



*Building Value in Venezuela*

## MANAGEMENT DISCUSSION & ANALYSIS

### YEAR ENDED DECEMBER 31, 2007

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The following management discussion and analysis (“MD&A”) is prepared as of March 31, 2008. This MD&A, as provided by the management of PetroFalcon Corporation (“PetroFalcon” or the “Company”), should be read in conjunction with the Company’s audited consolidated financial statements for the years ended December 31, 2007, and December 31, 2006. These financial statements have been prepared in accordance with Canadian generally accepted accounting principles (“Canadian GAAP”). Estimates and forward-looking information are based on assumptions of future events and actual results may vary from these estimates.

All dollar amounts are expressed in US dollars (“USD”).

Effective January 1, 2008, the currency unit of the monetary system of Venezuela dropped three zeros, and all amounts are now denominated in a new smaller scale of Bolívars under the temporary name of “Bolívars Fuertes”, which after a period of time will revert to the name Bolívars. For the year ended December 31, 2007, transactions and balances using Venezuelan Bolívars Fuertes (“BsF”) are converted into USD at the implied exchange rate of 5.74 BsF/USD rather than the official exchange rate of 2.15 BsF/USD.

For the purposes of calculating mixed company production, natural gas has been converted to a barrel of oil equivalent (“boe”) using a conversion rate of six thousand cubic feet (“mcf”) equal to one barrel (6:1).

## CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION

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Forward-looking information and statements are included through this MD&A and include, but are not limited to statements with respect to the mixed companies (“Empresas Mixtas”) PetroCumarebo and Baripetrol; the gas licenses Cardon III and Cardon IV; royalty payments; oil and natural gas production; general and administrative expenses; future income tax; future drilling; planned growth and development; contractual obligations; new projects; forecasted production; future plans; objectives and results. The above constitute forward-looking information within the meaning of applicable Canadian securities legislation, which involve risks, uncertainties and assumptions including, without limitation, risks associated with operating exclusively in a foreign jurisdiction; being a minority partner in an Empresa Mixta; being dependent on dividends from an Empresa Mixta; the imposition of higher royalties and income taxes; the impact of general economic conditions in Venezuela and world-wide; industry conditions including the adoption of environmental, tax and other laws and changes in how they are interpreted and enforced; the existence of operating risks in finding, developing and producing oil and natural gas; volatility of oil and natural gas prices; oil and natural gas product supply and demand; processing facility access; risks inherent in the ability to generate sufficient cash flow from operations to meet current and future obligations; stock market volatility; commodity prices; interest rates; opportunities available to or pursued by the Company; and other factors, many of which are beyond our control.

All such forward-looking information is based on certain assumptions and analyses made by us in light of our experience and perception of historical trends, current conditions and expected future developments, as well as other factors we believe are appropriate in the circumstances. The foregoing factors are not exhaustive and are further discussed in PetroFalcon’s most recent annual information form available on SEDAR at [www.sedar.com](http://www.sedar.com). Actual results, performance or achievements could differ materially from those expressed in, or implied by, such forward-looking information and, accordingly, no assurance can be given that any of the events anticipated by the forward-looking information will transpire or occur, or if any of them do so, what benefits will be derived there from. Investors should not place undue reliance on forward-looking information. Statements relating to “reserves” or “resources” are also deemed to be forward-looking information as they involve the implied assessment, based on certain estimates and assumptions that the resources and reserves described can be profitably produced in the future. Except as required by law, PetroFalcon Corporation and its subsidiaries expressly disclaim any intention or obligation to update or revise any forward-looking information, whether as a result of new information, future events or otherwise. In the event subsequent events prove past statements about current trends to be materially different, we may choose to issue a news release explaining the reasons for the difference and update the guidance on the anticipated impact on revenue, earnings and other key events.

The information contained in this MD&A is expressly qualified by this cautionary statement.

## **CURRENT STATUS OF PETROFALCON**

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PetroFalcon Corporation is engaged in the exploration, development, production and management of oil and natural gas properties.

### **PetroCumarebo Background**

Through its wholly-owned subsidiary, Vinccler Oil and Gas, C.A. (“Vinccler Venezuela”), PetroFalcon owns 40% of the mixed company (“Empresa Mixta”), PetroCumarebo, S.A. (“PetroCumarebo”). PetroCumarebo operates the East and West Falcon blocks in north-western Venezuela and has current onshore production of oil and natural gas.

PetroFalcon’s revenues for the three months ended March 31, 2006, were derived from the East Falcon Block under the Operating Service Agreement (“East Falcon OSA”) with Petróleos de Venezuela, S.A. (“PDVSA”). Effective March 21, 2006, Vinccler Venezuela completed the acquisition of West Falcon Hydrocarbons, S.R.L. (“West Falcon”), a subsidiary of Samson International LLC, which owned a separate Operating Service Agreement for the West Falcon Block (“West Falcon OSA”).

On September 29, 2006, Vinccler Venezuela and Corporación Venezolana del Petróleo (“CVP”), an affiliate of PDVSA, executed the Empresa Mixta Conversion Agreement (“Conversion Contract”), which identified PetroCumarebo and confirmed the ownership structure as 40% held by Vinccler Venezuela and 60% held by CVP. Under the terms of the Conversion Contract, Vinccler Venezuela’s East Falcon OSA and West Falcon OSA were contributed to the Empresa Mixta PetroCumarebo effective April 1, 2006. The Conversion Contract also established the following general terms for PetroCumarebo:

- The effective date of PetroCumarebo is April 1, 2006;
- PetroCumarebo has the exclusive right to explore for, develop and produce oil and natural gas in its area of operations (838,000 acres) for a term of 20 years;
- PetroCumarebo can only sell its oil and natural gas production to PDVSA;
- PetroCumarebo pays a royalty of 33.3% on oil and natural gas production;
- PetroCumarebo has an applicable income tax rate of 50%;
- PetroCumarebo pays a “special advantage” tax, which requires that if in any year the aggregate amount of royalties, taxes and certain other contributions is less than 50% of the gross value of the hydrocarbons produced, PetroCumarebo must pay the Venezuelan government the difference;
- Vinccler Venezuela, as a 40% shareholder, will be responsible for 40% of PetroCumarebo’s capital expenditures and operating expenses, if no other means of financing is available to the mixed company; and

- When there are sufficient net and available profits, and subject to the prior approval of the shareholders, Vinccler Venezuela may receive annual dividends in US dollars, or quarterly loans against those projected dividends, derived from its 40% participation.

### **PetroCumarebo Accounting**

Historically, PetroFalcon has considered its investment in and relationship with PetroCumarebo to be one of joint control and accordingly has accounted for its 40% interest in PetroCumarebo using proportional consolidation. In effect, PetroFalcon recognized 40% of PetroCumarebo's revenues, expenses, assets and liabilities in PetroFalcon's financial statements.

In 2007, PetroFalcon re-evaluated its relationship with PetroCumarebo and concluded that, for accounting purposes, PetroFalcon's investment in PetroCumarebo does not currently meet the criteria for proportional consolidation or equity method accounting. Accordingly, PetroFalcon has accounted for PetroCumarebo using the cost method of accounting for the year ended December 31, 2007. Under the cost method, PetroFalcon does not recognize its 40%-share of revenues, expenses, assets or liabilities from PetroCumarebo and instead only recognizes income from the investment to the extent that dividends are declared by PetroCumarebo. As a result, PetroFalcon has no revenues for the year ended December 31, 2007, and has restated the first three quarters of 2007. For the year ended December 31, 2008, the Company intends to provide restated comparable quarters for the previous periods.

Despite this change for accounting purposes, PetroFalcon remains an oil and gas company carrying on active operations in Venezuela, and Management does not consider PetroFalcon to be a company with only passive investments.

As a consequence of adopting the cost method of accounting, certain continuous disclosure for the year ended 2007 varies from that provided in 2006, including continuous disclosure relating to oil and gas operations. However, Management of PetroFalcon has determined that, because PetroFalcon remains an oil and gas company carrying on active operations in Venezuela, it is important to provide comparative and relevant oil and gas information in the MD&A, where possible. Therefore, disclosure in the MD&A will provide relevant oil and gas information in respect of its 40% working interest in PetroCumarebo to the extent possible. This information will be based upon unaudited information provided by PetroCumarebo to Management and upon a 51-101 compliant technical report obtained by Management of PetroFalcon.

### **Venezuelan Currency Exchange Rate**

During the year, the Company reviewed the accounting for foreign currency transactions in Venezuela due to the increasing spread between the official rate and the implied market rate in Venezuela. It has been determined that as a consequence of the rapid decline in the valuation of the Venezuelan Bolivar as reflected in the implied market for foreign currencies in Venezuela that the method of translation from Bolivars to US dollars using the official rate is no longer appropriate. As a result of this review, Management determined that Bolivar balances would be translated at implied market rates for the year ended December 31, 2007.

Recognizing the implied exchange rate of 5.74 BsF/USD in 2007 rather than the official exchange rate of 2.15 BsF/USD significantly decreases PetroFalcon's short-term Bolivar-

denominated debt when converted to US dollars. The recognition of the implied exchange rate also eliminates PetroFalcon's gain on currency transactions during the year.

### **Lundin Transaction**

On February 1, 2008, PetroFalcon acquired 100% of the issued and outstanding shares of Lundin Venezuela, which owns 5% of Baripetrol, a mixed company with PDVSA, Tecpetrol de Venezuela, S.A. ("Tecpetrol") and Perenco Oil and Gas International Limited ("Perenco"). The Company acquired Lundin Venezuela from Lundin Petroleum BV ("Lundin BV"), a wholly-owned subsidiary of Lundin Petroleum AB ("Lundin Petroleum"), in consideration for the issuance of 57,254,505 common shares of the Company at a price of CDN\$0.80 per share. At closing, Lundin Venezuela had approximately \$22 million in cash.

Concurrent with the acquisition, Lundin BV subscribed for 6,665,995 units of PetroFalcon at a purchase price of CDN\$0.80 per unit, resulting in additional proceeds to the Company of approximately \$5.1 million. Each unit consists of one common share and approximately 0.75 warrants, such that Lundin BV now holds an aggregate of 5 million warrants. Each whole warrant expires on February 1, 2010, and is exercisable for one common share of PetroFalcon upon payment of CDN\$1.20 per share.

In total, Lundin BV has acquired 63,920,500 common shares, representing 42% of the issued and outstanding common shares of PetroFalcon on an undiluted, post-closing basis, plus 5 million warrants of the Company. All of PetroFalcon's outstanding stock options vested immediately at the closing of the transactions with Lundin BV due to the change of control provision in the stock option agreements.

On March 4, 2008, Lundin Venezuela received a \$1.9 million dividend from Baripetrol for operations between January and September 2007. According to the sale and purchase agreement between PetroFalcon and Lundin BV, all Baripetrol dividends received by Lundin Venezuela for 2007 are for the benefit of PetroFalcon.

The above transactions with Lundin BV and the dividend received from Baripetrol have been treated as subsequent events and do not appear in PetroFalcon's 2007 year-end financial statements.

### **PetroFalcon Production Update**

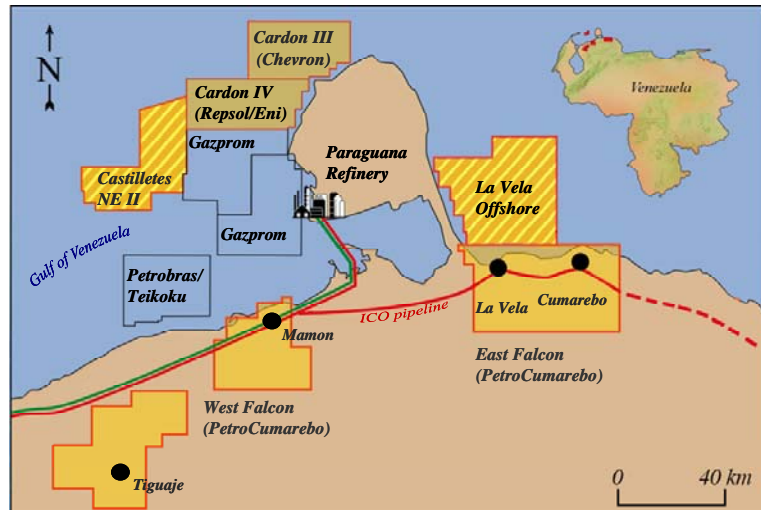
PetroFalcon's total working interest production before royalties, including both PetroCumarebo and Baripetrol, is now approximately 1,000 bbls/d of oil and 6 mmcf/d of natural gas, or 2,000 boe/d. Depending on the results of the mixed company drilling programs, PetroFalcon's total working interest production before royalties is estimated to significantly increase by the end of 2008 to approximately 1,550 bbls/d of oil and 10 mmcf/d of natural gas, or 3,233 boe/d.

## New Business Update – Exploration

### *Chevron – Cardon III Block*

Subject to the approval of the Venezuelan Ministry of Energy and Petroleum (“MEP”), PetroFalcon is acquiring a 30% interest from Chevron Corporation (“Chevron”) in the offshore natural gas license for the Cardon III Block (“Cardon III”) in the Gulf of Venezuela. The Company anticipates that the transaction will be completed in 2008.

The acquisition of 530 square kilometers of 3D seismic data over the Cardon III Block was completed in April 2007. The data is now being processed, and a drilling decision for an exploration well is expected in mid-2008, with a likely spud date in early 2009. A jack-up rig is being secured with a multi-operator group from adjoining blocks in the Gulf of Venezuela. If successful, first commercial production of natural gas is expected in 2011.



### *Repsol YPF – Cardon IV Block*

PetroFalcon is also acquiring a 25% interest from Repsol YPF, S.A. (“Repsol”) in the offshore natural gas license for the Cardon IV Block (“Cardon IV”) in the Gulf of Venezuela. The Cardon IV transaction is subject to the negotiation and execution of a sale and purchase agreement, as well as the approval of MEP and Eni, SpA (“Eni”), The Company anticipates that the transaction will be completed in 2008, subject to the above conditions.

The acquisition of 700 square kilometers of 3D seismic data over the Cardon IV Block was completed in February 2007. The data is now being interpreted, and a drilling decision for an exploration well is expected in mid-2008, with a likely spud date in mid-2009. A jack-up rig is being secured with a multi-operator group from adjoining blocks in the Gulf of Venezuela. If successful, first commercial production of natural gas is expected in 2011.

## **PETROCUMAREBO 2007 Q4 PRODUCTION**

### **ICO Pipeline Update**

PetroCumarebo delivers natural gas into PDVSA’s Interconnection Centro Occidente (“ICO”) natural gas pipeline, which then transports the natural gas to the nearby Paraguana Refinery Complex. On December 6, 2006, PDVSA’s ICO pipeline experienced a joint rupture between the La Vela and Cumarebo valve stations, and PDVSA closed the pipeline section leading to PetroCumarebo’s East Falcon Block. In August 2007, PetroCumarebo began delivering natural

gas from the La Vela Field into the ICO pipeline. Deliveries from the Cumarebo field resumed in February 2008, and repairs to the ICO pipeline are now complete.

**PetroCumarebo Production Summary:**

	<b>PetroCumarebo (Gross)</b>	<b>PetroFalcon (Net)</b>	
	<b>Three months ended Dec 31, 2007</b>	<b>Three months ended Dec 31, 2007</b>	<b>Three months ended Dec 31, 2006</b>
<b>Daily production</b>			
Oil - bbls/d	903	361	347
Natural gas - mcf/d	9,678	3,871	3,278
<b>Total – boe/d</b>	<b>2,516</b>	<b>1,006</b>	<b>893</b>

Note: Production is shown before royalties. PetroFalcon, through Vinccler Venezuela, owns 40% of PetroCumarebo.

As detailed in the table above, PetroCumarebo’s average gross production from both the East Falcon and West Falcon blocks for the three months ended December 31, 2007, was 2,516 boe/d. PetroFalcon’s 40% share before royalties was 1,006 boe/d. For the comparable period ended December 31, 2006, PetroCumarebo’s average production was 2,232 boe/d, PetroFalcon’s 40% share before royalties being 893 boe/d.

PetroCumarebo’s oil and natural gas production is delivered to PDVSA, and PetroCumarebo expects to receive payment for its deliveries as outlined in the Conversion Contract. The price per barrel of crude oil delivered is derived from detailed formulas outlined in the Conversion Contract that are specific to the quality and gravity of crude oil delivered, and are based on different weightings of several global benchmark oil prices. These formulas equate on average to a price that is approximately 100% of WTI for East Falcon oil and 85% of WTI for West Falcon oil. PetroCumarebo produces light sweet crude oil that sells at a premium to most of the oil produced in Venezuela.

Payment from PDVSA to PetroCumarebo is 100% in US dollars for crude oil and natural gas liquids and will be 100% in Bolivars for natural gas. Potential dividends from PetroCumarebo to Vinccler Venezuela will be 100% in US dollars and are at the discretion of the shareholders of PetroCumarebo, depending on net and available profits.

**PETROFALCON FINANCIAL STATEMENTS**

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**Please see “Current Status of PetroFalcon”.**

The following expense items refer to the corporate expenses of PetroFalcon and are not comparable to the prior periods in 2006, which were recorded under the proportional consolidation method of accounting. Under the cost method of accounting adopted for the year ended 2007, PetroFalcon is no longer recognizing its 40% share of revenues, expenses, assets or liabilities from PetroCumarebo and instead only recognizes income to the extent that dividends are declared by PetroCumarebo. As a result, PetroFalcon has no revenues for the year ended

December 31, 2007, and has restated the first three quarters of 2007. To date, no dividends have been declared by PetroCumarebo.

## **GENERAL AND ADMINISTRATIVE (“G&A”) EXPENSE**

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**Please see “Current Status of PetroFalcon”.**

PetroFalcon’s general and administrative expenses were \$1,539,572 during the three months ended December 31, 2007, as compared to \$1,116,404 during the three months ended December 31, 2006. PetroFalcon’s G&A expenses were \$5,065,369 during the year ended December 31, 2007, as compared to \$2,951,380 during the year ended December 31, 2006.

The increase in G&A expense is mainly due to increased accounting, tax and legal expenses during the year related to the Lundin transaction. In addition, in 2007, PetroFalcon recognized the full cost of consultants and employees either seconded to PetroCumarebo or under the technical service agreement between Vinccler Venezuela and PetroFalcon. During the year ended December 31, 2007, Management made a \$0.9 million provision in general and administrative expenses, which included: a) \$0.5 million for invoices between July and December 2006 under the technical service agreement between Vinccler Venezuela and PetroFalcon. Under the terms of the Conversion Contract, the technical service agreement was transferred from Vinccler Venezuela to PetroCumarebo on April 1, 2006. PetroCumarebo paid PetroFalcon for technical service invoices in April, May and September 2006, but Management is currently renegotiating the terms of this contract and may not be able to collect from PetroCumarebo on subsequent amounts; and b) \$0.4 million for the difference between the sale price and the book value related to inventories sold by Vinccler Venezuela to PetroCumarebo.

PetroFalcon does not capitalize general and administrative expenses.

## **DEPRECIATION, DEPLETION AND AMORTIZATION (“DD&A”) EXPENSE**

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**Please see “Current Status of PetroFalcon”.**

PetroFalcon’s depreciation, depletion and amortization expenses were \$26,683 during the three months ended December 31, 2007, as compared to \$89,929 during the three months ended December 31, 2006. PetroFalcon’s DD&A expenses were \$123,938 during the year ended December 31, 2007, as compared to \$1,696,762 during the year ended December 31, 2006.

PetroFalcon’s three months and year ended December 31, 2007, is not comparable to the periods in 2006 due to the adoption of cost method accounting in 2007. Under the cost method of accounting, PetroFalcon is no longer recognizing its 40% share of revenues, expenses, assets or liabilities from PetroCumarebo and instead only recognizes income to the extent that dividends are declared by PetroCumarebo. In 2006, PetroFalcon used the proportional consolidation method, which resulted in the recognition of 40% of PetroCumarebo’s revenues, expenses, assets and liabilities.

## STOCK-BASED COMPENSATION

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During the three months ended December 31, 2007, the Company recorded \$276,934 in stock-based compensation expense as compared to \$919,916 during the three months ended December 31, 2006. During the year ended December 31, 2007, the Company recorded \$2,046,665 in stock-based compensation expense as compared to \$2,809,668 during the year ended December 31, 2006. The higher stock-based compensation expense in 2006 was due to a greater number of stock options vesting during the periods.

All of the Company's outstanding stock options immediately vested at the closing of the Lundin transaction on February 1, 2008. PetroFalcon's stock options agreements have a change of control provision that causes all stock options to vest immediately when more than 20% of the Company is purchased.

## INTEREST INCOME AND EXPENSE

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At December 31, 2007, PetroFalcon had \$4.8 million in cash and short-term deposits compared to \$11.9 million at December 31, 2006. During the three months ended December 31, 2007, the Company recorded interest income in the amount of \$59,755 as compared to \$124,145 during the three months ended December 31, 2006. During the year ended December 31, 2007, the Company recorded interest income in the amount of \$279,789 as compared to \$328,020 during the year ended December 31, 2006.

PetroFalcon incurred interest expense of \$320,427 during the three months ended December 31, 2007, as compared to \$468,077 during the three months ended December 31, 2006. During the year ended December 31, 2007, the Company recorded interest expense in the amount of \$1,414,568 as compared to \$2,186,973 during the year ended December 31, 2006. The decrease in interest expense is primarily due to the conversion of the outstanding debt from the World Bank's private investment arm, the International Finance Corporation ("IFC").

## INCOME TAXES

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(\$000s)	Three months ended December 31, 2007	Three months ended December 31, 2006
Consolidated Current Income Tax Expense	82	460
Future Income Tax	-	55

(\$000s)	Year ended December 31, 2007	Year ended December 31, 2006
Consolidated Current Income Tax Expense	82	1,016
Future Income Tax	-	343

During the three month period ended December 31, 2007, PetroFalcon recorded a current income tax expense adjustment of \$81,927 (100% Vincler Oil and Gas Corporation), compared to

\$459,654 during the three months ended December 31, 2006. During the year ended December 31, 2007, PetroFalcon recorded a current income tax expense of \$81,927, compared to \$1,015,632 in the year ended December 31, 2006.

During the three months ended December 31, 2007, the Company realized no future income tax, compared to \$55,401 of net future income tax assets recorded during the three months December 31, 2006, related to carry-forward losses of PetroFalcon and Vinccler Oil and Gas Corporation. During the year ended December 31, 2007, the Company realized no future income tax, compared to \$343,428 of net future income tax assets recorded during the year ended December 31, 2006, related to carry-forward losses of PetroFalcon and Vinccler Oil and Gas Corporation.

Effective October 30, 2007, PetroFalcon Corporation and its wholly-owned Canadian subsidiary, Vinccler Oil and Gas Corporation, were amalgamated and continued as PetroFalcon Corporation.

## **PETROFALCON 2007 CAPITAL EXPENDITURES**

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Please see “Current Status of PetroFalcon”.

### **PetroCumarebo 2007 Capital Expenditures**

The following table outlines PetroCumarebo’s capital expenditures for the year ended December 31, 2007. The “PetroCumarebo 2007 Budget” represents the initial gross budget of PetroCumarebo, of which Vinccler Venezuela was responsible for 40%. To date, PetroCumarebo’s capital expenditures have been funded without cash calls to Vinccler Venezuela.

(\$000s)	PetroCumarebo 2007 Budget	PetroFalcon 40% Share	Incurred As of December 31, 2007
<b>Drilling and Work-overs</b>			
- La Vela	14,700	5,880	27,244
- Cumarebo	5,700	2,280	Nil
- West Falcon	Nil	Nil	Nil
- Total Drilling and Work-overs	20,400	8,160	27,244
<b>Processing Facilities and Infrastructure</b>			
- La Vela	4,400	1,760	5,174
- Cumarebo	2,800	1,120	2,512
- West Falcon	Nil	Nil	Nil
- Total Central Processing Facilities	7,200	2,880	7,686
<b>Total Capital Expenditures</b>	<b>27,600</b>	<b>11,040</b>	<b>34,930</b>

Since beginning drilling operations in the La Vela Field with the LV-11 well in late November 2006, PetroCumarebo has drilled eleven development wells in the La Vela Field and three in the Cumarebo Field.

The initial PetroCumarebo 2007 budget contemplated the drilling of eight wells in the La Vela Field and three shallow wells in the Cumarebo Field. In July 2007, the Board of Directors of PetroCumarebo approved an updated drilling program due to the delay in the ICO pipeline

repairs. At that time, PetroCumarebo decided to continue drilling in La Vela with two additional shallow wells, LV-19 and LV-20, and one deeper well, LV-21.

### *La Vela Drilling*

The drilling of wells LV-11 through LV-18 were previously discussed in detail. In November 2007, PetroCumarebo finished drilling the LV-19, LV-20 and LV-21 wells.

The LV-19 well was drilled directionally from Platform A toward the southern flank of the La Vela south anticline. It is now producing 3 mmcf/d.

The LV-20 well was drilled as a vertical well on a new pad located in the south-eastern flank of the La Vela south anticline, up-dip from LV-6X. The well was drilled to a total depth of 3,616 feet through the Socorro formation basal sands, with high gas shows and gas cut mud. These sands, also present in LV-10 and LV-6X, are composed of two sand bodies between 3,505 feet and 3,540 feet, with a total net hydrocarbon bearing section of 27 feet, according to the wireline logs. The well will be tested in these prospective sands, which, if successful, will represent a new reservoir in the La Vela south field. The well also encountered approximately 20 feet of hydrocarbon bearing sands in the Caujarao formation similar to those already tested in previous wells.

The LV-21 is a deep well (8,500 feet) designed to test the prospectivity of the Cerro Pelado and Pedregoso formations in the eastern part of the La Vela south anticline. These formations were previously evaluated with the LV-6X and LV-10 wells, in the southern and western flanks of the La Vela south anticline. The well was drilled as a J-type deviated well with a north-northwest direction from the same platform where LV-20 was drilled. According to logs run while drilling, the well encountered the Cerro Pelado formation at 5,055 feet, finding at least 25 feet of hydrocarbon bearing sands. These same sands have been on production from the nearby LV-6X well. The Pedregoso formation was found at 6,360 feet with 15 feet of gas bearing sands at the top of the formation, equivalent to those which tested gas in LV-6X. A total of 84 feet of oil bearing sands, equivalent to those already tested in LV-6X and LV-10, were found between 7,300 and 7,800 feet.

PetroCumarebo recently moved the rig to the Cumarebo Field and has recently finished drilling the CU-171 well. The LV-20, LV-21 and CU-169 wells will be tested soon.

### *Cumarebo Drilling*

The CU-169 well was drilled vertically to a total depth of 3,174 feet, as a development well for sands 8, 9 and 10, in a faulted block in the north-eastern part of the Cumarebo Field. The well found sands 8 and 9 to be gas-bearing, and sand 10 to be absent due to faulting. The well will be tested soon.

The CU-170 well was drilled as a development well for sand 15, a gas and condensate reservoir in the north-eastern part of the field. The well was drilled as a J-type well, paralleling the trajectory of CU-141, a well drilled in 1954 but not tested because of the lack of a market for gas at that time in the region. The well encountered 94 feet of gas-bearing sand at a depth of 5,296 feet. The well will be tested soon.

The CU-171 well is an appraisal well drilled from the same location as CU-170, but directed towards the north-east, with the objective of extending the 15-sand gas and condensate reservoir. At the time of this MD&A, the well is drilling directionally at 5,700 feet with the entry point in sand 15 expected at 5,800 feet. If successful, the well will add significant reserves to the 15-sand gas condensate reservoir.

### **Cardon III 2007 Capital Expenditures**

The following table outlines the Cardon III Block's capital expenditures for the year ended December 31, 2007, of which Vinccler Venezuela was responsible for 30%.

(\$MM)	<b>Cardon III 2007 Expenditures</b>	<b>PetroFalcon 30% Share</b>
3-D Seismic and Processing	8.0	2.4
Surface Rental, G&A, etc.	2.7	0.8
<b>Total Capital Expenditures</b>	<b>10.7</b>	<b>3.2</b>

Because the acquisition of Lundin Venezuela was subsequent to December 31, 2007, Baripetrol's 2007 capital expenditures have not been included herein.

### **PETROFALCON 2008 CAPITAL EXPENDITURES BUDGET**

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#### **PetroFalcon Summary 2008 Budget:**

(\$MMs)	<b>PetroFalcon Net Share</b>
PetroCumarebo	12.0
Baripetrol	3.0
Cardon III	1.6
Cardon IV	1.3
<b>PetroFalcon Total Budget</b>	<b>17.9</b>

The table above represents PetroFalcon's net share of the 2008 planned expenditures for each of PetroFalcon's oil and gas investments. The budgets for PetroCumarebo and Baripetrol are expected to be self-funded without cash calls to PetroFalcon. The Cardon III and Cardon IV investments are subject to MEP approval.

## PetroCumarebo 2008 Budget:

(\$000s)	PetroCumarebo 2008 Budget	PetroFalcon 40% Share
<b>Drilling and Work-overs</b>		
- La Vela	9,400	3,760
- Cumarebo	8,700	3,480
- West Falcon	400	160
- Total Drilling and Work-overs	18,500	7,400
<b>Processing Facilities and Infrastructure</b>		
- La Vela	4,230	1,692
- Cumarebo	3,770	1,508
- West Falcon	3,500	1,400
Total Processing Facilities and Infrastructure	11,500	4,600
<b>Total Capital Budget</b>	<b>30,000</b>	<b>12,000</b>

PetroCumarebo's board recently approved a 2008 capital expenditures budget of \$30 million (40% net to PetroFalcon being \$12 million). The work program will involve drilling four development wells in Cumarebo, six deeper development wells in La Vela and two exploration wells nearby Cumarebo and La Vela. The exploration wells, San Patricio and La Cruz South, will test two prospects with expected unrisks potential of 110 million barrels of oil and 100 billion cubic feet of natural gas reserves. The Pride 421 900 HP rig is on long-term contract to PetroCumarebo through 2008.

De-bottlenecking of the La Vela and Cumarebo processing facilities will continue in order to increase the gas processing plants capacities to 20 mmcf/d in La Vela and 30 mmcf/d in Cumarebo. The engineering work on the La Vela processing facilities commenced in 2007 and will continue in 2008.

## PetroCumarebo Production Update

The current gross production of PetroCumarebo is approximately 1,200 bbls/d of oil and 15 mmcf/d of natural gas, or 3,700 boe/d. Depending on the results of PetroCumarebo's drilling program, PetroCumarebo's 2008 budget of \$30 million is estimated to significantly increase production for the East Falcon and West Falcon blocks to approximately 2,000 bbls/d and 24 mmcf/d, or 6,000 boe/d.

## Baripetrol 2008 Budget:

(\$000s)	Baripetrol 2008 Budget	PetroFalcon 5% Share
<b>Seismic, Drilling and Work-overs</b>		
- Rosario	1,910	96
- La Palma	33,500	1,675
- Socuavo	13,290	664
- Los Manueles	1,890	95
- Bonito	370	18
- West Tarra	590	30
- Total Drilling and Work-overs	51,550	2,578
<b>Processing Facilities and Infrastructure</b>		
- Rosario	1,640	82
- La Palma	2,350	117
- Socuavo	1,430	72
- Los Manueles	1,140	57
- Bonito	1,000	51
- West Tarra	990	49
- Total Processing Facilities and Infrastructure	8,550	428
<b>Total Capital Budget</b>	<b>60,100</b>	<b>3,006</b>

Baripetrol's board of directors recently approved a 2008 capital expenditures budget of \$60 million (5% net to PetroFalcon being \$3 million). The work program includes four development wells in the La Palma field, a 165-square-kilometer 3-D seismic campaign in the Socuavo field and twenty work-overs in the La Palma, Rosario, Socuavo, Los Manueles, West Tarra and Bonito fields. A 2,000 HP Petrex drilling rig is scheduled to begin operations in April 2008 and is on long-term contract to Baripetrol through 2011.

The 2008 Processing Facilities and Infrastructure budget emphasizes the fire fighting equipment in all fields, the process digital control systems and the improvement of the safety and environment procedures.

## Baripetrol Production Update

The current gross production of Baripetrol is approximately 10,500 bbls/d of oil and 5 mmcf/d of natural gas, or 11,333 boe/d. Depending on the results of Baripetrol's drilling program, Baripetrol's 2008 budget of \$60 million is estimated to significantly increase production for the Colon Block to 15,000 bbls/d of oil and almost 10 mmcf/d of natural gas, or 16,666 boe/d.

### Cardon III 2008 Budget:

(\$MMs)	Cardon III 2008 Budget	PetroFalcon 30% Share
Area Leasing Annual Payment	0.46	0.14
3D Seismic Processing	0.30	0.09
Mapping, AVO, Subsurface Studies	4.49	1.35
<b>Total Capital Budget</b>	<b>5.25</b>	<b>1.58</b>

Vinccler Venezuela's acquisition of 30% of the offshore natural gas license for the Cardon III Block from Chevron is subject to MEP approval.

Following the evaluation of the 3D seismic data later this year, Chevron and Vinccler Venezuela will decide whether to proceed with an exploration well in 2009, at an additional estimated cost of \$9 million net to PetroFalcon. If successful, first commercial production of natural gas from Cardon III is expected in 2011.

### Cardon IV 2008 Budget:

(\$MM)	Cardon IV 2008 Budget	PetroFalcon 25% Share
Surface and License Fees	3.35	0.84
General & Administrative	1.82	0.45
<b>Total Capital Budget</b>	<b>5.17</b>	<b>1.29</b>

Vinccler Venezuela's acquisition of 25% of the offshore natural gas license for the Cardon IV Block from Repsol is subject to the approval of Eni and MEP, as well as the negotiation and execution of a sale and purchase agreement.

Following the evaluation of the 3D seismic data later this year, Repsol, Eni and Vinccler Venezuela will decide whether to proceed with an exploration well in 2009, at an additional estimated cost of \$15 million net to PetroFalcon, including a 2-for-1 promote under the terms of the farm-in agreement. If successful, first commercial production of natural gas from Cardon III is expected in 2011.

## LIQUIDITY AND CAPITAL RESOURCES

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As of March 31, 2008, PetroFalcon had 151,171,120 issued and outstanding common shares and 161,867,614 common shares on a fully diluted basis.

As of December 31, 2007, PetroFalcon had 86,581,336 issued and outstanding common shares and 97,377,830 common shares on a fully diluted basis. As of December 31, 2006, PetroFalcon had 86,331,336 issued and outstanding common shares and 96,837,830 common shares on a fully diluted basis.

As of December 31, 2007, PetroFalcon had \$4.8 million in cash and short-term deposits and working capital of \$2.1 million. As of December 31, 2007, PetroFalcon's total short-term debt was \$2.5 million and total long-term debt was zero. At December 31, 2006, PetroFalcon had \$11.9 million in cash and short-term deposits and working capital of \$4.3 million. At December 31, 2006, PetroFalcon had total current debt of \$11.9 million and total long-term debt of zero.

At December 31, 2007, PetroFalcon had \$2.4 million in accounts receivable compared to \$13.3 million at December 31, 2006. As of December 31, 2007, the Company had \$3.6 million in accounts payable compared to \$10.0 million at December 31, 2006.

At March 31, 2008, PetroFalcon had no material contractual obligations.

The planned growth and development activities for the next twelve months may require additional funds. PetroFalcon Management anticipates that these funds will be obtained from potential dividends from PetroCumarebo and Baripetrol, lines of credit and additional debt or equity securities financing. The Company cannot be certain that capital will be available when needed.

## SUMMARY OF QUARTERLY RESULTS

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The following table sets forth selected consolidated financial information of PetroFalcon for the last eight quarters:

(\$000s, except per share amounts)	2006				2007			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Revenue	3,129	NA	5,707	2,315	Nil	Nil	Nil	Nil
Net income (loss)	(1,181)	(1,700)	(1,313)	(2,502)	(2,305)	(3,538)	1,689	566
Earnings (loss) per share basic and diluted	(0.02)	(0.02)	(0.02)	(0.03)	(0.03)	(0.04)	0.02	0.01

Note: Q2 2006 revenue is shown as "NA", because PetroFalcon did not recognize revenue from PetroCumarebo during the three months ended June 30, 2006, since the Empresa Mixta conversion had not yet been completed. This revenue was subsequently recognized in Q3 2006.

PetroFalcon's financials during the year ended December 31, 2007, are not comparable to the periods in 2006 due to the adoption of the cost method of accounting in 2007. Under the cost method, PetroFalcon does not recognize its 40%-share of revenues, expenses, assets or liabilities from PetroCumarebo and instead only recognizes income from the investment to the extent that dividends are declared by PetroCumarebo. As a result, PetroFalcon has no revenues for the year ended December 31, 2007, and has restated the first three quarters of 2007. For the year ended December 31, 2008, the Company intends to provide restated comparable quarters for the previous periods.

## **RELATED PARTY TRANSACTIONS**

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Pacific Oil and Gas, LLC and Venezolana de Inversiones y Construcciones Clerico, C.A. (“Vinccler C.A.”) are controlled by officers of PetroFalcon. For the three months ended December 31, 2007, the Company was invoiced by Pacific Oil and Gas, LLC, controlled by PetroFalcon’s Vice Chairman, Clarence Cottman, and PetroFalcon’s President, William Gumma, \$135,00 for professional services, compared to \$210,000 for the three months ended December 31, 2006. These invoices for professional services include the salaries of Mr. Gumma and PetroFalcon’s Chief Financial Officer, Garrett Soden, as well as the operating expenses for PetroFalcon’s technical office in Carpinteria, California. For the year ended December 31, 2007, the Company was invoiced by Pacific Oil and Gas, LLC \$540,000, compared to \$840,000 for the year ended December 31, 2006.

PetroFalcon also receives construction services provided by Vinccler C.A., an independent operating construction company controlled by the Company’s Chairman and Chief Executive Officer, Juan Francisco Clerico. During the three month periods ended December 31, 2007, and 2006, PetroFalcon did not receive services from Vinccler C.A. During the year ended December 31, 2007, PetroFalcon did not receive services from Vinccler C.A., compared to \$11,669 during the year ended December 31, 2006. On August 25, 2006, Vinccler C.A. paid on behalf of Vinccler Venezuela the amount of \$350,000 to purchase the data package for the Delta Caribe offshore natural gas bid process in Venezuela. This amount was repaid with interest on March 25, 2008.

These related party transactions are in the normal course of operations and are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

## **CRITICAL ACCOUNTING ESTIMATES**

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The Company makes assumptions in applying the following critical accounting estimates that are uncertain at the time the accounting estimate is made and may have a significant effect on the financial statements of the Company.

## **STOCK-BASED COMPENSATION**

The Company uses the fair value method of accounting for its stock-based compensation expense associated with its stock option plan. Compensation expense is based on the fair value of stock options at the grant date using the Black-Scholes option pricing model. The Black-Scholes model requires estimates for the expected volatility of the Company's stocks, a risk-free interest rate, expected dividends on the stock and expected life of the option. Changes in these estimates may result in the actual compensation expense being materially different than the compensation expense recognized. However, this expense is not subsequently adjusted for changes in these factors.

## **PETROCUMAREBO ACCOUNTING**

PetroCumarebo's Conversion Contract indicates that both parties agree to contractually share the continuing power to determine its strategic operating, investing and financing policies. When accounting for Vincler Venezuela's interests in PetroCumarebo, it is essential that the Company reflects the substance and underlying economic reality of its interest. Management believes that, despite the terms established in the Conversion Contract, PetroFalcon's investment in PetroCumarebo does not currently meet the criteria for proportional consolidation or equity method accounting. Accordingly, PetroFalcon has accounted for its investment in PetroCumarebo using the cost method of accounting for the year ended December 31, 2007. Under the cost method, PetroFalcon does not recognize its 40% share of revenues, expenses, assets or liabilities from PetroCumarebo and instead only recognizes income to the extent that dividends are declared by PetroCumarebo.

Despite this change for accounting purposes, PetroFalcon remains an oil and gas company carrying on active operations in Venezuela, and Management does not consider PetroFalcon to be a company with only passive investments.

Management is reviewing the new accounting standards for 2008 and any potential impacts on PetroFalcon's financial statements. As of March 31, 2008, there is no indication of a potential impairment for PetroFalcon.

## **CONCLUSION REGARDING EFFECTIVENESS OF DISCLOSURE CONTROLS AND PROCEDURES AND DESIGN OF INTERNAL CONTROLS OVER FINANCIAL REPORTING**

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The Chief Executive Officer and Chief Financial Officer of PetroFalcon have carried out an evaluation of the effectiveness of PetroFalcon's disclosure controls and procedures and assessed the design of its internal control over financial reporting for the period ended December 31, 2007, pursuant to the requirements of Multilateral Instrument 52-109. Based on the evaluation conducted, the Chief Executive Officer and Chief Financial Officer have concluded that the design and operation of PetroFalcon's disclosure controls and procedures were effective, but contained certain weaknesses, as at the end of the period ended December 31, 2007.

Management has concluded that as of December 31, 2007, the following weaknesses existed in the design of internal controls over financial reporting. These weaknesses should also be considered as weaknesses in the Company's disclosure controls and procedures.

The Company lacks expertise in Canadian GAAP reporting, which has resulted in material adjustments being identified by the external auditor to accurately account for certain items in the consolidated financial statements reflected under Canadian GAAP.

Also, the Company uses commercial software for its bookkeeping, but due to the complexity of some transactions, the Company uses Excel spreadsheets to make calculations of certain costs, which are easily subject to errors.

Even though there are certain weaknesses that the Company intends to address during 2008, Management has concluded and the Board of Directors has agreed that, taking into account the best interests of the Company and its shareholders, the Company does not have sufficient size and scale to warrant the hiring of additional staff to correct the weaknesses in Canadian GAAP expertise at this time.

PetroFalcon's Management and Board of Directors policy is transparency and completeness in its disclosures. Therefore, the existence of internal control over financial reporting and disclosure and procedures control weaknesses in a business with a small number of employees and limited resources, such as PetroFalcon, need not necessarily be interpreted as evidence of a lack of integrity, of unsound business practices or of unacceptable risks to its shareholders and other related parties.

During the three months ended December 31, 2007, there were no changes to internal controls over financial reporting that have materially affected, or are reasonably like to materially affect, the Company's internal controls over financial reporting.

## **ADDITIONAL INFORMATION**

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Additional information regarding the Company, including its annual information form, reserves information and annual report, may be found on the SEDAR website at [www.sedar.com](http://www.sedar.com) or by visiting the Company's website at [www.petrofalcon.com](http://www.petrofalcon.com).