) Market risk:

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: currency risk, interest rate risk and other price risk. The Company is exposed to market risks resulting from fluctuations in commodity prices, foreign exchange rates and interest rates in the normal course of operations. A variety of derivative instruments may be used to reduce exposure to these risks.

Foreign currency exchange rate risk is the risk that the fair value or future cash flows will fluctuate as a result of changes in foreign exchange rates. While substantially all of the Company's sales are denominated in Canadian dollars, the market prices in Canada for oil and natural gas are impacted by changes in the exchange rate between the Canadian and United States dollar. A strengthening Canadian \$ compared to the United States \$ negatively impacts Midnight. The Company had no forward exchange rate contracts in place as at December 31, 2008 and 2007.

Commodity price risk is the risk that the fair value or future cash flows will fluctuate as a result of changes in commodity prices. Commodity prices for petroleum and natural gas are impacted by not only the relationship between the Canadian and United States dollar, as outlined above, but also world economic events that dictate the levels of supply and demand. There were no financial instruments in place to manage commodity prices during the years ended December 31, 2008 and 2007.

Interest rate risk is the risk that future cash flows will fluctuate as a result of changes in market interest rates. The Company is exposed to interest rate risk on its cash and cash equivalents, when held, and long-term debt that have a floating interest rates. If interest rates had been 100 basis points lower for the year ended December 31, 2008, net income would have increased \$214,000 and cash flow from operations would have been \$287,000 higher. An equal and opposite impact would have occurred to net income and cash flow from operations had interest rates been 100 basis points higher for the period. The Company had no interest rate swaps or hedges at December 31, 2008 and 2007.

(e) Capital management:

The Company's policy is to maintain a strong capital base for the objectives of maintaining financial flexibility which will allow it to execute on its capital investment program, provide creditor and market confidence and to sustain the future development of the business.

The management of capital includes share capital of \$109,660,000 and net debt of \$8,730,000 which includes working capital (the sum of current assets and current liabilities) and long-term debt. The Company manages its capital structure and makes adjustments by continually monitoring its business conditions, including: changes in economic conditions, the risk profile of its drilling inventory, the efficiencies of past investments, the efficiencies of forecasted investments and the timing of such investments, the current and forecasted net debt levels, the forecasted commodity prices and resulting cash flow. The Company strives to balance the proportion of debt and equity in its capital structure and monitors net debt to funds from operations. The calculation of this ratio is based on current net debt divided by funds from operations from the previous 2 quarters which is annualized. Funds from operations is defined as cash flow from operations before abandonment expenditures and changes in non-cash working capital from operating activities. At December 31, 2008 this ratio was 0.3 times, lower than expected due to the property disposition at October 31, 2008. The calculation is detailed as follows:

	<b>December 31, 2008</b>	<b>December 31, 2007</b>
Long-term debt	\$ 18,844	\$ 28,934
Current assets	(40,246)	(13,908)
Current liabilities	30,132	13,348
Net debt	\$ 8,730	\$ 28,374
Cash flow from operations for 4 <sup>th</sup> quarter	\$ 7,563	\$ 6,026
Changes in non-cash working capital from operations	(3,365)	(1,145)
Abandonment expenditures	484	17
Funds from operations for 4 <sup>th</sup> quarter	\$ 4,682	\$ 4,898
Prior quarter funds from operations	7,923	4,920
	\$ 12,605	\$ 9,818
	x 2	x 2
Annualized funds from operations	\$ 25,210	\$ 19,636
Ratio of net debt to annualized funds from operations	0.3	1.4

In order to maintain or adjust the capital structure, the Company may from time to time issue shares, if available on reasonable terms, sell assets, farm out properties and adjust its capital spending to manage current and projected debt levels. The Company may also review its level of bank credit obtainable based on the growth of its oil and natural gas reserves.

The Company's share capital is not subject to external restrictions; however the credit facility is a reserve based loan. The Company has not paid or declared any dividends since the date of incorporation, nor are any contemplated in the foreseeable future.

The Company's capital management objectives, evaluation measures and targets have remained unchanged over the periods presented.

## **10. Commitments**

Midnight's normal day to day activities includes farm-ins and farm-outs of joint venture properties. Midnight had entered into a farm-in commitment at Bilbo to drill and complete six wells to earn the lands. At December 31, 2008 Midnight had spent \$3,253,000 towards this farm-in and anticipates spending \$14 million to \$18 million in 2009 to fulfill this commitment. Midnight expects to have drilled five of the six wells by March 31, 2009 with the remaining well deferred until later in 2009.

## **11. Related Party**

Midnight is considered related to Daylight Energy Ltd. ("Daylight"), the administrator of Daylight Resources Trust, as a director and officer of Midnight is Daylight's Chairman. In addition, a director and officer of Daylight is also a director of Midnight. Midnight and Daylight are joint venture partners in certain properties, and as a result, revenues and costs related to these properties are allocated to each partner under standard joint venture billing arrangements. Each partner's costs and revenues are based on the exchange amounts which reflect actual third party costs incurred and revenue received. All transactions are conducted under standard business terms and are considered within the normal course of the Company's business activities and operations.

On October 31, 2008, Midnight sold its West Central assets to Daylight in exchange for \$1,930,000, net of purchase price adjustments, and 3,750,000 Daylight Resource Trust Units. This transaction was valued at the exchange amount as determined and agreed to by the related parties.

Daylight charged Midnight \$1,100,000 for the year ended December 31, 2008 (2007 - \$1,400,000) for administrative services and premise costs. At December 31, 2008 Midnight had a receivable balance, which includes joint venture and commodity marketing amounts of approximately \$2,800,000 million due from Daylight (2007 - \$4,700,000). Midnight also has \$3,900,000 due to Daylight for unexpended cash calls received at year end.

## Selected Quarterly Information

	2008				2007			
	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
<b>Financial</b> (000's, except for per share amounts)								
Petroleum and natural gas sales	\$ 7,828	\$ 14,930	\$ 15,576	\$ 11,243	\$ 10,811	\$ 10,439	\$ 11,009	\$ 10,894
Royalties	1,515	3,171	3,567	2,541	1,649	1,597	1,618	1,990
Operating expenses	1,683	1,934	1,883	2,154	2,746	2,227	1,781	2,176
Transportation expenses	64	80	114	207	200	255	312	189
Netback	\$ 4,566	\$ 9,745	\$ 10,012	\$ 6,341	\$ 6,216	\$ 6,360	\$ 7,298	\$ 6,539
G&A – cash charge	1,012	1,453	1,017	811	1,128	1,001	803	713
Interest	257	369	350	396	369	439	426	339
Other income	(1,385)	-	(39)	(103)	(179)	-	-	-
Funds from operations	\$ 4,682	\$ 7,923	\$ 8,684	\$ 5,237	\$ 4,898	\$ 4,920	\$ 6,069	\$ 5,487
Per share – Basic	0.10	0.17	0.18	0.11	0.10	0.10	0.13	0.11
– Diluted	0.10	0.17	0.18	0.11	0.10	0.10	0.13	0.11
Net income (loss)	\$ 760	\$ 1,647	\$ 2,174	\$ 8	\$ (19)	\$ (827)	\$ 51	\$ (424)
Per share – Basic	0.02	0.03	0.05	0.00	(0.00)	(0.02)	0.00	(0.01)
– Diluted	0.02	0.03	0.05	0.00	(0.00)	(0.02)	0.00	(0.01)
Petroleum and natural gas additions	\$ 13,423	\$ 6,417	\$ 4,695	\$ 11,632	\$ 8,092	\$ 3,217	\$ 3,439	\$ 12,582
Property dispositions	(30,371)	-	-	-	-	-	-	-
Net debt	8,730	29,536	31,042	34,996	28,374	24,886	26,577	29,170
Total assets	177,056	172,180	172,905	169,706	164,681	160,573	161,537	159,594
Shares outstanding								
Basic	46,175	47,423	47,423	47,423	47,595	47,828	47,828	47,828
Diluted	50,318	53,591	53,543	52,430	52,600	52,953	53,168	53,001
<b>Operations</b>								
Average daily production								
Natural gas (mcf/d)	5,465	6,097	5,799	5,239	5,573	5,981	5,769	6,891
Oil & NGLs (bbls/d)	803	941	942	883	1,036	1,050	1,185	1,090
Combined (boe/d)	1,714	1,957	1,908	1,756	1,965	2,047	2,146	2,239
Average prices received								
Natural gas (\$/mcf)	\$ 6.96	\$ 8.64	\$ 10.44	\$ 7.95	\$ 6.17	\$ 5.33	\$ 7.22	\$ 7.82
Oil & NGLs (\$/bbl)	58.54	114.18	116.87	91.88	79.62	77.16	66.76	61.39
Combined (\$/boe)	\$ 49.65	\$ 82.91	\$ 89.71	\$ 70.35	\$ 59.81	\$ 55.43	\$ 56.37	\$ 54.06
Royalties	9.61	17.61	20.54	15.90	9.12	8.48	8.29	9.88
Operating expenses	10.67	10.74	10.85	13.48	15.19	11.82	9.12	10.80
Transportation expenses	0.41	0.44	0.66	1.30	1.11	1.36	1.59	0.93
Netback received (\$/boe)	\$ 28.96	\$ 54.12	\$ 57.66	\$ 39.67	\$ 34.39	\$ 33.77	\$ 37.37	\$ 32.45