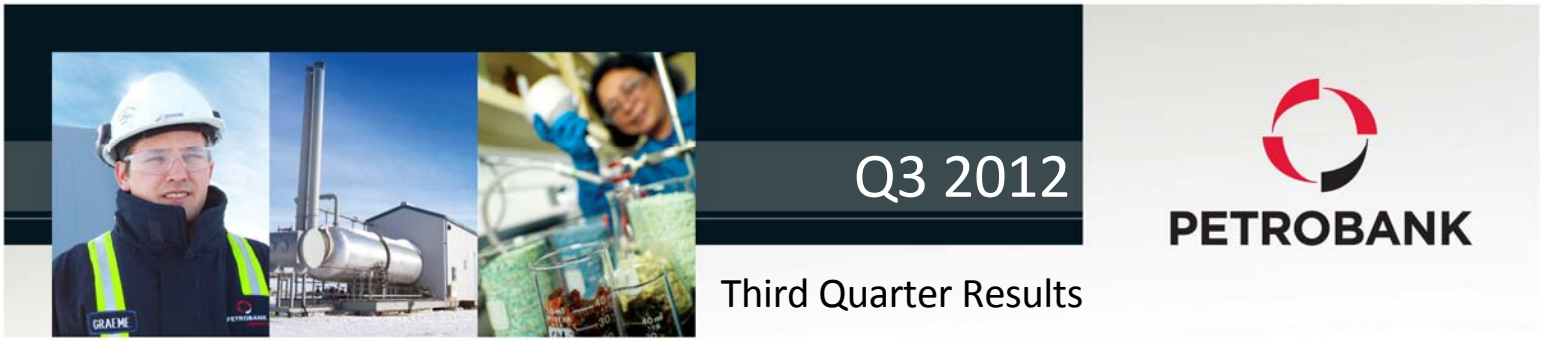


## PETROBANK REPORTS Q3 2012 FINANCIAL AND OPERATIONAL RESULTS

In this report, quarterly comparisons are third quarter 2012 compared to third quarter 2011 unless otherwise noted. All financial figures are unaudited and in Canadian dollars ($) unless otherwise noted.

## SUMMARY OF FINANCIAL AND OPERATING RESULTS

| | Three months ended Sept. 30, | | | Nine months ended Sept. 30, | | |
|---|---|---|---|---|---|---|
| | **2012** | 2011 | % Change | **2012** | 2011 | % Change |
| **Financial** | | | | | | |
| **($000s, except where noted)** | | | | | | |
| Oil and natural gas sales | **237,833** | 272,346 | (13) | **808,399** | 828,595 | (2) |
| Funds flow from operations [1] | **119,570** | 147,452 | (19) | **419,750** | 464,276 | (10) |
| Per share – basic ($) | **1.20** | 1.39 | (14) | **4.06** | 4.37 | (7) |
| – diluted ($) | **1.19** | 1.37 | (13) | **4.02** | 4.27 | (6) |
| Adjusted net income attributable to Petrobank shareholders [1] | **13,495** | 7,517 | 80 | **127,801** | 38,155 | 235 |
| Per share – basic ($) | **0.14** | 0.07 | 100 | **1.24** | 0.36 | 244 |
| – diluted ($) | **0.13** | 0.07 | 86 | **1.22** | 0.34 | 259 |
| Capital expenditures [1] | | | | | | |
| PetroBakken | **283,078** | 271,861 | 4 | **599,255** | 692,352 | (13) |
| Heavy Oil Business Unit ("HBU") | **9,624** | 30,772 | (69) | **32,027** | 140,668 | (77) |
| Total capital expenditures | **292,702** | 302,633 | (3) | **631,282** | 833,020 | (24) |
| Total assets | **6,471,738** | 6,852,270 | (6) | **6,471,738** | 6,852,270 | (6) |
| **Common shares outstanding, end of period (000s)** | | | | | | |
| Basic | **98,741** | 106,327 | (7) | **98,741** | 106,327 | (7) |
| Diluted [2] | **102,892** | 111,216 | (7) | **102,892** | 111,216 | (7) |
| **Operations** | | | | | | |
| **PetroBakken operating netback ($/boe)** [1] [3] | | | | | | |
| Oil, NGL and natural gas revenue [4] | **66.58** | 75.37 | (12) | **71.04** | 77.98 | (9) |
| Royalties | **9.09** | 12.20 | (25) | **10.26** | 12.36 | (17) |
| Production expenses | **12.40** | 13.13 | (6) | **12.78** | 12.73 | - |
| Operating netback [1] [3] [5] | **45.09** | 50.04 | (10) | **48.00** | 52.89 | (9) |
| Average daily production [3] | | | | | | |
| PetroBakken – oil and NGL (bbls) | **31,662** | 33,112 | (4) | **34,733** | 32,965 | 5 |
| PetroBakken – natural gas (Mcf) | **41,048** | 35,776 | 15 | **39,420** | 34,030 | 16 |
| Total conventional (boe) [3] [6] | **38,503** | 39,074 | (1) | **41,303** | 38,636 | 7 |

(1) Non-GAAP measure. See "Non-GAAP Measures" section.
(2) Consists of common shares, stock options, directors deferred common shares, deferred common shares, and incentive shares as at the period end date.
(3) Six Mcf of natural gas is equivalent to one barrel of oil equivalent ("boe").
(4) Net of transportation expenses.
(5) Excludes hedging activities.
(6) HBU heavy oil volumes are excluded from average daily production as HBU operations are considered to be in the exploration and evaluation phase and accordingly are capitalized.

## HIGHLIGHTS

### Q3 2012 Financial and Operating Highlights

- Funds flow from operations decreased 19 percent from the third quarter of 2011 to $119.6 million, or $1.19 per diluted share, primarily as a result of lower realized commodity prices, as light oil differentials to WTI were wider than historical levels.
- PetroBakken's third quarter production averaged 38,503 barrels of oil equivalent per day ("**boepd**") (82% light oil and liquids), relatively flat over the third quarter of 2011, due primarily to the disposition of producing assets in the first half of 2012 and a delayed start to the second half 2012 capital program.
- PetroBakken's nine month production averaged 41,303 boepd, a 7% increase over the same period in 2011.
- Capital expenditures before dispositions totalled $292.7 million in the third quarter with PetroBakken drilling 82 net wells.
- Production from Petrobank's Kerrobert project averaged 305 barrels of upgraded THAI® oil per day ("**bopd**") in Q3 2012, an increase from 236 bopd in Q2 2012.
- In mid-September, we renewed our Normal Course Issuer Bid ("**NCIB**") and can repurchase and cancel up to 7,784,304 Petrobank shares until September 13, 2013. Under this NCIB and through our Automatic Share Repurchase and PetroBakken Share Sale Plan, we have repurchased 3.5 million Petrobank shares and sold an equivalent number of PetroBakken shares through to October 31, 2012. The sale of one PetroBakken share for each Petrobank share repurchased under this plan resulted in net cash proceeds to Petrobank of $1.1 million.
- On October 29, 2012, Petrobank and PetroBakken entered into an agreement to complete a corporate reorganization that will see Petrobank shareholders effectively receive Petrobank's proportionate interest in our PetroBakken share holdings while maintaining their interest in the remaining Petrobank assets (the "**Reorganization**"). A joint information circular describing the Reorganization is expected to be mailed to shareholders in mid-November for a shareholder vote in mid-December. Subject to approval of shareholders of both Companies and other standard approvals, the Reorganization will be effective December 31, 2012.

## LIQUIDITY AND CAPITAL RESOURCES

Petrobank and PetroBakken manage their capital structure independently, generate their own cash flows and have the ability to fund their operations through the issuance of secured and unsecured debt as well as equity financing. Petrobank's capital resources are focused on funding corporate and Heavy Oil Business Unit expenditures. At September 30, 2012, on a standalone basis independent of PetroBakken, Petrobank's HBU and Corporate operating segment had cash and cash equivalents of $96.1 million and a net working capital surplus (including cash) of $84.9 million.

Based on Petrobank's current ownership and PetroBakken's current annual dividend of $0.96 per PetroBakken share, Petrobank expects to receive approximately $8.5 million of dividends per month. PetroBakken instituted a DRIP in early 2012, which allows shareholders to reinvest monthly cash dividends in new shares at a five percent discount to the then current market price. Due to Petrobank's significant positive working capital balance, we elected to participate at a 100% level in PetroBakken's DRIP starting with the March dividend. We believe that receiving additional shares in PetroBakken is an attractive investment at this time. We anticipate that we will receive the October and November PetroBakken dividends in PetroBakken shares through the DRIP and the December dividend (payable in January 2013) in cash.

Petrobank currently expects to fund our future working capital requirements and HBU capital expenditure program with available cash and cash from operations.

## PETROBANK AND PETROBAKKEN REORGANIZATION

On October 29, 2012, PetroBakken and Petrobank entered into an arrangement agreement that will see Petrobank shareholders receive Petrobank's proportionate interest in PetroBakken (the "**Reorganization**"). Pursuant to the Reorganization, a new Alberta corporation will be formed ("**New Petrobank**") which will acquire all of the existing assets and liabilities of Petrobank, including THAI® and related technologies, but excluding Petrobank's ownership interest in PetroBakken shares, and existing shareholders of Petrobank will receive one share of New Petrobank for each Petrobank share held.

Following this distribution of Petrobank's heavy oil business to New Petrobank, Petrobank and PetroBakken will, through a series of transactions, amalgamate, with the resulting company to continue under the name "PetroBakken Energy Ltd." ("**New PetroBakken**"). Existing PetroBakken shareholders will receive one share of New PetroBakken for every share of PetroBakken held prior to the Reorganization and Petrobank shareholders will receive, in aggregate, a number of New PetroBakken shares equal to the number of PetroBakken shares held by Petrobank immediately prior to the Reorganization, being approximately 1.06 to 1.10 New PetroBakken shares for each Petrobank share held. The number of shares outstanding in New PetroBakken will be the same as the number of shares outstanding in PetroBakken immediately prior to the Reorganization.

The Reorganization will not result in any changes to the business of Petrobank or our existing Board and senior management. The Reorganization is subject to the approval of the shareholders of each of Petrobank and PetroBakken.

## MANAGEMENT'S DISCUSSION AND ANALYSIS ("MD&A")

The following MD&A is dated November 12, 2012 and should be read in conjunction with the unaudited condensed interim consolidated financial statements and accompanying notes of Petrobank Energy and Resources Ltd. ("Petrobank", "we", "our" or the "Company") as at and for the three and nine months ended September 30, 2012 ("interim Consolidated Financial Statements"), as well as the audited consolidated financial statements as at and for the year ended December 31, 2011 (the "Consolidated Financial Statements") and MD&A for the year ended December 31, 2011. The disclosures throughout the MD&A agree to Note 2 - Segmented Information in the interim Consolidated Financial Statements.

Management is responsible for preparing the MD&A. The Audit Committee of the Petrobank Board of Directors (the "Board") reviewed the MD&A and recommended its approval by the Board. The Board approved the MD&A.

This MD&A and the interim Consolidated Financial Statements and comparative information have been prepared in accordance with International Financial Reporting Standards ("IFRS") applicable to the preparation of interim financial statements, including IAS 34, *Interim Financial Reporting*, which are also generally accepted accounting principles ("GAAP") for publicly accountable enterprises in Canada. For all periods up to and including the year ended December 31, 2010, we prepared our consolidated financial statements in accordance with Canadian generally accepted accounting principles as set out in the Handbook of the Canadian Institute of Chartered Accountants Part V *Pre-changeover Accounting Standards* ("previous Canadian GAAP"). In accordance with the standard related to the first time adoption of IFRS, our transition date to IFRS was January 1, 2010 and therefore the comparative information for 2010 has been prepared in accordance with IFRS.

All amounts are presented in Canadian dollars, unless otherwise stated and all tabular amounts are in thousands of Canadian dollars, except share amounts or as otherwise noted. The energy content of natural gas has been measured in gigajoules ("GJ"). Natural gas volumes have been converted to barrels of oil equivalent ("boe"). Six thousand cubic feet ("Mcf") of natural gas is equal to one barrel ("bbl") based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead. Boes may be misleading, especially if used in isolation.

Additional information for the Company, including the Annual Information Form ("AIF"), can be found on SEDAR at www.sedar.com or at www.petrobank.com.

### *Forward-Looking Statements*

In addition to historical information, the MD&A contains forward-looking statements that are generally identifiable as any statements that express, or involve discussions as to, expectations, beliefs, plans, objectives, assumptions or future events of performance. Specifically, this MD&A contains forward-looking statements relating to future capital plans and projects, future production levels, sources of funding and future dividend rates. Forward-looking statements are necessarily based upon assumptions and judgments with respect to the future including, but not limited to, the outlook for commodity markets and capital markets, success of future evaluation and development activities, the successful application of technology, prevailing commodity prices, the performance of producing wells and reservoirs, well development and operating performance, general economic and business conditions, weather, and the regulatory and legal environment. These statements are not historical facts and may be forward-looking and may involve estimates, assumptions and uncertainties which could cause actual results or outcomes to differ materially from those expressed in such forward-looking statements. The reader is cautioned that assumptions used in the preparation of such information, although considered reasonable at the time of preparation, may prove to be incorrect. Actual results achieved during the forecast period will vary from the information provided herein as a result of numerous known and unknown risks and uncertainties and other factors. Such factors include, but are not limited to: general economic, market and business conditions; fluctuations in oil and gas prices; the results of exploration and development of drilling and related activities; costs and availability of services; fluctuation in foreign currency exchange rates; the uncertainty of reserve estimates; changes in environmental and other regulations; risks associated with oil and gas operations; the ability to economically test, develop and utilize the Company's patented technologies, the feasibility of the technologies; and other factors, many of which are beyond the control of the Company. Accordingly, there is no representation by Petrobank that actual results achieved during the forecast period will be the same in whole or in part as those forecasts. Except to the extent required by law, Petrobank assumes no obligation to publicly update or revise any forward-looking statements made in this MD&A or otherwise, whether as a result of new information, future events or otherwise.

### *Non-GAAP Measures*

This report contains certain financial measures, such as funds flow from operations, funds flow per share, adjusted net income, adjusted net income per share, capital expenditures and operating netback, which are not standardized measures recognized under GAAP and do not have a standardized meaning prescribed by GAAP. These measures are commonly utilized in the oil and gas industry and are considered informative for management and shareholders.

**Funds flow from operations** reflects cash generated from operating activities before changes in non-cash working capital. Funds flow per share is calculated as funds flow from operations divided by the weighted average number of shares outstanding for the period.

The following table reconciles cash flow from operating activities to funds flow from operations:

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | **2012** | 2011 | **2012** | 2011 |
| Cash flow from operating activities | **72,740** | 158,085 | **431,636** | 473,719 |
| Adjustments: | | | | |
| Changes in non-cash working capital | **46,830** | (10,633) | **(11,886)** | (9,443) |
| Funds flow from operations | **119,570** | 147,452 | **419,750** | 464,276 |

**Adjusted net income** is determined by adding back to net income any losses or deducting any gains on the derivative financial liability, adding back any losses or deducting any gains on settlement of convertible debentures, and adding back impairments. Adjusted net income per share is calculated as adjusted net income divided by the weighted average number of shares outstanding for the period.

The following table reconciles net income to adjusted net income:

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | **2012** | 2011 | **2012** | 2011 |
| Net income attributable to Petrobank shareholders | **10,179** | 15,348 | **13,446** | 94,224 |
| Adjustments: | | | | |
| Loss (gain) on derivative financial liability | **3,316** | (10,606) | **9,346** | (71,654) |
| Loss on settlement of convertible debentures | **-** | - | **44,009** | - |
| Impairment | **-** | 2,775 | **61,000** | 15,585 |
| Adjusted net income attributable to Petrobank shareholders | **13,495** | 7,517 | **127,801** | 38,155 |

Management considers funds flow from operations, funds flow per share, adjusted net income and adjusted net income per share important as they help evaluate performance and demonstrate the Company's ability to generate sufficient cash to fund future growth opportunities and repay debt.

**Capital expenditures** represent expenditures on property, plant and equipment, exploration and evaluation expenditures and other intangible asset expenditures.

**Operating netback** reflects revenues less royalties, transportation costs, and production expenses divided by production for the period. Operating netback demonstrates profitability relative to commodity prices per unit of production.

Funds flow from operations, funds flow per share, adjusted net income, adjusted net income per share, operating netback, and capital expenditures do not have standardized meanings and therefore may not be comparable to those reported by other companies, nor should they be viewed as an alternative to cash flow from operations or other measures of financial performance calculated in accordance with GAAP.

### *Petrobank's Operating Segments*

During the three and nine months ended September 30, 2012, the Company comprised of two operating segments: the Heavy Oil Business Unit ("HBU") and PetroBakken Energy Ltd. ("PetroBakken"). Where segmented information is provided throughout this MD&A, the HBU is combined with activities performed at the Petrobank parent company corporate level ("Corporate") and is referred to as "Petrobank Standalone".

The HBU operates our heavy oil projects using Petrobank's patented THAI® heavy oil recovery process in the field. THAI® (Toe to Heel Air Injection), is an evolutionary in-situ combustion technology for the recovery of heavy oil and bitumen. The HBU projects are in the exploration and evaluation phase and accordingly all expenses, net of revenues, are capitalized. Therefore, it is important to note that throughout this MD&A, results relating to the HBU are not included in operational results such as average daily production, revenue, royalties, production expenses, netbacks, or depletion and depreciation expense.

PetroBakken, 57 percent owned by Petrobank as at September 30, 2012, owns conventional oil and gas operations throughout western Canada with a primary focus on light oil developments from the Bakken formation in southeast Saskatchewan and in the Cardium play in Alberta. Petrobank results include 100 percent of PetroBakken's results; the 43 percent minority interest share, which Petrobank does not own, is recorded as income attributable to non-controlling interest ("NCI") on the consolidated statements of operations and comprehensive income and as paid-in capital and NCI on the consolidated statements of financial position.

### *Comparatives*

Comparisons presented in this MD&A are the three and nine months ended September 30, 2012 compared to the three and nine months ended September 30, 2011, unless otherwise noted.

## FINANCIAL AND OPERATIONAL REVIEW

## PETROBANK STANDALONE

*Significant Transactions*

- We sold the May River oil sands property on February 28, 2012, including the Conklin demonstration project, for cash proceeds of approximately $225 million, net of closing adjustments, and concurrently cancelled our credit facility and withdrew our May River regulatory application.
- In the nine months ended September 30, 2012, we repurchased 8,813,001 Petrobank common shares through our Normal Course Issuer Bid ("NCIB") for a total cost of $109.3 million. To help fund a portion of the Petrobank share repurchases, we sold 7,030,801 PetroBakken common shares for proceeds of $88.6 million.
- On October 29, 2012, Petrobank and PetroBakken entered into an agreement to complete a corporate reorganization that will see Petrobank shareholders effectively receive Petrobank's proportionate interest in our PetroBakken share holdings while maintaining their interest in the remaining Petrobank assets (the "Reorganization"). The Reorganization is anticipated to become effective on December 31, 2012 (the "Effective Date"). Pursuant to the Reorganization, a new Alberta corporation will be formed ("New Petrobank") which will, through a series of transactions, directly or indirectly acquire all of Petrobank's assets and liabilities, including our heavy oil assets, the THAI® and related patents and cash (the "Heavy Oil Business"), but excluding our investment in PetroBakken (the "PetroBakken Shares"). Existing Petrobank shareholders will receive one share of New Petrobank for every share of Petrobank held on the Effective Date.

  Following this distribution of Petrobank's Heavy Oil Business to New Petrobank, Petrobank and PetroBakken will, through a series of transactions, amalgamate, with the resulting company to continue under the name "PetroBakken Energy Ltd." ("New PetroBakken"). Existing PetroBakken shareholders will receive one share of New PetroBakken for every share of PetroBakken held on the Effective Date and Petrobank shareholders will receive, in aggregate, a number of New PetroBakken shares equal to the number of PetroBakken Shares held by Petrobank on the Effective Date. The number of New PetroBakken shares to be received for each Petrobank share held will be equal to the PetroBakken/Petrobank exchange ratio on the Effective Date, which will be calculated by dividing the number of PetroBakken shares owned by Petrobank by the number of Petrobank shares outstanding.

  New Petrobank will be a well-positioned junior heavy oil company with significant capital, an attractive asset base, a patented heavy oil extraction technology, and a plan to grow production and reserve value.

As previously described, the HBU operations are in the exploration and evaluation phase and accordingly operating costs and royalties, net of any revenues received, are charged to exploration assets as opposed to being recognized in net income.

The following table includes Petrobank Standalone results only.

| | Three months ended September 30, | | | Nine months ended September 30, | | |
|---|---|---|---|---|---|---|
| | **2012** | 2011 | Change | **2012** | 2011 | Change |
| General and administrative | **2,769** | 3,960 | (30%) | **9,616** | 10,958 | (12%) |
| Share-based compensation | **908** | 2,531 | (64%) | **441** | 7,105 | (94%) |
| Finance and other | **(276)** | 647 | - | **547** | 1,922 | (72%) |
| Impairment | **-** | 2,775 | (100%) | **-** | 15,585 | (100%) |
| Foreign exchange (gain) loss | **-** | 76 | (100%) | **(102)** | 103 | - |
| Depletion and depreciation expense | **241** | 223 | 8% | **690** | 614 | 12% |
| Deferred income tax recovery | **-** | (1,941) | (100%) | **-** | (7,001) | (100%) |
| Net loss for operating segment | **3,642** | 8,271 | (56%) | **11,192** | 29,286 | (62%) |

*General and Administrative*

Total general and administrative costs decreased in the three and nine months ended September 30, 2012 primarily due to fewer personnel related costs as a result of a decrease in the number of employees associated with the sale of our May River oil sands property.

*Share-Based Compensation*

Share-based compensation expenses relate to stock options, deferred common shares, directors deferred common shares and incentive shares (collectively, "Share-Based Awards") granted. The calculation of this non-cash expense is based on the fair value of the Share-Based Awards granted, amortized over the vesting period of the option or incentive share using the graded vesting method, or immediately upon grant of the deferred common shares and directors deferred common shares.

The decrease in share-based compensation in the three and nine months ended September 30, 2012 is due primarily to the forfeiture of Share-Based Awards as a result of a decrease in the number of employees associated with the sale of our May River oil sands property, and a lower fair value of new awards granted resulting from a lower share price compared to the prior period.

*Finance and Other*

Finance and other expenses includes accretion on decommissioning liabilities, amortization of deferred financing costs, and cash interest expense, offset by interest income. Cash interest expense includes interest on bank debt and standby fees. The Petrobank Standalone segment capitalizes interest on bank debt in accordance with our accounting policy.

The decrease in finance and other costs during the three and nine months ended September 30, 2012 is a result of the cancellation of the credit facility at the end of February 2012. The excess cash held by the Company resulting from the sale of our May River oil sands property has been invested in short term bankers' acceptances and is earning interest income.

*Impairment*

The impairment expense during the three and nine months ended September 30, 2011 of $2.8 million and $15.6 million, respectively, related to capitalized operating costs at our HBU's Conklin cash generating unit ("CGU"). Conklin was our oil sands demonstration project operating near Conklin, Alberta. By the end of the third quarter of 2011 we had completed all of our near-term testing operations scheduled for Conklin and we suspended the facility in the fourth quarter of 2011. Our May River oil sands property, which included the Conklin demonstration project, was sold on February 28, 2012 for cash proceeds of approximately $225 million, net of closing adjustments. As such, there is no related impairment in 2012.

*Foreign Exchange (Gain) Loss*

There is an immaterial foreign exchange impact in the first nine months of 2012 and 2011 as most of the Petrobank Standalone transactions are in Canadian dollars.

*Depletion and Depreciation Expense*

Petrobank Standalone depletion and depreciation expense includes only depreciation on other fixed assets and other intangible assets.

*Deferred Income Tax Recovery*

The calculated deferred income tax recovery has not been recorded to date in 2012 as it is not probable that future taxable profit will be available against which the deferred tax asset can be utilized. The calculated deferred income tax recovery for the three and nine months ended September 30, 2012 was consistent with income earned adjusted for non-deductible tax items.

| *Capital Expenditures* | Three months ended Sept. 30, | | | Nine months ended Sept. 30, | | |
|---|---|---|---|---|---|---|
| | **2012** | 2011 | Change | **2012** | 2011 | Change |
| Property, plant and equipment | **40** | 353 | (89%) | **110** | 729 | (85%) |
| Exploration and evaluation | **9,581** | 30,171 | (68%) | **31,535** | 139,146 | (77%) |
| Other intangible assets | **3** | 248 | (99%) | **382** | 793 | (52%) |
| Total capital expenditures | **9,624** | 30,772 | (69%) | **32,027** | 140,668 | (77%) |

| *Capital Expenditures By Type* | Three months ended Sept. 30, | | | Nine months ended Sept. 30, | | |
|---|---|---|---|---|---|---|
| | **2012** | 2011 | Change | **2012** | 2011 | Change |
| Drilling, completions and workovers | **2,548** | 7,437 | (66%) | **3,874** | 67,285 | (94%) |
| Facilities | **1,837** | 12,569 | (85%) | **5,574** | 50,227 | (89%) |
| Land, seismic and exploration | **549** | 998 | (45%) | **4,006** | 4,071 | (2%) |
| Other [(1)] | **4,690** | 9,768 | (52%) | **18,573** | 19,085 | (3%) |
| Total capital expenditures | **9,624** | 30,772 | (69%) | **32,027** | 140,668 | (77%) |

(1) Includes health, safety and environmental, capitalized salaries and benefits for qualifying employees, office furniture and fixtures and computer equipment, capitalized interest expense and operating costs, net of revenue, for projects in the exploration and evaluation phase, and expenditures on other intangible assets.

*Exploration and Evaluation Expenditures by CGU – Three months ended September 30, 2012*

| | Drilling, Completions, and Workovers | Facilities | Land, Seismic and Exploration | Other [(1)] | Total |
|---|---|---|---|---|---|
| Kerrobert | 2,312 | 1,261 | 59 | 4,086 | 7,718 |
| Dawson | 50 | - | 13 | 45 | 108 |
| Plover | 186 | 576 | 19 | 445 | 1,226 |
| Other | - | - | 458 | 71 | 529 |
| **Total** | **2,548** | **1,837** | **549** | **4,647** | **9,581** |

(1) Includes health, safety and environmental, capitalized salaries and benefits for qualifying employees, and capitalized interest and operating costs, net of revenue, for projects in the exploration and evaluation phase.

*Exploration and Evaluation Expenditures by CGU – Nine months ended September 30, 2012*

| | Drilling, Completions, and Workovers | Facilities | Land, Seismic and Exploration | Other [(1)] | Total |
|---|---|---|---|---|---|
| Kerrobert | 2,780 | 2,051 | 306 | 12,818 | 17,955 |
| Conklin and May River | - | 1,140 | 39 | 3,495 | 4,674 |
| Dawson | 637 | 1,762 | 43 | 909 | 3,351 |
| Plover | 457 | 621 | 3,090 | 656 | 4,824 |
| Other | - | - | 528 | 203 | 731 |
| **Total** | **3,874** | **5,574** | **4,006** | **18,081** | **31,535** |

(1) Includes health, safety and environmental, capitalized salaries and benefits for qualifying employees, and capitalized interest and operating costs, net of revenue, for projects in the exploration and evaluation phase.

The majority of HBU expenditures in the three and nine months ended September 30, 2012 related to capitalized operating costs, net of revenue, incurred at Kerrobert, drilling three stratigraphic wells at our Plover property, reactivating eight wells in the Kerrobert trend lands for cold production, facility commitments related to our May River and Dawson projects, and drilling a water disposal well at Kerrobert.

The HBU operates two significant projects which have not commenced generating significant revenue:

Kerrobert:

Production continued its upward trend in the third quarter averaging 305 barrels of oil per day ("bopd"), compared to 236 bopd in the second quarter of 2012. These production volumes represent actual sale volumes for each period reported. Oil production continues to average 13 to 14 degrees API, providing more evidence that upgraded THAI® oil is being produced.

Since the full Kerrobert field was placed on production in September 2011, we have maintained a consistent and patient operating philosophy to rateably increase sustained production of upgraded THAI® oil. This philosophy includes managing air injection rates in order to gradually build out the combustion front and optimizing the type, configuration and placement of the production pumps to extend their useful life and reduce downtime and maintenance costs. Our optimization strategy also includes reducing downtime of our surface facilities. Based on our experience with the two pilot wells, as the initial cold native oil production transitions to hot upgraded THAI® oil production, we expect production rates to greatly improve. However, our operating approach may extend the time frame for achieving project design production rates.

Our operational plan at Kerrobert is to continue to increase air injection rates, build out the combustion front as mentioned, increase production of upgraded THAI® oil, and reduce per barrel costs with the focus on reaching commercial production levels and beyond in 2013.

Dawson:

Our Dawson demonstration project was initially planned to consist of two THAI® well-pairs. The project is located in the Peace River, Alberta area, situated on a large Bluesky formation of heavy oil/oil sands fairway. In the second half of 2011 we drilled two THAI® well-pairs that we left waiting for completion. Since that time, we have continued to review the Dawson reservoir and project plans. Based on this analysis, we determined that the Dawson reservoir would benefit from being pre-conditioned for THAI® operations by producing conventional cold heavy oil from our current horizontal production wells. During the three months ended September 30, 2012, we completed the first of the two horizontal THAI® production wells and commenced cold oil production. We expect to complete and initiate cold production at the second well before the end of 2012. We may drill additional horizontal conventional production wells near the demonstration project area to further pre-condition the reservoir for THAI® operations.

*Commitments*

The following is a summary of the estimated costs required to fulfill Petrobank Standalone's remaining contractual commitments as at September 30, 2012:

| Type of Commitment | < 1 Year | 1-3 Years | 4-5 Years | Thereafter | Total |
|---|---|---|---|---|---|
| Office operating leases [1] | $ 1,004 | $ 1,041 | $ 386 | $ 383 | $ 2,814 |
| Finance leases | 570 | 716 | - | - | 1,286 |
| **Total Commitments** | **$ 1,574** | **$ 1,757** | **$ 386** | **$ 383** | **$ 4,100** |

[1] Minimum lease payments are net of sub-lease payments received by Petrobank, which reduces rent expense included in general and administrative expenses on the consolidated statement of operations.

*Liquidity and Capital Resources*

Petrobank Standalone and PetroBakken manage their capital structure independently and generate their own cash flows, and have the ability to fund their operations through the issuance of secured and unsecured debt as well as equity financing. The table below outlines the composition of Petrobank Standalone's capital structure and liquidity as at September 30, 2012:

| | | **Petrobank Standalone** |
|---|---|---|
| Working capital surplus [1] | **$** | **84,854** |
| Bank debt – principal | **$** | **-** |
| Common share capital | **$** | **1,456,241** |
| Credit facility | **$** | **-** |
| Committed credit capacity | **$** | **-** |

[1] Working capital surplus is calculated as the operating segment's current assets less current liabilities.

At September 30, 2012, Petrobank Standalone had a working capital surplus of $84.9 million, including $96.1 million in cash and cash equivalents.

Petrobank manages our capital structure and makes adjustments to it in light of changes in economic conditions and the risk characteristics of the underlying assets. Petrobank considers our capital structure to include common share capital and working capital. In order to maintain or adjust the capital structure, from time to time Petrobank may issue common shares or other securities, sell a portion of our ownership in PetroBakken or other corporate assets or adjust our capital spending to manage current and projected cash levels.

Petrobank received cash proceeds of approximately $225.0 million, net of closing adjustments, on February 28, 2012 from the sale of our May River property. Proceeds from this transaction were used to repay outstanding bank debt and resulted in Petrobank having a significant positive cash and working capital balance. We cancelled our credit facility concurrent with the closing of the sale due to our cash availability.

Petrobank currently receives a monthly dividend from PetroBakken of $0.08 per PetroBakken share. PetroBakken instituted a dividend re-investment plan ("DRIP") in 2012, which allows shareholders to reinvest monthly cash dividends in new shares at a five percent discount to the then current market price. Due to Petrobank's significant positive working capital balance, we elected to participate at a 100 percent level in PetroBakken's DRIP, starting with the March dividend. During the nine months ended September 30, 2012, Petrobank received dividends totalling approximately $8.8 million in cash and 5,429,263 PetroBakken common shares.

In April 2012, Petrobank entered into an Automatic Share Repurchase and PetroBakken Share Sale Plan (the "Plan") pursuant to which our designated broker was instructed to automatically sell one PetroBakken share for each Petrobank share purchased under the NCIB, subject to certain trading parameters set forth in the Plan and to daily and aggregate trading limits imposed by the rules and policies of the Toronto Stock Exchange.

In the nine months ended September 30, 2012, Petrobank has sold 7,030,801 PetroBakken common shares for total proceeds of $88.6 million. The transactions under the Plan resulted in net cash proceeds to Petrobank of $5.3 million. As a result of the Plan and our NCIB, the number of PetroBakken shares owned per Petrobank share outstanding increased to approximately 1.10 at September 30, 2012 from 1.03 at December 31, 2011. Subsequent to September 30, 2012, Petrobank sold an additional 1,927,100 PetroBakken common shares for proceeds of $25.6 million.

Petrobank currently expects to fund our future working capital requirements and HBU capital expenditure program with available cash and cash from operations.

*Capital Plan*

HBU activity in the remainder of 2012 will focus on increasing Kerrobert production and bringing the project to commerciality. We are nearing completion of our water disposal well near our Kerrobert project which will result in lower operating costs going forward. We also expect to drill four stratigraphic wells in Q4 2012 to better define our resources in the Luseland area, near our Kerrobert project, and acquire seismic to further delineate these assets for future development. We are also anticipating capital expenditures at Dawson in 2012 in order to convert the second horizontal THAI® production well into a conventional production well. In addition, we are undertaking research and development activities at Archon Technologies Ltd., our wholly owned technology subsidiary, to improve and protect our intellectual property.

*Dividends*

The Petrobank legal entity has not paid or declared any dividends since the date of incorporation.

## PETROBAKKEN

*Significant Transactions*

- On January 30, 2012, PetroBakken closed a private placement of senior unsecured notes (the "Notes") with a principal amount of US$900 million. The Notes bear interest at a rate of 8.625 percent per annum and mature February 1, 2020.
- On January 31, 2012, PetroBakken completed the repurchase of US$450 million of convertible debentures at a price of US$99,000 per US$100,000 of principal amount.
- In the first nine months of the year, PetroBakken closed non-core asset dispositions for gross proceeds $646.5 million, which included the disposal of primarily non-operated southeast Saskatchewan Bakken assets for gross proceeds of $427.0 million on March 16, 2012, the disposal of a 2.2 percent interest in the Weyburn unit for gross proceeds of $105.0 million on February 24, 2012, the disposal of other minor non-core assets and the disposition of undeveloped land. Total production disposed of in the first nine months of 2012 was 3,780 barrels of oil equivalent per day ("boepd").

*Average Daily Production*

| | Three months ended Sept. 30, | | | Nine months ended Sept. 30, | | |
|---|---|---|---|---|---|---|
| | **2012** | 2011 | Change | **2012** | 2011 | Change |
| Oil and natural gas liquids ("NGL") (bbls) | **31,662** | 33,112 | (4%) | **34,733** | 32,965 | 5% |
| Natural gas (Mcf) | **41,048** | 35,776 | 15% | **39,420** | 34,030 | 16% |
| Total (boe) | **38,503** | 39,074 | (1%) | **41,303** | 38,636 | 7% |

Production for the three months ended September 30, 2012 decreased slightly compared to the prior year, primarily resulting from the disposition of producing assets in the first half of 2012, and a delayed start to PetroBakken's capital program in the second half of 2012. Production for the nine months ended September 30, 2012 increased by seven percent, primarily due to an increase in oil production resulting from the execution of PetroBakken's new well program from the fourth quarter of 2011 through the third quarter of 2012. The increase in gas production was primarily the result of gas associated with PetroBakken's light-oil properties and investment in gas conservation infrastructure. During the third quarter of 2012, PetroBakken drilled 82 net wells and brought 52 net wells on production. In the first nine months of 2012, PetroBakken drilled 138 net wells and brought 104 net wells on production. At September 30, 2012, there were 43 net wells waiting to be completed and/or brought on production, which reflects the high level of field activity in the latter part of the quarter.

Beginning late in the fourth quarter of 2011 and continuing through the first nine months of 2012, PetroBakken executed divestitures of non-core assets that resulted in 4,230 boepd of production being sold for gross proceeds of $662.5 million. The proceeds were initially used to reduce PetroBakken's overall debt and a portion is expected to be used for reinvestment in core assets.

In southeast Saskatchewan, the Bakken business unit averaged 15,767 boepd of production, an increase of six percent over the second quarter as the majority of PetroBakken's shut-in production was restored. Capital activity increased throughout the third quarter resulting in 40 net wells drilled and 31 net wells brought on production. At September 30, 2012, there were 17 net Bakken wells waiting to go on production.

In Alberta, the Cardium business unit averaged 14,721 boepd of production, an increase of 31 percent over the third quarter of 2011. Production decreased by seven percent from the second quarter of 2012 due to a delayed start to PetroBakken's capital program in the second half of 2012, restricted production and downtime resulting from routine maintenance of individual wells and facilities. During the quarter, PetroBakken drilled 32 net wells and brought 15 net wells on production, most of which were in the last half of the quarter, resulting in minimal production impact. At September 30, 2012, PetroBakken had 23 net Cardium wells waiting to be completed and/or brought on production, which will contribute to fourth quarter 2012 production growth.

Early November production is approximately 45,000 boepd based on field estimates. PetroBakken currently has a total of 17 drilling rigs operating, with eight drilling in the Cardium fairway, seven in the Bakken fairway, and the remaining two within PetroBakken's conventional Saskatchewan business unit and new resource play area in central Alberta. Well inventory levels at the end of October increased to 53 net wells waiting to be completed and/or brought on production as new wells drilled in October more than offset the 31 wells brought on production in the month. Production is expected to increase in the fourth quarter with ongoing field activity, which includes reducing the inventory of wells not on production to approximately 20 net wells by year end.

*Average Benchmark and Realized Prices*

| | Three months ended Sept. 30, | | | Nine months ended Sept. 30, | | |
|---|---|---|---|---|---|---|
| | **2012** | 2011 | Change | **2012** | 2011 | Change |
| WTI (US$/bbl) | **92.22** | 89.76 | 3% | **96.21** | 95.47 | 1% |
| WTI ($/bbl) | **91.70** | 87.86 | 4% | **96.02** | 93.28 | 3% |
| Edmonton Par ($/bbl) | **85.01** | 91.74 | (7%) | **87.06** | 94.26 | (8%) |
| Differential % of WTI | **(7%)** | 4% | - | **(9%)** | 1% | - |
| AECO natural gas ($/Mcf) | **2.30** | 3.66 | (37%) | **2.12** | 3.76 | (44%) |
| US$ per C$1 | **0.99** | 0.98 | 1% | **1.00** | 0.98 | 2% |
| Oil and NGL | | | | | | |
| Realized price per bbl ($/bbl) | **78.40** | 85.08 | (8%) | **82.25** | 87.83 | (6%) |
| Differential % of Edmonton Par | **(8%)** | (7%) | 14% | **(6%)** | (7%) | (14%) |
| Natural gas | | | | | | |
| Realized price per Mcf ($/Mcf) | **2.50** | 4.01 | (38%) | **2.37** | 4.11 | (42%) |

Realized oil and NGL prices decreased for both the three and nine months ended September 30, 2012 due to a weaker Edmonton par price relative to WTI. This wider differential reflects a persistent weakness of Edmonton par and other Canadian prices relative to WTI over the course of the year resulting from decreased demand for Canadian sourced crude, in part caused by refinery turnarounds, short-term pipeline issues, and an increase in U.S. based supply. Year to date oil differentials have been volatile, ranging from below the historically normal five percent discount to as high as a 24 percent discount to WTI. PetroBakken expects these differentials to remain volatile and wider than historical norms due to the lack of spare capacity in the pipeline and refining infrastructure, particularly in the mid-west U.S.

*Revenue*

| | Three months ended Sept. 30, | | | Nine months ended Sept. 30, | | |
|---|---|---|---|---|---|---|
| | **2012** | 2011 | Change | **2012** | 2011 | Change |
| Oil and natural gas sales | **237,833** | 272,346 | (13%) | **808,399** | 828,595 | (2%) |
| Royalties | **(32,209)** | (43,871) | (27%) | **(116,157)** | (130,409) | (11%) |
| Revenue | **205,624** | 228,475 | (10%) | **692,242** | 698,186 | (1%) |

The change in the third quarter 2012 sales is due to a combination of lower realized prices and decreased volumes. The decrease in sales for the first nine months of 2012 is due to lower pricing partially offset by increased oil volumes. The table below summarizes these changes:

**Reconciliation of Changes in Oil and Natural Gas Sales**

| | Three months ended | Nine months ended |
|---|---|---|
| September 30, 2011 | 272,346 | 828,595 |
| Sales volume | (3,529) | 57,377 |
| Realized prices | (30,984) | (77,573) |
| **September 30, 2012** | **237,833** | **808,399** |
| $ change in oil and natural gas sales | (34,513) | (20,196) |
| % change in oil and natural gas sales | (13%) | (2%) |

*Net Realized Prices*

| | Three months ended Sept. 30, | | | Nine months ended Sept. 30, | | |
|---|---|---|---|---|---|---|
| | **2012** | 2011 | Change | **2012** | 2011 | Change |
| Oil and natural gas sales | **237,833** | 272,346 | (13%) | **808,399** | 828,595 | (2%) |
| Transportation expense | **1,987** | 1,416 | 40% | **4,449** | 5,991 | (26%) |
| Total sales, net of transportation expense | **235,846** | 270,930 | (13%) | **803,950** | 822,604 | (2%) |
| Gross sales ($/boe) | **67.14** | 75.76 | (11%) | **71.43** | 78.55 | (9%) |
| Transportation costs ($/boe) | **0.56** | 0.39 | 44% | **0.39** | 0.57 | (32%) |
| Realized price, net of transportation expense ($/boe) | **66.58** | 75.37 | (12%) | **71.04** | 77.98 | (9%) |

Net realized price decreased for both the three and nine months ended September 30, 2012 primarily due to wider differentials. Transportation expense increased both on a unit of production and total basis in the third quarter of 2012 due to higher Cardium clean oil trucking costs resulting from non-recurring third party pipeline and facility turnarounds. During the first nine months of 2012, transportation expense decreased on a unit of production and total basis due primarily to infrastructure investments made in southeast Saskatchewan resulting in single well batteries being tied-in to this infrastructure, which led to a reduction in trucking costs.

*Royalties*

| | Three months ended Sept. 30, | | | Nine months ended Sept. 30, | | |
|---|---|---|---|---|---|---|
| | **2012** | 2011 | Change | **2012** | 2011 | Change |
| Royalties [1] | **32,209** | 43,871 | (27%) | **116,157** | 130,409 | (11%) |
| $ per boe | **9.09** | 12.20 | (25%) | **10.26** | 12.36 | (17%) |
| Royalties as a % of realized price, net of transportation costs | **14%** | 16% | (13%) | **14%** | 16% | (13%) |

[1] PetroBakken royalties include the Saskatchewan Resource Surcharge determined as a percentage of sales from PetroBakken's Saskatchewan Crown lands.

Royalties decreased for both the three and nine months ended September 30, 2012 on a total and unit of production basis commensurate with the decrease in revenues and a lower royalty rate. As a percentage of revenue, royalties decreased due to new production receiving a royalty holiday. On Crown lands in Saskatchewan, the first 37,740 boe of production from horizontal wells receive a royalty incentive but incur Saskatchewan Resource Surcharge of 1.7 percent. On Crown lands in Alberta, horizontal oil wells are subject to a maximum five percent royalty rate for 18 to 48 months or 50,000 to 100,000 boe of production, whichever comes first, depending on well length.

*Gain (Loss) on Risk Management Contracts*

PetroBakken enters into commodity price derivative contracts to limit exposure to declining commodity prices, thereby protecting project economics and providing increased stability of cash flows, dividends and capital expenditure programs. Commodity prices fluctuate for a number of reasons including changes in economic conditions, political events, weather conditions, disruptions in supply, and changes in demand. PetroBakken's risk management activities are conducted pursuant to risk management policies that have been approved by PetroBakken's Board of Directors.

PetroBakken enters into foreign exchange contracts to limit exposure to variability in exchange rates on U.S. dollar interest payments on the senior unsecured notes and convertible debentures, thereby providing increased stability of cash flows. At September 30, 2012, PetroBakken recorded a $0.1 million liability related to foreign exchange contracts. The fair value of this liability represents the estimated amount that would be received for settling PetroBakken's outstanding contracts on September 30, 2012, and will be different than what will eventually be realized.

PetroBakken's financial commodity derivative contracts are option-based contracts and as such their fair value at a particular point in time is affected by underlying commodity prices, expected commodity price volatility and the duration of the contract. The fair value of fixed price derivative contracts at a particular point in time is determined by the expected future settlements of the underlying commodity. At September 30, 2012, the fair value of financial derivative contracts was an asset of $11.4 million (December 31, 2011 - liability of $0.8 million). The fair value of this asset represents the estimated amount that would be received for settling PetroBakken's outstanding contracts on September 30, 2012 and will be different than what will eventually be realized.

The gain or loss on risk management contracts is made up of two components; the realized component reflects actual settlements that occurred during the period, and the unrealized component represents the change in the fair value of contracts during the period. The unrealized loss on risk management contracts in the third quarter of 2012 and the unrealized gain over the first nine months of 2012 was primarily the result of the fluctuations in expected future WTI prices, and is summarized below:

| | Three months ended Sept. 30, | | | Nine months ended Sept. 30, | | |
|---|---|---|---|---|---|---|
| | **2012** | 2011 | Change | **2012** | 2011 | Change |
| Realized (loss) gain: | | | | | | |
| Crude oil derivative contracts | **9** | (190) | - | **1,173** | (4,864) | - |
| Natural gas derivative contracts | **-** | 471 | (100%) | **-** | 1,647 | (100%) |
| Interest rate swap contracts | **18** | (222) | - | **(140)** | (668) | (79%) |
| Foreign exchange contracts | **(360)** | - | - | **(435)** | - | - |
| | **(333)** | 59 | - | **598** | (3,885) | - |
| Unrealized (loss) gain: | | | | | | |
| Crude oil derivative contracts | **(16,657)** | 55,837 | - | **12,199** | 56,520 | (78%) |
| Natural gas derivative contracts | **-** | (387) | (100%) | **-** | (1,560) | (100%) |
| Interest rate swap contracts | **-** | (130) | (100%) | **188** | (315) | - |
| Foreign exchange contracts | **(98)** | - | - | **(135)** | - | - |
| | **(16,755)** | 55,320 | - | **12,252** | 54,645 | (78%) |
| (Loss) gain on risk management contracts | **(17,088)** | 55,379 | - | **12,850** | 50,760 | (75%) |

*Production Expenses*

| | Three months ended Sept. 30, | | | Nine months ended Sept. 30, | | |
|---|---|---|---|---|---|---|
| | **2012** | 2011 | Change | **2012** | 2011 | Change |
| Production expenses | **43,914** | 47,207 | (7%) | **144,635** | 134,291 | 8% |
| $ per boe | **12.40** | 13.13 | (6%) | **12.78** | 12.73 | - |

Production expenses for the three months ended September 30, 2012 decreased on a total and unit of production basis due to lower emulsion trucking costs resulting from the completion of a new Cardium facility at the end of the second quarter of 2012, combined with higher operating costs in the third quarter of 2011 due to a longer than normal spring break-up. Production expenses for the first nine months of 2012 were higher on a total basis as a result of higher production. On a unit of production basis, costs were relatively consistent.

*Netbacks ($/boe)*

| | Three months ended Sept. 30, | | | Nine months ended Sept. 30, | | |
|---|---|---|---|---|---|---|
| | **2012** | 2011 | Change | **2012** | 2011 | Change |
| Oil, NGL and natural gas sales [(1)] | **66.58** | 75.37 | (12%) | **71.04** | 77.98 | (9%) |
| Royalties | **9.09** | 12.20 | (25%) | **10.26** | 12.36 | (17%) |
| Production expenses | **12.40** | 13.13 | (6%) | **12.78** | 12.73 | - |
| Operating netback [(2)] | **45.09** | 50.04 | (10%) | **48.00** | 52.89 | (9%) |

(1) Net of transportation expenses.
(2) Non-GAAP measure. See “Non-GAAP Measures” section within the MD&A.

The decrease in PetroBakken’s netbacks for both the third quarter and first nine months of 2012 was primarily the result of lower realized oil prices partially offset by lower royalties.

*General and Administrative Expenses*

| | Three months ended Sept. 30, | | | Nine months ended Sept. 30, | | |
|---|---|---|---|---|---|---|
| | **2012** | 2011 | Change | **2012** | 2011 | Change |
| General and administrative expenses | **10,239** | 10,654 | (4%) | **34,741** | 29,058 | 20% |
| $ per boe | **2.89** | 2.96 | (2%) | **3.07** | 2.75 | 12% |

General and administrative expenses decreased slightly in the third quarter of 2012 on an absolute and per boe basis due primarily to higher recoveries from an increased number of partnered wells. The increase in general and administrative costs for the first nine months of 2012 is due primarily to additional personnel and office costs as a result of expanding operations.

*Share-Based Compensation Expense*

| | Three months ended Sept. 30, | | | Nine months ended Sept. 30, | | |
|---|---|---|---|---|---|---|
| | **2012** | 2011 | Change | **2012** | 2011 | Change |
| Share-based compensation expense | **4,338** | 6,083 | (29%) | **14,376** | 15,231 | (6%) |

Share-based compensation expense relates to stock options, deferred common shares and incentive shares granted. The calculation of this non-cash expense is based on the fair value of stock options, deferred common shares and incentive shares granted, amortized over the vesting period of the option and incentive share or immediately upon grant of the deferred common share. The decrease in share-based compensation is primarily due to the impact of graded vesting.

*Loss (Gain) on Derivative Financial Liability*

| | Three months ended Sept. 30, | | | Nine months ended Sept. 30, | | |
|---|---|---|---|---|---|---|
| | **2012** | 2011 | Change | **2012** | 2011 | Change |
| Loss (gain) on derivative financial liability | **3,316** | (10,606) | - | **9,346** | (71,654) | - |

The loss (gain) on the derivative liability represents the change in the fair value of derivative financial liability on the convertible debentures from the beginning to the end of the period. The fair value is determined using the Black-Scholes valuation model; refer to Note 9 in the interim Consolidated Financial Statements for further details. The loss in the third quarter of 2012 is primarily due to a higher share price at September 30, 2012 compared to June 30, 2012. The loss in the first nine months of 2012 is due to a higher share price at September 30, 2012 compared to December 31, 2011 and also reflects the loss incurred in January 2012 on the then outstanding US$750 million of convertible debentures (prior to the US$450 million repurchase of convertible debentures on February 1, 2012 as the share price at January 31, 2012 was higher than the share price at December 31, 2011).

*Finance and Other Expenses*

| | Three months ended Sept. 30, | | | Nine months ended Sept. 30, | | |
|---|---|---|---|---|---|---|
| | **2012** | 2011 | Change | **2012** | 2011 | Change |
| Interest expense on senior unsecured notes | **19,760** | - | - | **51,920** | - | - |
| Interest on credit facility and other | **4,676** | 10,781 | (57%) | **18,174** | 28,291 | (36%) |
| Interest expense on convertible debentures | **2,334** | 5,884 | (60%) | **8,318** | 17,268 | (52%) |
| Cash finance and other | **26,770** | 16,665 | 61% | **78,412** | 45,559 | 72% |
| Accretion of the convertible debentures | **2,631** | 6,040 | (56%) | **9,066** | 17,545 | (48%) |
| Accretion of decommissioning liability | **1,462** | 1,388 | 5% | **4,150** | 4,078 | 2% |
| Amortization of deferred financing costs | **471** | 466 | 1% | **1,444** | 2,868 | (50%) |
| Accretion of senior unsecured notes | **561** | - | - | **1,466** | - | - |
| Finance and other expense | **31,895** | 24,559 | 30% | **94,538** | 70,050 | 35% |

Interest expense on the credit facility includes interest on bank debt, stand-by fees, and fees on letters of credit. Interest on the credit facility decreased in the three and nine months ended September 30, 2012 primarily due to lower bank debt outstanding during the period. A portion of the bank debt was repaid at the end of January 2012 when the senior unsecured notes were issued, and the amount outstanding continued to decrease in February and March commensurate with disposition activity. The balance began to increase in April 2012 and continued into the third quarter as a result of capital spending. On average, bank debt outstanding for the third quarter 2012 was $355 million as compared to $1,128 million in the third quarter of 2011, and $459 million for the first nine months of 2012 as compared to $1,023 million in the first nine months of 2011.

Accretion and interest expense on the convertible debentures decreased due to the repurchase of US$450 million of the US$750 million principal amount outstanding in the first quarter of 2012.

Interest and accretion on senior unsecured notes are due to the issuance of US$900 million of senior unsecured notes on January 30, 2012. Accretion on the senior unsecured notes relates to the amortization of the issuance fees and the issuance discount over the life of the senior unsecured notes.

*Loss (Gain) on Dispositions*

| | Three months ended Sept. 30, | | | Nine months ended Sept. 30, | | |
|---|---|---|---|---|---|---|
| | **2012** | 2011 | Change | **2012** | 2011 | Change |
| Loss (gain) on dispositions | **842** | 122 | 590% | **(121,857)** | (15,070) | 709% |

The loss on dispositions in the three months ended September 30, 2012 relates to the disposal of a minor property for net proceeds of $7.8 million. The gain on dispositions for the first nine months of 2012 relates to the disposal of non-core properties for net proceeds of $635.7 million, representing approximately 3,780 boepd of production sold. The loss on dispositions for the third quarter of 2011 and the gain on dispositions for the first nine months of 2011 related to the disposal of non-core properties for net proceeds of $0.1 million and $22.7 million, respectively.

*Loss on Settlement of Convertible Debentures*

The loss on convertible debentures of $44.0 million in the first nine months of 2012 relates to the repurchase of US$450 million principal amount of the convertible debentures and consists of acceleration of the accretion on the retired portion of the convertible debenture liability of $72.1 million, partially offset by a gain on the derivative liability of $28.1 million.

*Impairment*

| | Three months ended Sept. 30, | | | Nine months ended Sept. 30, | | |
|---|---|---|---|---|---|---|
| | **2012** | 2011 | Change | **2012** | 2011 | Change |
| Impairment | **-** | - | - | **61,000** | - | - |

The impairment recognized in the nine months ended September 30, 2012 is related to PetroBakken's gas weighted BC CGU, and is the result of a decline in the fair value less costs to sell of the undeveloped land, land expiries and PetroBakken's intention not to actively develop these assets at this time. Of the impairment, $31.1 million is related to exploration assets, and $29.9 million is related to property, plant and equipment.

*Foreign Exchange Gain (Loss)*

| | Three months ended Sept. 30, | | | Nine months ended Sept. 30, | | |
|---|---|---|---|---|---|---|
| | **2012** | 2011 | Change | **2012** | 2011 | Change |
| Foreign exchange gain (loss) | **39,943** | (46,176) | - | **31,619** | (27,417) | - |

PetroBakken recognizes foreign exchange gains and losses primarily due to the appreciation or depreciation of the Canadian dollar relative to the U.S. dollar. PetroBakken's convertible debentures and senior unsecured notes are denominated in U.S. dollars and, as a result, the vast majority of unrealized foreign exchange gains or losses relate to the change in the foreign exchange rate compared to the rate at the end of the previous period. A stronger Canadian dollar at September 30, 2012 compared to June 30, 2012 and December 31, 2011 resulted in a foreign exchange gain in the three and nine months ended September 30, 2012.

*Depletion and Depreciation Expense*

| | Three months ended Sept. 30, | | | Nine months ended Sept. 30, | | |
|---|---|---|---|---|---|---|
| | **2012** | 2011 | Change | **2012** | 2011 | Change |
| Depletion and depreciation expense | **103,005** | 94,472 | 9% | **323,154** | 277,840 | 16% |
| $ per boe | **29.08** | 26.28 | 11% | **28.55** | 26.34 | 8% |

On an absolute basis, depletion and depreciation expense increased in the third quarter of 2012 due to a higher depletion rate. The increase for the first nine months of 2012 was primarily due to higher production. On a unit of production basis, the rate increased for both the third quarter and first nine months of 2012 as positive reserve additions were offset by an increase in future development costs related to undeveloped reserves.

*Income Tax Expense*

| | Three months ended Sept. 30, | | | Nine months ended Sept. 30, | | |
|---|---|---|---|---|---|---|
| | **2012** | 2011 | Change | **2012** | 2011 | Change |
| Income tax expense | **4,810** | 23,494 | (80%) | **86,908** | 65,200 | 33% |

The income tax expense in the third quarter of 2012 is consistent with the net income adjusted for non-deductible items. The increased income tax expense in the first nine months of 2012 was due primarily to non-deductible differences of $30.2 million on disposed properties related to goodwill associated with the assets, $11.4 million related to the loss on the settlement of convertible debentures and $2.4 million related to the change in the derivative liability valuation. Excluding these items, income tax expense for the first nine months of 2012 is consistent with income earned adjusted for other non-deductible tax items, generating an effective tax rate of 29 percent.

*Net Income Attributable to Non-Controlling Interest*

| | Three months ended Sept. 30, | | | Nine months ended Sept. 30, | | |
|---|---|---|---|---|---|---|
| | **2012** | 2011 | Change | **2012** | 2011 | Change |
| Net income attributable to NCI | **10,312** | 16,658 | (38%) | **16,774** | 87,082 | (81%) |

The net income attributable to NCI represents the minority interest share, which Petrobank does not own. The non-controlling interest share in PetroBakken averaged approximately 43 percent and 42 percent in the three and nine months ended September 30, 2012, respectively (2011 – 41 percent).

*Capital Expenditures*

| | Three months ended Sept. 30, | | | Nine months ended Sept. 30, | | |
|---|---|---|---|---|---|---|
| | **2012** | 2011 | Change | **2012** | 2011 | Change |
| Property, plant and equipment | **274,505** | 269,759 | 2% | **580,882** | 660,986 | (12%) |
| Exploration and evaluation | **8,573** | 2,102 | 308% | **18,373** | 31,366 | (41%) |
| Total capital expenditures | **283,078** | 271,861 | 4% | **599,255** | 692,352 | (13%) |

*Capital Expenditures by Type*

| | Three months ended Sept. 30, | | | Nine months ended Sept. 30, | | |
|---|---|---|---|---|---|---|
| | **2012** | 2011 | Change | **2012** | 2011 | Change |
| Drilling, completions, equipping and recompletions | **241,945** | 241,325 | - | **483,872** | 564,858 | (14%) |
| Facilities | **13,127** | 14,313 | (8%) | **62,642** | 59,210 | 6% |
| Land | **8,307** | 3,270 | 154% | **19,581** | 29,908 | (35%) |
| Seismic | **641** | 2,036 | (69%) | **3,397** | 3,842 | (12%) |
| Other [(1)] | **17,970** | 9,205 | 95% | **28,265** | 29,367 | (4%) |
| **Capital expenditures before acquisitions** | **281,990** | 270,149 | 4% | **597,757** | 687,185 | (13%) |
| Asset acquisitions | **1,088** | 1,712 | (36%) | **1,498** | 5,167 | (71%) |
| **Total capital expenditures** | **283,078** | 271,861 | 4% | **599,255** | 692,352 | (13%) |
| Proceeds from dispositions | **(7,845)** | (75) | 10,360% | **(635,665)** | (22,664) | 2,705% |
| **Net capital expenditures** | **275,233** | 271,786 | 1% | **(36,410)** | 669,688 | - |

(1) Includes health, safety and environmental, capitalized salaries and benefits for qualifying employees, office furniture and fixtures and leasehold improvements.

*Drilling Activity (Net), for the three months ended September 30, 2012 and 2011*

| | Net wells drilled | | Net wells pending completion and/or tie-in | | Dry and abandoned wells | | Success Rate | |
|---|---|---|---|---|---|---|---|---|
| Business Unit | **2012** | 2011 | **2012** | 2011 | **2012** | 2011 | **2012** | 2011 |
| Bakken | **40** [(1)] | 25 [(1)] | **17** | 13 | **-** | - | **100%** | 100% |
| Conventional | **10** | 12 | **3** | 7 | **2** | - | **80%** | 100% |
| Cardium | **32** | 32 | **23** | 23 | **-** | - | **100%** | 100% |
| BC/Other AB | **-** | 1 | **-** | 2 | **-** | - | **100%** | 100% |
| **Total** | **82** | **70** | **43** | 45 | **2** | - | **98%** | **100%** |

(1) Includes 30 net bilateral wells (2011 – 16).

*Drilling Activity (Net), for the nine months ended September 30, 2012 and 2011*

| | Net wells drilled | | Net wells pending completion and/or tie-in | | Dry and abandoned wells | | Success Rate | |
|---|---|---|---|---|---|---|---|---|
| Business Unit | **2012** | 2011 | **2012** | 2011 | **2012** | 2011 | **2012** | 2011 |
| Bakken | **69** [(1)] | 59 [(1)] | **17** | 13 | **-** | - | **100%** | 100% |
| Conventional | **18** | 17 | **3** | 7 | **4** | - | **78%** | 100% |
| Cardium | **51** | 73 | **23** | 23 | **-** | 1 | **100%** | 99% |
| BC/Other AB | **-** | 3 | **-** | 2 | **-** | - | **100%** | 100% |
| **Total** | **138** | **152** | **43** | 45 | **4** | 1 | **97%** | **99%** |

(1) Includes 50 net bilateral wells (2011 – 37 net).

The majority of PetroBakken's capital expenditures in the third quarter and first nine months of 2012 were focused on drilling, completions, equipping, recompletions, and facilities. Spending in the third quarter of 2012 was higher than in the second quarter of 2012 as PetroBakken ramped up the drilling program following spring break-up. In comparison to the third quarter of 2011, spending was marginally higher due to increased equipping costs as PetroBakken tied-in a significant number of wells late in the quarter to the newly constructed battery within the Cardium in central Alberta. Spending in the first nine months of 2012 was lower due to less drilling, completion, and equipping activity in the first quarter of the year as PetroBakken's initial capital plan contemplated reduced spending. Following the dispositions, PetroBakken increased the capital plan for the second half of the year. Facilities spending in the first nine months related to expansion of gathering systems at five major facilities in southeast Saskatchewan, and construction of a battery and expansion of gathering systems at facilities in the Cardium. Activity in the Cardium and the other Alberta business units resulted in the majority of land, property, and seismic acquisitions in 2012. Capital activity will remain strong for the remainder of the year as PetroBakken executes the increased capital plan. PetroBakken expects drilling rates and bringing wells on production in the fourth quarter of 2012 to outpace the activity levels achieved in 2011.

*Goodwill*

There were no changes to goodwill in the third quarter of 2012. Goodwill decreased by $94.1 million in the first nine months of 2012 due to $3.1 million of goodwill attributed to assets disposed of in the Conventional business unit and $91.0 million of goodwill being attributed to the assets disposed of in the Bakken business unit. Goodwill as at September 30, 2012 was $1,371.1 million (December 31, 2011 - $1,465.3 million).

*Decommissioning Liabilities*

PetroBakken's decommissioning liabilities increased by $7.5 million in the third quarter of 2012 primarily due to new wells drilled and accretion expense. PetroBakken's decommissioning liabilities decreased by $0.8 million in the nine months ended September 30, 2012, primarily as a result of the asset disposals partially offset by new wells drilled and accretion expense. The discount rate as at September 30, 2012 was 2.5 percent (December 31, 2011 - 2.5 percent). At September 30, 2012, PetroBakken's decommissioning liabilities were $214.3 million (December 31, 2011 - $215.1 million).

*Commitments*

The following is a summary of the estimated costs required to fulfill PetroBakken's remaining contractual commitments at September 30, 2012:

| Type of Commitment | < 1 Year | 1-3 Years | 4-5 Years | Thereafter | Total |
|---|---|---|---|---|---|
| Office operating leases [1] | 5,742 | 12,842 | 12,885 | 23,291 | 54,760 |
| Drilling and completion rigs | 20,301 | 19,013 | 622 | - | 39,936 |
| Other | 1,208 | 842 | 98 | - | 2,148 |
| **Total Commitments** | **$ 27,251** | **$ 32,697** | **$ 13,605** | **$ 23,291** | **$ 96,844** |

[1] Minimum lease payments are net of sub-lease payments received by PetroBakken, which reduces rent expense included in general and administrative expenses on the consolidated statement of operations and comprehensive income.

*Liquidity and Capital Resources*

The table below outlines the composition of PetroBakken's capital structure and liquidity as at September 30, 2012:

| | PetroBakken |
|---|---|
| Working capital deficit [1] | $ (213,652) |
| Bank debt – principal | $ 401,673 |
| Convertible debentures – principal amount (US$) | $ 300,000 |
| Senior unsecured notes – principal amount (US$) | $ 900,000 |
| Common share capital [2] | $ 3,168,663 |
| Credit facility – borrowing base | $ 1,400,000 |
| Available credit capacity | $ 998,327 |

(1) Working capital deficit is calculated as PetroBakken's accounts payable and accrued liabilities less PetroBakken's accounts receivable and prepaid expenses.

(2) The common share capital of PetroBakken eliminates upon consolidation of the interim Consolidated Financial Statements.

PetroBakken's strategy is to provide a reasonable dividend payout to shareholders combined with an accretive long-term growth-oriented business plan. PetroBakken is focused on securing appropriate levels of capitalization to support this business strategy. As commodity prices fluctuate, PetroBakken has the ability to alter the capital program and/or dividend payments in order to maintain acceptable debt levels. PetroBakken will continue to monitor plans and forecasts and make adjustments required to maintain acceptable levels of capitalization.

As at September 30, 2012, PetroBakken had $401.7 million of bank debt drawn on its $1.4 billion credit facility. PetroBakken's credit facility is with a syndicate of banks and has a maturity date of June 2, 2015. Generally the credit facility is not subject to periodic reviews unless a significant asset disposition occurs. The credit facility has an accordion feature providing that at any time during the term, on participation of any existing or additional lenders, PetroBakken can increase the facility by $100 million to $1.5 billion.

On January 30, 2012, PetroBakken closed a private placement of senior unsecured notes with a principal amount of US$900 million. The Notes bear interest at a rate of 8.625 percent per annum and mature February 1, 2020. The Notes contain covenants that could limit PetroBakken's ability to issue additional debt, pay dividends, and repurchase stock, among other restrictions. PetroBakken is in compliance with all of these covenants.

As at September 30, 2012, PetroBakken had convertible debentures outstanding of US$300 million with an annual coupon of 3.125 percent. This is a US$450 million decrease from December 31, 2011 as a portion of the proceeds from the Notes issuance was used to repurchase debentures. The convertible debentures have a financial covenant that limits the amount of security and encumbrances to 35 percent of PetroBakken's total assets. PetroBakken is in compliance with this covenant. The debentures have a one-time, one-day early put option on February 8, 2013 that allows those holders that elect to exercise the option to request payment in full for their debentures. In the event that holders request payment, PetroBakken has the option to repay in cash or through the issuance of PetroBakken shares based on the lower of the then current share price and conversion price.

In the first nine months of 2012, PetroBakken received $646.5 million of gross proceeds from dispositions, the majority of which were from two non-core producing assets in southeast Saskatchewan. The proceeds from these transactions were initially used to pay down the revolving credit facility.

Due to the reduction in debt and alteration in structure, PetroBakken increased available liquidity at September 30, 2012 to $1.0 billion from $0.2 billion at December 31, 2011.

In addition to the financial resources noted above, other possible sources of funds available to PetroBakken include the following:

- Funds flow from operations;
- Increases under the existing $1.4 billion credit facility;
- Issuance of common shares of PetroBakken;
- Dividend reduction;
- Issuance of additional subordinated or convertible debt;
- Renegotiating the terms of the existing convertible debentures;
- Adjustments to capital program;
- Sale of producing or non-producing assets. Cash generated from a sale may be reduced by any required debt repayments; and
- Monetization of risk management assets.

PetroBakken expects to satisfy ongoing working capital requirements with funds flow from operations, cash and available credit.

*Capital Plan*

PetroBakken's capital plan is focused on the development of Cardium light oil properties in central Alberta, development of Bakken and conventional Mississippian light oil properties in southeast Saskatchewan, and leveraging the significant undeveloped land base into new resource opportunities. PetroBakken's capital plan is expected to be financed through funds flow from operations and available financial resources.

*Dividends*

PetroBakken currently pays a monthly dividend of $0.08 per share or the equivalent of $0.96 per share per annum. The dividend represented 37 percent of PetroBakken's funds flow from operations in the three months ended September 30, 2012 before DRIP participation is considered, with the cash dividend representing 14 percent of third quarter funds flow from operations. The dividend is expected to remain the same for the remainder of 2012 and to be funded from operations and the shareholders participation in the DRIP. In the third quarter, approximately $28.2 million of the $45.4 million of dividends were paid in shares. In the first nine months of 2012 approximately $76.4 million of the $136.1 million of dividends were paid in shares.

## SUMMARY OF QUARTERLY RESULTS [1]

| | 2012 | | | 2011 | | | | 2010 |
|---|---|---|---|---|---|---|---|---|
| | **Q3** | **Q2** | **Q1** | Q4 | Q3 | Q2 | Q1 | Q4 |
| **Financial** ($000s except where noted) | | | | | | | | |
| Oil and natural gas sales from continuing operations | **237,833** | **240,205** | **330,361** | 366,881 | 272,346 | 274,952 | 281,297 | 258,359 |
| Funds flow from continuing operations [2] | **119,570** | **118,890** | **181,290** | 226,273 | 147,452 | 148,440 | 168,384 | 155,344 |
| Per share – basic ($) | **1.20** | **1.14** | **1.70** | 2.13 | 1.39 | 1.40 | 1.58 | 1.46 |
| – diluted ($) | **1.19** | **1.13** | **1.69** | 2.10 | 1.37 | 1.38 | 1.57 | 1.45 |
| Adjusted net income (loss) from continuing operations [2] | **13,495** | **31,999** | **82,307** | 26,712 | 7,517 | 30,659 | (21) | 17,543 |
| Per share – basic ($) | **0.14** | **0.31** | **0.77** | 0.25 | 0.07 | 0.29 | 0.00 | 0.17 |
| – diluted ($) | **0.13** | **0.31** | **0.76** | 0.25 | 0.07 | 0.28 | 0.00 | 0.16 |
| Adjusted net income (loss) attributable to Petrobank shareholders [2] [3] | **13,495** | **31,999** | **82,307** | 26,712 | 7,517 | 30,659 | (21) | 1,974,118 |
| Per share – basic ($) | **0.14** | **0.31** | **0.77** | 0.25 | 0.07 | 0.29 | 0.00 | 18.61 |
| – diluted ($) | **0.13** | **0.31** | **0.76** | 0.25 | 0.07 | 0.28 | 0.00 | 18.55 |
| Capital expenditures [2] | | | | | | | | |
| PetroBakken | **283,078** | **109,756** | **206,421** | 274,815 | 271,861 | 113,010 | 307,481 | 262,758 |
| HBU | **9,624** | **4,525** | **17,878** | 28,235 | 30,772 | 55,641 | 54,255 | 37,521 |
| Total from continuing operations | **292,702** | **114,281** | **224,299** | 303,050 | 302,633 | 168,651 | 361,736 | 300,279 |
| **PetroBakken Operations** | | | | | | | | |
| Oil equivalent sales price ($/boe) [4] [5] | **66.58** | **67.89** | **77.36** | 82.69 | 75.37 | 85.02 | 74.46 | 67.00 |
| Royalties | **9.09** | **9.44** | **11.92** | 12.51 | 12.20 | 13.15 | 11.84 | 9.84 |
| Production expenses | **12.40** | **13.37** | **12.61** | 10.97 | 13.13 | 15.24 | 10.20 | 8.97 |
| Operating netback [2] [5] [6] | **45.09** | **45.08** | **52.83** | 59.21 | 50.04 | 56.63 | 52.42 | 48.19 |
| *Average daily production* [5] | | | | | | | | |
| Crude oil and NGL (bbls) | **31,662** | **32,236** | **40,336** | 41,660 | 33,112 | 29,676 | 36,140 | 34,754 |
| Natural gas (Mcf) | **41,048** | **38,874** | **38,320** | 38,083 | 35,776 | 33,746 | 32,534 | 39,474 |
| Total (boe) [5] [7] | **38,503** | **38,715** | **46,722** | 48,007 | 39,074 | 35,300 | 41,562 | 41,333 |

(1) Petrominerales Ltd. ("Petrominerales") has been presented as discontinued operations in the comparative period as this business unit was distributed to Petrobank shareholders at December 31, 2010.

(2) Non-GAAP measure. See "Non-GAAP Measures" section within this MD&A.

(3) The comparative balances prior to 2011 include the operating results of Petrominerales, a $1.9 billion non-cash gain recorded on the disposal and $23.5 million accumulated other comprehensive loss resulting from the historic translations of Petrominerales U.S. dollar amounts. Petrominerales was distributed to Petrobank shareholders on December 31, 2010.

(4) Net of transportation expenses.

(5) Six Mcf of natural gas is equivalent to one boe.

(6) Excludes hedging activities.

(7) HBU bitumen and heavy oil volumes are excluded from average daily production as HBU operations are considered to be in the exploration and evaluation phase and accordingly are capitalized.

Significant factors influencing quarterly results were:

- PetroBakken's annual production profile follows a typical pattern of increasing throughout the third quarter as spring break-up conditions subside and capital activity ramps up. While production increased towards the end of the quarter, third quarter production levels are relatively flat to the second quarter of 2012 due to a delayed start to PetroBakken's capital program, fewer wells waiting to be brought on production past spring break-up and restricted production and turnaround activity in the Cardium. Similar to 2011, PetroBakken expects strong production increases in the fourth quarter of 2012 as wells in inventory at September 30, 2012 come on production and the remaining one-third of PetroBakken's planned program is drilled and the wells are brought on production.
- Capital expenditures have varied during the year due to the timing of development activities. PetroBakken's capital program ramped up considerably throughout the third quarter following spring break-up. This resulted in the significant increase in capital expenditures over the second quarter of 2012. Over two-thirds of PetroBakken's 2012 capital is expected to be spent in the second half of the year and generates the production profile described above.
- Funds flow from operations is primarily impacted by oil price variability, production levels and production expenses. The oil price PetroBakken receives has been influenced during this period through fluctuations in the typical reference price (WTI) and Canadian pricing differentials to WTI. Compared to 2011, 2012 pricing differentials have been more volatile and generally wider than historic levels, which has reduced funds flow from operations. Price differentials have been negatively impacted by refinery turnarounds, short term pipeline interruptions and the growth of North American supply creating infrastructure bottlenecks. Production levels are most impacted by PetroBakken's capital spending profile, with capital expenditures in the second half of 2012 being higher than the previous six months. Production expenses are influenced by production levels due to the fixed costs representing a higher percentage of overall expenditures and by general cost inflation associated with industry activity throughout this period.
- Adjusted net income fluctuations during the period have been caused by changes in funds flow from operations, unrealized gains and losses on commodity risk management contracts, unrealized foreign exchange gains and losses on converting U.S. dollar denominated debt to Canadian dollars and gains and losses on asset dispositions.

## Outstanding Share Data

The number of Petrobank shares outstanding at the date of this MD&A is 96,268,326, a decrease of 2,472,695 shares from September 30, 2012, which relates the repurchase and cancellation of shares (2,477,800), partially offset by the exercise of stock options and incentive shares (5,105).

## Risks and Uncertainties

There have been no significant changes in the three or nine months ended September 30, 2012 to the risk and uncertainties identified in the MD&A for the year ended December 31, 2011.

## Sensitivities

The Company's earnings and cash flow are sensitive to changes in crude oil and natural gas prices, exchange rates and interest rates.

The following factors demonstrate the expected impact on annualized before tax funds flow from operations excluding the effect of hedging for 2012:

| Change of: | | (millions) |
|---|---|---|
| **PetroBakken** | | |
| **Crude oil** | US$1.00/bbl WTI reference price (assuming 32,000 bopd) | **$8.9** |
| | 1,000 bopd of production @ US$90.00/bbl WTI | **$24.0** |
| **Natural gas** | $1.00/Mcf AECO reference price (assuming 41 MMcf /d) | **$12.7** |
| | 10.0 MMcf per day of production @ $2.00/Mcf AECO | **$5.8** |
| **Currency** | US$0.01 in exchange rate | **$8.9** |
| **Interest rate** | 1% change in interest rate | **$4.6** |

## Accounting Policies and Estimates

There have been no changes to the Company's critical accounting policies and estimates for the three or nine months ended September 30, 2012.

## Regulatory Policies

*Certification of Disclosures in Interim Filings*

In accordance with National Instrument 52-109 of the Canadian Securities Administrators, the Company quarterly issues a Certification of Interim Filings ("Certification"). The Certification requires certifying officers to state that they are responsible for establishing and maintaining disclosure controls and procedures ("DC&P") and internal control over financial reporting ("ICFR").

The Certification requires certifying officers to state that they designed DC&P, or caused it to be designed under their supervision, to provide reasonable assurance that: (i) material information relating to Petrobank is made known to the certifying officers by others; (ii) information required to be disclosed by Petrobank in reports filed with, or submitted to, securities regulatory authorities is recorded, processed, summarized and reported within the time periods specified under Canadian securities legislation. In addition, the Certification requires certifying officers to state that they have designed ICFR, or caused it to be designed under their supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes.

During the three and nine months ended September 30, 2012, there has been no change to the Company's ICFR that has materially affected, or is reasonably likely to materially affect, the Company's ICFR. The Company has procedures in place relating to DC&P and ICFR and will continue to monitor such procedures as the Company's business evolves.

## Outlook

In addition to the plans discussed in this MD&A, please see the Company's and PetroBakken's recent news releases, corporate presentations and Annual Information Forms.

## CONDENSED INTERIM CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME

(Unaudited, thousands of Canadian dollars, except per share amounts)

| | | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|---|
| | | **2012** | 2011 | **2012** | 2011 |
| | Note | | | | |
| Revenues | | | | | |
| Oil and natural gas sales | | **$ 237,833** | $ 272,346 | **$ 808,399** | $ 828,595 |
| Royalties | | **(32,209)** | (43,871) | **(116,157)** | (130,409) |
| Oil and natural gas revenues | | **205,624** | 228,475 | **692,242** | 698,186 |
| (Loss) gain on risk management contracts | 17 | **(17,088)** | 55,379 | **12,850** | 50,760 |
| | | **188,536** | 283,854 | **705,092** | 748,946 |
| Expenses | | | | | |
| Production | | **43,914** | 47,207 | **144,635** | 134,291 |
| Transportation | | **1,987** | 1,416 | **4,449** | 5,991 |
| General and administrative | | **13,008** | 14,614 | **44,357** | 40,016 |
| Share-based compensation | | **5,246** | 8,614 | **14,817** | 22,336 |
| Loss (gain) on derivative financial liability | 9 | **3,316** | (10,606) | **9,346** | (71,654) |
| Finance and other | 12 | **31,619** | 25,206 | **95,085** | 71,972 |
| Loss (gain) on dispositions | 7 | **842** | 122 | **(121,857)** | (15,070) |
| Loss on settlement of convertible debentures | 9 | **-** | - | **44,009** | - |
| Impairment | 4, 5 | **-** | 2,775 | **61,000** | 15,585 |
| Foreign exchange (gain) loss | | **(39,943)** | 46,252 | **(31,721)** | 27,520 |
| Depletion and depreciation expense | 5, 6 | **103,246** | 94,695 | **323,844** | 278,454 |
| | | **163,235** | 230,295 | **587,964** | 509,441 |
| **Income before taxes and non-controlling interest ("NCI")** | | **25,301** | 53,559 | **117,128** | 239,505 |
| Income tax expense | | **4,810** | 21,553 | **86,908** | 58,199 |
| **Income before NCI** | | **20,491** | 32,006 | **30,220** | 181,306 |
| Net income attributable to NCI | 15 | **10,312** | 16,658 | **16,774** | 87,082 |
| **Net and comprehensive income attributable to Petrobank shareholders** | | **$ 10,179** | $ 15,348 | **$ 13,446** | $ 94,224 |
| **Earnings per share** | | | | | |
| Basic earnings per share | 14 | **$ 0.10** | $ 0.14 | **$ 0.13** | $ 0.89 |
| Diluted earnings per share | 14 | **$ 0.10** | $ 0.14 | **$ 0.13** | $ 0.86 |

See accompanying notes to these condensed interim consolidated financial statements.

## CONDENSED INTERIM CONSOLIDATED STATEMENTS OF FINANCIAL POSITION

(Unaudited, thousands of Canadian dollars)

| As at | Note | September 30, 2012 | December 31, 2011 |
|---|---|---|---|
| **Assets** | | | |
| Current assets | | | |
| Cash and cash equivalents | | **$ 96,081** | $ - |
| Accounts receivable | | **147,589** | 194,296 |
| Prepaid expenses | | **10,327** | 10,608 |
| Risk management assets | 17 | **6,778** | 3,677 |
| Assets held for sale | 3 | **-** | 315,908 |
| | | **260,775** | 524,489 |
| Risk management assets | 17 | **5,406** | 4,317 |
| Exploration assets | 4 | **914,484** | 1,009,906 |
| Property, plant and equipment | 5 | **3,913,375** | 3,907,550 |
| Other intangible assets | 6 | **6,553** | 6,167 |
| Goodwill | 7 | **1,371,145** | 1,465,287 |
| **Total assets** | | **$ 6,471,738** | $ 6,917,716 |
| **Liabilities and shareholders' equity** | | | |
| Current liabilities | | | |
| Accounts payable and accrued liabilities | | **$ 382,225** | $ 410,650 |
| Current portion of finance lease obligations | | **570** | 588 |
| Risk management liabilities | 17 | **600** | 6,414 |
| Convertible debentures | 9 | **254,870** | - |
| Derivative financial liability | 9 | **14,303** | - |
| Liabilities held for sale | 3 | **-** | 11,874 |
| | | **652,568** | 429,526 |
| Bank debt | 8 | **396,847** | 1,262,003 |
| Senior unsecured notes | 10 | **861,968** | - |
| Convertible debentures | 9 | **-** | 639,014 |
| Derivative financial liability | 9 | **-** | 33,038 |
| Finance lease obligations | | **1,057** | 1,401 |
| Other long-term liabilities | | **10,398** | 11,938 |
| Decommissioning liabilities | 11 | **218,844** | 218,921 |
| Risk management liabilities | 17 | **362** | 2,610 |
| Deferred tax liabilities | | **647,320** | 561,408 |
| **Total liabilities** | | **2,789,364** | 3,159,859 |
| **Shareholders' equity** | | | |
| Common shares | 13 | **1,456,241** | 1,577,351 |
| Contributed surplus | | **66,364** | 50,449 |
| Paid-in capital | | **835,380** | 860,200 |
| Deficit | | **(162,501)** | (174,422) |
| Total Petrobank shareholders' equity | | **2,195,484** | 2,313,578 |
| Non-controlling interest | 15 | **1,486,890** | 1,444,279 |
| **Total equity** | | **3,682,374** | 3,757,857 |
| **Total liabilities and equity** | | **$ 6,471,738** | $ 6,917,716 |

Commitments (Note 19)

Subsequent events (Notes 13, 16 and 20)

See accompanying notes to these condensed interim consolidated financial statements.

## CONDENSED INTERIM CONSOLIDATED STATEMENTS OF CHANGE IN EQUITY

(Unaudited, thousands of Canadian dollars)

| | Note | Common Shares | Contributed Surplus | Paid-in Capital | Deficit | Total |
|---|---|---|---|---|---|---|
| January 1, 2011 | | $ 1,575,448 | $ 42,741 | $ 840,772 | $ (166,793) | $2,292,168 |
| Total net and comprehensive income attributable to Petrobank shareholders | | - | - | - | 94,224 | 94,224 |
| Issued under employee incentive plans | | 307 | - | - | - | 307 |
| Share-based settlements | | 1,105 | (1,105) | - | - | - |
| Share-based compensation | | - | 7,105 | - | - | 7,105 |
| Change in paid-in capital | | - | - | 18,952 | - | 18,952 |
| **September 30, 2011** | | **$ 1,576,860** | **$ 48,741** | **$ 859,724** | **$ (72,569)** | **$2,412,756** |
| | | | | | | |
| January 1, 2012 | | $ 1,577,351 | $ 50,449 | $ 860,200 | $ (174,422) | $ 2,313,578 |
| Total net and comprehensive income attributable to Petrobank shareholders | | - | - | - | 13,446 | 13,446 |
| Share repurchases | 13 | (130,209) | 22,394 | - | (1,525) | (109,340) |
| Issued upon asset acquisition | 13 | 739 | - | - | - | 739 |
| Issued under employee incentive plans | 13 | 1,440 | - | - | - | 1,440 |
| Share-based settlements | 13 | 6,920 | (6,920) | - | - | - |
| Share-based compensation | | - | 441 | - | - | 441 |
| Change in paid-in capital | | - | - | (24,820) | - | (24,820) |
| **September 30, 2012** | | **$ 1,456,241** | **$ 66,364** | **$ 835,380** | **$ (162,501)** | **$ 2,195,484** |

See accompanying notes to these condensed interim consolidated financial statements.

## CONDENSED INTERIM CONSOLIDATED STATEMENTS OF CASH FLOW

(Unaudited, thousands of Canadian dollars)

| | | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|---|
| | | **2012** | 2011 | **2012** | 2011 |
| **Operating Activities** | Note | | | | |
| Net income attributable to Petrobank shareholders | | **$ 10,179** | $ 15,348 | **$ 13,446** | $ 94,224 |
| Net income attributable to NCI | 15 | **10,312** | 16,658 | **16,774** | 87,082 |
| Unrealized loss (gain) on risk management contracts | 17 | **16,755** | (55,320) | **(12,252)** | (54,645) |
| Share-based compensation | | **5,246** | 8,614 | **14,817** | 22,336 |
| Loss (gain) on derivative financial liability | 9 | **3,316** | (10,606) | **9,346** | (71,654) |
| Non-cash finance and other | 12 | **5,151** | 8,259 | **17,183** | 25,531 |
| Loss (gain) on dispositions | 7 | **842** | 122 | **(121,857)** | (15,070) |
| Loss on settlement of convertible debentures | 9 | **-** | - | **44,009** | - |
| Impairment | 4, 5 | **-** | 2,775 | **61,000** | 15,585 |
| Unrealized foreign exchange (gain) loss | | **(40,101)** | 46,307 | **(30,041)** | 27,859 |
| Depletion and depreciation expense | 5, 6 | **103,246** | 94,695 | **323,844** | 278,454 |
| Income tax expense | | **4,810** | 21,553 | **86,908** | 58,199 |
| Decommissioning liabilities settled | 11 | **(186)** | (953) | **(3,427)** | (3,625) |
| | | **119,570** | 147,452 | **419,750** | 464,276 |
| Changes in non-cash working capital | 18 | **(46,830)** | 10,633 | **11,886** | 9,443 |
| Net cash provided by operating activities | | **72,740** | 158,085 | **431,636** | 473,719 |
| **Investing Activities** | | | | | |
| Expenditures on property, plant and equipment | | **(274,545)** | (270,112) | **(580,992)** | (661,715) |
| Exploration and evaluation expenditures | | **(18,154)** | (32,273) | **(49,908)** | (170,512) |
| Other intangible asset expenditures | | **(3)** | (248) | **(382)** | (793) |
| Proceeds from dispositions – net of costs | | **7,845** | 75 | **855,648** | 22,664 |
| Cash dividends received by Petrobank | 15 | **-** | 26,352 | **8,841** | 79,056 |
| Capital lease obligations | | **(112)** | (174) | **(362)** | (573) |
| Current tax on dispositions | | **-** | - | **(996)** | - |
| Changes in non-cash working capital | 18 | **136,337** | 160,195 | **14,316** | 19,525 |
| Net cash (used in) provided by investing activities | | **(148,632)** | (116,185) | **246,165** | (712,348) |
| **Financing Activities** | | | | | |
| Issuance (repayment) of bank debt | | **90,363** | 3,137 | **(865,991)** | 361,642 |
| Financing costs relating to bank debt | | **-** | (75) | **(1,794)** | (4,979) |
| (Repurchase) issuance of Petrobank common shares | 13 | **(31,157)** | 124 | **(107,899)** | 307 |
| Sale of PetroBakken common shares by Petrobank | 15 | **33,144** | - | **88,639** | - |
| Repurchase of PetroBakken convertible debentures – net costs | 9 | **-** | - | **(452,340)** | - |
| Issuance of PetroBakken senior unsecured notes – net of costs | 10 | **-** | - | **877,583** | - |
| Equity (repurchased) issued by PetroBakken | 15 | **(6,143)** | 1 | **(51,338)** | 5 |
| Cash dividends paid by PetroBakken | 15 | **(17,224)** | (44,880) | **(59,501)** | (134,692) |
| Amortization of obligations under gas sale contract | | **(208)** | (208) | **(619)** | (618) |
| Changes in non-cash working capital | 18 | **(430)** | 1 | **(8,460)** | (504) |
| Net cash provided by (used in) financing activities | | **68,345** | (41,900) | **(581,720)** | 221,161 |
| **Net change in cash and cash equivalents** | | **(7,547)** | - | **96,081** | (17,468) |
| **Cash and cash equivalents, beginning of period** | | **103,628** | - | **-** | 17,468 |
| **Cash and cash equivalents, end of period** | | **$ 96,081** | $ - | **$ 96,081** | $ - |
| Cash and cash equivalents consist of: | | | | | |
| Cash | | **$ 6,809** | $ - | **$ 6,809** | $ - |
| Cash equivalents | | **$ 89,272** | $ - | **$ 89,272** | $ - |
| Other cash flow information: | | | | | |
| Cash interest paid | | **$ 26,766** | $ 17,691 | **$ 79,521** | $ 47,370 |
| Cash interest received | | **$ 272** | $ - | **$ 640** | $ 102 |

See accompanying notes to these condensed interim consolidated financial statements.

## Note 1 – Corporate Information and Basis of Presentation

*Corporate Information*

Petrobank Energy and Resources Ltd. ("Petrobank", "we", "our" or the "Company") is a Canadian corporation with shares listed on the Toronto Stock Exchange ("TSX"). The records office and principal address is located at 3000, 525 – 8th Avenue S.W., Calgary, Alberta, T2P 1G1.

The Company is principally engaged in the exploration and development of oil and natural gas in western Canada. The condensed interim consolidated financial statements of the Company as at September 30, 2012 and for the three and nine months ended September 30, 2012 and 2011 comprise the financial statements of the Company and our subsidiaries.

*Basis of Presentation*

The condensed interim consolidated financial statements for Petrobank as at September 30, 2012 and for the three and nine months ended September 30, 2012 and 2011 should be read in conjunction with the audited consolidated financial statements as at and for the year ended December 31, 2011. The condensed interim consolidated financial statements are prepared using the same accounting policies and methods of computation as disclosed in the annual consolidated financial statements.

The condensed interim consolidated financials are presented in Canadian dollars and all amounts are rounded to the nearest thousand dollars ($000s), except where otherwise indicated. The condensed interim consolidated financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") applicable to the preparation of interim financial statements, including IAS 34, *Interim Financial Reporting*.

The condensed interim consolidated financial statements were approved by the Company's Board of Directors on November 12, 2012.

## Note 2 – Segmented Information

For the periods ended September 30, 2012, the Company comprised of two operating segments: the Heavy Oil Business Unit ("HBU") and PetroBakken Energy Ltd. ("PetroBakken"). Where segmented information is provided throughout these condensed interim consolidated financial statements, the HBU is combined with activities performed at the Petrobank corporate level and is referred to as "Petrobank Standalone".

The HBU operates our heavy oil projects using Petrobank's patented THAI® heavy oil recovery process in the field. THAI® (Toe to Heel Air Injection), is an evolutionary in-situ combustion technology for the recovery of heavy oil and bitumen. The HBU projects are in the exploration and evaluation phase and accordingly all expenses, net of revenues, are capitalized.

PetroBakken (TSX: PBN), 57% owned by Petrobank as September 30, 2012 (December 31, 2011 and September 30, 2011 - 59%), is focused on conventional oil and gas operations throughout western Canada with a primary focus on light oil developments from the Bakken formation in southeast Saskatchewan and in the Cardium play in Alberta.

Results by operating segment for the three and nine months ended September 30, 2012 and 2011 were as follows:

| Three months ended September 30, | 2012 | | | 2011 | | |
|---|---|---|---|---|---|---|
| | **PetroBakken** | **Petrobank Standalone** | **Total** | PetroBakken | Petrobank Standalone | Total |
| Revenues | | | | | | |
| Oil and natural gas sales | **$ 237,833** | **$ -** | **$ 237,833** | $ 272,346 | $ - | $ 272,346 |
| Royalties | **(32,209)** | **-** | **(32,209)** | (43,871) | - | (43,871) |
| Oil and natural gas revenues | **205,624** | **-** | **205,624** | 228,475 | - | 228,475 |
| (Loss) gain on risk management contracts | **(17,088)** | **-** | **(17,088)** | 55,379 | - | 55,379 |
| | **188,536** | **-** | **188,536** | 283,854 | - | 283,854 |
| Expenses | | | | | | |
| Production | **43,914** | **-** | **43,914** | 47,207 | - | 47,207 |
| Transportation | **1,987** | **-** | **1,987** | 1,416 | - | 1,416 |
| General and administrative | **10,239** | **2,769** | **13,008** | 10,654 | 3,960 | 14,614 |
| Share-based compensation | **4,338** | **908** | **5,246** | 6,083 | 2,531 | 8,614 |
| Loss (gain) on derivative financial liability | **3,316** | **-** | **3,316** | (10,606) | - | (10,606) |
| Finance and other | **31,895** | **(276)** | **31,619** | 24,559 | 647 | 25,206 |
| Loss on dispositions | **842** | **-** | **842** | 122 | - | 122 |
| Impairment | **-** | **-** | **-** | - | 2,775 | 2,775 |
| Foreign exchange (gain) loss | **(39,943)** | **-** | **(39,943)** | 46,176 | 76 | 46,252 |
| Depletion and depreciation expense | **103,005** | **241** | **103,246** | 94,472 | 223 | 94,695 |
| | **159,593** | **3,642** | **163,235** | 220,083 | 10,212 | 230,295 |
| **Income (loss) before taxes and NCI** | **28,943** | **(3,642)** | **25,301** | 63,771 | (10,212) | 53,559 |
| Income tax expense (recovery) | **4,810** | **-** | **4,810** | 23,494 | (1,941) | 21,553 |
| **Income (loss) before NCI** | **24,133** | **(3,642)** | **20,491** | 40,277 | (8,271) | 32,006 |
| Net income attributable to NCI | **10,312** | **-** | **10,312** | 16,658 | - | 16,658 |
| **Net income (loss) attributable to Petrobank shareholders** | **$ 13,821** | **$ (3,642)** | **$ 10,179** | $ 23,619 | $ (8,271) | $ 15,348 |
| Identifiable assets | **$ 6,131,988** | **$ 339,750** | **$ 6,471,738** | $ 6,346,447 | $ 505,823 | $ 6,852,270 |
| Total liabilities | **$ 2,769,772** | **$ 19,592** | **$ 2,789,364** | $ 2,886,781 | $ 92,722 | $ 2,979,503 |
| Capital expenditures | **$ 283,078** | **$ 9,624** | **$ 292,702** | $ 271,861 | $ 30,772 | $ 302,633 |
| Dividends paid (received) | **$ 45,392** | **$ (25,937)** | **$ 19,455** | $ 44,880 | $ (26,352) | $ 18,528 |

| Nine months ended September 30, | 2012 | | | 2011 | | |
|---|---|---|---|---|---|---|
| | **PetroBakken** | **Petrobank Standalone** | **Total** | PetroBakken | Petrobank Standalone | Total |
| Revenues | | | | | | |
| Oil and natural gas sales | **$ 808,399** | **$ -** | **$ 808,399** | $ 828,595 | $ - | $ 828,595 |
| Royalties | **(116,157)** | **-** | **(116,157)** | (130,409) | - | (130,409) |
| Oil and natural gas revenues | **692,242** | **-** | **692,242** | 698,186 | - | 698,186 |
| Gain on risk management contracts | **12,850** | **-** | **12,850** | 50,760 | - | 50,760 |
| | **705,092** | **-** | **705,092** | 748,946 | - | 748,946 |
| Expenses | | | | | | |
| Production | **144,635** | **-** | **144,635** | 134,291 | - | 134,291 |
| Transportation | **4,449** | **-** | **4,449** | 5,991 | - | 5,991 |
| General and administrative | **34,741** | **9,616** | **44,357** | 29,058 | 10,958 | 40,016 |
| Share-based compensation | **14,376** | **441** | **14,817** | 15,231 | 7,105 | 22,336 |
| Loss (gain) on derivative financial liability | **9,346** | **-** | **9,346** | (71,654) | - | (71,654) |
| Finance and other | **94,538** | **547** | **95,085** | 70,050 | 1,922 | 71,972 |
| Gain on dispositions | **(121,857)** | **-** | **(121,857)** | (15,070) | - | (15,070) |
| Loss on settlement of convertible debentures | **44,009** | **-** | **44,009** | - | - | - |
| Impairment | **61,000** | **-** | **61,000** | - | 15,585 | 15,585 |
| Foreign exchange (gain) loss | **(31,619)** | **(102)** | **(31,721)** | 27,417 | 103 | 27,520 |
| Depletion and depreciation expense | **323,154** | **690** | **323,844** | 277,840 | 614 | 278,454 |
| | **576,772** | **11,192** | **587,964** | 473,154 | 36,287 | 509,441 |
| **Income (loss) before taxes and NCI** | **128,320** | **(11,192)** | **117,128** | 275,792 | (36,287) | 239,505 |
| Income tax expense (recovery) | **86,908** | **-** | **86,908** | 65,200 | (7,001) | 58,199 |
| **Income (loss) before NCI** | **41,412** | **(11,192)** | **30,220** | 210,592 | (29,286) | 181,306 |
| Net income attributable to NCI | **16,774** | **-** | **16,774** | 87,082 | - | 87,082 |
| **Net income (loss) attributable to Petrobank shareholders** | **$ 24,638** | **$ (11,192)** | **$ 13,446** | $ 123,510 | $ (29,286) | $ 94,224 |
| Capital expenditures | **$ 599,255** | **$ 32,027** | **$ 631,282** | $ 692,352 | $ 140,668 | $ 833,020 |
| Dividends paid (received) | **$ 136,112** | **$ (78,661)** | **$ 57,451** | $ 134,692 | $ (79,056) | $ 55,636 |

Any transactions between reportable segments are eliminated on consolidation of these condensed interim consolidated financial statements. With the exception of dividends received by Petrobank Standalone from PetroBakken, there are no significant transactions between the entities representing the reportable segments.

## Note 3 – Assets and Liabilities Held for Sale

*HBU*

During the nine months ended September 30, 2012, the Company disposed of $224.5 million of assets held for sale and $9.7 million of liabilities held for sale (2011 - $nil assets held for sale and $nil liabilities held for sale) related to the May River property, which included the Conklin demonstration project. The disposition was completed February 28, 2012 for cash proceeds of approximately $225.0 million, net of closing adjustments. There was no gain or loss on the assets held for sale.

*PetroBakken*

During the three months ended September 30, 2012, PetroBakken disposed of $10.2 million of assets held for sale and $1.3 million of liabilities held for sale (2011 - $nil assets held for sale and $nil liabilities held for sale).

During the nine months ended September 30, 2012, PetroBakken disposed of $118.3 million of assets held for sale and $5.5 million of liabilities held for sale (2011 - $nil assets held for sale and $nil liabilities held for sale) and recognized a loss $12.7 million related to these dispositions.

## Note 4 – Exploration Assets

Exploration assets comprise the Company's projects in the exploration and evaluation stage which are pending determination of technical and commercial feasibility. The following is a continuity schedule of the Company's exploration assets for the nine month period ended September 30, 2012.

| For the nine months ended, | **Sept. 30, 2012** |
|---|---|
| Exploration assets, beginning of period | **$ 1,009,906** |
| Additions | **50,608** |
| Dispositions | **(25,712)** |
| Transfers to assets held for sale | **(2,808)** |
| Transfers to property, plant, and equipment | **(86,423)** |
| Impairment | **(31,087)** |
| Exploration assets, end of period | **$ 914,484** |

During the nine months ended September 30, 2012, PetroBakken recognized an impairment of $31.1 million (2011 - $nil) related to undeveloped land in the gas weighted northeast BC cash generating unit ("CGU") as a result of land expiries, a decline in the fair value of the land and PetroBakken's intention not to actively develop these assets at this time. The impairment was calculated based on the difference between the net book value and the fair value less cost to sell based on acquisition metrics of recent transactions.

## Note 5 – Property, Plant and Equipment

| | Oil and natural gas assets [1] | Other | Total |
|---|---|---|---|
| **Cost** | | | |
| As at January 1, 2012 | $ 5,287,202 | $ 42,643 | $ 5,329,845 |
| Additions | 578,863 | 13,179 | 592,042 |
| Dispositions | (285,543) | - | (285,543) |
| Transfers to assets held for sale | (33,655) | - | (33,655) |
| Transfers from exploration assets | 86,423 | - | 86,423 |
| As at September 30, 2012 | $ 5,633,290 | $ 55,822 | $ 5,689,112 |
| **Depletion, Depreciation and Impairment** | | | |
| As at January 1, 2012 | $ 1,403,903 | $ 18,392 | $ 1,422,295 |
| Depletion and depreciation | 318,044 | 5,485 | 323,529 |
| Impairment | 29,913 | - | 29,913 |
| As at September 30, 2012 | $ 1,751,860 | $ 23,877 | $ 1,775,737 |
| **Carrying amount as at September 30, 2012** | **$ 3,881,430** | **$ 31,945** | **$ 3,913,375** |

[1] Oil and natural gas assets relate entirely to PetroBakken at September 30, 2012.

Other fixed assets are mainly comprised of office furniture and fixtures and computer equipment.

During the nine months ended September 30, 2012, PetroBakken recognized an impairment of $29.9 million (2011 - $nil) related to the gas weighted northeast BC CGU as a result of a decline in the value of the assets and PetroBakken's intention not to actively develop these assets at this time. The impairment was calculated based on the difference between the net book value and the value in use.

The key assumptions used in determining the value in use were the discount rate, commodity prices, volumes, and inventory of undrilled locations. The values assigned to the key assumptions represent PetroBakken's assessment of the future trends in the oil and natural gas industry and are based on both internal and external sources. A discount rate of 10 percent was used in the assessment of impairment for all CGUs. If the discount rate were to change by 10 percent, PetroBakken would have additional impairment of $1.0 million in the BC CGU for the three and nine months ended September 30, 2012.

## Note 6 – Other Intangible Assets

| For the nine months ended, | Sept. 30, 2012 |
|---|---|
| Other intangible assets, beginning of period | **$ 6,167** |
| Additions from internal development | **382** |
| Acquisition | **319** |
| Depreciation charge | **(315)** |
| Other intangible assets, end of period | **$ 6,553** |

Other intangible assets comprise of certain patents, licenses, trademarks, agreements and other capital costs incurred to develop the Company's THAI® and related technologies. These assets have an estimated useful life of 15 years and began depreciating using the straight line method on January 1, 2011, when THAI® reserves were first assigned to the Company by our independent reserve engineers.

## Note 7 – Asset Divestitures

*HBU*

On February 28, 2012, the Company closed the disposition of our May River property, which includes the May River and Conklin cash generating units, for cash proceeds of approximately $225.0 million, net of closing adjustments. There was no gain or loss recorded on disposition.

*PetroBakken*

During the three months ended September 30, 2012, PetroBakken closed non-core divestures for net proceeds of $7.8 million (2011 - $0.1 million) resulting in a loss on disposition of $0.8 million (2011 - $0.1 million loss).

During the nine months ended September 30, 2012, PetroBakken closed non-core asset divestitures for net proceeds of $635.7 million (2011 - $22.7 million) resulting in a net gain of $121.9 million (2011 - $15.1 million gain), including the loss on assets held for sale.

The dispositions completed during the nine months ended September 30, 2012, had the following impact on goodwill:

| For the nine months ended, | **Sept. 30, 2012** |
|---|---|
| Goodwill, beginning of period | **$ 1,465,287** |
| Dispositions | **(90,998)** |
| Transfer to assets held for sale | **(3,144)** |
| Goodwill, end of period | **$ 1,371,145** |

## Note 8 – Bank Debt

*Petrobank Standalone*

On January 4, 2011, the Petrobank Standalone operating segment closed a $200 million secured credit facility with a syndicate of lenders. We cancelled the credit facility concurrent with the closing of the sale of our May River property on February 28, 2012 due to the cash available to the operating segment.

*PetroBakken*

PetroBakken's bank debt consists of borrowings against their covenant based credit facility. The facility is an extendible revolving facility in the amount of $1.4 billion from a syndicate of lenders with a maturity date of June 2, 2015. The maturity date may, at the request of PetroBakken and with consent of the lenders, be extended on an annual basis. The credit facility has an accordion feature providing that at any time during the term, on participation of any existing or additional lenders, PetroBakken can increase the facility by $100 million to $1.5 billion.

| As at September 30, 2012 | **Petrobank Standalone** | **PetroBakken** | **Petrobank Consolidated** |
|---|---|---|---|
| Bank debt outstanding | $ - | $ 401,673 | $ 401,673 |
| Deferred financing costs [1] | - | (4,826) | (4,826) |
| **Bank debt** | **$ -** | **$ 396,847** | **$ 396,847** |

[1] Deferred financing costs are amortized straight line over the term of the credit facility.

## Note 9 – Convertible Debentures

*PetroBakken*

On January 31, 2012, PetroBakken completed the repurchase of US$450 million of the US$750 million of convertible debentures at a price of US$99,000 per US$100,000 of principal amount. This resulted in a loss of $44.0 million, which consists of acceleration on the accretion of the convertible debentures of $72.1 million, partially offset by a gain of $28.1 million on the retirement of a portion of the derivative liability.

The remaining US$300 million of convertible debentures mature in February 2016. Individual holders have a one-time put option right of prepayment of the debentures for 100 percent of the par value plus accrued interest on February 8, 2013. A holder has a 10 day period between December 10, 2012 and December 20, 2012 to exercise their put option. PetroBakken can elect to make the repayment to any holder at either the put or maturity date in cash or common shares. If settlement in common shares is elected by PetroBakken, the share price used is based on the 20 day weighted average trading price ending five days prior to payment or the conversion price. Upon conversion, based on the adjusted conversion price of US$33.90, a minimum of 8,850,784 common shares may be issued. As the debentures can be redeemed in less than one year at the option of the holder, they have been classified as current as at September 30, 2012.

The following table summarizes the liability component of the Company's debentures at September 30, 2012:

| For the nine months ended, | Sept. 30, 2012 |
|---|---|
| Liability component, beginning of period | $ 639,014 |
| Repurchase of convertible debentures – net of costs | (380,250) |
| Accretion | 9,066 |
| Changes in exchange rate | (12,960) |
| **Liability component, end of period** | **$ 254,870** |

The following assumptions were used in determining the fair value of the derivative financial liability:

| As at | Sept. 30, 2012 |
|---|---|
| Risk free interest rate | 1.16% |
| Annual dividend per share [1] | - |
| Expected life (years) | 3.4 |
| Expected volatility [2] | 48% |
| US/CDN $ FX rate | 0.98 |
| Market share price | CDN$13.95 |
| Conversion share price | US$33.90 |

(1) Dividend per share is nil because the share conversion price is adjusted to reflect dividends paid.

(2) Expected volatility includes a premium for the difference between US$/CDN$ exchange rates.

The following table summarizes the derivative financial liability:

| For the nine months ended, | Sept. 30, 2012 |
|---|---|
| Derivative financial liability, beginning of period | $ 33,038 |
| Repurchase of convertible debentures | (28,081) |
| Loss | 9,346 |
| **Derivative financial liability, end of period** | **$ 14,303** |

## Note 10 – Senior Unsecured Notes

On January 30, 2012, PetroBakken closed a private placement of senior unsecured notes (the "Notes") with a principal amount of US$900 million at 99.5 percent of face value. The Notes bear interest at a rate of 8.625 percent per annum and mature on February 1, 2020. PetroBakken has the option to redeem the Notes beginning on February 1, 2016 at the following redemption prices (expressed as a percentage of the principal amount of the debenture): 2016 - 104.313 percent; 2017 - 102.156 percent; 2018 and thereafter - 100 percent. The Notes are subordinate to PetroBakken's credit facility. The Notes have been classified as a liability and will be carried at amortized cost, net of $20.8 million in transaction costs and a $4.5 million initial discount on principal proceeds. The transaction costs and initial discount are accreted up to the principal balance at maturity using the effective interest method. The accretion and interest paid are expensed as finance and other expense in the condensed interim consolidated statement of operations and comprehensive income.

The U.S. dollar denominated Notes are translated for accounting purposes based on the Canadian dollar exchange rate on the date of issuance and at the end of the applicable reporting period.

The following table summarizes the Notes:

| For the nine months ended, | Sept. 30, 2012 |
|---|---|
| Notes, beginning of period | $ - |
| Proceeds, net of face value discount | 898,366 |
| Transaction costs | (20,783) |
| Accretion | 1,466 |
| Changes in foreign exchange rate | (17,081) |
| **Notes, end of period** | **$ 861,968** |

## Note 11 – Decommissioning Liabilities

The total future decommissioning liabilities were estimated by management based on the Company's net ownership interest in all wells, gathering lines and facilities, estimated costs to reclaim and abandon the wells, gathering lines and facilities and the estimated timing of the costs to be incurred in future periods.

Changes to decommissioning liabilities were as follows:

| For the nine months ended, | Sept. 30, 2012 |
|---|---|
| Decommissioning liabilities, beginning of year | $ 218,921 |
| Obligations incurred | 11,431 |
| Obligations disposed | (8,993) |
| Obligations settled | (3,427) |
| Accretion expense | 4,222 |
| Transfers to liabilities held for sale | (3,310) |
| Decommissioning liabilities, end of period | $ 218,844 |

The decommissioning liabilities have been calculated using an inflation rate of two percent per annum and discounted using a risk free rate of two and a half percent per annum (December 31, 2011 - inflation rate of two percent and risk free rate of two and a half percent). Most of these obligations are not expected to be paid for several years, extending up to 28 years in the future for the HBU and 45 years in the future for PetroBakken, and are expected to be funded from general resources of the Company at their respective settlement dates. The total undiscounted amount of estimated cash flows required to settle the obligations at September 30, 2012 before inflation is $5.0 million (December 31, 2011 - $4.4 million) for the obligations in our HBU, and $222.8 million (December 31, 2011 - $235.2 million) for the obligations in PetroBakken.

## Note 12 – Finance and Other

The finance and other balance includes the following:

| Three months ended September 30, | 2012 | | | 2011 | | |
|---|---|---|---|---|---|---|
| | **Petrobank Standalone** | **PetroBakken** | **Total** | Petrobank Standalone | PetroBakken | Total |
| Interest expense on senior unsecured notes | **$ -** | **$ 19,760** | **$ 19,760** | $ - | $ - | $ - |
| Interest expense on credit facilities and other | **1** | **4,676** | **$ 4,677** | 914 | 10,781 | 11,695 |
| Interest expense on convertible debentures | **-** | **2,334** | **2,334** | - | 5,884 | 5,884 |
| Interest income and other | **(303)** | **-** | **(303)** | - | - | - |
| Borrowing costs capitalized [1] | **-** | **-** | **-** | (632) | - | (632) |
| **Cash finance and other** | **(302)** | **26,770** | **26,468** | 282 | 16,665 | 16,947 |
| Accretion of convertible debentures | **-** | **2,631** | **2,631** | - | 6,040 | 6,040 |
| Accretion of decommissioning liabilities | **26** | **1,462** | **1,488** | 112 | 1,388 | 1,500 |
| Amortization of deferred financing costs | **-** | **471** | **471** | 253 | 466 | 719 |
| Accretion of senior unsecured notes | **-** | **561** | **561** | - | - | - |
| **Finance and other expenses** | **$ (276)** | **$ 31,895** | **$ 31,619** | $ 647 | $ 24,559 | $ 25,206 |

| Nine months ended September 30, | 2012 | | | 2011 | | |
|---|---|---|---|---|---|---|
| | **Petrobank Standalone** | **PetroBakken** | **Total** | Petrobank Standalone | PetroBakken | Total |
| Interest expense on senior unsecured notes | **$ -** | **$ 51,920** | **$ 51,920** | $ - | $ - | $ - |
| Interest expense on credit facilities and other | **795** | **18,174** | **18,969** | 1,902 | 28,291 | 30,193 |
| Interest expense on convertible debentures | **-** | **8,318** | **8,318** | - | 17,268 | 17,268 |
| Interest income and other | **(699)** | **-** | **(699)** | (102) | - | (102) |
| Borrowing costs capitalized [1] | **(606)** | **-** | **(606)** | (918) | - | (918) |
| **Cash finance and other** | **(510)** | **78,412** | **77,902** | 882 | 45,559 | 46,441 |
| Accretion of convertible debentures | **-** | **9,066** | **9,066** | - | 17,545 | 17,545 |
| Accretion of decommissioning liabilities | **72** | **4,150** | **4,222** | 328 | 4,078 | 4,406 |
| Amortization of deferred financing costs | **985** | **1,444** | **2,429** | 712 | 2,868 | 3,580 |
| Accretion of senior unsecured notes | **-** | **1,466** | **1,466** | - | - | - |
| **Finance and other expenses** | **$ 547** | **$ 94,538** | **$ 95,085** | $ 1,922 | $ 70,050 | $ 71,972 |

[1] The HBU credit facility was a general borrowing and related borrowing costs were capitalized in accordance with IAS 23, *Borrowing Costs.*

## Note 13 – Share Capital

The equity account balances include only those of the Petrobank parent entity. PetroBakken's equity account balances eliminate upon consolidation of these financial statements.

*Authorized*

The authorized share capital of Petrobank consists of an unlimited number of common shares without nominal or par value, and an unlimited number of preferred shares, issuable in series, without nominal or par value.

*Normal Course Issuer Bid ("NCIB")*

Petrobank completed its prior NCIB purchases in mid-July, having repurchased our full NCIB limit for the period from September 14, 2011 to September 13, 2012 of 7,273,401 common shares at an average cost of $12.09 per share. During the three months ended September 30, 2012, Petrobank renewed the normal course issuer bid. The Company is authorized to purchase up to 7,784,304 common shares, representing approximately 10 percent of the public float of the Company's shares, during the period from September 14, 2012 to September 13, 2013, or until such earlier time as the NCIB is completed or terminated at the option of Petrobank.

During the three months ended September 30, 2012, the Company repurchased 2,456,001 common shares (2011 - nil) for a total cost of $31.4 million. The shares had an average price of $12.78 per share. Of the amount paid, $36.3 million was charged against share capital and $4.9 million was credited to contributed surplus.

During the nine months ended September 30, 2012, the Company repurchased 8,813,001 common shares (2011 - nil) for a total cost of $109.3 million. The shares had an average price of $12.41 per share. Of the amount paid, $130.2 million was charged against share capital, $22.4 million was credited to contributed surplus, and $1.5 million was charged against retained earnings. All shares acquired under the NCIB were cancelled.

Subsequent to September 30, 2012, Petrobank repurchased an additional 1,927,100 common shares at an average cost of $13.07 per share.

*Common Shares*

| **Changes in Common Shares** | **Number** | **Amount** |
|---|---|---|
| Balance at December 31, 2011 | 106,400,220 | $ 1,577,351 |
| Repurchase of common shares under NCIB | - | (130,209) |
| Cancellation of common shares under NCIB | (8,262,301) | - |
| Exercise of stock options, incentive shares and DCS | 553,102 | 1,440 |
| Issued upon asset acquisition | 50,000 | 739 |
| Share-based settlements | - | 6,920 |
| **Balance at September 30, 2012** | **98,741,021** | **$ 1,456,241** |

*Stock Options*

The following is a continuity of stock options outstanding:

| | **Stock Options** | **Weighted-Average Exercise Price** |
|---|---|---|
| Balance at December 31, 2011 | 3,989,827 | $ 16.55 |
| Granted | 1,003,880 | 13.48 |
| Exercised | (388,985) | 3.68 |
| Forfeited | (990,884) | 18.05 |
| Expired | (78,397) | 23.11 |
| **Balance at September 30, 2012** | **3,535,441** | **$ 16.53** |

The following summarizes information about stock options outstanding as at September 30, 2012:

| **Stock Options Outstanding** | | | | **Stock Options Exercisable** | |
|---|---|---|---|---|---|
| Range of Exercise Prices | Number | Weighted-Average Remaining Life (Years) | Weighted-Average Exercise Price | Number | Weighted-Average Exercise Price |
| 0.05 – 10.00 | 417,794 | 4.20 | 2.31 | 207,101 | 1.55 |
| 10.01 – 13.00 | 922,710 | 5.82 | 12.23 | 61,030 | 11.80 |
| 13.01 – 16.00 | 544,190 | 5.01 | 14.60 | 190,276 | 15.55 |
| 16.01 – 20.00 | 493,702 | 5.03 | 16.67 | 83,317 | 17.41 |
| 20.01 – 24.00 | 533,470 | 4.11 | 21.54 | 107,540 | 22.46 |
| 24.01 – 31.00 | 560,325 | 5.42 | 28.83 | 356,300 | 28.52 |
| 31.01 – 38.47 | 63,250 | 4.46 | 37.27 | 51,250 | 38.12 |
| | **3,535,441** | **5.05** | **$ 16.53** | **1,056,814** | **$ 18.91** |

*Deferred Common Shares*

The following is a continuity of deferred common shares ("DCS") outstanding:

| | DCS |
|---|---|
| Balance at December 31, 2011 | 397,871 |
| Granted | 12,864 |
| Exercised | (139,822) |
| **Balance at September 30, 2012** | **270,913** |

*Directors Deferred Common Shares*

The following is a continuity of directors DCS deferred common shares outstanding:

| | Directors DCS |
|---|---|
| Balance at December 31, 2011 | 43,131 |
| Granted | 20,400 |
| Forfeited | (2,192) |
| **Balance at September 30, 2012** | **61,339** |

*Incentive Shares*

The following is a continuity of incentive shares outstanding:

| | Incentive Shares |
|---|---|
| Balance at December 31, 2011 | 374,999 |
| Granted | 83,490 |
| Exercised | (24,295) |
| Forfeited | (148,930) |
| Expired | (1,945) |
| **Balance at September 30, 2012** | **283,319** |

## Note 14 – Earnings Per Share

Basic earnings per share is calculated by dividing net income attributable to Petrobank shareholders by the weighted average number of common shares outstanding during the period. Diluted earnings per share reflects the potential dilution of stock options, deferred common shares, directors deferred common shares and incentive shares (collectively, "Share-Based Awards").

The following tables provide a reconciliation of the numerators and the denominators of the basic and diluted per share computations for income or loss attributable to Petrobank shareholders.

| | Three months ended Sept. 30, | | Nine months ended Sept. 30, | |
|---|---|---|---|---|
| | **2012** | 2011 | **2012** | 2011 |
| **Net income attributable to Petrobank shareholders adjustments** | | | | |
| Basic earnings | **$ 10,179** | $ 15,348 | **$ 13,446** | $ 94,224 |
| Impact of PetroBakken dilution on net income | **(159)** | (167) | **(381)** | (680) |
| Diluted earnings | **$ 10,020** | $ 15,181 | **$ 13,065** | $ 93,544 |
| **Weighted average common share adjustments** | | | | |
| Weighted average common shares outstanding, basic | **99,681,019** | 106,321,982 | **103,368,411** | 106,281,550 |
| Effect of Share-Based Awards | **846,908** | 1,606,636 | **962,770** | 2,499,004 |
| Weighted average common shares outstanding, diluted | **100,527,927** | 107,928,618 | **104,331,181** | 108,780,554 |

In determination of the weighted average number of diluted common shares outstanding for the three and nine months ended September 30, 2012, 3,101,831 and 2,654,185 stock options are excluded, respectively, because the effect would be anti-dilutive (2011 – 2,983,532 and 2,566,736).

## Note 15 – Non-Controlling Interest

The components of the Company's non-controlling interest in PetroBakken are as follows:

| | | |
|---|---|---|
| Balance at December 31, 2011 | $ | 1,444,279 |
| Attributable income | | 16,774 |
| Share-based compensation | | 14,376 |
| Common shares repurchased | | (51,338) |
| Changes in ownership interest [1] | | 24,820 |
| Cash dividends paid or declared by PetroBakken | | (59,501) |
| Cash dividends received by Petrobank | | 8,841 |
| Sale of PetroBakken common shares by Petrobank | | 88,639 |
| **Balance at September 30, 2012** | **$** | **1,486,890** |

(1) Reflects the book values of the NCI share related to PetroBakken shares issued in connection with the dividend reinvestment plan and PetroBakken stock options, deferred common shares, and incentive shares exercised in the period.

## Note 16 – Capital Management

The Company's policy is to maintain a strong capital base in order to provide flexibility in the future development of the business and maintain investor, creditor and market confidence. Petrobank Standalone and PetroBakken manage their capital structure independently, generate their own cash flows, and have the ability to fund their operations through the issuance of secured and unsecured debt as well as equity financing. The table below outlines the composition of Petrobank's consolidated capital structure:

| | Petrobank Standalone | PetroBakken | **Petrobank Consolidated** |
|---|---|---|---|
| Working capital surplus (deficit) [1] | $ 84,854 | $ (213,652) | **$ (128,798)** |
| Bank debt – principal | $ - | $ 401,673 | **$ 401,673** |
| Convertible debentures – principal amount (US$) | $ - | $ 300,000 | **$ 300,000** |
| Senior unsecured notes – principal amount (US$) | $ - | $ 900,000 | **$ 900,000** |
| Common share capital [2] | $ 1,456,241 | $ 3,168,663 | **$ 1,456,241** |
| Credit facility | $ - | $ 1,400,000 | |
| Available credit capacity | $ - | $ 998,327 | |

(1) Working capital surplus (deficit) is calculated as cash and cash equivalents, accounts receivable and prepaid expenses less accounts payable and accrued liabilities and the current portion of finance lease obligations.

(2) The common share capital of PetroBakken eliminates upon consolidation of these financial statements.

*Petrobank Standalone*

We manage our capital structure and make adjustments to it in light of changes in economic conditions and the risk characteristics of the underlying assets. We consider our capital structure to include common share capital and working capital. In order to maintain or adjust the capital structure, from time to time we may issue common shares or other securities, sell a portion of our ownership in PetroBakken or other corporate assets or adjust our capital spending to manage current and projected cash levels.

Petrobank received cash proceeds of approximately $225.0 million, net of closing adjustments, on February 28, 2012 from the sale of our May River property. Proceeds from this transaction were used to repay outstanding bank debt and result in Petrobank having a significant positive cash and working capital balance. We cancelled our credit facility concurrent with the closing of the sale due to our cash availability.

Petrobank currently receives a monthly dividend from PetroBakken of $0.08 per PetroBakken share. PetroBakken instituted a dividend re-investment plan ("DRIP") in 2012, which allows shareholders to reinvest monthly cash dividends in new shares at a five percent discount to the then current market price. Due to Petrobank's significant positive working capital balance, we elected to participate at a 100 percent level in PetroBakken's DRIP, starting with the March dividend. During the nine months ended September 30, 2012, Petrobank received dividends totalling approximately $8.8 million in cash and 5,429,263 PetroBakken common shares.

In April 2012, Petrobank entered into an Automatic Share Repurchase and PetroBakken Share Sale Plan (the "Plan") pursuant to which our designated broker was instructed to automatically sell one PetroBakken share for each Petrobank share purchased under the NCIB, subject to certain trading parameters set forth in the Plan and to daily and aggregate trading limits imposed by the rules and policies of the Toronto Stock Exchange.

In the nine months ended September 30, 2012, Petrobank has sold 7,030,801 PetroBakken common shares for total proceeds of $88.6 million. The transactions under the Plan resulted in net cash proceeds to Petrobank of $5.3 million. As a result of the Plan and our NCIB, the number of PetroBakken shares owned per Petrobank share outstanding increased to approximately 1.10 at September 30, 2012 from 1.03 at December 31, 2011. Subsequent to September 30, 2012, Petrobank sold an additional 1,927,100 PetroBakken common shares for proceeds of $25.6 million.

The Petrobank legal entity has not paid or declared any dividends since the date of incorporation.

*PetroBakken*

PetroBakken's policy is to maintain a strong capital base in order to provide flexibility for the future development of the business.

PetroBakken manages their capital structure and makes adjustments to it in light of changes in economic conditions and the risk characteristics of the underlying assets. PetroBakken considers their capital structure to include common shares, bank debt outstanding, convertible debentures, senior unsecured notes and working capital. In order to maintain or adjust the capital structure, from time to time PetroBakken may issue common shares, debt or other securities, sell assets or adjust capital spending or dividend payments to manage current and projected debt levels.

PetroBakken monitors their leverage and adjusts the capital structure based on the ratio of non-convertible debt to annualized earnings before interest, taxes and non-cash items. At September 30, 2012, the ratio of non-convertible debt to annualized third quarter 2012 earnings before interest, taxes and non-cash items was 2.2 to 1, which is acceptable to management on a short term basis. PetroBakken uses the ratio of non-convertible debt to annualized earnings before interest, taxes and non-cash items as a key indicator of PetroBakken's leverage and to monitor the strength of the statement of financial position. In order to facilitate the management of this ratio, PetroBakken prepares annual budgets, which are updated as necessary depending on varying factors including current and forecast commodity prices, changes in capital structure, execution of PetroBakken's business plan and general industry conditions. The annual budget is approved by the PetroBakken Board of Directors and updates are prepared and reviewed as required.

PetroBakken is in compliance with all covenants on the credit facility agreement. The credit facility has financial covenants that limit the ratio of secured debt (defined as total drawn on credit facility) to earnings before interest, taxes, depreciation and amortization ("EBITDA") to 3:1, limit the ratio of total debt (defined as total drawn on credit facility plus value of outstanding convertible debenture in Canadian dollars plus the value of the senior unsecured notes in Canadian dollars) to EBITDA on a trailing 12 month basis to 4:1, and limit secured debt to 50 percent of total liabilities plus total equity.

PetroBakken's convertible debentures are considered by management to be equity as opposed to debt for capital management purposes. PetroBakken has the option to repay the principal and interest amount in common shares or cash at the put or maturity date. PetroBakken is in compliance with the covenants on its convertible debentures. The convertible debenture agreement stipulates that the ratio of secured debt to total assets is not to exceed 35 percent.

PetroBakken is in compliance with all covenants on the Notes. The Notes contain covenants that could limit the Company's ability to issue additional debt, pay dividends, and repurchase stock among other restrictions.

PetroBakken had positive cash flow from operations for the three and nine months ended September 30, 2012 and a credit facility with $1.0 billion of available capacity as at September 30, 2012 (December 31, 2011 - $0.2 billion).

## Note 17 – Financial Instruments and Financial Risk Management

The Company identifies and analyzes the risks faced by the Company and may utilize financial instruments to mitigate these risks.

*Commodity Contracts*

PetroBakken had the following crude oil derivative contracts in place as at September 30, 2012:

**Crude Oil Price Risk Management Contracts – WTI [(1)]**

| Term | Volume (bopd) | Average Price ($/bbl) | Benchmark |
|---|---|---|---|
| Oct. 2012 – Dec. 2012 | 12,000 | $78.02 floor / $118.94 ceiling | US$ WTI |
| Jan. 2013 – Jun. 2013 | 12,000 | $78.23 floor / $119.43 ceiling | US$ WTI |
| Jul. 2013 – Dec. 2013 | 10,750 | $79.30 floor / $118.20 ceiling | US$ WTI |
| Jan. 2014 – Jun. 2014 | 5,750 | $80.65 floor / $111.26 ceiling | US$ WTI |
| Jul. 2014 – Dec. 2014 | 3,000 | $81.67 floor / $112.92 ceiling | US$ WTI |
| Jan. 2015 – Jun. 2015 | 250 | $80.00 floor / $106.75 ceiling | US$ WTI |

(1) Prices are the volume weighted average prices for the period.

The fair value of the commodity risk management contracts as at September 30, 2012 is an $11.4 million asset (December 31, 2011 - $0.8 million liability).

There were additional crude oil contracts entered into subsequent to September 30, 2012. Below is a summary of contracts in place as of the date of this report:

**Crude Oil Price Risk Management Contracts – WTI [(1)]**

| Term | Volume (bopd) | Average Price ($/bbl) | Benchmark |
|---|---|---|---|
| Oct. 2012 – Dec. 2012 | 12,000 | $78.02 floor / $118.94 ceiling | US$ WTI |
| Jan. 2013 – Jun. 2013 | 12,000 | $78.23 floor / $119.43 ceiling | US$ WTI |
| Jul. 2013 – Dec. 2013 | 11,500 | $79.35 floor / $117.17 ceiling | US$ WTI |
| Jan. 2014 – Jun. 2014 | 6,500 | $80.58 floor / $110.23 ceiling | US$ WTI |
| Jul. 2014 – Dec. 2014 | 3,750 | $81.33 floor / $110.80 ceiling | US$ WTI |
| Jan. 2015 – Jun. 2015 | 1,000 | $80.00 floor / $103.45 ceiling | US$ WTI |

(1) Prices are the volume weighted average prices for the period.

*Foreign Exchange*

PetroBakken entered into short-term foreign exchange contracts for their U.S. dollar interest payments. The following is a summary of foreign exchange contracts in place at September 30, 2012:

**Foreign Exchange Risk Management Contracts**

| Settlement | Type | Amount (US$) | Rate (USD/CAD) |
|---|---|---|---|
| Jan. 2013 | Forward | $25,000,000 | $0.9913 [1] |

[1] Weighted average rate.

The fair value of the foreign exchange contracts as at September 30, 2012 is a $0.1 million liability (December 31, 2011 - $nil).

*Fair Value of Financial Derivative Contracts*

The following table summarizes the change in the fair value of PetroBakken's derivative contracts:

| | Crude Oil | Interest | Foreign Exchange | Total |
|---|---|---|---|---|
| Risk management liability, as at December 31, 2011 | $ (842) | $ (188) | $ - | $ (1,030) |
| Unrealized gain (loss) | 12,199 | 188 | (135) | 12,252 |
| **Risk management asset (liability), as at Sept. 30, 2012** | **$ 11,357** | **$ -** | **$ (135)** | **$ 11,222** |

The net risk management asset consists of current and non-current assets and liabilities. The table below summarizes the components of the net risk management asset as at September 30, 2012:

| | Crude Oil | Foreign Exchange | Sept. 30, 2012 |
|---|---|---|---|
| **Current** | | | |
| Risk management asset | $ 6,778 | $ - | $ 6,778 |
| Risk management liability | (465) | (135) | (600) |
| **Non-current** | | | |
| Risk management asset | 5,406 | - | 5,406 |
| Risk management liability | (362) | - | (362) |
| **Net risk management asset (liability)** | **$ 11,357** | **$ (135)** | **$ 11,222** |

The realized (loss) gain represents the risk management contracts settled in the period. The unrealized (loss) gain represents the change in fair value of the underlying risk management contracts to be settled in the future. The table below summarizes the components of the realized and unrealized risk management gains and losses for the three and nine months ended September 30, 2012 and 2011:

| | Three months ended Sept. 30, | | Nine months ended Sept. 30, | |
|---|---|---|---|---|
| | **2012** | 2011 | **2012** | 2011 |
| Realized (loss) gain on risk management contracts: | | | | |
| Crude oil derivative contracts | **$ 9** | $ (190) | **$ 1,173** | $ (4,864) |
| Natural gas derivative contracts | **-** | 471 | **-** | 1,647 |
| Interest rate swap contracts | **18** | (222) | **(140)** | (668) |
| Foreign exchange derivative contracts | **(360)** | - | **(435)** | - |
| | **(333)** | 59 | **598** | (3,885) |
| Unrealized (loss) gain on risk management contracts: | | | | |
| Crude oil derivative contracts | **(16,657)** | 55,837 | **12,199** | 56,520 |
| Natural gas derivative contracts | **-** | (387) | **-** | (1,560) |
| Interest rate swap contracts | **-** | (130) | **188** | (315) |
| Foreign exchange derivative contracts | **(98)** | - | **(135)** | - |
| | **(16,755)** | 55,320 | **12,252** | 54,645 |
| (Loss) gain on risk management contracts | **$ (17,088)** | $ 55,379 | **$ 12,850** | $ 50,760 |

## Note 18 – Changes in Non-Cash Working Capital

| | Three months ended Sept. 30, | | Nine months ended Sept. 30, | |
|---|---|---|---|---|
| | **2012** | 2011 | **2012** | 2011 |
| Change in: | | | | |
| Accounts receivable | **$ (20,609)** | $ (4,284) | **$ 46,707** | $ 17,294 |
| Prepaid expenses | **1,815** | 1,713 | **281** | (2,834) |
| Accounts payable and accrued liabilities | **108,178** | 171,798 | **(28,425)** | 7,546 |
| Other | **(307)** | 1,602 | **(921)** | 6,458 |
| | **89,077** | 170,829 | **17,642** | 28,464 |
| Working capital deficiencies acquired | **-** | - | **100** | - |
| | **$ 89,077** | $ 170,829 | **$ 17,742** | $ 28,464 |
| Changes relating to: | | | | |
| Attributable to operating activities | **$ (46,830)** | $ 10,633 | **$ 11,886** | $ 9,443 |
| Attributable to investing activities | **$ 136,337** | $ 160,195 | **$ 14,316** | $ 19,525 |
| Attributable to financing activities | **$ (430)** | $ 1 | **$ (8,460)** | $ (504) |
| | **$ 89,077** | $ 170,829 | **$ 17,742** | $ 28,464 |

## Note 19 – Commitments

The following is a summary of the estimated costs required to fulfill the Company's remaining contractual commitments at September 30, 2012:

| **Type of Commitment** | **< 1 Year** | **1-3 Years** | **4-5 Years** | **Thereafter** | **Total** |
|---|---|---|---|---|---|
| *Petrobank Standalone* | | | | | |
| Office operating leases [(1)] | $ 1,004 | $ 1,041 | $ 386 | $ 383 | $ 2,814 |
| Finance leases | 570 | 716 | - | - | 1,286 |
| *PetroBakken* | | | | | |
| Office leases [(1)] | 5,742 | 12,842 | 12,885 | 23,291 | 54,760 |
| Drilling and completion rigs | 20,301 | 19,013 | 622 | - | 39,936 |
| Other | 1,208 | 842 | 98 | - | 2,148 |
| **Total Commitments** | **$ 28,825** | **$ 34,454** | **$ 13,991** | **$ 23,674** | **$ 100,944** |

(1) Minimum lease payments are net of sub-lease payments received by the Company, which reduces rent expense included in general and administrative expenses on the condensed interim consolidated statement of operations.

**Note 20 – Subsequent Event**

On October 29, 2012, Petrobank and PetroBakken entered into an agreement to complete a corporate reorganization that will see Petrobank shareholders effectively receive Petrobank's proportionate interest in its PetroBakken share holdings while maintaining their interest in the remaining Petrobank assets (the "Reorganization"). The Reorganization is anticipated to become effective on December 31, 2012 (the "Effective Date"). Pursuant to the Reorganization, a new Alberta corporation will be formed ("New Petrobank") which will, through a series of transactions, directly or indirectly acquire all of Petrobank's assets and liabilities, including our heavy oil assets, the THAI® and related patents and cash (the "Heavy Oil Business"), but excluding our investment in PetroBakken (the "PetroBakken Shares"). Existing Petrobank shareholders will receive one share of New Petrobank for every share of Petrobank held on the Effective Date.

Following this distribution of Petrobank's Heavy Oil Business to New Petrobank, Petrobank and PetroBakken will, through a series of transactions, amalgamate, with the resulting company to continue under the name "PetroBakken Energy Ltd." ("New PetroBakken"). Existing PetroBakken shareholders will receive one share of New PetroBakken for every share of PetroBakken held on the Effective Date and Petrobank shareholders will receive, in aggregate, a number of New PetroBakken shares equal to the number of PetroBakken Shares held by Petrobank on the Effective Date. The number of New PetroBakken shares to be received for each Petrobank share held will be equal to the PetroBakken/Petrobank exchange ratio on the Effective Date, which will be calculated by dividing the number of PetroBakken shares owned by Petrobank by the number of Petrobank shares outstanding.

New Petrobank will be a well-positioned junior heavy oil company with significant capital, an attractive asset base, a patented heavy oil extraction technology, and a plan to grow production and reserve value.