Message to Shareholders

Mahalo ("Mahalo" or the "Company") is pleased to announce its results for first quarter 2007. In the short time since I addressed our 2006 results and outlook for 2007, we are once again seeing ongoing success and a further building of momentum which only adds to the high level of optimism already shared by your management team. Despite continued volatility within the industry, your directors and management continue to be extremely pleased with Mahalo's accomplishments since inception.

Summary of Results

Three months ended March 31,	**2007**	2006
Financial ***($000's except per share)***		
Petroleum and natural gas revenue	**10,432**	8,392
Operating netback *(1)*	**6,080**	4,839
Net income (loss)	**(1,037)**	544
Per share - basic & diluted	**(0.02)**	0.01
Funds from operations *(1)*	**3,494**	4,015
Per share - basic *(1)*	**0.06**	0.10
Capital expenditures *(2)*	**8,819**	31,957
Proceeds from sale of oil and gas assets	**14,183**	-
Long-term debt and working capital, end of period	**43,385**	25,438
Shareholders' equity, end of period	**116,313**	88,413
Operational		
Average daily sales volumes *(boe) (1)*	**2,624**	1,688
Average selling price *($/boe)*	**44.18**	55.25
Operating netback *($/boe)*	**25.75**	31.85

(1) Refer to advisory regarding non-GAAP financial measures.

(2) Corporate and property acquisitions include deemed value of non-cash consideration.

Q1 2007 Highlights

- **Realized average daily production of 2,624 boe with approximately 500 boe productive capability awaiting completion of facilities.**
- **Continuing successful delineation drilling at Lakeview with multiple Hartshorne coal wells producing greater than 775 Mcf per day.**
- **Completed and tied in first U.S. horizontal Woodford shale well with strong economic results.**
- **Completed additional non-core asset sales of $14.2 million in first quarter 2007.**
- **Received increase in credit facility borrowing base to Cdn $60 million from Cdn $53 million, based on successful U.S. drilling.**

Financial

Mahalo generated funds from operations of $3.5 million on sales of $10.4 million and recorded a net loss of $1.0 million in an environment of continued softness in natural gas prices.

During first quarter 2007, the Company sold non-core, high-cost conventional resource assets (285 boe per day) for $14.2 million, adding strength to our balance sheet and funding for our unconventional resource programs. Our bankers recognize our successes and have approved a further increase in our bank borrowing base to Cdn $60 million.

Operational

Having established a United States office in Tulsa, Oklahoma in 2006, Mahalo has moved into an active operator role on a portion of its 2007 U.S. drilling program. This will bring a better balance to our overall resource management, while still benefiting from a close association with joint venture partners and other operators.

The Company averaged 2,624 boe of oil and gas sales during first quarter 2007, primarily CBM natural gas. The Company also has approximately 500 boe per day of potential sales volumes being held behind pipe from several Hartshorne CBM wells in the Lakeview area due to pipeline capacity constraints. The Company continues with the installation of an expanded Greater Kayla West low-pressure gas gathering system needed to bring this Lakeview CBM production to market. This expansion will support continued development of numerous Lakeview/Poteau Hartshorne CBM drilling prospects.

Mahalo continued to enjoy good drilling success in its U.S. Hartshorne CBM program during first quarter 2007 and accomplished a major step in its quest to unlock the significant potential underlying its U.S. shale land holdings. In addition, we are seeing some promising results rapidly unfold in our Canadian coals as a result of research and development activity initiated in late 2006.

The Company has drilled 15 (6.8 net) CBM wells in the United States to date in 2007. Mahalo is also currently drilling an operated, 100 per cent working interest, Hartshorne tight gas sand prospect in its Poteau field. The success of this well will generate additional prospects; tie-ins from which can be accommodated within existing infrastructure.

The Company spudded its first Woodford shale horizontal well in Hughes County, Oklahoma in early 2007. The well was completed utilizing a multi-stage, high-volume stimulation program and is generating strong economic results. The well has been tied in, and while still cleaning-up, is producing at 1.3 to 1.5 mmcf per day. The operator is installing compression to reduce wellhead pressure which will further improve productivity. Total well costs, including drilling, completion and tie-in, were very attractive at approximately US$3.5 million. Mahalo's working interest in this well is approximately 20 per cent.

Mahalo has, subsequent to the quarter-end, undertaken the stimulation of two Caney shale wells acquired as a part of its 2005 Lakeview property acquisition. The first well is a standing, horizontal Caney shale well that was never completed or stimulated by the previous owner. The stimulation process used on this well was developed over the last twelve months utilizing, what the Company believes to be, a highly-suitable, multi-stage fracturing technique. Mahalo is also stimulating a vertical Caney shale well. Both wells are currently cleaning up and being tested. The Company's working interest in these wells is 95 and 94 per cent, respectively. Since both wells were already tied in, additional tie-in capital will not be required.

As a result of recent success, Mahalo will be pursuing further development on both Woodford and Caney shale prospects located within its Arkoma Basin asset base. The Company anticipates spudding a second Woodford horizontal well in Hughes County in early June. This well will be operated by Mahalo at a working interest of approximately 50 per cent.

Mahalo anticipates drilling three Caney horizontal wells in the third and fourth quarters with a working interest of greater than 40 per cent. Stimulation plans for the Caney have been under review for some time; Mahalo has a high level of confidence that multi-stage stimulation programs will also generate success in its Caney completions.

As previously reported, Mahalo has decided to focus its Canadian Mannville CBM efforts at Corbett Creek to further identify and decipher key differences between Canadian Mannville and U.S. Hartshorne coals. Efforts to date point to the need for multi-lateral horizontal wells to more rapidly and efficiently desorb and dewater the coal and thereby expedite cash flow and return on capital. In addition to benefiting from a more focused approach, Corbett Creek offers an excellent infrastructure already in place.

In an attempt to assess multi-lateral economics, Mahalo recently re-entered an existing Mannville horizontal well at Corbett Creek and successfully attached two laterals to the original well bore. The well is currently on pump and our operations personnel are closely monitoring well performance.

While we continue to be excited by the Mannville in Canada, and are aggressively addressing its unique challenges, our monitoring of competitor activity in the Horseshoe Canyon coals over the last number of months has convinced us that certain of our prospects lie directly within what may be referred to as the "sweet spot of the Horseshoe Canyon fairway". These Horseshoe Canyon coals are typically dry and can be developed with less capital. During first quarter 2007, the Company elected to spud the first well of a potential multi-well Horseshoe Canyon program in the Joffre area of Alberta. The well has been drilled and cased and will be completed once spring road bans are lifted. Results of the well are pending.

Outlook

While the Company will continue to actively pursue a better understanding of its Canadian coals, it continues to direct a majority of near and medium term capital towards United States CBM development. Recent and past success, more robust economics and the large number of readily drillable locations clearly favor continued Hartshorne CBM development. The Hartshorne also offers the greatest opportunity to maximize cash flow in the current gas pricing environment.

Mahalo plans to drill 18 (8.6 net) Hartshorne wells in Q2, and an additional 38 (15.2 net) wells in the balance of 2007. In addition, facilities de-bottlenecking will continue to alleviate back pressure problems.

The Company's recent horizontal shale drilling success and other ongoing shale developments provide an excellent opportunity to unlock substantial new gas reserves as evidenced in Mahalo's Contingent Resource Study, previously press released on December 12, 2006. The independent third party study quantified Mahalo interest discovered gas resource (best estimate case) at 524 Bcf in the Woodford shale and 3.04 Tcf in the Caney shale.

Further information about our first quarter results is set out in our Management's Discussion and Analysis for the three months ended March 31, 2007.

On behalf of the Board of Directors
"Signed"

Duncan Chisholm
President and Chief Executive Officer

MANAGEMENT'S DISCUSSION AND ANALYSIS

This management's discussion and analysis ("MD&A") is a review of the results of operations and changes in financial condition of Mahalo Energy Ltd. ("Mahalo" or the "Company") and is dated May 11, 2007. It should be read in conjunction with the Company's unaudited consolidated financial statements and notes thereto for the three months ended March 31, 2007, and the audited consolidated financial statements and notes thereto and the MD&A for the year ended December 31, 2006. The consolidated financial statements and this MD&A have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP"). All dollar references are to Canadian dollars, unless otherwise specified. References to "US$" are to United States dollars.

The following MD&A contains forward-looking information and statements, refers to and discusses certain non-GAAP financial measures and aggregates certain oil and gas information in terms of barrels of oil equivalent. The reader is specifically referred to and encouraged to read the section entitled "Special Cautionary Advisories" at the end of this MD&A.

Quarter ended,	Mar 31, 2007	Mar 31, 2006
Financial highlights		
($000s, except per share and number of shares)		
Petroleum and natural gas revenue	**10,432**	8,392
Operating netback *(1)*	**6,080**	4,839
Net income (loss)	**(1,037)**	544
Per share - basic & diluted	**(0.02)**	0.01
Funds from operations *(1)*	**3,494**	4,015
Per share - basic *(1)*	**0.06**	0.10
Capital expenditures *(2)*	**8,819**	31,956
Proceeds from sale of oil and gas assets	**14,183**	-
Total assets, end of period	**192,975**	132,417
Long-term debt and working capital, end of period	**43,385**	25,438
Shareholders' equity, end of period	**116,313**	88,413
Common shares, end of period *(000s)*	**59,286**	43,132
Weighted average - basic *(000s)*	**59,086**	42,941
Weighted average - diluted *(000s)*	**59,086**	44,013
Operational highlights		
Average daily sales volumes *(boe) (1) (3)*	**2,624**	1,688
Average selling price *($/boe)*	**44.18**	55.25
Royalties *($/boe)*	**8.35**	14.49
Operating *($/boe)*	**8.94**	7.66
Transportation *($/boe)*	**1.14**	1.25
Operating netback *($/boe)*	**25.75**	31.85
(1) Please refer to special advisory regarding use of non-GAAP financial measures and barrel of oil equivalent measures.		
(2) Includes capital expenditures paid with non-cash consideration of $2.7 million in the 2006 period.		
(3) Sales volumes are before deduction of royalties.		

PRIMARY BUSINESS

Mahalo Energy Ltd. is an independent, public company whose primary focus is the acquisition, exploration, development and production of natural gas, principally coalbed methane ("CBM") in Western Canada and coalbed methane and shale gas in the Arkoma Basin in the state of Oklahoma, U.S.A. The Company also has conventional oil and gas operations in Canada.

At March 31, 2007, Mahalo Energy Ltd. had one wholly-owned subsidiary, Mahalo Energy (USA) Inc., a company incorporated under the laws of Delaware. Unless the context otherwise requires, references herein to "Mahalo" or the "Company" include Mahalo Energy Ltd. and Mahalo Energy (USA) Inc.

RESULTS OF OPERATIONS

During the three months ended March 31, 2007, the Company generated funds from operations of $3.5 million on sales revenues of $10.4 million and recorded a net loss of $1.0 million. The following table provides a comparison of current period results with the immediately preceding quarter ended December 31, 2006 and the corresponding quarter ended March 31, 2006.

Quarter ended,	Mar 31, 2007	Dec 31, 2006	Mar 31, 2006
($000s, except per share)			
Petroleum and natural gas revenue	**$ 10,432**	$ 10,867	$ 8,392
Net income (loss)	**(1,037)**	(47,511)	544
Per share: basic and diluted	**(0.02)**	(0.81)	0.01
Funds from operations	**3,494**	1,488	4,015
Per share: basic	**0.06**	0.03	0.10

Fourth quarter 2006 net earnings were significantly impacted by a full cost ceiling test write-down of $36.3 million, before tax, and a goodwill write-down in the amount of $12.7 million. The ceiling test write-down was, in turn, responsible for a majority of a $10.0 million future income tax recovery booked in that quarter.

The following table illustrates the major factors that accounted for the increase in funds from operations during first quarter 2007 from that generated in fourth quarter 2006.

($000s)	
Funds from operations generated in fourth quarter 2006	**$ 1,488**
Increase (decrease) in funds during first quarter 2007 as a result of:	
Lower sales volumes	**(1,482)**
Higher realized sales prices	**1,046**
Lower royalties expense	**229**
Lower operating and transportation expense	**1,118**
Higher operating netback	**911**
Lower general and administrative expense	**217**
Lower interest and financing costs	**35**
Lower foreign exchange loss	**843**
Funds from operations generated in first quarter 2007	**$ 3,494**

Funds from operations and funds from operations per share are non-GAAP financial measures which management believes are useful to assess its operating results and its ability to generate funds to finance operations and service debt. These measures should not be considered as an alternative to or more meaningful than net earnings, cash provided by operating activities or other measures of financial performance or liquidity calculated in accordance with Canadian GAAP. Management refers the reader to a special advisory which discusses the calculation and use of non-GAAP financial measures in more detail. This and other important advisories are set out at the end of this MD&A.

Petroleum and natural gas sales

The following table illustrates selected operational and financial information contributing to the Company's petroleum and natural gas sales revenues on a country by country basis and in total during the periods under comparison.

Quarter ended,	Mar 31, 2007	Dec 31, 2006	Mar 31, 2006
Average daily sales volume *(1)*			
Natural gas *(Mcf/day)*			
Canada	**4,125**	4,305	580
United States	**10,528**	11,825	9,545
Total natural gas	**14,653**	16,130	10,125
Crude oil and NGL's *(bbls/day)*			
Canada	**182**	284	-
Barrels of oil equivalent *(boe/day) (2)*			
Canada	**869**	1,002	97
United States	**1,755**	1,971	1,591
Average daily sales volume *(boe/day) (1) (2)*	**2,624**	2,973	1,688
Total sales volume *(boe) (1) (2)*	**236,128**	273,406	151,877
Average realized selling price			
Natural gas *($/Mcf)*			
Canada	**$ 6.95**	$ 6.89	$ 6.53
United States	**$ 7.38**	$ 6.27	$ 9.37
Weighted average	**$ 7.26**	$ 6.44	$ 9.21
Crude oil and NGL's *($/bbl)*			
Canada	**$ 52.36**	$ 50.52	$ -
Average realized selling price *($/boe) (2)*	**$ 44.15**	$ 39.75	$ 55.25
Petroleum and natural gas revenue *($000s)*			
Natural gas			
Canada	**$ 2,581**	$ 2,727	$ 341
United States	**6,996**	6,822	8,051
Total natural gas	**$ 9,577**	$ 9,549	$ 8,392
Crude oil and NGL's			
Canada	**$ 855**	$ 1,318	$ -
Natural gas, crude oil & NGL's			
Canada	**$ 3,436**	$ 4,045	$ 341
United States	**6,996**	6,822	8,051
Total petroleum and natural gas revenue	**$ 10,432**	$ 10,867	$ 8,392
(1) Sales volumes are before deduction of royalties.			
(2) Natural gas volumes are converted to a barrel of oil equivalent at six mcf = one bbl of oil.			

The Company exited calendar 2006 with aggregate sales of approximately 3,000 boe per day, approximately double that of a year earlier. In May 2006, the Company added conventional crude oil and natural gas sales in Canada through a corporate acquisition; initial sales amounted to approximately 1,000 boe per day. Some of the acquired properties were subsequently sold in 2006, reducing related conventional oil and gas sales by about one third. In first quarter 2007, two additional properties with aggregate production of approximately 285 boe per day were sold. The asset sales reflect the Company's strategic plan of divesting of non-core assets and focusing on unconventional coal bed methane and shale gas development opportunities.

In the Lakeview area of Oklahoma, approximately 500 boe per day of natural gas, net to Mahalo, continues to be held behind pipe from several Hartshorne CBM wells due to pipeline capacity constraints. The Company is currently installing an expanded Greater Kayla West low-pressure gas gathering system to bring this CBM production to market. This expansion will also support continued development of numerous Lakeview/Poteau Hartshorne CBM drilling prospects.

North American natural gas prices softened considerably early in 2006 as warmer than normal weather reduced demand. Forecasts for a strong U.S. hurricane season, similar to that experienced in 2005, spurred aggressive drilling activity in 2006. This, coupled with a hurricane season that turned out to be less eventful than expected, resulted in a significant build-up of natural gas inventories keeping 2006 North American natural gas prices at levels well below 2005.

During early 2007, natural gas prices showed some strength as a result of colder temperatures and a reduction in natural gas storage levels in the United States. Natural gas prices are however expected to remain volatile and highly unpredictable as markets react rapidly to news events, weather forecasts and natural gas inventory reports. Mahalo attempts to minimize the impact of commodity price volatility, principally by entering into fixed price physical sales contracts and hedging arrangements when considered prudent.

A majority of the Company's sales continue to be natural gas from properties in the United States. Such production is delivered into the Oklahoma Gas Transmission and Centre Point East pipeline systems and sold to Oneok Energy Services Company LP of Tulsa, Oklahoma, a large U.S. mid-continent natural gas distributor.

Royalties

Royalties are paid to various government entities and other land and mineral rights owners. A majority of royalties paid during all periods under comparison relate to natural gas production from properties in the United States.

Quarter ended,	Mar 31, 2007	Dec 31, 2006	Mar 31, 2006
Royalties expense *($000s)*			
Canada	**$ 454**	$ 510	$ 123
United States	**1,517**	1,690	2,078
	$ 1,971	$ 2,200	$ 2,201
Royalties expense *($/boe)*			
Canada	**$ 5.80**	$ 5.54	$ 14.15
United States	**9.61**	9.32	14.51
	$ 8.35	$ 8.05	$ 14.49
Percentage of sales revenues	**19%**	20%	26%

The decrease in royalty expense on a per unit basis in first quarter 2007 and fourth quarter 2006, when compared with first quarter 2006, resulted mainly from lower realized natural gas prices and lower royalty rates associated with Canadian sales volumes.

Operating expense

Operating expense includes various costs, the most significant of which are contractor labour, compression, chemicals and treating supplies, water disposal, equipment rental, minor well workovers and operator overhead.

Quarter ended,	Mar 31, 2007	Dec 31, 2006	Mar 31, 2006
Operating expense *($000s)*			
Canada	**$ 1,071**	$ 2,051	$ 72
United States	**1,041**	891	1,091
	$ 2,111	$ 2,942	$ 1,163
Operating expense *($/boe)*			
Canada	**$ 13.69**	$ 22.27	$ 8.23
United States	**6.59**	4.91	7.62
	$ 8.94	$ 10.76	$ 7.66
Percentage of sales revenues	**20%**	27%	14%

The level of operating costs in Canada in fourth quarter 2006, when compared with first quarter 2006, was primarily due to the addition of higher cost conventional production in Canada effective May 31, 2006. The Company also continues to experience a general increase in North American oil and gas operating costs as companies compete for scarce resources. Operating costs in first quarter 2007 benefited from the sale of high cost conventional oil and gas properties in the latter part of fourth quarter 2006.

Transportation expense

Transportation expense includes costs to move saleable oil and gas from the crude oil wellhead or natural gas plant outlet to its ultimate point of sale. Total transportation costs, which are not significant relative to operating costs, fluctuated between two and five percent of sales revenues during the periods under comparison.

Operating netback

The following tables reflect how management calculates operating netback by geographic area for the respective periods under comparison.

	Canada		United States		Total	
Quarter ended March 31,	**2007**	**$/boe**	**2007**	**$/boe**	**2007**	**$/boe**
($000s, except per boe)						
Petroleum and natural gas revenue	**$ 3,436**	**$ 43.94**	**$ 6,996**	**$ 44.30**	**$ 10,432**	**$ 44.18**
Royalties	**454**	**5.81**	**1,517**	**9.61**	**1,971**	**8.35**
Operating	**1,071**	**13.69**	**1,041**	**6.59**	**2,111**	**8.94**
Transportation	**112**	**1.43**	**158**	**1.00**	**270**	**1.14**
Operating netback	**$ 1,799**	**$ 23.01**	**$ 4,281**	**$ 27.11**	**$ 6,080**	**$ 25.75**

	Canada		United States		Total	
Quarter ended December 31,	**2006**	**$/boe**	**2006**	**$/boe**	**2006**	**$/boe**
($000s, except per boe)						
Petroleum and natural gas revenue	$ 4,046	$ 43.93	$ 6,822	$ 37.62	$ 10,867	$ 39.75
Royalties	510	5.54	1,690	9.32	2,200	8.05
Operating	2,051	22.27	891	4.91	2,942	10.76
Transportation	116	1.26	440	2.43	556	2.03
Operating netback	$ 1,368	$ 14.86	$ 3,801	$ 20.96	$ 5,169	$ 18.91

	Canada		United States		Total	
Quarter ended March 31,	**2006**	**$/boe**	**2006**	**$/boe**	**2006**	**$/boe**
($000s, except per boe)						
Petroleum and natural gas revenue	$ 341	$ 39.17	$ 8,051	$ 56.23	$ 8,392	$ 55.25
Royalties	123	14.15	2,078	14.51	2,201	14.49
Operating	72	8.23	1,091	7.62	1,163	7.66
Transportation	-	-	189	1.32	189	1.25
Operating netback	$ 146	$ 16.79	$ 4,693	$ 32.78	$ 4,839	$ 31.85

Operating netback is a measure of net oil and gas revenue commonly used in the oil and gas industry. The Company uses this non-GAAP measure, in conjunction with a barrel of oil equivalent volumetric measure, to aggregate oil and gas volumes and assess comparability of petroleum sales and directly related costs between geographic business segments and periods. The Company cautions that operating netback should not be considered as an alternative to, or more meaningful than net earnings or cash from operating activities as determined in accordance with Canadian GAAP, as an indicator of the Company's performance or liquidity. This and other important advisories are set out at the end of this MD&A.

Operating netback in total and on a boe basis in first quarter 2007 benefited from an improvement in average realized prices, principally natural gas and primarily in the United States, when compared with fourth quarter 2006. Lower overall operating and transportation costs also contributed to the current period improvement.

Operating netback on a boe basis in first quarter 2006 reflected sharply higher natural gas prices; during this period, North American natural gas prices were also coming off their highs of 2005.

General and administrative expense

General and administrative expense amounted to $1.5 million in first quarter 2007, $1.7 million in fourth quarter 2006 and $0.5 million in first quarter 2006. General and administrative expense subsequent to first quarter 2006 reflects increased activity resulting from the May 2006 acquisition of Canadian conventional oil and gas operations and additional administration related to regulatory and other matters.

Stock-based compensation expense

Stock-based compensation expense remained relatively unchanged at approximately $0.4 million in each of the three quarters under comparison.

Foreign exchange gains and losses

A significant portion of the Company's monetary assets and liabilities and revenues and expenses are denominated in United States dollars. Shifts in Canadian/United States currency translation rates resulted in a foreign exchange gain of $0.5 million in first quarter 2007 and losses of $2.0 million and $0.3 million, in fourth and first quarters of 2006, respectively. Of these amounts, $0.5 million, $1.2 million and $0.1 million were unrealized at the respective quarter-ends.

Interest and financing expense

Interest and financing expense amounted to $1.0 million in first quarter 2007, $1.1 million in fourth quarter 2006 and $0.1 million in first quarter 2006, respectively. The expense results from borrowings under a three year revolving credit facility established in December 2005 with the Union Bank of California. Changes in the effective cost of borrowing did not have a significant impact on interest expense during the periods under comparison.

Depletion, depreciation and accretion expense

Total depletion and depreciation expense was significantly higher in fourth quarter 2006 due principally to the May 2006 corporate acquisition and, in general terms, the high cost of property acquisitions. The cost of acquisitions generally takes into account proven and probable reserves while the unit of production depletion calculation only considers proven reserves.

Quarter ended,	**Mar 31, 2007**	**Dec 31, 2006**	**Mar 31, 2006**
($000s, except per boe)			
Depletion and depreciation expense	**$ 4,157**	$ 8,261	$ 2,265
Accretion expense	**101**	139	18
Depletion, depreciation and accretion expense	**$ 4,258**	$ 8,400	$ 2,283
Depletion and depreciation expense ($/boe)	**$ 17.61**	$ 30.22	$ 14.92

Depletion and depreciation expense also increased during fourth quarter 2006 as a result of a downward adjustment to estimated proved reserves at year-end 2006. At December 31, 2006, the Company recorded a ceiling test write-down that reduced property and equipment costs, subject to depletion and depreciation, by $36.3 million. The write-down also resulted in a lower effective depletion and depreciation rate in first quarter 2007.

The Company records an asset retirement obligation which reflects the present value of the estimated clean-up and restoration costs of wells, well sites, gathering lines and processing facilities at the time they are acquired or constructed and put into use. The liability is also adjusted when properties and related asset retirement obligations are disposed of. The asset retirement liability is increased each reporting period due to the passage of time and the related amount, referred to as "accretion", is charged to earnings in the period. At March 31, 2007, the Company's asset retirement obligation amounted to $5.0 million compared with $5.8 million at December 31, 2006. The decrease resulted from the sale of certain conventional oil and gas properties in first quarter 2007.

Income tax expense

Future income taxes reflect the net tax effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes (book value) and the amounts used for income tax purposes (tax basis). Future income tax assets, which result when the tax basis of assets exceed the book basis, are only recognized to the extent that their realization is considered more likely than not based upon projections of operating results and tax planning strategies available to the Company.

In fourth quarter 2006, the Company recorded a write-down of Canadian property and equipment in the amount of $36.3 million. The effect of the write-down was to extinguish a previously recorded Canadian future income tax liability and create a Canadian income tax asset of $2.4 million. A valuation allowance was applied to fully offset this income tax asset at December 31, 2006.

During first quarter 2007, the Company recorded future income tax expense of $0.3 million. The Company's future income tax liability of $3.7 million at March 31, 2007 relates solely to the Company's United States operations. The income tax asset related to Canadian operations increased from $2.4 million to $2.8 million during first quarter 2007 and was fully offset by a valuation allowance at March 31, 2007.

LIQUIDITY AND CAPITAL RESOURCES

The following table provides a comparison of sources and uses of cash during the three months periods under comparison. The amounts reflected in the table include changes in non-cash working capital related to the respective activities during the period.

Quarter ended,	**Mar 31, 2007**	**Dec 31, 2006**	**Mar 31, 2006**
($000s)			
Cash provided by (used in)			
Operating activities	**$ 2,963**	$ (3,069)	$ 1,851
Financing activities	**(6,050)**	7,444	17,414
Investing activities	**10,143**	(610)	(18,891)
Increase in cash	**$ 7,056**	$ 3,765	$ 374

Operating activities

During first quarter 2007, the Company generated funds from operations of $3.5 million compared with $1.5 million in fourth quarter 2006. Funds from operations is a non-GAAP financial measure that Mahalo uses to assess its operating results and its ability to finance operations and service debt.

The following table illustrates the relationship of funds from operations, as calculated by Mahalo, to cash provided by operating activities for the periods under comparison.

Quarter ended,	**Mar 31, 2007**	**Dec 31, 2006**	**Mar 31, 2006**
($000s)			
Funds from operations	**$ 3,494**	$ 1,488	$ 4,015
Changes in non-cash working capital related to operating activities	**(531)**	(4,557)	(2,164)
Cash provided by operating activities	**$ 2,963**	$ (3,069)	$ 1,851

Financing activities

The Company has a three year revolving credit facility with the Union Bank of California that was established in December 2005. In 2006, the facility was increased to Cdn $75.0 million (subject to specific borrowing base approvals), underlying security was revised to include a floating charge on certain Canadian oil and gas assets acquired through a corporate acquisition and the borrowing base was set at Cdn $53.0 million. In March 2007, the Union Bank approved a further increase in the borrowing base to Cdn $60 million.

In fourth quarter 2006, 100,000 of a total 1,000,000 common share purchase warrants, originally issued in January 2005 in conjunction with a purchase and farm-in agreement, were exercised by the holder upon payment to the Company of $50,000. The 1,000,000 warrants were assigned an aggregate value of $560,000 at the time of issue. The remaining 900,000 warrants were exercised in first quarter 2007 upon payment of $450,000.

At March 31, 2007 and as at the date of this MD&A, the Company had 59,286,035 common shares, 1,440,000 common share purchase warrants and 912,000 performance warrants issued and outstanding. Contributed surplus at March 31, 2007 amounted to $6.5 million, reflective of aggregate stock-based compensation costs incurred from inception of the Company in 2004.

Investing activities

The Company has since its inception expanded its oil and gas asset and production base through farm-ins, corporate and property acquisitions and exploration and development activity. The following table reflects property and equipment expenditures for which cash was utilized and the amount of cash realized from asset divestures during the periods under comparison.

Quarter ended,	**Mar 31, 2007**	**Dec 31, 2006**	**Mar 31, 2006**
($000s)			
Land and seismic	**$ 675**	$ 466	$ 665
Drilling and completions	**7,613**	8,865	15,142
Facilities and equipment	**532**	1,291	4,991
Other	**-**	-	98
	8,819	10,622	20,895
Property and other acquisitions	**-**	-	8,388
Property divestures	**(14,183)**	(10,898)	-
Cash expenditures on property and equipment, net	**$ (5,363)**	$ (276)	$ 29,283
Canada	**$ (11,237)**	$ (5,717)	$ 13,951
United States	**5,873**	5,441	15,332
Cash expenditures on property and equipment, net	**$ (5,363)**	$ (276)	$ 29,283

The Company had an overall drilling success rate of approximately 97 per cent in 2006. During 2006, the Company participated in the drilling of 132 (54.2 net) oil and gas wells; 49 (25.8 net) in Canada and 83 (28.4) in the United States. Of the total wells drilled in 2006, 35 (18.5 net) and 15 (6.4 net) were drilled in the first and fourth quarters of 2006, respectively.

During first quarter 2007, the Company participated in 18 (9.9 net) oil and gas wells of which 16 (9.0 net) were capable of hydrocarbon production. Of the wells drilled, 4 (3.8 net) were in Canada and 14 (6.1) were in the United States.

In February 2006, the Company acquired an additional working interest in land and producing assets at Poteau, Oklahoma for cash consideration of $8.3 million and common shares valued at $2.7 million. During first quarter 2007 and fourth quarter 2006, the Company disposed of certain conventional resource properties for cash proceeds of $14.2 million and $10.9 million, respectively. The assets sold included certain properties located in southern Alberta and north-eastern British Columbia. The sales reflect the Company’s strategic plan of divesting of certain non-core assets and focusing on unconventional coal bed methane and shale gas development opportunities.

Contractual obligations

As at the date of this MD&A, the Company has committed to certain payments as follows:

Years ended December 31,	2007	2008	2009	2010	2011	Total
($000s)						
Office lease	$ 409	$ 506	$ 542	$ 568	$ 426	$ 2,451
Office lease *(US$)*	25	31	10	-	-	66
Equipment usage	1,782	2,376	2,376	594	-	7,128

The Company has contracts outstanding with respect to natural gas. The following is a summary of the commodity fixed forward commitments entered into by the Company as of the date of this MD&A.

	Volume	Frequency	Contract Price	Term
Sell	2,000 GJs	Daily	Cdn $7.35 per GJ	January 2007 - December 2007
Sell	1,000 GJs	Daily	US $7.23 per MMBtu	November 2006 - October 2007
Sell	450 GJs	Daily	Cdn $6.55 per GJ	November 2006 - October 2007
Buy	2,000 GJs	Daily	Cdn $7.07 per GJ	April 2007 - October 2007

The Company indemnifies its directors and officers against all claims and losses reasonably incurred in the performance of duties to the extent permitted by law. The Company maintains Directors and Officers insurance in amounts deemed adequate.

Liquidity

At March 31, 2007, the Company had working capital of $2.0 million (including cash of $8.3 million) compared with a working capital deficiency of $0.8 million (including cash of $1.3 million) at December 31, 2006. Working capital is an aggregation of current assets and current liabilities. The Company's operations generate and consume components of working capital of both a cash and non-cash nature. The ultimate conversion of non-cash working capital into cash is a critical step in corporate liquidity. During first quarter 2007, non-cash working capital was reduced by approximately $4.2 million.

Quarter ended,	Mar 31, 2007	Dec 31, 2006	Mar 31, 2006
($000s)			
Working capital (deficiency)	**$ 2,030**	$ (806)	$ (4,448)
Long term debt	**45,415**	52,349	20,990
Net debt	**43,385**	53,155	25,438
Shareholders' equity	**116,313**	116,764	88,413
Funds from operations (12 months trailing)	**12,372**	12,893	10,615
Net debt to funds from operations ratio	**3.51**	4.12	2.40
Net debt as a % of shareholders' equity	**37%**	46%	29%
Net debt as a % of net debt plus shareholders' equity	**27%**	31%	22%

Management anticipates that the Company will continue to have adequate financial resources to fund working capital, capital expenditures and contractual obligations during 2007 through a combination of funds from operations, proceeds from the disposition of non-core conventional resource properties and debt and/or equity financing. There is no assurance that debt or equity financing will be available on terms acceptable to the Company to meet its funding requirements.

Dividends

The Company has not declared or paid any dividends on its outstanding common shares. Any decision to pay dividends will be made by the Board of Directors on the basis of the Company’s earnings, financial requirements and other conditions existing at the time. At present, the Company does not anticipate declaring and paying dividends in the near future.

OFF-BALANCE SHEET ARRANGEMENTS

The Company did not enter into any material off-balance sheet arrangements, except for certain office leases and equipment usage contracts as discussed under "contractual obligations".

OUTLOOK

Mahalo recognizes that sustaining acceptable growth while preserving a suitable balance sheet is a challenge in a marketplace where commodity prices fluctuate rapidly due to news events, weather forecasts and gas inventory statistics. In 2006, Mahalo made cash expenditures of approximately $77 million on property and equipment; it will spend less in 2007, pending improvement in natural gas pricing. As announced last fall, Mahalo will continue to direct a majority of its near and medium term capital spending towards United States CBM development. Recent and past success, more robust economics and the large number of readily drillable locations clearly favor continued Hartshorne CBM development. It also offers the greatest opportunity to maximize funds flow generation in an uncertain gas pricing environment.

While the Company will invest a meaningful amount of capital in 2007, it will also focus on debt reduction and a stronger balance sheet. This will better position Mahalo to continue its United States Hartshorne CBM development program, further refine its approach to Canadian Mannville CBM, and build on shale gas development success enjoyed by others within close proximity to its Oklahoma shale holdings.

COMPARATIVE AMOUNTS

Certain comparative amounts have been restated to conform to the presentation in the current period.

SUMMARY OF QUARTERLY FINANCIAL RESULTS (unaudited)

The following table presents a summary of consolidated operating results for each of the last eight quarters from June 2005 to March 2007.

Selected quarterly information	Q1 2007	Q4 2006	Q3 2006	Q2 2006	Q1 2006	Q4 2005	Q3 2005	Q2 2005
Financial *($000s, except per share)*								
Crude oil and natural gas revenue	**10,432**	10,867	11,578	8,714	8,392	8,152	3,534	1,513
Operating netback	**6,080**	5,169	5,612	4,532	4,839	5,243	2,431	828
General and administrative	**1,518**	1,735	1,088	1,040	523	757	454	211
Stock-based compensation	**445**	457	260	369	343	326	154	-
Foreign exchange loss (gain)	**(476)**	2,048	11	(902)	323	447	174	(78)
Interest and financing expense	**1,008**	1,089	1,027	645	135	16	46	172
Write-down of property and equipment	-	36,322	-	-	-	-	-	-
Write-down of goodwill	-	12,743	-	-	-	-	-	-
Depletion, depreciation and accretion	**4,258**	8,400	4,742	3,734	2,283	1,592	532	265
Future income taxes (recovery)	**294**	(10,033)	(552)	444	703	1,450	687	241
Net income (loss)	**(1,037)**	(47,511)	(797)	(802)	544	731	508	16
Per share: basic and diluted	**(0.02)**	(0.81)	(0.01)	(0.02)	0.01	0.02	0.01	-
Funds from operations *(1)*	**3,494**	1,488	3,435	3,955	4,015	4,123	1,955	522
Per share: basic *(1)*	**0.06**	0.03	0.06	0.08	0.09	0.10	0.05	0.02
Reconciliation:								
Funds from operations *(1)*	**3,494**	1,488	3,435	3,955	4,015	4,123	1,955	522
Changes in non-cash working capital	**(531)**	(4,557)	7,218	4,973	(2,164)	(2,927)	(1,181)	(1,228)
Cash provided by operating activities	**2,963**	(3,069)	10,653	8,928	1,851	1,196	774	(706)
Operational								
Average daily sales *(2)*								
Natural gas *(Mcf/day)*	**14,653**	16,130	14,861	12,799	10,125	7,732	3,748	2,644
Crude oil and NGLs *(bbls/day)*	**182**	284	463	161	-	-	-	-
Barrels of oil equivalent *(boe/day)*	**2,624**	2,972	2,939	2,294	1,688	1,289	625	441
Average realized selling prices								
Natural gas *($/Mcf)*	**7.26**	6.44	6.35	6.63	9.21	11.46	10.25	6.29
Crude oil and NGLs *($/bbl)*	**52.36**	50.53	68.18	67.68	-	-	-	-
Barrel of oil equivalent *($/boe)*	**44.15**	39.75	42.82	41.74	55.25	68.76	61.50	37.74
Average operating netback *($/boe)*	**25.75**	18.91	20.76	21.71	31.85	44.22	42.30	20.70
Exchange rate								
Cdn$/US$ average exchange rate	**0.854**	0.878	0.892	0.891	0.866	0.851	0.832	0.804

(1) Please refer to special advisory regarding use of non-GAAP financial measures.

(2) Sales volumes are before deduction of royalties.

Further details in respect of historical quarterly results can be found in the Company's quarterly reports filed on SEDAR at www.sedar.com or on the Company's web-site at www.mahaloenergy.com.

CONTROLS AND PROCEDURES

Disclosure controls and procedures

Disclosure controls and procedures are designed to ensure that information required to be disclosed by the Company is accumulated and communicated to management, including the Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), to allow timely decisions regarding required disclosure. The Company's CEO and CFO have concluded, based on their evaluation as of the end of the period covered by the interim filing that the Company's disclosure controls and procedures are effective to provide reasonable assurance that material information related to the issuer is made known to them by others within the Company. It should be noted that while the Company's CEO and CFO believe that the Company's disclosure controls and procedures provide a reasonable level of assurance and that they are effective, they do not expect that the disclosure controls and procedures or internal control over financial reporting will prevent all errors and fraud. A control system, no matter how well conceived or operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met.

Internal controls over financial reporting

Internal controls over financial reporting are designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with Canadian GAAP. Management has evaluated the design effectiveness of internal controls over financial reporting and has concluded that such internal controls over financial reporting are designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with Canadian GAAP. In addition, there have been no changes in the Company's internal control over financial reporting during the period covered by the interim filing that have materially affected, or are reasonable likely to materially affect, its internal control over financial reporting.

Management is aware that given the Company's smaller size, adequate segregation of duties may not always be achievable in which case the Company relies on compensating controls. Management is also aware that in-house expertise to deal with complex accounting, taxation and reporting matters may not be sufficient, which is common with companies of a similar size. The Company must periodically rely upon outside assistance and advice to effectively deal with such matters. The Company's internal controls over financial reporting may not prevent or detect all errors, misstatements and fraud. The design of internal controls must also take into account resource constraints. A control system, including the Company's internal controls over financial reporting, no matter how well conceived or operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met.

CRITICAL ACCOUNTING ESTIMATES

The preparation of financial statements in conformity with generally accepted accounting principles requires the Company to make assumptions, judgments and estimates that may have a significant impact on the financial statements. Estimates are reviewed periodically and as adjustments become necessary, they are reported in earnings in the periods in which they become known. A summary of the Company's significant accounting policies can be found in Note 2 of the 2006 Consolidated Financial Statements.

ACCOUNTING CHANGES

Effective January 1, 2007, the Company adopted CICA Handbook Section 1506, Accounting Changes which requires expanded disclosures for changes in accounting polices, accounting estimates and corrections of errors. Under the new standard, accounting changes are applied retrospectively unless otherwise permitted or where impracticable to determine. As well, voluntary changes in accounting policy are made only when required by a primary source of GAAP or the change results in more relevant and reliable information.

Effective January 1, 2007, the Company adopted CICA Handbook Section 3855, Financial Instruments - Recognition and Measurement; Section 3865, Hedges; Section 1530, Comprehensive Income; Section 3251, Equity; and Section 3861, Financial Instruments – Disclosure and Presentation. The new standards bring Canadian rules in line with the current rules in the United States. The standards introduce the concept of "Comprehensive Income" to Canadian GAAP and require that an enterprise (a) classify items of comprehensive income by their nature in a financial statement and (b) display the accumulated balance of comprehensive income separately from retained earnings and additional paid-in capital in the equity section of a statement of financial position. Derivative contracts are carried on the balance sheet at their marked-to-market value, with the change in value flowing to either net income or comprehensive income. Gains and losses on instruments that are identified as hedges flow initially to comprehensive income and are brought into net income at the time the underlying hedge is settled. Any instruments that do not qualify for hedge accounting are marked-to-market with the adjustment (tax effected) flowing through the statement of operations. These standards were adopted retroactively without restating prior years, except for the presentation of translation gains or losses on self-sustaining operations.

CANADIAN ACCOUNTING PRONOUNCEMENTS

Financial instruments – disclosures and presentation of financial instruments

Effective January 1, 2008, the Company will be required to adopt two new CICA standards, Handbook Section 3862, Financial Instruments Disclosures and Section 3863, Financial Instruments Presentation which will replace Section 3861, Financial Instruments Disclosure and Presentation. The new disclosure standard increases the emphasis on the risks associated with both recognized and unrecognized financial instruments and how those risks are managed. The new presentation standard carries forward the former presentation requirements. The new financial instruments presentation and disclosure requirements were issued in 2006 and the Company is assessing the impact on its Consolidated Financial Statements.

Capital disclosures

Effective January 1, 2008, the Company will be required to adopt the CICA Handbook Section 1535, Capital Disclosures which will require companies to disclose their objectives, policies and processes for managing capital. In addition, disclosures are to include whether companies have complied with externally imposed capital requirements. The new capital disclosure requirements were issued in 2006 and the Company is assessing the impact on its Consolidated Financial Statements.

Convergence with International Reporting Standards

In 2006, Canada's Accounting Standards Board ratified a strategic plan that will result in Canadian GAAP, as used by public companies, being converged with International Financial Reporting Standards over a transitional period currently expected to be about five years. The precise timing of convergence will depend on an Accounting Standards Board progress review to be undertaken by early 2008. The impact of this transition on the Corporation's consolidated financial statements has not yet been determined; however, management continues to monitor these regulatory developments.

RISKS AND UNCERTAINTIES

The business of exploring for, developing and producing oil and gas reserves is inherently risky. There is a risk that the sale of the Company's reserves may be delayed indefinitely due to process constraints, lack of pipeline capacity or lack of markets. The price the Company receives for its crude oil and natural gas fluctuates continuously and for the most part is beyond its control. The Company is also subject to the risks associated with oil and gas properties, including exploration, development and production risks, and environmental risks such as the pollution of air, land and water. In all areas of the Company's business, it competes against entities that have greater technical and financial resources. The Company's growth is dependent upon external sources of financing which may not be available on acceptable terms. Additional information regarding business risks and uncertainties can be found under the heading "Risk Factors" in the Company's Annual Information Form dated March 30, 2007 at www.sedar.com.

SPECIAL CAUTIONARY ADVISORIES

Forward-looking statements

Except for historical financial information contained herein, the matters discussed in this document may be considered forward-looking statements. Such statements include declarations regarding management's intent, belief or current expectations. Prospective investors are cautioned that any such forward-looking statements are not guarantees of future performance and involve a number of risks and uncertainties; actual results could differ materially from those indicated by such forward-looking statements. Among the important factors that could cause actual results to differ materially from those indicated by such forward-looking statements are: (i) that the information is of a preliminary nature and may be subject to further adjustment, (ii) the possible unavailability of financing, (iii) risks related to the exploration and development of oil and gas properties, (iv) the impact of price fluctuations and the demand and pricing for oil and natural gas, (v) the seasonal nature of the business, (vi) start-up risks, (vii) general operating risks, (viii) dependence on third parties, (ix) changes in government

regulation, (x) the effects of competition, (xi) dependence on senior management, (xii) impact of economic conditions, and (xiii) fluctuations in currency exchange rates and interest rates. Mahalo undertakes no obligation to update or revise any forward-looking statements, except as required by law.

Non-GAAP financial measures

The Company uses and makes reference to "funds from operations", "funds from operations per share" and "operating netback" in this MD&A. These terms do not have any standardized meaning, are not defined under Canadian Generally Accepted Accounting Principles ("GAAP") and are therefore referred to as non-GAAP financial measures. The non-GAAP financial measures, as calculated and used by the Company, may not be comparable to similarly titled measures reported by other companies.

Management considers these non-GAAP measures as useful supplemental measures to analyze operations, compare performance between periods and provide shareholders and potential investors with additional information. These non-GAAP measures are also used by research analysts to value and compare oil and gas exploration and production companies, and are frequently included in published research when providing investment recommendations.

Funds from operations and funds from operations per share should not be considered as an alternative to, or more meaningful than net earnings, cash provided by operating, financing and investing activities or other measures of financial performance or liquidity calculated in accordance with Canadian GAAP.. Funds from operations represent cash from operating activities before change in related non-cash working capital. Funds from operations per share are calculated using the weighted average shares outstanding, consistent with the calculation of net income per share. These measures are used by Mahalo to assess its operating results and its ability to generate funds to finance operations and service debt.

Operating netback should not be considered an alternative to, or more meaningful than, net earnings or other measures of performance or liquidity calculated in accordance with Canadian GAAP. Operating netback presents a measure of net oil and gas revenue by deducting royalties and operating and transportation costs from oil and gas sales revenues. This non-GAAP measure is used by the Company to assess comparability of petroleum sales and directly related costs between periods.

Barrel of oil equivalent ("boe") volumetric measures

The oil and gas industry commonly expresses production, sales and reserves volumes on a barrel of oil equivalent ("boe") basis whereby natural gas volumes are converted at a ratio of six thousand cubic feet to one barrel of crude oil. The boe measure is used by the Company to aggregate oil and gas volumes. The measure is also considered to be useful for comparisons with other industry participants. The conversion ratio is based on an approximate energy equivalency of these commodities at the burner tip and does not represent a value equivalency at the well head. This conversion may therefore be misleading, particularly if used in isolation.

ADDITIONAL INFORMATION

Additional information relating to the Company is available on the System for Electronic Document Analysis and Retrieval ("SEDAR") at www.sedar.com or at the Company's web-site at www.mahaloenergy.com.

Unaudited Interim Financial Statements

For the Three Months Ended March 31, 2007 and 2006

MAHALO ENERGY LTD.
Unaudited interim Consolidated Financial Statements

Consolidated Balance Sheets

As at	March 31 2007	December 31 2006
ASSETS (note 6)		
Current		
Cash	$ 8,342,560	$ 1,286,858
Accounts receivable	12,367,763	15,166,749
Inventory	2,714,140	2,713,940
Prepaid and deposits	1,194,657	1,401,528
	24,619,120	20,569,075
Deferred financing costs (note 3)	-	366,972
Property and equipment (note 5)	168,355,808	178,678,530
	$ 192,974,928	$ 199,614,577
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Accounts payable and accrued liabilities	$ 22,226,599	$ 21,025,306
Unrealized loss on financial instruments (note 4)	362,400	349,988
	22,588,999	21,375,294
Long-term debt (note 6)	45,415,126	52,348,715
Asset retirement obligations (note 7)	5,000,311	5,762,524
Future income taxes	3,657,624	3,364,110
	76,662,060	82,850,643
Shareholders' equity		
Share capital (note 8)	158,936,830	157,982,830
Warrants (note 8)	1,990,412	2,494,412
Contributed surplus (note 8)	6,541,790	6,035,385
Deficit	(51,156,164)	(49,748,693)
	116,312,868	116,763,934
	$ 192,974,928	$ 199,614,577

Commitments (note 11)

See accompanying notes to the consolidated financial statements

MAHALO ENERGY LTD.
Unaudited interim Consolidated Financial Statements

Consolidated Statements of Operations and Deficit

For the three months ended March 31	2007	2006
REVENUES		
Petroleum and natural gas revenue	$ 10,432,391	$ 8,391,677
Royalties expense	(1,970,970)	(2,200,739)
	8,461,421	6,190,938
Gain (loss) on financial instruments (note 4)	(73,860)	-
Interest and other income	10,152	15,835
	8,397,713	6,206,773
EXPENSES		
Operating	2,111,482	1,162,711
Transportation	269,605	189,346
General and administrative (note 5)	1,518,177	523,244
Stock-based compensation (note 8)	445,231	342,831
Foreign exchange (gain) loss (note 9)	(476,427)	323,309
Interest and financing costs (note 6)	1,007,569	134,993
Depletion, depreciation and accretion	4,258,287	2,283,188
	9,133,924	4,959,622
Income (loss) before income tax	(736,211)	1,247,151
Current income taxes	7,009	-
Future income taxes	293,515	702,845
NET INCOME (LOSS) ANDCOMPREHENSIVE INCOME (LOSS)	(1,036,735)	544,306
DEFICIT, BEGINNING OF PERIOD	(49,748,693)	(1,182,763)
Adoption of accounting policy (note 3)	370,736	-
DEFICIT, END OF PERIOD	$ (51,156,164)	$ (638,457)
Net income (loss) per share (note 8)		
Basic and diluted	$ (0.02)	$ 0.01

See accompanying notes to the consolidated financial statements

MAHALO ENERGY LTD.
Unaudited interim Consolidated Financial Statements

Consolidated Statements of Cash Flows

For the three months ended March 31	2007	2006
OPERATING ACTIVITIES		
Net income (loss)	$ (1,036,735)	$ 544,306
Non-cash items		
Stock-based compensation	445,231	342,831
Depletion, depreciation and accretion	4,258,287	124,502
Unrealized financial derivative loss (note 4)	12,412	-
Unrealized foreign exchange (gain) loss (note 9)	(478,378)	124,502
Amortization of deferred financing costs	-	17,528
Future income taxes	293,515	702,845
	3,494,332	4,015,200
Change in non-cash working capital (note 10)	(531,442)	(2,164,476)
	2,962,890	1,850,724
FINANCING ACTIVITIES		
Issue of common shares	450,000	-
Long-term debt	(6,500,000)	17,507,003
Deferred financing costs	-	(93,347)
	(6,050,000)	17,413,656
INVESTING ACTIVITIES		
Expenditure on property and equipment	(8,819,270)	(20,894,689)
Property and other acquisitions	-	(8,388,038)
Proceeds on sale of oil and gas properties	14,182,666	-
Change in non-cash working capital (note 10)	4,779,416	10,392,106
	10,142,812	(18,890,621)
INCREASE IN CASH	7,055,702	373,759
CASH BEGINNING OF PERIOD	1,286,858	856,665
CASH END OF PERIOD	$ 8,342,560	$ 1,230,424

See accompanying notes to the consolidated financial statements

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

FOR THE THREE MONTHS ENDED MARCH 31, 2007 AND 2006
All amounts are expressed in Canadian dollars unless otherwise stated

1. NATURE OF OPERATIONS

Mahalo Energy Ltd. ("Mahalo" or the "Company") was incorporated under the Business Corporations Act (Alberta) on April 21, 2004. Mahalo completed its initial public offering and was listed on the Toronto Stock Exchange on July 29, 2005. Mahalo has one wholly-owned subsidiary, Mahalo Energy (USA) Inc.

The Company's primary business is the acquisition of, exploration for and development and production of coal bed methane and shale gas in Canada and the United States, as well as conventional oil and gas in Canada.

2. SIGNIFICANT ACCOUNTING POLICIES

The interim consolidated financial statements of the Company have been prepared by management in accordance with Canadian generally accepted accounting principles. The interim consolidated financial statements have been prepared following the same accounting policies and methods of computation as the consolidated financial statements for the fiscal year ended December 31, 2006, except for the change described in note 3 and that certain disclosures required in annual financial statements have been condensed or omitted.

The interim consolidated financial statements should be read in conjunction with the Company's consolidated financial statements and notes thereto as at and for the year ended December 31, 2006. The results of operations for the three months ended March 31, 2007 may not be indicative of the results for the 2007 fiscal year.

3. CHANGE IN ACCOUNTING POLICY

Effective January 1, 2007, Mahalo adopted the following Canadian Institute of Chartered Accountants ("CICA") Handbook Sections:

CICA Section 1506, "Accounting Changes," provides expanded disclosures for changes in accounting policies, accounting estimates and corrections of errors. Under the new standard, accounting changes should be applied retrospectively unless otherwise permitted or where impracticable to determine. As well, voluntary changes in accounting policy are made only when required by a primary source of GAAP or the change results in more relevant and reliable information.

CICA Section 1530, "Comprehensive Income," introduces a new requirement to temporarily present certain gains and loss from changes in fair value outside net income. It includes unrealized gains and losses, such as: changes in the currency translation adjustment relating to self-sustaining foreign operations; unrealized gains or losses on available-for-sale investments; and the effective portion of gains or losses on derivatives designated as cash flow hedges. The application of this standard did not result in a difference between comprehensive income (loss) and net income (loss) for the periods presented.

CICA Section 3855, "Financial Instruments – Recognition and Measurement" and Section 3861, "Financial Instruments – Recognition and Measurement," outlines when and at what amount the financial instrument is to be recognized on the balance sheet. The new standard also specifies how financial instrument gains and losses are to be presented. All financial instruments are classified into one of the following five categories; held for trading, held–to-maturity, loans and receivables, available-for-sale financial assets, or other financial liabilities.

Initial and subsequent measurement and recognition of changes in the value of financial instruments depends on their initial classification;

- Held-to-maturity investments, loans and receivables, and other financial liabilities are initially measured at fair value and subsequently measured at amortized cost. Amortization of premiums or discounts and losses due to impairment are included in current period net earnings.
- Available-for-sale financial assets are measured at fair value. Revaluation gains and losses are included in other comprehensive income until the asset is removed from the balance sheet.
- Held for trading financial instruments are measured at fair value. All gains and losses are included in net earnings in the period in which they arise.
- All derivative financial instruments are classified as held for trading financial instruments and are measured at fair value, even when they are part of a hedging relationship. All gains and losses are included in net earnings in the period in which they arise.

The financial instruments recognized on Mahalo's balance sheet are recorded at amounts that approximate their estimated fair values; therefore no further adjustments were required upon adoption of the new sections. There were no financial assets on the balance sheet which were designated as held-for-trading, held-to-maturity or available-for-sale, except for the financial derivative contracts (see note 4). For financial assets and financial liabilities that are not classified as held for trading, the new accounting standards require the transaction costs that are directly attributable to the acquisition or issue of a financial asset or financial liability to be added to the fair value initially recognized for that financial instrument or expensed to earnings as incurred.

As a result of adopting Sections 3855 and 3861, unamortized deferred financing costs of $370,736 relating to the Company's debt facility have been reclassified for presentation purposes as an adjustment to opening retained earnings as at January 1, 2007. The Company has elected future financing costs to be charged to income as incurred.

CICA Section 3865, "Hedges," provides alternative treatments to Section 3855 for entities which choose to designate qualifying transactions as hedges for accounting purposes. It replaces and expands on Accounting Guideline 13 "Hedging Relationships," and the hedging guidance in Section 1650, "Foreign Currency Translation," by specifying how hedge accounting is applied and what disclosures are necessary when it is applied. The Company is currently using mark-to-market accounting for its derivative instrument, which does not qualify or has not been designated as a hedge.

Accounting Pronouncements

Effective January 1, 2008, the Company will be required to adopt two new CICA standards, Handbook Section 3862, Financial Instruments Disclosures and Section 3863, Financial Instruments Presentation which will replace Section 3861, Financial Instruments Disclosure and Presentation. The new disclosure standard increases the emphasis on the risks associated with both recognized and unrecognized financial instruments and how those risks are managed. The new presentation standard carries forward the former presentation requirements. The new financial instruments presentation and disclosure requirements were issued in 2006 and the Company is assessing the impact on its Consolidated Financial Statements.

Effective January 1, 2008, the Company will be required to adopt the CICA Handbook Section 1535, Capital Disclosures which will require companies to disclose their objectives, policies and processes for managing capital. In addition, disclosures are to include whether companies have complied with externally imposed capital requirements. The new capital disclosure requirements were issued in 2006 and the Company is assessing the impact on its Consolidated Financial Statements.

In 2006, Canada's Accounting Standards Board ratified a strategic plan that will result in Canadian GAAP, as used by public companies, being converged with International Financial Reporting Standards over a transitional period currently expected to be about five years. The precise timing of convergence will depend on an Accounting Standards Board progress review to be undertaken by early 2008. The impact of this transition on the Corporation's consolidated financial statements has not yet been determined; however, management continues to monitor these regulatory developments.

4. FINANCIAL INSTRUMENTS

a) Carrying Values of Financial Assets and Liabilities

Effective January 1, 2007, Mahalo has elected to designate its financial instruments as follows;

- Loans and receivables – accounts receivables
- Held-for-trading – financial instruments
- Other financial liabilities – bank debt and accounts payables

Due to the short-term nature of these financial instruments, carrying value approximates fair value.

b) Financial Sales Contracts

As at March 31, 2007, the Company had the following financial derivative contracts.

Transaction Type	Volume	Contract Price	Expiry
WTI Collar	30 Bbl/Day	US $38.00 - $44.65	October 2007
WTI Puts	30 Bbl/Day	US $ 40	November 2007
AECO Financial Hedge	300 GJ/Day	CDN $ 6.64	October 2007

Based on dealer quotes, the unrealized loss on these contracts was $267,110 at March 31, 2007 (2006 - $ nil). As at March 31, 2007, the loss on these contracts recognized in income was $114,699 (2006 - $ nil) composed of an unrealized financial derivative loss of $53,251 (2006 - $ nil) and a realized loss of $61,448 (2006 - $ nil).

The Company recorded a liability of $231,420 related to the fair value of physical sales contracts assumed on the May 2006 acquisition of Peregrine Energy Ltd. The amount is being amortized over the term of the physical sales contracts. As at March 31, 2007, amortization amounted to $40,839, which has been recognized in income, leaving an unamortized balance of $95,290.

The following table reconciles the Company's unrealized loss on financial instruments.

	Amount
Unrealized loss on financial derivative contracts	267,110
Unamortized financial liability	95,290
Balance, March 31, 2006	362,400

5. PROPERTY AND EQUIPMENT

	Cost	Accumulated Depletion and Depreciation	Net Book Value
March 31, 2007:			
Canada:			
Petroleum and natural gas properties and equipment	$ 105,245,839	$ 32,015,675	$ 73,230,164
Other	1,975,712	159,230	1,816,482
	107,221,551	32,174,905	75,046,646
USA:			
Petroleum and natural gas properties and equipment	107,293,508	14,885,628	92,407,880
Other	907,409	6,127	901,282
	108,200,917	14,891,755	93,309,162
	$ 215,422,468	$ 47,066,660	$ 168,355,808

December 31, 2006:			
Canada:			
Petroleum and natural gas properties and equipment	$ 116,402,916	$ 30,420,647	$ 85,982,269
Other	2,874,953	139,726	2,735,227
	119,277,869	30,560,373	88,717,496
USA:			
Petroleum and natural gas properties and equipment	101,429,780	12,332,472	89,097,308
Other	869,852	6,126	863,726
	102,299,632	12,338,598	89,961,034
	$ 221,577,501	$ 42,898,971	$ 178,678,530

Costs associated with unproven properties excluded from costs subject to depletion amounted to $74,316,915 (December 31, 2006 - $72,755,560). Of the total excluded costs, $54,299,994 (December 31, 2006 - $55,443,939) related to Canada and $20,016,921 (December 31, 2006 - $17,311,621) to the United States.

Future development costs of $23,028,700 (December 31, 2006 - $23,118,400) have been included in the costs subject to depletion, of which $7,244,700 related to Canada (December 31, 2006 - $7,244,700) and $15,784,000 (December 31, 2006 - $15,873,700) to the United States.

The Company capitalized $54,804 of direct general and administrative costs related to petroleum and natural gas properties in the three month period ended March 31, 2007 (2006 - $52,981). In addition, the Company capitalized $61,174 (2006 - $47,552) of stock based compensation during the same period.

During the current quarter, the Company sold certain non-core conventional oil and gas assets and facilities for net proceeds of $14.2 million.

6. BANK DEBT

As at March 31, 2007, Mahalo has a CDN $75.0 million revolving credit facility with a United States bank with an approved borrowing base of CDN $60.0 million. The Company has drawn CDN $45.4 million on the facility. The revolving credit facility bears interest at the lender’s base, US prime rate or Libor plus 0.0 to 1.5 percent depending on the level of facility utilization. The facility requires Mahalo to maintain certain financial ratios and other covenants and is collateralized by a fixed charge on Mahalo’s United States assets and a floating charge on its Canadian assets.

The effective interest rate on amounts outstanding under the credit facility at March 31, 2007 was 7.54 percent (2006 – 7.78 percent).

7. ASSET RETIREMENT OBLIGATIONS

The Company’s asset retirement obligations result from net ownership interests in petroleum and natural gas properties and equipment including well sites, gathering systems and processing facilities.

At March 31, 2007, the estimated total undiscounted amount required to settle the asset retirement obligations, adjusted for inflation, is approximately $12.6 million (December 31, 2006 - $13.9 million). This amount has been discounted using a credit adjusted risk free interest rate of 8.5 percent. The expected period until settlement is dependent upon the useful lives of the underlying assets, which currently extend up to 50 years.

A reconciliation of the asset retirement obligation is provided below:

	2007
Balance, beginning of period	$ 5,762,524
Liabilities incurred	90,554
Liabilities disposed	(957,828)
Revision to assumptions	4,463
Accretion expense	100,598
Balance, end of period	$ 5,000,311

8. SHARE CAPITAL

(a) Authorized

Unlimited number of voting common shares with no par value.
Unlimited number of non-voting preferred shares issuable in series.

(b) Issued

Common shares	Number of Shares	Issue Price per Share ($)	Amount
Balance, December 31, 2006	58,386,035		$ 157,982,830
Exercise of share purchase warrants	900,000	1.06	954,000
Balance, March 31, 2007	59,286,035		$ 158,936,830

During the current quarter, 900,000 share purchase warrants were exercised to purchase an equivalent number of common shares at $0.50 per share. Each warrant was assigned a value of $0.56 based on a net asset value of the Company at the date of issue.

The weighted average number of shares outstanding is as follows:

	March 31, 2007	March 31, 2006
Weighted average basic	59,086,035	42,941,423
Weighted average diluted	59,086,035	44,013,115

The reconciling items between the basic and diluted weighted average common shares for 2006 are outstanding stock options and common share purchase warrants.

(c) Share Purchase Warrants

At March 31, 2007, the Company had 912,000 performance warrants at a strike price of $4.92 per share. The warrants will become 100 per cent vested when the Company's stock price is $8.33 per share on a 45 day weighted average trading price. The warrants expire July 29, 2010. The warrants carry a "Put Right" whereby the warrant holders, at their option, may receive cash in an amount equal to the excess of the market price at the time of exercise over the strike price. No value was assigned to these warrants. The warrants will be valued by the changes in the market price of the common shares at the end of each accounting period and will be amortized into earnings over their expected life once the performance condition becomes likely.

In addition, the Company had warrants, which enables the warrant holder to acquire 1,440,000 common shares at $4.17 per share. These warrants expire November 30, 2009.

(d) Stock Options

The Company has a stock option plan whereby the Company may grant options to its directors, officers, employees and consultants, for up to 10 percent of the issued and outstanding common shares.

The following table provides a continuity of stock options outstanding and the weighted average share prices for which shares have been reserved.

	Options	Weighted Average Exercise Price ($)
Outstanding, December 31, 2006	4,967,700	4.15
Granted	40,000	3.20
Forfeited	(5,000)	4.50
Outstanding, March 31, 2007	5,002,700	4.72
Exercisable, March 31, 2007	1,902,832	4.64

The following summarizes information about stock options outstanding at March 31, 2007.

Range of Exercise Price	Stock Options Outstanding	Stock Options Exercisable	Weighted Average Remaining Term (Years)
$2.30 to $3.54	1,774,200	96,000	3.87
$4.19 to $4.77	2,825,100	1,625,100	3.36
$5.00 to $5.68	383,400	175,066	3.08
$7.38 to $7.40	20,000	6,666	3.39
	5,002,700	1,902,832	3.51

(e) Stock-Based Compensation

The fair value of stock options granted during the year was estimated using the Black-Scholes option-pricing model, using the following weighted average assumptions:

	2007
Risk free interest rate (%)	3.5
Dividend rate (years)	-
Expected life (years)	5.0
Expected volatility (%)	41.0

The weighted average fair value of options granted was $1.61 per share.

During the three months ended March 31, 2007, the Company recorded stock-based compensation of $506,405 (2006 - $390,383), respectively, related to options granted under the formal stock option plan, of which $445,231 (2006 - $342,831) was recognized as an expense and $61,174 (2006 - $47,552) was capitalized to property and equipment.

(f) Contributed Surplus

The following table reconciles Mahalo's contributed surplus.

	Amount
Balance, December 31, 2006	$ 6,035,385
Stock-based compensation costs	506,405
Balance, March 31, 2007	$ 6,541,790

9. FOREIGN EXCHANGE

During the three months ended March 31, 2007, the Company recognized a net foreign exchange gain of $476,427 (2006 – net loss of $323,309), of which $ 478,378 (2006 – net loss of $124,500) was unrealized at the period end. The amounts recorded reflect the impact of fluctuations in the Canadian/United States exchange rate on monetary assets and liabilities and revenues and expenses of the Company that are denominated in United States dollars.

10. SUPPLEMENTAL CASH FLOW INFORMATION

Changes in non-cash working capital for the three months ended March 31 were as follows:

	2007	**2006**
Decrease (increase) in non-cash working capital		
Accounts receivable	$ 2,840,010	$ 614,784
Inventory	(200)	-
Prepaid and deposits	206,871	(303,044)
Accounts payable and accrued liabilities	1,201,293	7,915,890
Net change in non-cash working capital	$ 4,247,974	$ 8,227,630
Relating to:		
Operating activities	$ (531,442)	$ (2,164,476)
Investing activities	4,779,416	10,392,106
	4,247,974	8,227,630

11. COMMITMENTS

The Company has committed to certain payments over the next five years as follows:

	2007	**2008**	**2009**	**2010**	**2011**	**Total**
Canada:						
Office lease	$ 408,910	$ 506,401	$ 542,147	$ 568,145	$ 426,109	$ 2,451,712
Equipment Usage	1,782,000	2,376,000	2,376,000	594,000	-	7,128,000
	$ 2,190,910	$ 2,882,401	$ 2,918,147	$ 1,162,145	$ 426,109	$ 9,579,712
USA (US$):						
Office lease	$ 25,452	$ 31,191	$ 10,450	$ -	$ -	$ 67,093

The Company has sales contracts outstanding with respect to the physical delivery of natural gas at a fixed price. The following is a summary of the commodity fixed forward physical commitments entered into by the Company as at March 31, 2007.

	Daily Volume	**Contract Price**	**Term**
Sell	2,000 GJ	CDN $7.35 /GJ	January 2007 – December 2007
Sell	1,000 GJ	US $7.23/MMBtu	November 2006 - October 2007
Sell	450 GJ	CDN $6.55/GJ	November 2006 - October 2007
Purchase	2,000 GJ	CDN $ 7.07/GJ	April 2007 – October 2007

The estimated fair value of these contracts as at March 31, 2007 is a loss of $ 129,850, which has not been recognized to income as the Company has elected these non-financial derivative contracts to meet normal purchase and sale usage requirements and the pricing variables are closely related to the asset being purchased and sold.

12. SEGMENTED INFORMATION

The Company's petroleum and natural gas exploration, development and production operations are conducted in two geographic segments: Canada and the United States. The following table reflects segmented information as at and for the three months ended March 31.

	Canada	United States	Total
2007:			
Net revenue	$ 2,918,331	$ 5,479,381	$ 8,397,713
Net income (loss)	(1,964,842)	928,107	(1,036,735)
Net capital expenditures	(11,237,339)	5,873,943	(5,363,396)
Property and equipment	75,046,645	93,309,163	168,355,808
Total assets	110,022,887	82,952,041	192,974,928
2006:			
Net revenue	$ 225,683	$ 5,981,090	$ 6,206,773
Net income (loss)	(557,017)	1,099,323	544,306
Net capital expenditures	13,951,162	18,005,313	31,956,475
Property and equipment	36,705,856	81,040,669	117,733,825
Total assets	72,607,962	59,809,523	132,417,485

13. RELATED PARTY TRANSACTIONS

The Company is related to Avenir Capital Corporation and Avenir Operating Corp. by virtue of certain directors in common. The Company conducts joint operating activities with these companies in the normal course of business. During the quarter, the Company sold certain non-core properties to Avenir Operating Corp. for $7.2 million.

14. COMPARATIVE AMOUNTS

Certain comparative figures have been restated to conform to the current year's presentation.