Quarterly Report

For the Three and Nine Months ended September 30, 2007
(Unaudited)

Message to Shareholders

Mahalo Energy Ltd. ("Mahalo" or the "Company") is pleased to announce its results for the three and nine months ended September 30, 2007.

Summary of Results

	Three Months Ended		Nine Months Ended	
	Sept 30 2007	**Sept 30 2006**	**Sept 30 2007**	**Sept 30 2006**
Financial				
($000's except per share)				
Petroleum and natural gas revenue	**11,390**	11,578	**32,693**	28,684
Operating netback *(1)*	**5,693**	5,612	**17,150**	14,984
Net income (loss)	**(1,813)**	(798)	**(3,020)**	(1,054)
Per share - basic & diluted	**(0.03)**	(0.01)	**(0.05)**	(0.02)
Funds from operations *(1)*	**3,334**	3,434	**10,372**	11,402
Per share - basic *(1)*	**0.06**	0.06	**0.18**	0.23
Capital expenditures *(2)*	**13,540**	20,781	**35,723**	147,139
Proceeds from sale of oil and gas assets	**2,235**	17,004	**16,509**	17,004
Net debt, end of period *(1)*	**59,607**	53,452	**59,607**	53,452
Operational				
Average daily sales volumes *(boe) (1)*	**3,407**	2,939	**2,948**	2,312
Average selling price *($/boe)*	**36.34**	42.82	**40.62**	45.45
Operating netback *($/boe)*	**18.16**	20.76	**21.30**	23.74

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

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

Q3 2007 Highlights

- **Realized average daily oil and gas sales of 3,407 boe in third quarter 2007 with September’s average rate being 3,500 boe per day and September exit at 3,550 boe per day, a Company record.**
- **Reduced operating costs below $7.00 per boe.**
- **Reduced general and administrative expense to $4.21 per boe.**
- **Assumed full operatorship of the Poteau field in Oklahoma.**

Financial

Mahalo generated funds from operations of $3.3 million on sales of $11.4 million and recorded a net loss of $1.8 million in an environment of continued softness in natural gas prices during the three months ended September 30, 2007.

Operational

I believe that the common saying “good food takes time to prepare” is analogous to developing a solid, unconventional resource company; it is a process that requires a variety of skills, serious commitment, patience and time. Mahalo has worked hard to educate and encourage investors to better understand the process of building such an entity. With such an understanding, we are certain that investors will see Mahalo as a worthwhile and profitable longer term investment.

Mahalo is pleased to present operational and financial results that emphasize the benefits of a successful asset base managed by a competent team of skilled, committed professionals. Although we were still plagued by low natural gas prices in the third quarter, we demonstrated significant production growth, reduction in operating costs per boe and lower general and administrative expenses. Despite the downward pressure applied to gas, we have a drilling portfolio that was and can be called upon to produce results even when wellhead prices are depressed. Mahalo is actively operating prospects in both Canada and the United States, including the Poteau field in Oklahoma, and continues to benefit from a strong relationship with partners who operate a certain number of our prospects. This brings a better balance to our overall resource management.

The Company averaged 3,407 boe per day of oil and gas sales, primarily CBM natural gas, during third quarter 2007. This represents a 21 percent increase over the preceding quarter. The previously announced expansion of the Kayla West pipeline transportation system freed up constrained production from a number of Hartshorne CBM wells in the United States. This fully commissioned gathering system, together with additional Canadian drilling success of both unconventional and conventional prospects, has allowed the Company to exit the third quarter with record oil and gas sales volumes of approximately 3,550 boe per day.

The Company was active through third quarter 2007 with the selective drilling of 44 (27 net) wells. In the third quarter, we drilled 13 (9.7 net) wells. We drilled Canadian Mannville CBM horizontals, US Hartshorne CBM horizontals, US Woodford Shale wells and also participated in some seismically determined conventional prospects.

The on-going development of the Hartshorne coal was a primary objective in the third quarter. Mahalo drilled 7 Hartshorne coal wells in the Lakeview area during this period. Three of the wells were operated by Mahalo.

During third quarter 2007, Mahalo drilled a 64 per cent owned Woodford Shale horizontal well in Hughes County, Oklahoma. Although the well was cased, completion is being deferred pending higher natural gas prices. The well will be stimulated utilizing a multi-stage high-volume stimulation program.

In Canada, our drilling portfolio showed that certain shallow prospects in one of our West Central Alberta fields were ideal to be drilled during the third quarter due to the availability of lower cost services and infrastructure. The Company drilled 4 (3.8 net) wells. Three of these wells are currently producing; the fourth well encountered a mud filtrate problem and is scheduled for remedial work in early 2008.

Mahalo continues to focus its Canadian CBM efforts at its Corbett Creek, Alberta property. Our primary focus is to expedite the dewatering phase of exploiting this massive resource. Earlier this year, the Company re-entered an existing well producing from the Mannville through a single horizontal lateral and subsequently completed the well as a multi-lateral, three legged producer. Productivity is stable at 1.0 Mmcf per day. The dewatering time has improved noticeably; the original dewatering time was estimated at 3 to 6 months. The multi-lateral well delivered CBM production within 6 weeks.

As reported last quarter, Mahalo re-entered a second well at Corbett Creek, drilled an additional two lateral legs and brought the well back on production in mid-July. This second multi-lateral well has now had adequate time to display a production trend that appears to be similar to the first well; a noticeable improvement in accelerated dewatering and CBM production capability. The Company is encouraged by the recent results at Corbett Creek and with existing infrastructure already in place to support related reserves and expedited production, Corbett activity is practically a must do project for our 2008 budget.

Outlook

Mahalo continues to strategically plan its 2007 activity around a Cdn $38 million capital expenditure program of which approximately Cdn $33 million was spent through the third quarter. Our 2007 production exit target of 3,800 boe per day appears to be reachable with less capital than anticipated; consequently, our current mandate is to identify and execute projects that will achieve our exit target and, at the same time, allow us to under spend our approved 2007 capital budget.

Projects that will be instrumental in the formulation of our 2008 capital program include the drilling of a Hartshorne CBM multi-lateral well in fourth quarter 2007, which if successful, should allow us to further improve our Hartshorne CBM economics and reduce related finding and development costs.

The Company will also continue to examine farm-in offers for the development of shale drilling prospects within our acreage that can assist us in determining the resource potential sitting beneath our lands. The ability for Mahalo to participate directly in drilling notices will require careful consideration due to the capital magnitude of such development. In addition, to encouraging drilling activity within our own acreage, the development activity surrounding Mahalo's shale lands is providing the Company with good insight into third party technical successes and adding value in the Company's on-going assessment of this large resource.

Mahalo is currently assessing the Alberta government's revised oil and gas royalty framework which will become effective January 2009. Initial indications are that Mahalo's Alberta government royalties would not increase and may in fact decrease under the new royalty framework given our focus on CBM development and current commodity price assumptions.

The primary concern that shareholders express to the Company is our current debt leveraging position, which, in turn is likely having a negative impact on our stock price. Our current debt level has been exasperated to a great extent by the continued and seemingly unrelenting softness in gas prices. Mahalo is currently in negotiations to divest of certain additional non-core assets. Key objectives include monetizing non-core assets, reducing outstanding bank debt while maintaining our current approved borrowing base despite the asset sales.

Further information about our third quarter results is set out in our Management's Discussion and Analysis for the six and nine months ended September 30, 2007.

Tribute

This continues to be a time of emptiness and sadness for me, the family, friends and business associates of Vernon Haberlack, our Vice President of Production. Vern passed away suddenly while at work on October 9, 2007. The expression "the greatest resource of any corporation is its human resource" is never felt more and better understood than at a time when a higher calling steps in and removes a quality person from within your company.

We at Mahalo are extremely appreciative of what we accomplished with Vern's hard work, guidance and leadership. In recognition of his many contributions and in his memory, Mahalo has licensed and named its first US Hartshorne CBM multi-lateral horizontal well, the "Haberlack MH 1-7-9N-16E "

Vern leaves behind his loving wife, Tania and 8 year old son, Cole. In memory of Vern, Mahalo Energy Ltd. has created the "Cole Haberlack Personal Development Fund". Details regarding the fund can be found on the Mahalo website at www.mahaloenergy.com.

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") of the results of operations and changes in financial condition of Mahalo Energy Ltd. ("Mahalo" or the "Company") is dated November 9, 2007 and should be read in conjunction with the Company's unaudited interim consolidated financial statements and accompanying notes for the three and nine months ended September 30, 2007, and the audited consolidated financial statements and accompanying notes and the MD&A for the year ended December 31, 2006.

The financial data presented has been prepared in accordance with Canadian generally accepted accounting principles ("GAAP"). The reporting and measurement currency is the Canadian dollar, unless otherwise specified. References to "US$" are to United States dollars.

The reader is advised that historical results are not necessarily indicative of future performance. 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.

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.

	Three Months Ended		**Nine Months Ended**	
	Sept 30 2007	**Sept 30 2006**	**Sept 30 2007**	**Sept 30 2006**
Financial highlights				
($000s, except per share)				
Petroleum and natural gas revenue	**11,390**	11,578	**32,693**	28,684
Operating netback *(1)*	**5,693**	5,612	**17,150**	14,984
Net income (loss)	**(1,813)**	(798)	**(3,020)**	(1,054)
Per share - basic & diluted	**(0.03)**	(0.01)	**(0.05)**	(0.02)
Funds from operations *(1)*	**3,334**	3,434	**10,372**	11,402
Per share - basic *(1)*	**0.06**	0.06	**0.18**	0.23
Capital expenditures *(2)*	**13,540**	20,781	**35,723**	147,139
Proceeds from sale of oil and gas assets	**2,235**	17,004	**16,509**	17,004
Total assets, end of period	**202,778**	263,951	**202,778**	263,951
Net debt, end of period *(1)*	**59,607**	53,452	**59,607**	53,452
Shareholders' equity, end of period	**115,318**	163,678	**115,318**	163,678
Common shares, end of period *(000s)*	**59,298**	58,286	**59,298**	58,286
Weighted average - basic and diluted *(000s)*	**59,298**	58,286	**59,226**	49,841
Operational highlights				
Average daily sales volumes *(boe) (1) (3)*	**3,407**	2,939	**2,948**	2,312
Average selling price *($/boe)*	**36.34**	42.82	**40.62**	45.45
Royalties *($/boe)*	**8.83**	8.95	**9.33**	11.30
Operating *($/boe)*	**6.99**	11.35	**8.05**	9.00
Transportation *($/boe)*	**2.36**	1.76	**1.94**	1.41
Operating netback *($/boe)*	**18.16**	20.76	**21.30**	23.74

(1) Please refer to special advisories regarding use of non-GAAP financial measures and barrel of oil equivalent measures.
(2) Includes capital expenditures paid with non-cash consideration of $78.9 million in the nine month period of 2006.
(3) Petroleum and natural gas revenue and 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 September 30, 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

The following table provides a comparison of current quarter results with the immediately preceding quarter and the corresponding quarter ended September 30, 2006. Selected financial data is also provided for the nine month periods ended September 30, 2007 and 2006.

	Three Months Ended			Nine Months Ended	
	Sept 30 2007	**Jun 30 2007**	**Sept 30 2006**	**Sept 30 2007**	**Sept 30 2006**
($000s, except per share)					
Petroleum and natural gas revenue	**$ 11,390**	$ 10,871	$ 11,578	**$ 32,693**	$ 28,684
Net income (loss)	**(1,813)**	(171)	(798)	**(3,020)**	(1,054)
Per share: basic and diluted	**(0.03)**	0.00	(0.01)	**(0.05)**	(0.02)
Funds from operations	**3,334**	3,545	3,434	**10,372**	11,402
Per share: basic	**0.06**	0.06	0.06	**0.18**	0.23

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. Funds from operations, which represent net earnings adjusted for non-cash items, 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. Funds from operations may not be comparable to similar measures presented by other companies.

The major factors that accounted for the change in funds from operations during third quarter 2007, when compared with the immediately preceding quarter, were as follows:

($000s)		
Funds from operations generated in second quarter 2007		**$ 3,545**
Increase (decrease) in funds during third quarter 2007 as a result of:		
Higher operating netback		
Higher sales volumes	**$ 1,225**	
Lower realized sales prices	**(1,958)**	
Lower per unit royalties expense	**633**	
Lower per unit operating and transportation expense	**414**	**314**
Lower general and administrative expense		**905**
Higher interest and financing costs		**(286)**
Lower realized foreign exchange gain		**(1,159)**
Other		**15**
Funds from operations generated in third quarter 2007		**$ 3,334**

Petroleum and natural gas sales

The following table illustrates selected financial and operational 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.

	Three Months Ended						Nine Months Ended			
		Sept 30 2007		**Jun 30 2007**		**Sept 30 2006**		**Sept 30 2007**		**Sept 30 2006**
Petroleum and natural gas revenue *($000s)*										
Natural gas										
Canada	**$**	**3,641**	$	3,130	$	2,421	**$**	**9,352**	$	3,682
United States		**7,410**		7,473		6,256		**21,880**		21,110
	$	**11,051**	$	10,603	$	8,677	**$**	**31,232**	$	24,792
Crude oil and NGL's										
Canada	**$**	**339**	$	268	$	2,901	**$**	**1,461**	$	3,891
Natural gas, crude oil & NGL's										
Canada	**$**	**3,980**	$	3,398	$	5,322	**$**	**10,813**	$	7,573
United States		**7,410**		7,473		6,256		**21,880**		21,110
	$	**11,390**	$	10,871	$	11,578	**$**	**32,693**	$	28,683
Total sales volume *(boe) (1) (2)*		**313,455**		255,286		270,416		**804,869**		631,042
Average daily sales volume *(1)*										
Natural gas *(Mcf/day)*										
Canada		**7,446**		4,839		4,162		**5,482**		2,154
United States		**12,642**		11,714		10,698		**11,636**		10,458
		20,088		16,553		14,860		**17,118**		12,612
Crude oil and NGL's *(bbls/day)*										
Canada		**59**		47		463		**95**		209
Barrels of oil equivalent *(boe/day) (2)*										
Canada		**1,300**		853		1,156		**1,009**		569
United States		**2,107**		1,952		1,783		**1,939**		1,743
		3,407		2,805		2,939		**2,948**		2,312
Average realized selling price										
Natural gas *($/Mcf)*										
Canada	**$**	**5.32**	$	7.11	$	6.32	**$**	**6.25**	$	6.26
United States		**6.37**		7.01		6.36		**6.89**		7.39
Weighted average		**5.98**		7.04		6.35		**6.68**		7.20
Crude oil and NGL's *($/bbl)*										
Canada		**62.32**		63.12		68.18		**56.19**		68.05
Barrel of oil equivalent *($/boe) (2)*		**36.34**		42.58		42.82		**40.62**		45.45

(1) Petroleum and natural gas revenue and 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.

Sales of oil and gas averaged 3,407 boe per day in third quarter 2007, 2,805 boe per day in the immediately preceding quarter of 2007 and 2,939 boe per day in the corresponding third quarter of 2006. Oil and gas sales in the month of September 2007 averaged approximately 3,500 boe per day while the September 2007 exit rate was approximately 3,550 boe per day.

In June 2007, installation of gas gathering facilities in the Lakeview area of Oklahoma allowed for tie in of several Hartshorne CBM wells. Production from these wells was being held back for several months due to pipeline constraints. These facilities benefited third quarter 2007 sales and will support future development of numerous Lakeview Hartshorne CBM prospects. During third quarter 2007, the Company also benefited from higher sales of Canadian natural gas stemming from successful exploration and development activities on both conventional and unconventional prospects.

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, however, the improvement did not hold. During summer 2007, natural gas prices declined further; the Company's average realized price for natural gas amounted to $5.98 per Mcf in third quarter 2007 compared with $7.04 per Mcf in the immediately preceding quarter.

North American natural gas prices are 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 for sale into the Oklahoma Gas Transmission and Centre Point East pipeline.

Royalty expense

Oil and gas 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. In Oklahoma, government royalty assessments are generally based on the price realized for the underlying petroleum product.

In Canada, the rate of royalties payable to government entities depends on many factors such as prescribed reference prices, well productivity, geographical location and field discovery date, method of recovery and the type and quality of petroleum product produced.

The decrease in royalty expense on a boe basis in third quarter 2007 when compared with the immediately preceding quarter resulted mainly from lower realized prices. Although various factors impact the computation of royalty expense, realized price continues to be the predominate factor for oil and gas produced by Mahalo.

	Three Months Ended			Nine Months Ended	
	Sept 30 2007	**Jun 30 2007**	**Sept 30 2006**	**Sept 30 2007**	**Sept 30 2006**
Royalty expense *($000s)*					
Canada	**$ 876**	$ 809	$ 783	**$ 2,139**	$ 1,185
United States	**1,891**	1,961	1,637	**5,369**	5,946
	$ 2,767	$ 2,770	$ 2,420	**$ 7,508**	$ 7,132
Royalty expense *($/boe)*					
Canada	**$ 7.33**	$ 10.42	$ 7.36	**$ 7.77**	$ 7.64
United States	**9.76**	11.04	9.98	**10.14**	12.50
Weighted average	**8.83**	10.85	8.95	**9.33**	11.30

In October 2007, the Alberta government introduced a revised oil and gas royalty framework which will become effective in January 2009. Initial indications are that Mahalo's Alberta government royalties would not increase and may in fact decrease under the new royalty framework given our focus on CBM development and current commodity price assumptions. In September 2007, Canadian sales accounted for approximately 37 per cent of the Company's total sales on a boe basis.

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.

	Three Months Ended			Nine Months Ended	
	Sept 30 2007	**Jun 30 2007**	**Sept 30 2006**	**Sept 30 2007**	**Sept 30 2006**
Operating expense *($000s)*					
Canada	**$ 1,158**	$ 1,014	$ 2,135	**$ 3,243**	$ 2,948
United States	**1,032**	1,160	934	**3,233**	2,732
	$ 2,190	$ 2,174	$ 3,069	**$ 6,476**	$ 5,681
Operating expense *($/boe)*					
Canada	**$ 9.68**	$ 13.07	$ 20.07	**$ 11.78**	$ 18.99
United States	**5.32**	6.53	5.70	**6.11**	5.74
Weighted average	**6.99**	8.52	11.35	**8.05**	9.00

During the current quarter, the Company realized a 21 per cent increase in sales volume when compared with the preceding quarter. Since certain operating costs are of a fixed nature, the higher volume did not translate into a similar percentage increase in total operating expense. As a result, operating expense per boe was down when compared with the preceding quarter of 2007. Operating costs per boe for the nine months ended September 30, 2007 decreased from the same period in 2006 primarily as a result of the disposition of certain conventional oil and gas properties which were more expensive to operate.

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 cost fluctuated between two and six percent of sales revenues during the periods under comparison.

Operating netback

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 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.

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

	Canada		United States		Total	
Three months ended Sept 30	**2007**	**$/boe**	**2007**	**$/boe**	**2007**	**$/boe**
($000s, except per boe)						
Petroleum and natural gas revenue	**$ 3,980**	**$ 33.28**	**$ 7,410**	**$ 38.23**	**$ 11,390**	**$ 36.34**
Royalties	**876**	**7.33**	**1,891**	**9.76**	**2,767**	**8.83**
Operating and transportation	**1,282**	**10.72**	**1,648**	**8.50**	**2,930**	**9.35**
Operating netback	**$ 1,822**	**$ 15.23**	**$ 3,871**	**$ 19.97**	**$ 5,693**	**$ 18.16**

	Canada		United States		Total	
Three months ended Jun 30	**2007**	**$/boe**	**2007**	**$/boe**	**2007**	**$/boe**
($000s, except per boe)						
Petroleum and natural gas revenue	$ 3,398	$ 43.77	$ 7,473	$ 42.06	$ 10,871	$ 42.58
Royalties	809	10.42	1,961	11.04	2,770	10.85
Operating and transportation	1,084	13.97	1,639	9.23	2,723	10.67
Operating netback	$ 1,505	$ 19.38	$ 3,873	$ 21.80	$ 5,378	$ 21.06

During third quarter 2007, the Company realized an average operating netback of $18.16 per boe as compared with $21.06 per boe in second quarter 2007. Total sales volumes increased by approximately 21 per cent during third quarter 2007 when compared with second quarter 2007. The negative impact of a sharply lower average realized price during the current quarter, partially offset by a reduction in per unit royalties and operating and transportation expense, allowed absolute operating netback to increase by only 15 per cent when compared with second quarter 2007. In the three month period ended September 30, 2006, the average operating netback was $20.76 per boe.

	Canada				United States				Total			
Three months ended Sept 30		**2006**		**$/boe**		**2006**		**$/boe**		**2006**		**$/boe**
($000s, except per boe)												
Petroleum and natural gas revenue	$	5,322	$	50.03	$	6,256	$	38.14	$	11,578	$	42.82
Royalties		783		7.36		1,637	$	9.98		2,420	$	8.95
Operating and transportation		2,303		21.64		1,243	$	7.58		3,546	$	13.11
Operating netback	$	2,236	$	21.02	$	3,376	$	20.58	$	5,612	$	20.76

The following tables reflect operating netback by geographic area for the respective nine month periods under comparison.

	Canada				United States				Total			
Nine months ended Sept 30		**2007**		**$/boe**		**2007**		**$/boe**		**2007**		**$/boe**
($000s, except per boe)												
Petroleum and natural gas revenue	**$**	**10,814**	**$**	**39.26**	**$**	**21,879**	**$**	**41.33**	**$**	**32,693**	**$**	**40.62**
Royalties		**2,139**		**7.77**		**5,369**		**10.14**		**7,508**		**9.33**
Operating and transportation		**3,549**		**12.89**		**4,486**		**8.48**		**8,035**		**9.99**
Operating netback	**$**	**5,126**	**$**	**18.60**	**$**	**12,024**	**$**	**22.71**	**$**	**17,150**	**$**	**21.30**

	Canada				United States				Total			
Nine months ended Sept 30		**2006**		**$/boe**		**2006**		**$/boe**		**2006**		**$/boe**
($000s, except per boe)												
Petroleum and natural gas revenue	$	7,574	$	48.80	$	21,110	$	44.37	$	28,684	$	45.45
Royalties		1,186		7.64		5,946		12.50		7,132		11.30
Operating and transportation		3,161		20.35		3,407		7.16		6,568		10.41
Operating netback	$	3,227	$	20.81	$	11,757	$	24.71	$	14,984	$	23.74

General and administrative expense

General and administrative expense amounted to $1.3 million in third quarter 2007, $2.2 million in second quarter 2007 and $1.1 million in third quarter 2006. The higher general and administrative expense in second quarter 2007 was primarily due to one-time, non-recurring restructuring costs associated with assuming operatorship of a growing percentage of United States operations.

For the nine months ended September 30, 2007, general and administrative expense was $5.1 million compared with $2.7 million in the first nine months of 2006. During both these periods, the Company capitalized $0.2 million of general and administrative costs as directly related to petroleum and natural gas properties.

General and administrative expense in the 2007 period was higher mainly due to administrative costs associated with Canadian conventional oil and gas operations acquired May 31, 2006 and the various costs associated with the growing operational emphasis in the United States. The 2006 period included only four months of Canadian conventional oil and gas operations.

Stock-based compensation expense

Stock-based compensation results from the amortization of the aggregate fair value of stock options over their related vesting period. The amount is primarily determined by the number of options granted, the vesting period and the estimated fair value of the options. During the nine months ended September 30, 2007, 667,000 (2006 – 1,883,200) stock options were granted.

For the nine months ended September 30, 2007, stock-based compensation costs amounted to $1.5 million (2006 - $1.2 million) of which $1.3 million (2006 - $1.0 million) was expensed and $0.2 million (2006 - $0.2 million) was capitalized as directly relating to petroleum and natural gas properties. Stock-based compensation expense remained relatively unchanged during the three quarterly periods under comparison, ranging from $0.3 million to $0.5 million per quarter.

Foreign exchange gains and losses

A portion of the Company's monetary assets and liabilities are denominated in United States dollars. Shifts in Canadian/United States currency rates result in foreign exchange gains and losses when account balances in a currency other than the reporting currency are settled or translated at the period end.

During third quarter 2007, foreign exchange gains amounted to $0.4 million, virtually all of which was unrealized. In the immediately preceding quarter, the Company recorded a foreign exchange gain of $1.9 million, of which $0.7 million was unrealized. A majority of the realized gain in second quarter 2007 resulted from the conversion of $37.8 million of U.S. dollar bank debt to a Canadian dollar obligation. For the nine months ended September 30, 2007, the company recorded a foreign exchange gain of $2.8 million (gain of $1.6 million unrealized) compared with a gain of $0.6 million (loss of $0.3 million unrealized) in the first nine months of 2006.

Interest and financing expense

Interest and financing expense amounted to $1.1 million in third quarter 2007, $0.8 million in second quarter 2007 and $1.0 million in third quarter 2006, respectively. For the nine months ended September 30, 2007, interest and financing expense was $2.8 million compared with $1.8 million in the first nine months of 2006. The expense during each of these periods resulted primarily from borrowings under a three year revolving credit facility established in December 2005 with the Union Bank of California. A majority of the change in interest and financing expense resulted from the level of borrowings during the respective periods. Changes in the effective cost of borrowing did not have a significant impact on interest expense. No interest and financing expense was capitalized during the periods under comparison.

Depletion, depreciation and accretion expense

Total depletion and depreciation expense increased in the three and nine months ended September 30, 2007 primarily as a result of higher sales volumes when compared with the same periods in 2006.

Depletion and depreciation expense on a boe basis fluctuates from period to period primarily as a result of changes in the underlying proved reserves base and in the amount of costs subject to depletion. In addition, reserves and costs are segregated and depleted on a county by country basis. A shift in the volume of oil and gas sold from properties in Canada and the United States can impact the overall rate when computed on a boe basis.

	Three Months Ended			Nine Months Ended	
	Sept 30 2007	**Jun 30 2007**	**Sept 30 2006**	**Sept 30 2007**	**Sept 30 2006**
($000s, except per boe)					
Depletion and depreciation expense	**$ 4,784**	$ 4,227	$ 4,629	**$ 13,167**	$ 10,580
Accretion expense	**38**	89	113	**228**	179
Depletion, depreciation and accretion expense	**$ 4,822**	$ 4,316	$ 4,742	**$ 13,395**	$ 10,759
Depletion and depreciation expense *($/boe)*	**$ 15.26**	$ 16.55	$ 17.12	**$ 16.36**	$ 16.77

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 September 30, 2007, the Company's asset retirement obligation amounted to $4.7 million compared with $5.8 million at December 31, 2006. The sale of certain conventional oil and gas properties in 2007 contributed to the decrease.

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. 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 the nine months ended September 30, 2007, the income tax asset related to Canadian operations increased to $3.8 million and continued to be fully offset by a valuation allowance at the quarter end.

During third quarter 2007, the Company recorded future income taxes of $0.3 million compared with a small future income tax recovery in the immediately preceding quarter. Future income tax expense amounted to $0.5 million and $0.6 million in the nine months ended September 30, 2007 and 2006, respectively. At September 30, 2007, the Company had a future income tax liability of $3.9 million which related solely to the Company's United States operations.

LIQUIDITY AND CAPITAL RESOURCES

The Company's capital resources consist primarily of funds from operations, available credit facilities and access to debt and capital markets. In addition, the Company has realized cash proceeds from the sale of non-core oil and gas assets and will continue to seek opportunities to prudently rationalize its resource asset base. The Company's strategy is to focus on unconventional and selective conventional resource projects that offer the greatest opportunity to maximize funds flow generation and shareholder value.

The following table reflects cash provided by or used in operating, financing and investing activities. The table also illustrates the relationship between net earnings, funds from operations and cash provided by operating activities.

	Three Months Ended			Nine Months Ended	
	Sept 30 2007	**Jun 30 2007**	**Sept 30 2006**	**Sept 30 2007**	**Sept 30 2006**
($000s)					
Net income (loss)	**$ (1,813)**	$ (171)	$ (798)	**$ (3,020)**	$ (1,054)
Non-cash items	**5,147**	3,716	4,232	**13,392**	12,456
Funds from operations	**3,334**	3,545	3,434	**10,372**	11,402
Change in non-cash working capital related to operating activities	**258**	(3,314)	7,218	**(3,587)**	10,027
Cash provided by operating activities	**3,592**	231	10,652	**6,785**	21,429
Cash provided by (used in) financing activities	**7,805**	7,302	(4,133)	**9,057**	28,475
Cash provided by (used in) investing activities	**(9,819)**	(16,410)	(7,217)	**(16,086)**	(53,241)
Increase (decrease) in cash	**$ 1,578**	$ (8,877)	$ (698)	**$ (244)**	$ (3,337)

Operating activities

The Company generated funds from operations of $10.4 million and $11.4 million during the nine months ended September 30, 2007 and 2006, respectively. Funds from operations, which represent net earnings adjusted for non-cash items, is a non-GAAP measure used by Mahalo to assess its operating results and its ability to generate funds to finance future capital investment and service debt.

Cash provided by (used in) operating activities takes into account net earnings, adjusted for non-cash items, and includes a further adjustment for the change in operating-related, non-cash working capital that occurred during the respective periods. The majority of the change in non-cash working capital involved shifts in accounts receivable and accounts payable balances resulting from operational activity levels and the timing of cash receipts and payments.

Financing activities

The Company has a three year revolving credit facility with the Union Bank of California that was established in December 2005. In March 2007, the approved borrowing base was set at Cdn $60.0 million. Net borrowings under the facility during the nine months ended September 30, 2007 amounted to $8.6 million resulting in a balance equivalent to Cdn $58.6 million at September 30, 2007.

The credit facility, which is collateralized by a fixed charge on the Company's United States assets and a floating charge on its Canadian assets, requires the Company to maintain certain financial covenants and ratios. At September 30, 2007, the Company was in non-compliance with respect to a "consolidated leverage ratio" as defined in the credit agreement. Non-compliance with the ratio was formally waived by the lender. Based on projected fourth quarter 2007 operating results, the Company expects to be in compliance with the consolidated leverage ratio at year-end 2007. The Company is also currently in negotiations to divest of additional non-core assets and will utilize proceeds to reduce long term debt.

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.

	Three Months Ended			Nine Months Ended	
	Sept 30 2007	**Jun 30 2007**	**Sept 30 2006**	**Sept 30 2007**	**Sept 30 2006**
($000s)					
Land and seismic	**$ 1,018**	$ 682	$ 480	**$ 2,375**	$ 1,502
Drilling and completions	**7,557**	11,841	15,824	**27,011**	39,738
Facilities and equipment	**2,165**	840	4,477	**3,537**	13,942
Other	**-**	-	-	**-**	138
	10,740	13,363	20,781	**32,923**	55,320
Property and other acquisitions	**2,800**	-	-	**2,800**	12,918
Property divestures	**(2,235)**	(91)	(17,004)	**(16,509)**	(17,004)
Cash expenditures on property and equipment, net	**$ 11,305**	$ 13,272	$ 3,777	**$ 19,214**	$ 51,234
(000s)					
Canada	**$ 4,139**	$ 3,369	$ (2,305)	**$ (3,729)**	$ 24,737
United States	**7,166**	9,903	6,082	**22,943**	26,497
Cash expenditures on property and equipment, net	**$ 11,305**	$ 13,272	$ 3,777	**$ 19,214**	$ 51,234

During third quarter 2007, the Company participated in 13 (9.6 net) wells. Of the wells drilled, 4 (3.8 net) were in Canada and 9 (5.9 net) were in the United States. In the immediately preceding quarter of 2007, 16 (10.4 net) wells were drilled. Of these wells, 4 (3.8 net) were in Canada and 12 (6.4 net) were in the United States. During the nine months ended September 30, 2007, Mahalo participated in a total of 44 (27.0 net) wells.

During third quarter 2007, the Company increased its working interest ownership in its Corbett Creek CBM property in Alberta to 100 per cent. Property divestures during the first nine months of 2007 involved primarily conventional resource assets located in southern Alberta and north-eastern British Columbia. The 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 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. In May 2006, the Company acquired a Calgary-based conventional oil and gas company in a share-for-share exchange arrangement. The cost of the acquisition was 15,153,630 common shares with a deemed value of $4.79 per share and an aggregate value of $72.6 million. In addition, all outstanding convertible securities of the acquired company were exchanged for comparable convertible securities of Mahalo on the same exchange ratio. Estimated cash transaction costs and assumption of a bank overdraft amounted to $4.5 million.

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	$ 123	$ 506	$ 542	$ 568	$ 426	$ 2,165
Office lease *(US$)*	7	31	10	-	-	48
Equipment usage	1,074	2,376	2,376	874	-	6,700

The equipment usage obligation results from a three year drilling rig lease contract with Western Lakota Energy Services Inc. entered into on January 27, 2006. The terms of the contract include a commitment to utilize a specific drilling rig for a minimum of 250 days per year for three years, with the contract to take effect as of the date the rig is released to Mahalo. The rig was released to Mahalo in 2007. The terms of the agreement specify that the Company is obligated to pay, at a minimum, a standby rate of $17,760 per day with full crew or $9,504 per day with no crew. The obligation reflected in the above table is based on the latter rate.

The Company had the following financial derivative contracts outstanding as at September 30, 2007 and as at the date of this MD&A.

Transaction Type	**Volume**	**Contract Price**	**Expiry**
WTI Collar	30 Bbl/day	US $38.00 - $44.65/Bbl	October 2007
WTI Puts	30 Bbl/day	US $ 40.00/Bbl	November 2007
AECO Financial Hedge	300 GJ/day	CDN $ 6.64/Bbl	October 2007

The Company considers the liquidity risks associated with the above-note financial derivative contracts to be immaterial. Two of the three contracts have expired as at the date of this MD&A and the remaining contract expires at the end of November 2007.

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

Transaction Type	Volume	Contract Price	Term
Sell	2,000 GJs/day	Cdn $7.35 per GJ	January 2007 - December 2007
Sell	1,000 GJs/day	US $7.23 per MMBtu	November 2006 - October 2007
Sell	450 GJs/day	Cdn $6.55 per GJ	November 2006 - October 2007
Sell	3,000 Mmbtu/day	US $7.30 per MMbtu	November 2007 - October 2008
Sell	2,000 GJs/day	Cdn $7.43 per GJ	January 2008 - December 2008
Purchase	2,000 GJs/day	Cdn $7.07 per GJ	April 2007 - October 2007

The Company does not consider the liquidity risks associated with the above-note physical delivery contracts to be material. Three of the six contracts have expired as at the date of this MD&A and the remaining three contracts do not represent a significant portion of the Company's current or anticipated natural gas production volumes.

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

Liquidity

Working capital is an aggregation of current assets and current liabilities. Operating, financing and investing activities generate and consume components of working capital of both a cash and non-cash nature. At September 30, 2007, the Company had a working capital deficit of $1.1 million compared with a deficit of $0.8 million at December 31, 2006. These working capital deficit positions, which were not significant, could have been eliminated at the balance sheet dates through additional borrowings under the Company's long-term credit facility.

The following table illustrates components of net debt and the balance of shareholders' equity at September 30, 2007 and December 31, 2006. The table also reflects certain measures and ratios which the Company considers useful in assessing liquidity. These measures and ratios are computed using non-GAAP financial measures, including "net debt" and "funds from operations"; the reader is referred to the section entitled "Special Cautionary Advisories" at the end of this MD&A.

As at		Sept 2007		Dec 31 2006
($000s)				
Working capital (deficiency)	**$**	**(1,122)**	$	(805)
Unrealized loss on financial instruments		**83**		350
Long term debt		**58,568**		52,349
Net debt	**$**	**59,607**	$	52,804
Shareholders' equity	**$**	**115,318**	$	116,763
Funds from operations (twelve months trailing) *($000s)*	**$**	**11,861**	$	12,893
Net debt to trailing funds from operations ratio		**5.03**		4.10
Net debt as a % of shareholders' equity		**52%**		45%
Net debt as a % of net debt plus shareholders' equity		**34%**		31%

At September 30, 2007 and November 9, 2007, the Company had 59,298,035 common shares, 1,440,000 common share purchase warrants and 535,200 performance warrants issued and outstanding. Contributed surplus at September 30, 2007 amounted to $7.5 million, reflective of aggregate stock-based compensation costs incurred from inception of the Company in 2004.

Management anticipates that the Company will have adequate financial resources to fund operations, contractual obligations and discretionary capital expenditures through a combination of funds from operations, proceeds from the disposition of non-core 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".

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 nine months ended September 30, 2007, the Company sold certain non-core properties to Avenir Operating Corp. for $7.2 million. The measurement basis used for the transaction was an independent reserves valuation as at December 31, 2006. The transaction value was also compared with current market sales metrics from an independent public source. The asset sale transaction was a cash transaction and did not include any ongoing contractual or other commitments. Management considers the nature of the transaction to be in the normal course of its operations.

SUMMARY OF QUARTERLY FINANCIAL RESULTS (unaudited)

The following table presents a summary of consolidated quarterly operating results for the quarters ended December 31, 2005 through September 30, 2007.

Selected quarterly information	Q3 2007	Q2 2007	Q1 2007	Q4 2006	Q3 2006	Q2 2006	Q1 2006	Q4 2005
Financial *($000s, except per share)*								
Petroleum and natural gas revenue	**11,390**	10,871	10,432	10,867	11,578	8,714	8,392	8,152
Operating netback	**5,693**	5,378	6,080	5,169	5,612	4,532	4,839	5,243
General and administrative	**1,320**	2,225	1,518	1,735	1,088	1,040	523	757
Stock-based compensation	**514**	324	445	457	260	369	343	326
Foreign exchange loss (gain)	**(450)**	(1,877)	(476)	2,048	11	(902)	323	447
Interest and financing expense	**1,058**	771	1,008	1,089	1,027	645	135	16
Write-down of property and equipment	**-**	-	-	36,322	-	-	-	-
Write-down of goodwill	**-**	-	-	12,743	-	-	-	-
Depletion, depreciation and accretion	**4,822**	4,316	4,258	8,400	4,742	3,734	2,283	1,592
Future income taxes (recovery)	**271**	(31)	294	(10,033)	(552)	444	703	1,450
Net income (loss)	**(1,813)**	(171)	(1,037)	(47,511)	(798)	(802)	544	731
Per share: basic and diluted	**(0.03)**	0.00	(0.02)	(0.81)	(0.01)	(0.02)	0.01	0.02
Funds from operations *(1)*	**3,334**	3,545	3,494	1,488	3,434	3,955	4,015	4,123
Per share: basic *(1)*	**0.06**	0.06	0.06	0.03	0.06	0.08	0.09	0.10
Reconciliation:								
Funds from operations *(1)*	**3,334**	3,545	3,494	1,488	3,434	3,955	4,015	4,123
Changes in non-cash working capital related to operating activities	**258**	(3,314)	(531)	(4,557)	7,218	4,974	(2,164)	(2,927)
Cash provided by (used in) operating activities	**3,592**	231	2,963	(3,069)	10,652	8,929	1,851	1,196
Operational								
Average daily sales *(2)*								
Natural gas *(Mcf/day)*	**20,088**	16,553	14,653	16,130	14,861	12,799	10,125	7,732
Crude oil and NGLs *(bbls/day)*	**59**	47	182	284	463	161	-	-
Barrels of oil equivalent *(boe/day)*	**3,407**	2,805	2,624	2,972	2,939	2,294	1,688	1,289
Average realized selling prices								
Natural gas *($/Mcf)*	**5.98**	7.04	7.26	6.44	6.35	6.63	9.21	11.46
Crude oil and NGLs *($/bbl)*	**62.32**	63.12	52.36	50.53	68.18	67.68	-	-
Barrel of oil equivalent *($/boe)*	**36.34**	42.58	44.15	39.75	42.82	41.74	55.25	68.76
Average operating netback *($/boe)*	**18.16**	21.06	25.75	18.91	20.76	21.71	31.85	44.22
Exchange rate								
Cdn$/US$ average exchange rate	**0.957**	0.911	0.854	0.878	0.892	0.891	0.866	0.851

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

(2) Petroleum and natural gas revenue and sales volumes are before deduction of royalties.

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

COMPARATIVE AMOUNTS

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

OUTLOOK

Mahalo continues to strategically plan its 2007 activity around a Cdn $38 million capital expenditure program of which approximately Cdn $33 million was spent through the third quarter. Our 2007 production exit target of 3,800 boe per day appears to be reachable with less capital than anticipated; consequently, our current mandate is to identify and execute projects that will achieve our exit target and, at the same time, allow us to under spend our approved 2007 capital budget.

Mahalo is now actively operating prospects in both Canada and the United States, including the Poteau field in Oklahoma, and continues to benefit from a strong relationship with partners who operate a certain number of our prospects. This brings a better balance to our overall resource management.

Projects that will be instrumental in the formulation of our 2008 capital program include the drilling of a Hartshorne CBM multi-lateral well in fourth quarter 2007, which if successful, should allow us to further improve our Hartshorne CBM economics and reduce related finding and development costs.

The Company will also continue to examine farm-in offers for the development of shale drilling prospects within our acreage that can assist us in determining the resource potential sitting beneath our lands. The ability for Mahalo to participate directly in drilling notices will require careful consideration due to the capital magnitude of such development. In addition, to encouraging drilling activity within our own acreage, the development activity surrounding Mahalo's shale lands is providing the Company with good insight into third party technical successes and adding value in the Company's on-going assessment of this large resource.

Mahalo is currently in negotiations to divest of certain additional non-core assets. Key objectives include monetizing additional non-core assets, reducing outstanding bank debt and maintaining our current approved borrowing base despite the asset sales. 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.

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 Consolidated Financial Statements for the year ended December 31, 2006.

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", "operating netback" and "net debt" 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 (basic and diluted) 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 future capital investments 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 relative to realized commodity prices by deducting royalties and operating and transportation costs from oil and gas sales revenues. This non-GAAP measure is also used by the Company to assess comparability of petroleum sales and directly related costs on a per unit basis between periods.

Net debt as calculated by the Company represents long-term debt less working capital (excluding unrealized gain or loss on financial instruments).

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 ("Mcf") to one barrel ("bbl") 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 Consolidated Financial Statements

For the Three and Nine Months Ended September 30, 2007 and 2006

MAHALO ENERGY LTD.

Unaudited Interim Consolidated Financial Statements

Consolidated Balance Sheets

($000's)

As at		September 30 2007		December 31 2006
ASSETS (note 6)				
Current				
Cash	$	1,043	$	1,287
Accounts receivable		13,459		15,167
Inventory		2,189		2,714
Prepaid and deposits		2,456		1,402
		19,147		20,570
Deferred financing costs (note 3)		-		366
Property and equipment (note 5)		183,631		178,678
	$	202,778	$	199,614
LIABILITIES AND SHAREHOLDERS' EQUITY				
Current				
Accounts payable and accrued liabilities	$	20,186	$	21,025
Unrealized loss on financial instruments (note 4)		83		350
		20,269		21,375
Long-term debt (note 6)		58,568		52,349
Asset retirement obligations (note 7)		4,725		5,763
Future income taxes		3,898		3,364
		87,460		82,851
Shareholders' equity				
Share capital (note 8)		158,979		157,983
Warrants (note 8)		1,990		2,494
Contributed surplus (note 8)		7,489		6,035
Deficit		(53,140)		(49,749)
		115,318		116,763
	$	202,778	$	199,614

Commitments (note 11)

See accompanying notes to the consolidated financial statements

MAHALO ENERGY LTD.

Unaudited Interim Consolidated Financial Statements

Consolidated Statements of Loss, Comprehensive Loss and Deficit

($000's, except per share)

	Three Months		Nine Months	
For the periods ended September 30	**2007**	**2006**	**2007**	**2006**
REVENUES				
Petroleum and natural gas revenue	$ 11,390	$ 11,578	$ 32,693	$ 28,684
Royalty expense	(2,767)	(2,421)	(7,508)	(7,132)
	8,623	9,157	25,185	21,552
Gain on financial instruments (note 4)	27	174	124	158
Interest and other income	9	16	33	43
	8,659	9,347	25,342	21,753
EXPENSES				
Operating	2,190	3,069	6,476	5,681
Transportation	740	476	1,558	888
General and administrative (note 5)	1,320	1,088	5,063	2,651
Stock-based compensation (note 8)	514	260	1,283	971
Foreign exchange (gain) loss (note 9)	(450)	11	(2,804)	(568)
Interest and financing costs (note 6)	1,058	1,027	2,837	1,806
Depletion, depreciation and accretion	4,822	4,742	13,395	10,759
	10,194	10,673	27,808	22,188
Loss before income tax	(1,535)	(1,326)	(2,466)	(435)
Current income taxes	7	24	20	24
Future income taxes (recovery)	271	(552)	534	595
NET LOSS AND COMPREHENSIVE LOSS	(1,813)	(798)	(3,020)	(1,054)
DEFICIT, BEGINNING OF PERIOD	(51,327)	(1,440)	(49,749)	(1,183)
Adoption of accounting policy (note 3)	-	-	371	-
DEFICIT, END OF PERIOD	$ (53,140)	$ (2,238)	$ (53,140)	$ (2,238)
Net loss per share (note 8)				
Basic and diluted	$ (0.03)	$ (0.01)	$ (0.05)	$ (0.02)

See accompanying notes to the consolidated financial statements

MAHALO ENERGY LTD.
Unaudited Interim Consolidated Financial Statements

Consolidated Statements of Cash Flows
($000's)

	Three Months		Nine Months	
For the periods ended September 30	**2007**	**2006**	**2007**	**2006**
OPERATING ACTIVITIES				
Net loss	$ (1,813)	$ (798)	$ (3,020)	$ (1,054)
Non-cash items:				
Stock-based compensation	514	260	1,283	971
Depletion, depreciation and accretion	4,821	4,742	13,395	10,759
Unrealized financial derivative (gain) loss (note 4)	(57)	(225)	(268)	(223)
Unrealized foreign exchange (gain) loss (note 9)	(403)	(27)	(1,552)	280
Amortization of deferred financing costs	-	34	-	75
Future income taxes	271	(552)	534	594
	3,333	3,434	10,372	11,402
Change in non-cash working capital (note 10)	258	7,218	(3,587)	10,027
	3,591	10,652	6,785	21,429
FINANCING ACTIVITIES				
Issue of common shares	-	-	450	(113)
Exercise of stock options	-	-	42	-
Bank operating loan advances	-	(14,400)	-	(11,600)
Long-term debt	7,805	10,387	8,565	40,491
Deferred financing costs	-	(120)	-	(303)
	7,805	(4,133)	9,057	28,475
INVESTING ACTIVITIES				
Expenditure on property and equipment	(10,740)	(20,781)	(32,923)	(55,320)
Property and other acquisitions	(2,800)	-	(2,800)	(12,918)
Proceeds on sale of oil and gas properties	2,235	17,004	16,509	17,004
Change in non-cash working capital (note 10)	1,486	(3,440)	3,128	(2,007)
	(9,819)	(7,217)	(16,086)	(53,241)
INCREASE (DECREASE) IN CASH	1,577	(698)	(244)	(3,337)
CASH (BANK INDEBTEDNESS), BEGINNING OF PERIOD	(535)	(1,782)	1,287	857
CASH (BANK INDEBTEDNESS), END OF PERIOD	$ 1,043	$ (2,480)	$ 1,043	$ (2,480)

See accompanying notes to the consolidated financial statements

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

FOR THE THREE AND NINE MONTH PERIODS ENDED SEPTEMBER 30, 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, except that certain disclosures have been condensed or omitted. 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.

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 and nine months ended September 30, 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 or 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 measured at fair value. 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. 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 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 – cash and deposits
- Other financial liabilities – long-term debt and accounts payables

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

b) Derivatives

As at September 30, 2007, the Company had the following derivatives.

Transaction Type	Volume	Contract Price/Bbl	Expiry
WTI Collar	30 Bbl/Day	US $38.00 - $44.65	October 2007
WTI Puts	30 Bbl/Day	US $ 40.00	November 2007
AECO Financial Hedge	300 GJ/Day	CDN $ 6.64	October 2007

Based on dealer quotes, the unrealized loss on these contracts was $69,486 at September 30, 2007 (December 31, 2006 - $312,355). In addition, 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, leaving an unamortized balance of $13,613 (December 31, 2006 - $136,129).

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

($000's)	September 30 2007	December 31 2006
Unrealized loss on financial derivative contracts	$ 69	$ 214
Unamortized financial liability	14	136
	$ 83	$ 350

The following table summarized the unrealized and realized gain (loss) on these contracts for the three and nine months September 30, 2007.

	Three Months Ended September 30, 2007	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2007	Nine Months Ended September 30, 2006
Unrealized gain (loss) on contracts	$ 15,506	$ 170,289	$ 144,373	$ 168,089
Realized gain (loss) on contracts	(29,059)	(51,022)	(142,484)	(64,993)
	(13,553)	119,267	1,889	103,096
Amortization of financial liability	40,839	54,452	122,517	54,452
Gain (loss) on contracts	$ 27,286	$ 173,719	$ 124,406	$ 157,548

5. PROPERTY AND EQUIPMENT

($000s)	Cost	Accumulated Depletion and Depreciation	Net Book Value
September 30, 2007:			
Canada:			
Petroleum and natural gas properties and equipment	$ 112,799	$ 35,030	$ 77,769
Other	1,539	218	1,321
	114,338	35,248	79,090
USA:			
Petroleum and natural gas properties and equipment	124,357	20,803	103,554
Other	1,002	15	987
	125,359	20,818	104,541
	$ 239,697	$ 56,066	$ 183,631
December 31, 2006:			
Canada:			
Petroleum and natural gas properties and equipment	$ 116,403	$ 30,421	$ 85,982
Other	2,875	140	2,735
	119,278	30,561	88,717
USA:			
Petroleum and natural gas properties and equipment	101,430	12,332	89,098
Other	870	6	864
	102,300	12,338	89,962
	$ 221,578	$ 42,899	$ 178,678

Costs associated with unproven properties excluded from costs subject to depletion amounted to $78,227,605 (December 31, 2006 - $72,755,560). Of the total excluded costs, $48,915,338 (December 31, 2006 - $55,443,939) related to Canada and $29,312,267 (December 31, 2006 - $17,311,621) to the United States.

Future development costs of $16,892,436 (December 31, 2006 - $23,118,400) have been included in the costs subject to depletion, of which $4,364,700 (December 31, 2006 - $7,244,700) is related to Canada and $12,527,736 (December 31, 2006 - $15,873,700) to the United States.

The Company capitalized $171,841 (2006 - $177,791) of direct general and administrative costs related to petroleum and natural gas properties in the nine months ended September 30, 2007. In addition, the Company capitalized $170,835 (2006 - $200,347) of stock based compensation during the same period.

During the nine months ended September 30, 2007, the Company purchased the remaining working interests in certain petroleum and producing assets in the Corbett Creek area of Alberta for $2,800,000. In addition, the Company sold certain non-core conventional oil and gas assets and facilities for net proceeds of $14,828,691 and seismic for $1,680,000

6. BANK DEBT

As at September 30, 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 $58,568,394 (December 31, 2006 – 52,348,715) on the facility. The revolving credit facility bears interest at the lender's base, US and CDN prime rate or Libor plus 0.0 to 1.5 percent depending on the level of facility utilization. The effective interest rate on amounts outstanding under the credit facility at September 30, 2007 was 7.29 percent (2006 – 7.78 percent).

The credit facility, which is collateralized by a fixed charge on the Company's United States assets and a floating charge on its Canadian assets, requires the Company to maintain certain financial covenants and ratios. At September 30, 2007, the Company was in non-compliance with respect to a "consolidated leverage ratio" as defined in the credit agreement. Non-compliance with the ratio was formally waived by the lender. Based on projected fourth quarter 2007 operating results, the Company expects to be in compliance with the consolidated leverage ratio at year-end 2007. The Company is also currently in negotiations to divest of additional non-core assets and will utilize proceeds to reduce long term debt.

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 September 30, 2007, the estimated total undiscounted amount required to settle the asset retirement obligations, adjusted for 2.0 percent inflation, is $12.4 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:

($000s)		
Balance, December 31, 2006	$	5,763
Liabilities incurred		374
Liabilities incurred on Corbett creek area acquisition (note 5)		83
Liabilities disposed		(1,735)
Revision to assumptions		12
Accretion expense		228
Balance, September 30, 2007	$	4,725

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		Amount ($000s)
Balance, December 31, 2006	58,386,035	$	157,983
Exercise of share purchase warrants	900,000		954
Exercise of stock options	12,000		42
Balance,September 30, 2007	59,298,035	$	158,979

During the nine months ended September 30, 2007, 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. In addition, 12,000 stock options were exercised to purchase an equivalent number of common shares at $3.54 per share.

The weighted average number of shares outstanding is as follows:

	Three Months Ended September 30		Nine Months Ended September 30	
	2007	2006	2007	2006
Weighted average basic	59,298,035	58,286,035	59,226,466	49,841,396
Weighted average diluted	59,298,035	58,286,035	59,226,466	49,841,396

(c) Share Purchase Warrants

The Company had 912,000 performance warrants, of which 376,800 were forfeited during the three months ended September 30, 2007. The remaining 535,200 performance warrants have 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 basis. 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 at the date of the grant. Once the performance condition becomes likely, 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. 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.

A reconciliation of warrants is provided below;

(000s)	Number of Warrants		Amount
Balance, December 31, 2006	2,340	$	2,494
Exercise of warrants	(900)		(504)
Balance, September 30, 2007	1,440	$	1,990

(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 an aggregate of 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	667,000	$ 3.88
Exercised	(12,000)	$ 3.54
Forfeited	(825,000)	$ 3.87
Outstanding, September 30, 2007	4,797,700	$ 4.18
Exercisable, September 30, 2007	2,486,059	$ 4.40

The following table summarizes information about stock options outstanding at September 30, 2007.

Range of Exercice Price	Stock Options Outstanding	Weighted Average Remaining Term (Years)	Stock Options Exercisable
$2.30 to $3.95	1,929,200	4.52	441,727
$4.19 to $4.77	2,460,100	2.83	1,862,600
$5.00 to $5.68	388,400	3.07	175,066
$7.38 to $7.40	20,000	3.29	6,666
	4,797,700	3.51	2,486,059

(e) Stock-Based Compensation

The fair value of stock options granted is estimated using the Black-Scholes option pricing model. Weighted average assumptions and resulting fair value for stock options granted during the nine months ended September 30, 2007 are as follows:

	2007
Risk free interest rate (%)	3.5
Expected life (years)	5.0
Expected volatility (%)	45
Weighted average fair value per share ($)	1.75

During the three and nine months ended September 30, 2007, the Company recorded stock-based compensation of $563,431and $1,453,363 (2006 - $319,181 and $1,140,604), respectively, related to options granted under the formal stock option plan, of which $513,816 and $1,282,528 (2006 - $259,613 and $971,472) was recognized as an expense and $50,615 and $170,835 (2006 - $59,568 and $169,132) was capitalized to property and equipment.

(f) Contributed Surplus

The following table reconciles the Company's contributed surplus.

($000s)		
Balance, December 31, 2006	$	6,035
Stock-based compensation costs		1,454
Balance, September 30, 2007	$	7,489

9. FOREIGN EXCHANGE

During the three and nine months ended September 30, 2007, the Company recognized a net foreign exchange gain of $450,833 and $2,804,663 (2006 – net loss of $10,986 and net gain of $568,126), respectively, of which a net gain of $403,835 and $1,552,702 (2006 – net gain of $27,180 and net loss of $280,499) was unrealized during the respective periods. The amounts recorded reflect the impact of fluctuations in the Canadian/United States exchange rate on monetary assets and liabilities and on revenue and expenses of the Company that are denominated in United States dollars.

10. SUPPLEMENTAL CASH FLOW INFORMATION

Change in non-cash working capital for the three and nine months ended September 30 was as follows:

	Three Months Ended September 30				**Nine Months Ended September 30**			
($000s)		**2007**		**2006**		**2007**		**2006**
(Decrease) increase in non-cash working capital								
Accounts receivable	$	(2,055)	$	(1,981)	$	(1,708)	$	(3,974)
Inventory		(224)		(1,462)		(525)		(3,126)
Prepaid and deposits		1,837		(383)		1,054		(1,446)
Accounts payable and accrued liabilities		2,186		7,604		720		17,449
Less working capital deficiency on business acquisition		-		-		-		(883)
Net change in non-cash working capital	$	1,744	$	3,778	$	(459)	$	8,020
Relating to:								
Operating activities	$	258	$	7,218	$	(3,587)	$	10,027
Investing activities		1,486		(3,440)		3,128		(2,007)
Net change in non-cash working capital	$	1,744	$	3,778	$	(459)	$	8,020

11. COMMITMENTS

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

		2007		**2008**		**2009**		**2010**		**2011**		**Total**
Canada: *($000s)*												
Office lease	$	123	$	506	$	542	$	568	$	426	$	2,165
Equipment usuage		1,074		2,376		2,376		874		-		6,700
	$	1,197	$	2,882	$	2,918	$	1,442	$	426	$	8,865
USA *(US$000s)* **:**												
Office lease	$	7	$	31	$	10	$	-	$	-	$	48

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 September 30, 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
Sell	3000 MMbtu	US $7.40/MMbtu	November 2007 - October 2008
Sell	2000 GJ	CDN $7.43/GJ	January 2008 - December 2008
Purchase	2,000 GJ	Cdn $7.07/GJ	April 2007 - October 2007

The estimated fair value of these contracts as at September 30, 2007 is a gain of $1,367,722, which has not been recognized in 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 tables reflect segmented information as at and for the three and nine months ended September 30, 2007 and 2006.

($000s)	Canada	United States	Total
Three months ended September 30, 2007			
Net revenue	$ 3,140	$ 5,519	$ 8,659
Net income (loss)	(2,685)	872	(1,813)
Net capital expenditures	4,139	7,166	11,305
Nine months ended September 30, 2007			
Net revenue	8,831	16,511	25,342
Net income (loss)	(6,576)	3,556	(3,020)
Net capital expenditures	(3,729)	22,943	19,214
As at September 30, 2007			
Property and equipment	79,090	104,541	183,631
Total assets	150,548	52,230	202,778

($000s)	Canada	United States	Total
Three months ended September 30, 2006			
Net revenue	$ 4,726	$ 4,621	$ 9,347
Net income (loss)	(1,259)	462	(798)
Net capital expenditures	(2,305)	6,082	3,777
Nine months ended September 30, 2006			
Net revenue	6,577	15,176	21,753
Net income (loss)	(3,503)	2,449	(1,054)
Net capital expenditures	103,638	26,497	130,135
As at September 30, 2006			
Property and equipment	151,886	87,775	239,661
Total assets	185,211	78,740	263,951

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 nine months ended September 30, 2007, the Company sold certain non-core properties to Avenir Operating Corp. for $7.2 million. The measurement basis used for the transaction was an independent reserves valuation as at December 31, 2006. The transaction value was also compared with current market sales metrics from an independent public source. The asset sale transaction was a cash transaction and did not include any ongoing contractual or other commitments. Management considers the nature of the transaction to be in the normal course of its operations.

14. COMPARATIVE AMOUNTS

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

CORPORATE INFORMATION

TSX - CBM

Board of Directors

William Gallacher, Chairman
Duncan Chisholm
J.G. (Jeff) Lawson
Gary Dundas
Michael Dilger
Kevin Wolfe
David Butler

Officers

Duncan Chisholm
President and CEO

David Burton
Vice President Engineering

William Dawidowski
Vice President Finance and CF O

Edward Marcinew
Vice President Exploration

Lindsay Goos
Controller

Banker

Union Bank of California

Legal Counsel

Burnet, Duckworth & Palmer, LLP

Auditor

Ernst & Young, LLP

Registrar and Transfer Agent

Olympia Trust Company

Independent Evaluation Engineer

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