



*Building Value in Venezuela*

## MANAGEMENT DISCUSSION & ANALYSIS

### SECOND QUARTER 2008

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The following management discussion and analysis (“MD&A”) is prepared as of August 11, 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 unaudited interim consolidated financial statements for the three and six months ended June 30, 2008, and 2007, together with the audited consolidated financial statements for the years ended December 31, 2007, and 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 three and six months ended June 30, 2008, and 2007, the balances were translated at implied market rates.

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. Through its wholly-owned Venezuelan subsidiaries, Vinccler Oil and Gas, C.A. (“Vinccler Venezuela”) and Lundin Latina de Petróleos, S.A. (“Lundin Venezuela”), PetroFalcon owns 40% of PetroCumarebo, S.A. (“PetroCumarebo”) and 5% of Baripetrol, S.A. (“Baripetrol”).

### **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 proportionate 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 proportionate consolidation or equity method accounting. Accordingly, PetroFalcon has accounted for PetroCumarebo using the cost method of accounting for the three and six months ended June 30, 2008, and 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 received by PetroCumarebo. As a result, PetroFalcon has no revenues for the three and six months ended June 30, 2008, and has restated the comparable periods in 2007.

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 three and six months ended June 30, 2008, varies from that provided in 2007, 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 PetroFalcon’s working interests in PetroCumarebo and Baripetrol to the extent possible. This information will be based upon unaudited information provided by PetroCumarebo and Baripetrol to Management and upon a 51-101 compliant technical report obtained by Management of PetroFalcon.

### **Lundin Transaction**

On February 1, 2008, PetroFalcon acquired 100% of the issued and outstanding shares of Lundin Venezuela, a holding company incorporated in Venezuela. Lundin Venezuela owns 5% of Baripetrol, a Venezuelan mixed company between Petróleos de Venezuela, S.A. (“PDVSA”), Tecpetrol de Venezuela, S.A. and Perenco Oil and Gas International Limited. Baripetrol operates the Colon Block, which includes approximately 297,000 acres in western Venezuela with current onshore production of oil and natural gas.

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 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.

As part of the transactions with Lundin Petroleum, PetroFalcon appointed two members to the Board of Directors of the Company: Ashley Heppenstall, President and CEO of Lundin Petroleum, and John Craig, a partner at Cassels Brock & Blackwell LLP, a law firm in Toronto.

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 2007 Baripetrol dividends received by Lundin Venezuela are for the benefit of PetroFalcon. The dividend was credited against the historical cost of the investment instead of being recognized as income in the first quarter of 2008 because the dividend was related to earnings before the closing of the transaction.

### **Anadarko Transaction**

On April 7, 2008, PetroFalcon announced the signing of a binding sale and purchase agreement for the acquisition of 100% of the issued and outstanding shares of Anadarko Venezuela Company (“Anadarko Venezuela”) from an affiliate of Anadarko Petroleum Corporation (“Anadarko Petroleum”).

PetroFalcon intends to acquire Anadarko Venezuela from Anadarko Petroleum for \$200 million in cash with a financial effective date of January 1, 2008. The agreement is subject to the approval of the Venezuelan Ministry of Energy and Petroleum (“MEP”).

Upon executing the sale and purchase agreement with Anadarko Petroleum, PetroFalcon delivered \$5 million (or 2.5% of the base purchase price) in cash to Anadarko Petroleum as a deposit for the transaction. This amount will be deducted from the purchase price at closing. According to the agreement, the cash deposit will be returned to PetroFalcon with interest if MEP approval is denied.

Anadarko Venezuela indirectly owns 18% of Petroritupano, S.A. (“Petroritupano”), a mixed company with PDVSA and Petrobras Energía, S.A. (“Petrobras”). In addition, Anadarko Venezuela holds a \$58 million voucher that can be used as credit with the Venezuelan government for new oil and gas investment opportunities.

Petroritupano has the exclusive right to explore, develop and produce oil and natural gas through 2025 from the Oritupano-Leona Block, which includes almost 340,000 acres in the Maturin sub-basin of eastern Venezuela with current onshore production of oil and natural gas.

Lundin Petroleum AB (“Lundin Petroleum”) has provided a guarantee to Anadarko Petroleum for the full purchase price. In consideration for the guarantee, PetroFalcon agreed to issue 17.1 million common shares of the Company to Lundin Petroleum or one of its subsidiaries, subject to regulatory approval. In April 2008, PetroFalcon issued 7.1 million of these shares to Lundin Petroleum, which, as of June 30, 2008, indirectly owned 45% of the issued and outstanding shares of the Company. If the transaction does not close, Lundin Petroleum will keep the initial 7.1 million shares. The remaining 10 million shares will be issued to Lundin Petroleum at closing of the acquisition.

PetroFalcon intends to fund the purchase price of the acquisition through third-party financing, which may be in the form of debt, equity or a combination thereof. If required, Lundin Petroleum has agreed to provide interim financing to PetroFalcon on commercial terms.

## New Business – Exploration

### *Chevron – Cardon III Block*

On February 26, 2007, Vincler Venezuela and Chevron Corporation (“Chevron”) announced signing a Heads of Terms agreement whereby Vincler Venezuela will acquire a 30% working interest from Chevron in the offshore natural gas license for the Cardon III Block (“Cardon III”) in the Gulf of Venezuela. Under the terms of the agreement effective January 1, 2007, Chevron remains operator and majority partner with a 70% interest. PDVSA retains the right to acquire up to 35% of the project after declaration of commerciality, and the transaction is subject to the approval of MEP. The Company anticipates that the transaction will be completed in 2008.

On March 9, 2007, Vincler Venezuela paid Chevron \$2.2 million, which included 30% of all Chevron’s costs related to the Cardon III Block before the effective date. On April 9, 2008, Vincler Venezuela paid Chevron an additional \$3.2 million for 30% of the costs related to the Cardon III Block in 2007. According to the agreement, all funds paid by Vincler Venezuela to Chevron will be returned with interest if MEP approval is denied.



The acquisition of 530 square kilometers of 3D seismic data over the Cardon III Block was completed in April 2007. A jack-up rig has been secured with a multi-operator group from adjoining blocks in the Gulf of Venezuela, and the expected spud date is in early 2009. If successful, first commercial production of natural gas is expected in 2011.

#### *Repsol – Cardon IV Block*

On March 12, 2008, PetroFalcon announced the signing of a letter of intent with Repsol YPF, S.A. (“Repsol”), whereby Vinccler Venezuela will acquire 25% of the Cardon IV Block (“Cardon IV”) in the Gulf of Venezuela. The transaction is subject to the approval of MEP, as well as the negotiation and execution of a sale and purchase agreement. The Company anticipates that the transaction will be completed in 2008.

Under the terms of the farm-in agreement, Vinccler Venezuela has no obligations relating to past capital expenditures on the Cardon IV Block and has paid nothing to date to Repsol.

The acquisition of 700 square kilometers of 3D seismic data over the Cardon IV Block was completed in February 2007. A jack-up rig has been secured with a multi-operator group from adjoining blocks in the Gulf of Venezuela. The expected spud date is in early 2009, immediately following the Cardon III well. If successful, first commercial production of natural gas is expected in 2011.

## **PETROFALCON 2008 Q2 PRODUCTION**

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### **PetroCumarebo Production Summary:**

	<b>PetroCumarebo (Gross)</b>	<b>PetroFalcon (Net)</b>	
	<b>Three months ended June 30, 2008</b>	<b>Three months ended June 30, 2008</b>	<b>Three months ended June 30, 2007</b>
<b>Daily production</b>			
Oil - bbls/d	932	373	323
Natural gas - mcf/d	15,285	6,114	147
<b>Total – boe/d</b>	<b>3,479</b>	<b>1,392</b>	<b>348</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 and West Falcon blocks for the three months ended June 30, 2008, was 3,479 boe/d. PetroFalcon’s 40% share before royalties was 1,392 boe/d. For the comparable period ended June 30, 2007, PetroCumarebo’s average production was 869 boe/d, PetroFalcon’s 40% share before royalties being 348 boe/d.

The current gross production of PetroCumarebo is approximately 1,100 bbls/d of oil and 18.5 mmcf/d of natural gas, or approximately 4,180 boe/d. The production has increased since the previous quarter due to the recent success of the CU-170 well in the Cumarebo Field.

PetroCumarebo produces light sweet crude oil that sells at a premium to most of the oil produced in Venezuela. Historically, PetroCumarebo's oil production was delivered to PDVSA at an average price that was approximately 103% of WTI for East Falcon oil and 85% of WTI for West Falcon oil.

Effective April 15, 2008, the Law of Special Contribution to Extraordinary Prices at the Hydrocarbons International Market ("Windfall Profits Tax") implemented by the Venezuelan government reduces the average price received by PetroCumarebo for oil deliveries. The Windfall Profits Tax establishes a special tax payable to the Venezuelan government when the average price of Brent crude exceeds \$70 per barrel. The tax is calculated as 50% of the increment between \$70 and \$100 Brent plus 60% of the increment above \$100 Brent. On July 10, 2008, the Venezuelan government amended the benchmark in the tax calculation from Brent to the Venezuelan basket of prices as published by MEP. The Windfall Profits Tax applies only to oil revenue and is a reduction in the price per barrel received by the mixed company from PDVSA.

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

#### Baripetrol Production Summary:

	<b>Baripetrol (Gross)</b>	<b>PetroFalcon (Net)</b>	
	<b>Three months ended June 30, 2008</b>	<b>Three months ended June 30, 2008</b>	<b>Three months ended June 30, 2007</b>
<b>Daily production</b>			
Oil - bbls/d	9,622	481	NA
Natural gas - mcf/d	5,897	295	NA
<b>Total – boe/d</b>	<b>10,605</b>	<b>530</b>	<b>NA</b>

Note: Production is shown before royalties. PetroFalcon, through Lundin Venezuela, owns 5% of Baripetrol. The comparable period in 2007 is prior to PetroFalcon's acquisition of Lundin Venezuela.

As detailed in the table above, Baripetrol's average gross production from the Colon Block for the three months ended June 30, 2008, was 10,605 boe/d. PetroFalcon's 5% share before royalties was 530 boe/d.

The current gross production of Baripetrol is approximately 8,800 bbls/d of oil and 6 mmcf/d of natural gas, or 9,800 boe/d. The recent decrease in production is due to the temporary closure of wells during workover activity and pump changes in the La Palma Field.

Historically, Baripetrol's oil production was delivered to PDVSA at an average price that was approximately 85% of WTI. Effective April 15, 2008, the Windfall Profits Tax reduces the average price received by Baripetrol for oil deliveries as described above.

Payment from PDVSA to Baripetrol is 100% in US dollars for crude oil and natural gas liquids and will be 100% in Bolivars for methane gas. Dividends from Baripetrol to PetroFalcon are paid in US dollars and are at the discretion of the shareholders of Baripetrol, depending on net and available profits.

## **PETROFALCON FINANCIAL STATEMENTS**

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

Under the cost method of accounting adopted for the three and six months ended June 30, 2008, 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 received by PetroCumarebo. As a result, PetroFalcon has no revenues for the three and six months ended June 30, 2008, and has restated the comparable periods in 2007. To date, no dividends have been received from PetroCumarebo.

PetroFalcon’s investment in Baripetrol is also recognized under the cost method of accounting. During the six months ended June 30, 2008, PetroFalcon received a \$1.9 million dividend from Baripetrol for the first nine months of 2007. The dividend was credited against the historical cost of the investment instead of being recognized as income in the first quarter of 2008 because the dividend was related to earnings before the closing of the transaction.

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

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

PetroFalcon’s G&A expenses were \$1,566,018 during the three months ended June 30, 2008, as compared to \$1,136,439 during the three months ended June 30, 2007. PetroFalcon’s G&A expenses were \$3,196,958 during the six months ended June 30, 2008, as compared to \$3,559,285 during the six months ended June 30, 2007.

G&A expenses decreased \$0.4 million during the six months ended June 30, 2008, compared with the six months ended June 30, 2007, due to a June 2007 \$0.5 million provision related to technical assistance invoiced to PetroCumarebo for services provided during April, May and September 2006. In addition, the Company recorded \$0.3 million of tax penalties and \$0.5 million of inventory loss. This decrease is partially offset by an increase in the G&A expenses incurred in Bolivars due to the revaluation of the Bolivar currency with respect to the US dollar, as well as an increase of \$0.2 million in consultant services incurred in connection with new business activities in Venezuela.

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”.**

For the three months ended June 30, 2008, PetroFalcon’s DD&A expense was \$26,299 compared to \$30,695 for the three months ended June 30, 2007. PetroFalcon’s DD&A expense was

\$51,711 during the six months ended June 30, 2008, as compared to \$70,652 during the six months ended June 30, 2007.

## **STOCK-BASED COMPENSATION**

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During the three months ended June 30, 2008, the Company recorded \$26,288 in stock-based compensation expense as compared to \$775,485 during the three months ended June 30, 2007. During the six months ended June 30, 2008, the company recorded \$755,045 in stock-based compensation expense as compared to \$1,513,123 during the six months ended June 30, 2007.

All of the Company's outstanding stock options immediately vested at the closing of the Lundin transaction on February 1, 2008. PetroFalcon's stock option 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 June 30, 2008, PetroFalcon had \$24.1 million in cash and short-term deposits compared to \$6 million at June 30, 2007. During the three months ended June 30, 2008, the Company recorded interest income in the amount of \$119,664 as compared to \$61,412 during the three months ended June 30, 2007. During the six months ended June 30, 2008, PetroFalcon recorded interest income in the amount of \$296,725 as compared to \$154,166 during the six months ended June 30, 2007.

During the three months ended June 30, 2008, the Company recorded a credit adjustment of \$158,389 to interest expenses due to the recognition of the implied market exchange rate, since the first quarter interest expenses were valued at the official exchange rate. During the three months ended June 30, 2007, the Company incurred interest expenses of \$189,278. PetroFalcon incurred interest expense of \$126,360 during the six months ended June 30, 2008, as compared to \$555,962 during the six months ended June 30, 2007. The decrease is primarily due to lower short-term debt during 2008. At June 30, 2008, PetroFalcon had no short-term debt compared to \$5.5 million at June 30, 2007.

The Company recorded expenses of \$3.3 million during the three months ended June 30, 2008, for the Anadarko Venezuela guarantee fee paid in shares to Lundin Petroleum.

## **INCOME TAXES**

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During the three and six months ended June 30, 2008 and 2007, PetroFalcon recorded no income tax expense since the Company had no taxable income for these periods.

## PETROFALCON 2008 CAPITAL EXPENDITURES BUDGET

### PetroFalcon Summary 2008 Budget:

(\$MMs)	PetroFalcon Net Share
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	Incurred as of June 30, '08 (Gross)	Incurred as of June 30, '08 (Net)
<b>Drilling and Work-overs</b>				
- La Vela	9,400	3,760	-	-
- Cumarebo	8,700	3,480	17,150	6,860
- West Falcon	400	160	-	-
- Total Drilling and Work-overs	18,500	7,400	17,150	6,860
<b>Processing Facilities and Infrastructure</b>				
- La Vela	4,230	1,692	700	280
- Cumarebo	3,770	1,508	1,852	741
- West Falcon	3,500	1,400	168	67
Total Processing Facilities and Infrastructure	11,500	4,600	2,720	1,088
<b>Total Capital Budget</b>	<b>30,000</b>	<b>12,000</b>	<b>19,870</b>	<b>7,948</b>

PetroCumarebo's 2008 capital expenditures budget of \$30 million (40% net to PetroFalcon being \$12 million) involves drilling four development wells and two appraisal wells in Cumarebo, three deeper development wells in La Vela and two exploration wells nearby Cumarebo and La Vela. Due to operational delays in the first half of 2008 and the strengthening of the implied market rate for the Bolivar against the US dollar (approximately 80% of drilling costs are Bolivar-based), PetroCumarebo's capital budget for 2008 will likely be revised upward in the third quarter.

During the second quarter of 2008, PetroCumarebo finished drilling one development well in the northern part of the Cumarebo Field with the San Antonio International (formerly Pride) 421 900 HP rig. PetroCumarebo also started drilling an appraisal well in the central part of the same field. These two new wells were recently perforated and are under evaluation.

PetroCumarebo is currently re-evaluating six wells (LV-12, LV-20, LV-21, CU-170, CU-171 and CU-173) drilled in the Cumarebo and La Vela fields in areas of known hydrocarbon accumulations. The wells will be re-perforated using high penetration gun technology.

The first well to be re-evaluated, CU-170, was successfully drilled as a J-type development well to a depth of 5,600 feet in February 2008 with the purpose of testing the downdip continuation of the CU-155 sand 15 gas and condensate reservoir. This reservoir is located in the northeastern part of the Cumarebo Field, which still requires further appraisal. The well found 22 feet of net hydrocarbon sand in the sand 12 reservoir and 35 feet of net hydrocarbon sands in the sand 15 reservoir. The well was perforated using stim gun and propellant technology in the sand 15 reservoir at selected intervals between 5,297 and 5,364 feet (22 feet total) and is producing initially at a rate of 4.6 mmcf/d of natural gas and 190 bbls/d of condensate with a 1/5" choke and 1,200 psi of wellhead flowing pressure.

PetroCumarebo is also performing two workovers in La Vela in order to re-complete wells in previously tested intervals. The LV-10 well will be re-opened in a deeper horizon, which tested an average of 200 bbls/d during the preliminary well evaluation performed by PetroFalcon. The LV-7X well will be re-perforated and re-opened in an area that was tested previously by PetroFalcon at a rate of 5 mmcf/d and 150 bbls/d, or approximately 980 boe/d.

During the second quarter, PetroCumarebo secured a workover rig for performing minor workover jobs in five wells in the Tiguaje Field.

PetroCumarebo plans to drill the San Patricio exploration well later this year in a prospective area east of the Cumarebo Field. This prospect is estimated to contain unrisks reserves of 1.3 mmbo and 53 bcf. PetroCumarebo also plans to drill the La Cruz South prospect, which has estimated unrisks reserves of 57 mmbo and 30 bcf. The La Cruz South prospect is part of a larger structure with three separate structural culminations (La Cruz South, North and East) and which is estimated to contain unrisks reserves of 110 mmbo and 317 bcf.

De-bottlenecking of the La Vela and Cumarebo processing facilities is scheduled during the second half of the year in order to increase the gas processing plants capacities to 20 mmcf/d in La Vela and 30 mmcf/d in Cumarebo.

### Baripetrol 2008 Budget:

(\$000s)	Baripetrol 2008 Budget	PetroFalcon 5% Share	Incurred as of June 30, '08 (Gross)	Incurred as of June 30, '08 (Net)
<b>Seismic, Drilling and Work-overs</b>				
- Rosario	1,910	96	-	-
- La Palma	33,500	1,675	3,930	196
- Socuavo	13,290	664	1,250	63
- Los Manueles	1,890	95	1,100	55
- Bonito	370	18	400	20
- West Tarra	590	30	420	21
- Total Drilling and Work-overs	51,550	2,578	7,100	355
<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>	<b>7,100</b>	<b>355</b>

Baripetrol's 2008 capital expenditures budget of \$60 million (5% net to PetroFalcon being \$3 million) includes four development wells in the La Palma field, a 165-square-kilometer 3-D seismic campaign in the Socuavo field and, together with the contracting of a second work-over rig, 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 September 2008 and is on long-term contract to Baripetrol through 2011. Due to the delay in securing the drilling rig, it is unlikely that Baripetrol will be able to spend its full capital budget in 2008.

### 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.

### 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>

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

### LIQUIDITY AND CAPITAL RESOURCES

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As of June 30, 2008, PetroFalcon had 158,501,120 issued and outstanding common shares and 172,634,780 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 June 30, 2008, PetroFalcon had \$24.1 million in cash, working capital of \$34.8 million and no debt. At December 31, 2007, PetroFalcon had \$4.8 million in cash and working capital of \$1.3 million. At December 31, 2007, PetroFalcon had short-term debt of \$2.5 million and no long-term debt.

On April 1, 2008, Vincler Venezuela repaid its outstanding short-term debt of \$2.1 million. As a result, as of August 11, 2008, PetroFalcon has no debt.

On May 6, 2008, Vincler Venezuela received \$1.0 million related to inventory sold to PetroCumarebo.

On May 9, 2008, Vincler Venezuela received \$3.6 million from PDVSA related to capital expenditures incurred during the first quarter of 2006 under the former East Falcon operating service agreement. These costs had been considered as part of the investment cost in PetroCumarebo.

At June 30, 2008, PetroFalcon had \$0.6 million in current accounts receivable compared to \$1.6 million at December 31, 2007. As of June 30, 2008, the Company had \$0.7 million in accounts payable compared to \$3.6 million at December 31, 2007.

The sale and purchase agreement with Anadarko Petroleum for the acquisition of Anadarko Venezuela establishes that if the agreement is terminated under certain circumstances and Anadarko is entitled to retain the cash deposit, the Company will pay to Anadarko an additional amount equal to 17.5% of the base purchase price. This amount is covered under the guarantee provided by Lundin Petroleum.

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

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

(\$000s, except per share amounts)	2006		2007				2008	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Revenue	5,707	2,315	Nil	Nil	Nil	Nil	Nil	Nil
Net income (loss)	(1,313)	(2,502)	(801)	(3,538)	1,689	566	(1,675)	(4,412)
Earnings (loss) per share basic and diluted	(0.02)	(0.03)	(0.01)	(0.04)	0.02	0.01	(0.01)	(0.03)

Note: 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.

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 received by PetroCumarebo. As a result, PetroFalcon has no revenues for the three and six months ended June 30, 2008, and has restated the comparable periods in 2007. For the year ended December 31, 2008, the Company intends to provide restated comparable quarters for the prior periods.

## RELATED PARTY TRANSACTIONS

Pacific Oil and Gas, LLC (“Pacific Oil and Gas”) and Venezolana de Inversiones y Construcciones Clerico, C.A. (“Vinccler Construction”) are controlled by officers of PetroFalcon. Pacific Oil and Gas is controlled by PetroFalcon’s Vice Chairman, Clarence Cottman, and PetroFalcon’s President and CEO, William Gumma. For the three months ended June 30, 2008, and 2007, the Company paid Pacific Oil and Gas for professional services in the amount of \$135,000. The Company paid Pacific Oil and Gas \$270,000 for the six months ended June 30, 2008, and 2007. These payments 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.

PetroFalcon also receives construction services provided by Vinccler Construction, an independent operating construction company controlled by the Company’s Chairman, Juan Francisco Clerico. During the three and six months ended June 30, 2008, and 2007, PetroFalcon did not receive services from Vinccler Construction. On August 25, 2006, Vinccler Construction

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. On March 27, 2008, Vinccler Venezuela repaid this amount plus interest.

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.

Lundin Petroleum has provided a guarantee to Anadarko Petroleum for the full purchase price of Anadarko Venezuela. In consideration for the guarantee, PetroFalcon agreed to issue 17.1 million common shares of the Company to Lundin Petroleum or one of its subsidiaries, subject to regulatory approval. In April 2008, PetroFalcon issued 7.1 million of these shares to Lundin Petroleum, with a fair value of \$1.11 (CDN\$1.12) per share for a total amount of \$7,878,842. The remaining 10 million shares will be issued to Lundin Petroleum at closing of the transaction (see note 1). The guarantee fee amount has been amortized over the period of the guarantee from April 4, 2008, to October 31, 2008. During the three months ended June 30, 2008, the Company recorded expenses related to this guarantee in the amount of \$3.3 million.

## **INTERNAL CONTROLS OVER FINANCIAL REPORTING**

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During the three months ended June 30, 2008, 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).