



Management's Discussion and Analysis and Audited Financial Statements  
for the years ended December 31, 2008 and 2007.

## **BLACKWATCH ENERGY SERVICES CORP. MANAGEMENT'S DISCUSSION AND ANALYSIS AT MARCH 20, 2009**

This Management's Discussion and Analysis ("MD&A") of BlackWatch Energy Services Corp. (the "Company" or "BlackWatch") is a review of the financial condition and results of operations of the Company and its predecessor BlackWatch Energy Services Trust and should be read in conjunction with the consolidated financial statements for the years ended December 31, 2008 and 2007. Statements in this MD&A are based on information available as at March 20, 2008. The definitions of certain non-GAAP measures used within this MD&A have been included at the end of this MD&A. Readers should also refer to the "Forward-Looking Statements" legal advisory at the end of this MD&A.

In certain circumstances the Company has amended the presentation of historical information to provide more meaningful comparative values for the period ended December 31, 2008. The consolidated financial statements were prepared in accordance with Canadian generally accepted accounting principles ("GAAP") and all amounts presented are denominated in Canadian dollars.

Additional information concerning the Company, including the Annual Information Form, is filed electronically on SEDAR and available at [www.sedar.com](http://www.sedar.com).

### **OVERVIEW**

BlackWatch Energy Services Corp. ("NewCo") was incorporated on October 14, 2008 as a wholly owned subsidiary of BlackWatch Energy Services Trust (the "Trust"), a publicly traded, open-ended, unincorporated investment trust. On December 31, 2008 the unitholders of the Trust exchanged their units for common shares of NewCo. (on a one-for-one basis) as part of a plan of arrangement (the "Reorganization"). The plan of arrangement resulted in the Trust becoming wholly owned by NewCo. These transactions are accounted for on a continuity of interest basis and accordingly, the consolidated financial statements reflect the financial position, results of operations and cash flows of NewCo consolidated with the Trust and all its acquired subsidiaries (the "Company" or "BlackWatch") as if NewCo had always held the units of the Trust and carried on the business formerly carried on by the Trust and its subsidiaries. The Company trades on the Toronto Stock Exchange under the symbol BWT and provides a range of oilfield services to customers operating in the western Canadian sedimentary basin.

### **Drilling**

The drilling division operates ten modern, highly mobile truck mounted single drilling rigs and one telescopic double pad rig. Of the ten single rigs, eight are capable of drilling to depths of up to 1,700 meters and two are capable of drilling to 1,300 meters. Five of the rigs have integrated drilling air compression packages used for underbalanced drilling. These rigs are also equipped with hydraulic top drive systems and hydraulic remote pipe handling systems, both of which increase operational efficiency and provide improved safety for rig personnel. The rig systems are of a modular design that is scalable to suit diverse well drilling programs. The telescopic double pad rig is capable of drilling to depths of 3,400 meters. The rig is equipped with an AC electric power system, top drive, mechanical pipe handling system and a walking system that independently moves the rig between wells while fully rigged up.

### **Downhole Services**

The downhole services division operates nine electric-wireline ("e-line") units. The e-line units are used in the well completion process to deliver cased-hole logging tools and perforating guns or to install mechanical plugs in well bores. The division is also engaged in pipe recovery services that are used during downhole fishing operations. The division specializes in tubing conveyed perforating and offers proprietary propellant services used in the perforation process. The e-line units are based out of Red Deer and Grande Prairie, Alberta and provide services in Alberta and northeastern British Columbia.

In the second quarter of 2008 the Company closed the Drumheller coil tubing and swabbing location and the Lloydminster coil tubing location and discontinued its coil tubing operation. In October 2008 BlackWatch ceased the remaining coil tubing operations and instituted a plan to sell the coil tubing assets not already held for sale. At December 31, 2008 the net book value of coiled tubing assets was \$4.2 million. Coil tubing units were used to deploy and retrieve downhole tools such as plugs, valves, drill bits and fishing tools or to circulate or place stimulation and/or clean out fluids or gases relating to the well completion or workover process.

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**Production Services**

The production services division provides a range of services focused on the supply, storage, handling, treatment and disposal of various oilfield fluid products. The division provides mobile storage systems, site access matting and related transportation services to support the supply and recovery of its fluid products. The fluid products provided by the division are used primarily in gas drilling and production operations for well completion, stimulation and workover. The division dispatches and retrieves these fluid products for re-use, storage or disposal using a modern fleet of vacuum trucks, hot oilers and tank trucks. These services are provided from the division's operations center in Drumheller, Alberta for gas well development activities in east-central and southern Alberta.

**Rentals**

Oil and gas exploration and production companies do not maintain the large assortment of oilfield equipment necessary for drilling, completion and production operations. They generally rent much of the necessary equipment for such operations. BlackWatch's rental division maintains an inventory of rental equipment such as rig mats, swamp matting, flare tanks, storage tanks, premix tanks, shale bins, flock tanks, invert systems and other equipment. The rental division provides an array of transportation equipment to support the deployment of its rental equipment fleet to client locations. Rental operations are conducted from dedicated bases in Valleyview and Sundre Alberta and through other BlackWatch base locations as necessary. The division provides oilfield rental services to operators in west-central and north-western Alberta.

**Transportation**

The transportation division operates a fleet of 23 heavy transport units providing a variety of oilfield hauling services, including rig moving, heavy equipment transportation and specialized hauling. The fleet consists of: three mobile crane units for loading and unloading pipe, casing and heavy equipment; six bed trucks which are used for off-road heavy hauling such as positioning large rig pieces on well sites; and 15 winch tractors primarily used for highway transportation of heavy equipment. The transportation division conducts operations from bases in Vegreville and Drumheller Alberta and provides services primarily in eastern and northern Alberta. In March the Company ceased all operations related to its transportation division and has entered into an agreement to sell the assets of this division, which is scheduled to close on or about April 30, 2009.

**SUMMARY FINANCIAL INFORMATION**

	<b>Years ended December 31,</b>	
	<b>2008</b>	<b>2007</b>
Revenue from continuing operations	\$ 46,231	\$ 37,647
Gross margin from continuing operations <sup>1</sup>	\$ 7,097	\$ 3,416
EBITDA <sup>1</sup>	\$ 2,980	\$ (1,016)
Loss from continuing operations	\$ (17,152)	\$ (33,483)
Per share unit - basic and diluted	\$ (0.50)	\$ (1.22)

<sup>1</sup> See definition within the *Non-GAAP Measures* section.

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(\$ thousands)	As at December 31,			
	2008		2007	
Total assets	\$	64,437	\$	81,894
Debt and future capital obligations:				
Current	\$	42,907	\$	43,726
Long-term	\$	189	\$	475
Shareholders' Equity	\$	15,038	\$	33,650

In the year ended December 31, 2008 the Company increased revenues and showed a lower loss and improved cash flow compared to 2007. The increase in revenues reflects higher utilization in our drilling division somewhat offset by lower utilization in our downhole and production services divisions. The drilling division increased its utilization from 17% in 2007 to 30% in 2008 whereas the industry activity levels in the same period remained flat, with average industry drilling rig utilization of approximately 40% in 2008, compared to 39% in 2007. The improvement in gross margin from 9% to 15%, combined with lower administrative costs led to a significant improvement in EBITDA for year ended December 31, 2008. The improved gross margin, which related primarily to the drilling division, was achieved through increased utilization throughout the year and reduced operating costs.

Natural gas and oil prices weakened significantly during the year and these weaker prices are having a negative effect on oil and gas industry activity in western Canada in 2009. Falling commodity prices coupled with decreasing global demand for oil and gas have caused many producers to scale back their 2009 capital budgets. This will reduce the demand for oilfield services.

In September 2008 BlackWatch completed the construction of a telescopic double pad rig ("Rig #11") and the rig began working under a take-or-pay contract with an intermediate oil and gas producer. The agreement provides for a commitment of 200 days per year for two years. In March and October 2008 BlackWatch received payments of \$1.375 million under the take-or-pay contract, which were used to partially fund the completion of Rig #11. The rig commenced operations on September 28, 2008 and as of December 31, 2008 had worked for 85 days. In 2009 Rig #11 has worked steadily and is scheduled to work through spring break up.

In October 2008 the Company made the decision to shut down its remaining coil tubing operations and has expanded the program to dispose of the assets related to this business unit. See further details in *Note 19* in the *Consolidated Financial Statements*. In 2008 BlackWatch sold three electric-wireline units, two swabbing units, five coil tubing units and various other assets for net proceeds of \$4.9 million. BlackWatch plans to continue to dispose of underutilized assets and use the proceeds from these asset sales to pay down the senior debt.

At December 31, 2008 the Company performed an impairment test of its property, plant and equipment, resulting in a non-cash impairment charge of \$10 million (2007 - \$10.4 million). The impairment charge of \$7 million was recorded for the production services and rentals divisions and \$3 million for the coil tubing assets which are not operating and recorded as held for sale on the balance sheet.

Effective March 18, 2009 BlackWatch discontinued the operations of its transportation division. Management has entered into an agreement to sell the transportation assets in April 2009. Proceeds from the disposition of the assets will be used to reduce the senior debt. Previous initiatives to sell the division as a going concern were unsuccessful. The truck fleet is aging and the financial results do not justify the significant maintenance capital investment necessary to continue the business unit. Gross margin contributed by this division in 2008 was negative and the discontinuance of operations is not expected to have a material negative effect on future cash flow from operations.

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**RESULTS OF OPERATIONS**

(\$ thousands)	Years ended December 31,	
	2008	2007
Revenue from continuing operations	46,231	37,647
Operating Expenses		
Labour	19,425	16,361
Fuel	4,532	3,141
Repairs and maintenance	3,410	3,154
Sub-contractors	2,677	2,135
Other	9,090	9,440
Expenses from continuing operations	39,134	34,231
Gross margin from continuing operations	\$ 7,097	\$ 3,416

Revenues from continuing operations for the year ended December 31, 2008 were \$46.2 million. Representing an increase of \$8.6 million or 23% compared to the year ended December 31, 2007. The increase in revenues relates primarily to the drilling division and was partially offset by a decrease in revenue in the downhole and production services divisions.

Overall operating expenses from continuing operations as a percentage of revenue from continuing operations were 85% (2007 – 91%). Labour costs, which represent the most significant component of operating expenses, dropped from 43% to 42% of revenue because of changes in field bonuses and guarantee arrangements within some of the operating divisions and reduction of staffing levels. Fuel costs increased from 8% of revenues in 2007 to 10% in 2008, which reflects an increase in the average price of gasoline and diesel fuel in 2008 compared to 2007. Repairs and maintenance declined from 8% of revenues to 7% in 2008. In 2008 the Company continued to focus its repairs and maintenance efforts on high utilization assets while demobilizing underutilized assets. Furthermore, management has implemented strict cost controls and expenditure approvals for repairs and maintenance programs. These controls, combined with the more robust preventative maintenance program, allowed the Company to limit repairs and maintenance expenses in the period and reduce unexpected repairs. Subcontractor costs as a percentage of revenue remained consistent in 2008 compared to 2007. Other operating costs consist primarily of non-variable costs, which have declined from 25% in 2007 to 20% in 2008 because of a decrease in insurance and vehicle lease costs offset by an increase in bad debt expense.

The overall reduction in operating costs as a percentage of revenues in the year ended December 31, 2008 compared to the same periods in 2007 primarily reflects the cost-cutting initiatives undertaken in the latter half of 2007 and increased utilization in the drilling division.

**DIVISIONAL RESULTS**

(\$ thousands)	For the Year Ended December 31, 2008					
	Consolidated	Drilling	Downhole Services	Transportation	Production Services	Rentals
Revenue from continuing operations	\$ 46,231	\$ 22,830	\$ 6,702	\$ 6,228	\$ 5,125	\$ 5,346
Operating Expenses						
Labour	\$ 19,425	\$ 9,509	\$ 3,372	\$ 2,245	\$ 2,224	\$ 2,075
Fuel	4,532	2,364	342	839	460	527
Repairs and maintenance	3,410	1,515	394	723	345	433
Sub-contractors	2,677	382	135	1,441	22	697
Other	9,090	3,028	2,852	1,083	1,272	855
Total operating expenses from continuing operations	\$ 39,134	\$ 16,798	\$ 7,095	\$ 6,331	\$ 4,323	\$ 4,587
Gross Margin from continuing operations	\$ 7,097	\$ 6,032	\$ (393)	\$ (103)	\$ 802	\$ 759

Amounts above are shown after intercompany eliminations.

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	For the year Ended December 31, 2007						
	Consolidated	Drilling	Downhole Services	Transportation	Production Services	Rentals	
Revenue from continuing operations	\$ 37,647	\$ 10,866	\$ 9,374	\$ 6,012	\$ 5,979	\$ 5,416	
Operating Expenses							
Labour	\$ 16,361	\$ 5,030	\$ 4,195	\$ 2,195	\$ 2,780	\$ 2,161	
Fuel	3,141	1,023	394	704	542	478	
Repairs and maintenance	3,154	1,391	482	517	354	410	
Sub-contractors	2,135	116	112	1,103	77	727	
Other	9,440	2,946	3,283	1,058	1,273	880	
Total operating expenses from continuing operations	\$ 34,231	\$ 10,506	\$ 8,466	\$ 5,577	\$ 5,026	\$ 4,656	
Gross Margin from continuing operations	\$ 3,416	\$ 360	\$ 908	\$ 435	\$ 953	\$ 760	

Amounts above are shown after intercompany eliminations.

**Contract Drilling**

The drilling division generated revenues of \$22.8 million in the year ended December 31, 2008 compared to \$10.9 million in 2007. Gross margin was \$6 million in 2008 compared to \$360,000 in 2007. Much of this increase in revenue is the result of a very active first quarter which saw industry average rig utilization of 56%. BlackWatch operated ten rigs achieving an average utilization rate of 62% in this quarter. In addition BlackWatch was able to increase its overall yearly utilization from 17% in 2007 to 30% in 2008. The rise in the average utilization rate is primarily the result of diversification of drilling services within the division, increased operational efficiencies and the addition of one telescopic double pad rig, which was completed in the third quarter of 2008 and operated throughout most of the fourth quarter. The addition of oil sands related drilling and casing drilling services lifted total drilling days for the first quarter by 53% to 564 drilling days from the 369 drilling days generated in 2007. The addition of a telescopic double pad rig and improved operational performance contributed to an average utilization of 32% in the fourth quarter. The increased activity in the first and fourth quarters of the year was partially offset by utilization of 3% in the second quarter and 23% in the third quarter of 2008 because of wet weather in the core operating areas, which restricted the movement of equipment.

Labour costs for rig crews decreased from 46% of revenues in 2007 to 42% in 2008. This decrease is the result of reductions in fixed labour costs combined with higher revenues. Fuel increased from 9% to 10% of revenue, reflecting the general increase in fuel prices throughout most of the year. Repairs and maintenance decreased by 6% for the year ended December 31, 2008 compared to the same period in 2007. Management implemented strict cost controls and expenditure approvals for repairs and maintenance programs. These controls, combined with the more robust preventative maintenance program and minimal repairs required on the new telescopic double pad rig, allowed BlackWatch to limit repairs and maintenance expenses in the period and reduce unexpected repairs. Other expenses remained consistent in the year ended December 31, 2008 compared with the same period in 2007.

**Downhole Services**

In the year ended December 31, 2008 the downhole services division generated revenues of \$6.7 million, compared to \$9.4 million during the same period last year. The reduction in e-line revenue of approximately \$2.7 million is the result of lower industry activity in our service areas. Fuel, repairs and maintenance and sub contractor costs as a percentage of revenues remained consistent between periods, which reflects better cost controls, logistics management and reduced equipment utilization. Labour and other operating expenses as a percentage of revenue have increased from 45% and 35% respectively in the year ended December 31, 2007 to 50% and 43% for the year ended December 31, 2008. This increase is the result of decreased revenue and slower fixed cost reductions such as salaries and vehicle leases within this division. The downhole services division requires a high degree of specialization and as a result highly trained individuals are retained by BlackWatch throughout the year, which makes a significant portion of labour costs non-variable.

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**Transportation**

The transportation division generated revenues of \$6.2 million in the year ended December 31, 2008 compared to \$6 million last year, reflecting consistent industry levels of drilling and other oilfield activities.

Labour and other costs as a percentage of revenue remained consistent in the year ended December 31, 2008 compared to the same period of 2007. Fuel costs have increased to 13% (2007 – 12%) of revenues due to the increased price of gasoline and diesel fuel. Repairs and maintenance expenses have increased during the year due to three unexpected repairs for accidents not covered by insurance. Sub contractor costs have increased from 18% of revenue in the year ended December 31, 2007 to 23% in 2008 because subcontractors were used to temporarily replace certain services during high utilization periods in the year.

**Production Services**

Production services revenue decreased to \$5.1 million in 2008 compared to \$6 million in 2007. This reflects lower oilfield activity in our service area in 2008 because of reduced shallow gas drilling. Labour costs have decreased to 43% (2007 – 46%) of revenues due to the Company’s reduction of non-billable hours. Other costs have increased to 25% of revenues (2007 – 21%). This increase is due to higher product costs which have decreased the margins received on product sales, partially offset by lower insurance, materials and supplies costs and a recovery of an accounts receivable balance previously thought to be uncollectible. Fuel, repairs and maintenance and sub-contractor costs within the production services division have remained generally consistent in 2008 compared to 2007.

**Rentals**

The rentals division revenue decreased to \$5.3 million in 2008 compared to \$5.4 million in 2007. Labour costs have decreased to 39% (2007 – 40%) of revenues due to reductions in administrative head count and an increased emphasis on reductions to non-billable hours. All other operating costs within the rental division have remained generally consistent in 2008 compared to 2007.

***Selling, General and Administrative Expenses***

(\$ thousands, except where otherwise indicated)	Years ended December 31,	
	2008	2007
Selling, general and administrative	\$ 4,117	\$ 4,432
Percentage of revenue from continuing operations	9%	12%

In the year ended December 31, 2008 the Company’s selling, general and administrative expenses (“SG&A”) decreased by 7% compared to 2007. The decrease in SG&A was achieved through various rationalization initiatives implemented in the latter half of 2007, including head count reductions, revisions to benefit programs, reduction in office space, elimination of discretionary expenditures and reduction of outsourced services. These cost deductions were slightly offset by increases in advisory and professional fees associated with strategic initiatives and the Company’s conversion from a trust to a corporation. BlackWatch is continuing to focus on cost minimization initiatives. The corporate office was reduced from an average of 25 staff in 2007 to 20 in 2008.

All costs included in this caption are incurred at a corporate or head office level. Any support costs incurred directly by the operating divisions are classified as operating expenses.

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*Interest Expense on Debt*

(\$ thousands)	Years ended December 31,	
	2008	2007
Interest on debt	\$ 4,764	\$ 4,082
Other interest and bank charges	1,868	2,275
Total interest expense	\$ 6,632	\$ 6,357

Interest for the year ended December 31, 2008 increased by 4% compared to the same period in 2007 because of higher interest rates partially offset by lower debt levels throughout period. The average blended interest rate on the outstanding debt increased to 11.1% in 2008 (2007 – 8.8%) because of the replacement of a portion of debt drawn under the senior credit with the higher rate subordinated debt.

The Company has incurred interest on its senior credit facility of \$1.5 million (2007 - \$3.6 million) in the year ended December 31, 2008. The interest rate for this period ranged from 6.125% - 8.625% (2007 – 7.125% - 8.625%). The prime lending rate decreased from 5.75% to 3.50% in the year ended December 31, 2008.

The Company announced on January 22, 2009 that it had successfully extended its \$22.5 million senior credit facility and \$22.5 million subordinated facility until June 1, 2009. Interest on the extended credit facility was set at prime plus 5.5% and on the subordinated debt at 15%. An additional \$5 million bulge facility was granted to temporarily fund working capital, which bears interest at prime plus 1.25% and matures on June 1, 2009. As a result of the extension the Company expects that cash interest costs in 2009 will be higher than in 2008.

In the year ended December 31, 2008 interest of \$3.2 million (2007 - \$521,000) was incurred on the subordinated loan, which only existed for three months in the period ended December 31, 2007. Interest on the subordinated debt for 2008 ranged from 12% - 15% and was settled through the issuance of 4,518,622 trust units in 2008 and 1,575,342 common shares in 2009 at the requirement of the senior lender. The trust units and common shares were issued at the ten day weighted average price immediately proceeding the last day of the quarter. The agreement provides that if the ten day average market share price is lower then \$0.54/share, as was the case in the latter part of the year, then interest is settled at \$0.54/share.

Other interest and bank charges have increased in the year ended December 31, 2008 as a result of fees that were paid to extend the senior and subordinated loan facility and expenses recorded as part of the conversion feature related to the subordinated debt. See further details in *Note 7ii* in the *Consolidated Financial Statements*.

The Company paid an extension fee of \$125,000 and is required to pay an additional exit fee of \$250,000 if the credit facility is not repaid in full by June 1, 2009. The Company can only draw funds under the bulge facility with written consent of the subordinated lender, such consent not to be unreasonably withheld or delayed if such drawdown is for working capital purposes. Consent is required from the subordinated lender as they have provided the senior lender with a letter of credit securing the bulge facility.

A financial covenant under the senior credit agreement requires that Cumulative Adjusted EBITDA, less interest, tax and lease payments, from January 1, 2008 must be greater than zero at each quarter end. The Company was not in compliance with this covenant at December 31, 2008. However, the senior lender waived the covenant breach as part of the January 21, 2009 extension

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*Depreciation and Amortization*

(\$ thousands)	Years ended December 31,	
	2008	2007
Depreciation of capital assets	\$ 7,701	\$ 10,073
Amortization of intangibles	-	6,744
Depreciation and amortization	7,701	16,817
Depreciation and amortization from discontinued operations	936	4,183
Depreciation and amortization from continuing operations	\$ 6,765	\$ 12,634

Depreciation and amortization from continuing operations has decreased by 54% in the year ended December 31, 2008 compared to 2007. Depreciation has decreased because of the lower net book values at December 31, 2008, reflecting depreciation and impairment charges in excess of additions. Amortization of intangibles in the current year is nil as the entire balance was fully amortized as of December 31, 2007.

**INCOME TAXES**

After the Reorganization the Company is a taxable Canadian entity. As a result, the Company has estimated its future tax position as at December 31, 2008. The excess of the net book value over related tax pools of property, plant and equipment indicates a future tax liability of approximately \$2.4 million, which is more than offset by a future income tax asset of \$10.3 million related to non-capital tax loss carry forwards and share issue costs available to offset future taxable income. The net future tax asset is not recorded because of the uncertainty of future taxable income to realize the tax asset.

**INVESTING ACTIVITIES**

*Capital Expenditures*

Capital costs consist of either growth or maintenance expenditures. Maintenance capital expenditures reflect the costs of replacing existing assets. Growth capital expenditures reflect investment costs to generate incremental productive capacity.

The \$7.5 million (2007 - \$8.1 million) of capital expenditures incurred during the year ended December 31, 2008 were growth expenditures, primarily consisting of:

- \$6 million in the drilling division for: 1) completion of a telescopic double drilling rig ("Rig #11); and 2) addition of certain coring related equipment.
- \$1.1 million within the rental and production services divisions for the purchase of oilfield hauling equipment, 148 flow back tanks, and the construction of a new brine plant.
- \$295,000 within the transportation division for the purchase of a new winch truck and other transportation related equipment

The Company's capital expenditures for the period ended December 31, 2008 were funded from operating cash flows and amounts drawn on the senior credit facility.

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**RELATED PARTY TRANSACTIONS**

During 2008, the Company incurred expenses of \$466,000 (2007, \$462,000) relating to the rental of land, buildings and equipment owned by certain officers who are also shareholders of the Company. In 2007, the Company incurred expenses of \$12,500 in the normal course of business related to accounting services performed by principals and officers of the Company. The Company has incurred legal fees with a legal firm in which one of the Company's directors is a partner in the amount of \$566,000 (2007, \$496,000). These fees relate to work completed for strategic initiatives, banking matters, corporate reorganization and general corporate matters. Of these fees \$217,000 (2007, \$36,000) are included in accounts payable as at December 31, 2008. The amounts of these transactions were completed at exchange values which approximate fair values.

The Company has also entered into a \$22.5 million subordinated loan with an entity substantially owned by a director. As at December 31, 2008 the outstanding balance of this loan is \$22.5 million. Accrued interest of \$851,000 (2007 – \$521,000) was outstanding as at December 31, 2008. Additionally, the subordinated lender has provided the Company's senior lender with a letter of credit securing the bulge facility, at no additional cost to the Company. See further details in Note 20 in the Consolidated Financial Statements. These transactions were completed at exchange values which approximate fair values.

**LIQUIDITY AND CAPITAL RESOURCES**

As at December 31, 2008 the Company had drawn approximately \$20.1 million of its available \$22.5 million syndicated senior credit facility and had drawn \$22.5 million under the subordinated loan. Additional debt of approximately \$488,000 is outstanding related to lease financing on capital equipment, which are subject to fixed interest rates. See further details below within the *Contractual Obligations and Commitments* section. As at March 19, 2009 the Company had drawn approximately \$21.7 million on the senior credit facility. In 2009 the Company will draw on the senior credit and bulge facility to fund working capital increases. It is anticipated that any drawings under this facility will be repaid in the second quarter as receivables are collected and working capital is reduced.

The Company announced on January 22, 2009 that it extended its \$22.5 million senior credit facility and \$22.5 million subordinated facility until June 1, 2009. Interest on the extended credit facility is prime plus 5.5% and 15% on the subordinated debt. An additional \$5 million bulge facility was granted to temporarily fund working capital which bears interest at prime plus 1.25% and matures on June 1, 2009. The credit facility restricts capital expenditures to no more than \$250,000 in aggregate for the period of January 21, 2009 to June 1, 2009 without the prior written consent of all of the Lenders, unless such capital expenditures are funded exclusively by the issuance of equity securities of the Company, deeply subordinated debt or subordinated third party debt. The Company currently has no plans to incur capital expenditures in excess of this limit.

***Earnings Before Interest, Depreciation and Amortization, Tax and Unit Compensation***

(\$ thousands)	Years ended December 31,	
	2008	2007
Loss from continuing operations	\$ (17,152)	\$ (33,483)
Add: Depreciation and amortization	6,765	12,634
Add: Impairment on property, plant and equipment	6,959	6,483
Add: Impairment on goodwill	-	6,289
Add: Interest	6,632	6,357
Add: Unit compensation	246	93
Add: Income tax expense (recovery)	(65)	169
Add: Other expense (income)	(21)	(30)
Add: Loss (gain) on sale of equipment	(507)	472
Add: Unrealized foreign exchange loss	123	
EBITDA from continuing operations	\$ 2,980	\$ (1,016)

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For the last two years the Company has not generated sufficient EBITDA to fully fund the interest on its senior and subordinated debt. Continuing weak demand for energy services in western Canada increases the uncertainty as to the Company's ability to improve its financial performance and generate sufficient cash flow to service its debt obligations and fund new capital investments. The Company's weak financial results, combined with poor general credit market conditions, make it uncertain that it will be able to renew its credit facilities beyond June 1, 2009, or refinance the debt obligations.

It is expected that funds from operations and the available capacity under the subordinated loan will be the primary sources of funding for other future capital expenditures. The Company made significant investments in new equipment in 2006 and early 2007 so its fleet of equipment is relatively new. BlackWatch is planning very limited capital expenditures in 2009, focused on accessing higher margin business and improving utilization of existing assets.

For further details on the Company's liquidity see *Contractual Obligations and Commitments* and the *Outlook* sections below.

### SHAREHOLDERS' EQUITY

As of March 19, 2009 the Company had issued 38,453,953 common shares 3,000,000 warrants for the purchase of common shares and 2,572,000 options to purchase common shares.

### CONTRACTUAL OBLIGATIONS AND COMMITMENTS

The Company has various vehicle and equipment obligations under capital leases with interest rates ranging from non-interest bearing to 14.2%. The leases have expiry dates ranging from January 2009 through November 2017.

The following table summarizes the amount of contractual obligations for each of the next five years:

Contractual obligations	Payments due by period					
	Total	2009	2010	2011	2012	2013 - 2017
Debt	\$ 42,608	\$ 42,608	\$ -	\$ -	\$ -	\$ -
Capital lease obligations	488	299	139	50	-	-
Operating leases	5,215	1,622	1,314	814	336	1,129
Purchase obligations	-	-	-	-	-	-
Other long term obligations	-	-	-	-	-	-
<b>Total contractual obligations</b>	<b>\$ 48,311</b>	<b>\$ 44,529</b>	<b>\$ 1,453</b>	<b>\$ 864</b>	<b>\$ 336</b>	<b>\$ 1,129</b>

### SUMMARY OF QUARTERLY RESULTS

(\$ thousands, except per Share unit amounts)	2008				2007			
	Q4	Q3	Q2	Q1	Q4 <sup>2</sup>	Q3	Q2 <sup>2</sup>	Q1 <sup>2</sup>
Revenue from continuing operations	\$ 12,506	\$ 10,127	\$ 4,080	\$ 19,518	\$ 7,642	\$ 9,066	\$ 4,088	\$ 16,851
Gross margin from continuing operations	\$ 2,249	\$ 676	\$ (1,720)	\$ 5,892	\$ 525	\$ 1,604	\$ (2,527)	\$ 3,814
Selling, general and administrative expenses	\$ 1,091	\$ 1,096	\$ 972	\$ 958	\$ 974	\$ 726	\$ 1,225	\$ 1,507
Net income (loss) from continuing operations	\$ (9,148)	\$ (3,562)	\$ (5,801)	\$ 1,359	\$ (14,459)	\$ (2,086)	\$ (14,055)	\$ (2,883)
Per Share unit - basic	\$ (0.26)	\$ (0.10)	\$ (0.17)	\$ 0.04	\$ (0.46)	\$ (0.08)	\$ (0.57)	\$ (0.12)
Per Share unit - diluted	\$ (0.26)	\$ (0.10)	\$ (0.17)	\$ 0.04	\$ (0.46)	\$ (0.08)	\$ (0.57)	\$ (0.12)
Funds from continuing operations	\$ 484	\$ (816)	\$ (2,971)	\$ 4,324	\$ (667)	\$ (220)	\$ (4,912)	\$ 1,007
Per Share unit - basic	\$ 0.01	\$ (0.02)	\$ (0.09)	\$ 0.12	\$ (0.01)	\$ (0.01)	\$ (0.19)	\$ 0.04
Per Share unit - diluted	\$ 0.01	\$ (0.02)	\$ (0.09)	\$ 0.12	\$ (0.01)	\$ (0.01)	\$ (0.19)	\$ 0.04
Weighted average Common Shares - basic	36,011	35,053	34,110	32,174	31,320	27,482	24,781	24,781
Weighted average Common Shares - diluted	36,011	35,063	34,120	32,187	31,333	27,482	24,805	24,808
Common Shares, end of period	38,269	36,692	35,118	34,154	32,174	29,499	24,781	24,781

<sup>1</sup> Revenue in Q1 and Q2 2007 include \$182,000 and \$34,000 which was generated by the pipeline construction division from other divisions of the Trust

<sup>2</sup> The Company has revised its quarterly information to reflect the sale and discontinuation of its pipeline construction division and the discontinuation of its coiled tubing operation.

Variances between the quarters are primarily due to seasonality. Traditionally, second quarter results are the weakest for oil and gas services companies (see "Seasonality" below) and in 2007 and 2008 the sector experienced longer than normal spring breakup followed by significant amounts of precipitation in June.

# **BLACKWATCH ENERGY SERVICES CORP.**

## **MANAGEMENT'S DISCUSSION AND ANALYSIS AT MARCH 20, 2009**

### *Fourth Quarter*

The 2008 fourth quarter results were significantly better than 2007 with increased revenue and margins primarily due to increased utilization within the drilling division.

Fourth quarter drilling rig utilization rates within the industry averaged 44%, up from 37% in 2007. The utilization rate within the BlackWatch drilling fleet was 32% (2007 - 12%) in the fourth quarter of 2008 compared to 23% in the third quarter. BlackWatch increased its 2008 fourth quarter utilization compared to 2007 and the third quarter of 2008 because the Company commissioned a new rig in the later part of the third quarter of 2008. The Company's drilling utilization rates are still below industry averages because BlackWatch's drilling business is directed primarily toward shallow gas and CBM drilling and development activities, which have experienced the greatest reductions within the industry.

In the fourth quarter of 2008, BlackWatch performed an impairment test of its property, plant and equipment, resulting in a non-cash impairment charge of \$10 million (2007 - \$10.4 million). The impairment charge of \$7 million was recorded for the production services and rentals divisions and \$3 million for the coil tubing assets which are not operating and recorded as held for sale on the balance sheet. Selling general and administrative expenses in the fourth quarter of 2008 were higher than 2007 because of additional costs discussed under *Summary Financial Information*.

### **SEASONALITY**

The geographical region within which the Company operates is subject to significant changes in activity levels as a result of seasonal weather patterns. Historically, oilfield service activities are higher in the first and fourth quarters of the year, resulting in higher revenues in those periods. Spring weather, due to melting snow and rain, impacts the accessibility of work sites because of road bans implemented to avoid damage to secondary roads. These conditions are normally seen during the months of April and May; however, the timing and duration may vary. In addition, the temperature conditions experienced within the winter season can impact the levels of service demand. Abnormally cold or warm temperatures can affect the ability to perform work and, therefore, decrease activity and utilization rates.

### **OFF-BALANCE SHEET ARRANGEMENTS**

The Company has not entered into any off-balance sheet arrangements as at December 31, 2008.

### **FINANCIAL INSTRUMENTS**

Financial instruments of the Company consist of accounts receivable, marketable securities, accounts payable and accrued liabilities, obligations under capital lease and finance contracts and debt. There are no significant differences between the net carrying value of these financial instruments and their fair value. The Company is exposed to credit risks on its accounts receivable because it grants credit to customers in the normal course of business. That credit risk is concentrated because most accounts receivable are from entities in the oil and gas industry but, this risk is mitigated to the extent possible by regular reviews of outstanding accounts receivable, monitoring of the financial status of customers and termination of credit to customers with poor payment history.

The Company is exposed to fluctuations in interest rates on its senior credit facility, which bears interest at floating rates.

## **BLACKWATCH ENERGY SERVICES CORP. MANAGEMENT'S DISCUSSION AND ANALYSIS AT MARCH 20, 2009**

### **DISCLOSURE CONTROLS AND PROCEDURES AND INTERNAL CONTROLS OVER FINANCIAL REPORTING**

BlackWatch's Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") have designed or caused to be designed under their supervision, disclosure controls and procedures ("DC&P") to provide reasonable assurance that all information required to be disclosed by the Company is recorded, processed, summarized and reported to senior management, including the CEO and CFO, in an appropriate manner to allow timely decisions regarding required disclosure as defined under Multilateral Instrument 52-109, Certification of Disclosures in Annual and Interim Filings. An evaluation of the design and operating effectiveness of the disclosure controls and procedures was performed as at December 31, 2008. BlackWatch's CEO and CFO have concluded, based on these evaluations of the design and operating effectiveness at December 31, 2008, that the Company's disclosure controls and procedures are effective to provide reasonable assurance that material information related to BlackWatch, including its consolidated subsidiaries, is adequately disclosed.

The CEO and CFO do not expect that the disclosure controls and procedures will prevent or detect all errors, misstatements and fraud but are designed to provide reasonable assurance of achieving their objectives. A control system, no matter how well designed or operated, can only provide reasonable, not absolute, assurance that the objectives of the control system are met.

In addition to disclosure controls and procedures, the CEO and CFO are responsible for designing internal controls over financial reporting ("ICFR"), or causing them 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 in accordance with Canadian GAAP. Management, under the supervision of the CEO and CFO, has evaluated the effectiveness of BlackWatch's ICFR using the framework and criteria established in Internal Control - Integrated Framework (COSO Framework), which is a recognized and suitable framework developed by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The CEO and CFO have concluded that the Company's internal controls over financial reporting, as of the end of the period covered by the annual filings, are designed and operating effectively to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with Canadian GAAP.

The Company's internal controls over financial reporting may not prevent or detect all errors, misstatements and fraud. The design of internal controls must take into account cost-benefit constraints. A control system, no matter how well designed or operated, can only provide reasonable, not absolute, assurance that the objectives of the control system are met.

There have been no significant changes in the Company's disclosure controls and procedures and internal controls over financial reporting that occurred during the year and no material weaknesses or significant deficiencies have been identified in the design and operating effectiveness of these controls, that could materially affect or be reasonably likely to affect BlackWatch's internal controls over financial reporting.

### **CHANGES IN ACCOUNTING POLICIES**

- (i) As of January 1, 2008, the Company has adopted CICA Handbook Section 1535, Capital Disclosures, which requires entities to disclose their objectives, policies and processes for managing capital, and in addition, whether the entity has complied with any externally imposed capital requirements. The Company has determined that the only impact is the disclosure contained in *Note 15* to the *Consolidated Financial Statements*.
- (ii) As of January 1, 2008, the Company has adopted CICA Handbook Section 3031, Inventory. This new standard is effective for interim and annual financial statements relating to fiscal years beginning on or after July 1, 2007. This new standard has no effect on the Company's consolidated financial statements because the Company's policies complied with the standard.
- (iii) As of January 1, 2008, the Company has adopted CICA Handbook Section 3862, Financial Instruments – Disclosures, and Section 3863, Financial Instruments – Presentations. The only significant effect on the Company's consolidated financial statements is the incremental disclosures in *Note 14* to the *Consolidated Financial Statements* regarding the significance of financial instruments to

## **BLACKWATCH ENERGY SERVICES CORP. MANAGEMENT'S DISCUSSION AND ANALYSIS AT MARCH 20, 2009**

the Company's financial position and performance, and the nature, extent and management of risks arising from financial instruments to which the Company is exposed.

- (iv) As of December 31, 2008, the Company has early adopted CICA Handbook Section 3064, Goodwill and intangible assets. The new Section is required for financial statements relating to fiscal years beginning on or after October 1, 2008. This new standard has no effect on the Company's consolidated financial statements as the Company's policies complied with the standard.
- (v) The Company presents the outstanding conversion feature on subordinated debt in their debt and equity component parts on the consolidated balance sheet. The debt and equity component is determined by valuing the equity component using the Black-Scholes option pricing model. The value determined for each component is then adjusted on a pro rata basis to ensure that the sum of the carrying amounts assigned to the components equals the amount of the consideration received for the conversion feature of the subordinated debt. The equity component of the convertible debenture is presented under "Shareholders' equity" in the consolidated balance sheet. Upon conversion of the subordinated debt into company units by the holder, a proportionate amount of both debt and equity components are transferred to Unitholders capital. Interest expense for the subordinated debt is recorded in the Consolidated Statements of Operations and Comprehensive Income (Loss) and Deficit as interest on debt

### ***IFRS Conversion Plan:***

In the second quarter the Company began planning for the conversion to International Financial Reporting Standards ("IFRS"). As part of the planning process the Company is ensuring that individuals that will have a direct responsibility over the implementation process obtain appropriate training. The Company is developing a plan to identify the effects of IFRS on its accounting policies, information systems, internal controls, investor relations, external communications and other business activities. The Company expects to have a formalized plan documented in 2009.

Further details on the transitional impact of accounting changes and a discussion of recent accounting pronouncements are presented in *Note 2 to the Consolidated Financial Statements*.

### **CRITICAL ACCOUNTING ESTIMATES**

The preparation of the consolidated financial statements requires that certain estimates and judgments be made with regard to the reported amount of revenues and expenses and the carrying values of assets and liabilities. These estimates are based on historical experience and management judgment. Anticipating future events involves uncertainty and consequently the estimates used by management in the preparation of the consolidated financial statements may change as future events unfold, additional experience is acquired, or the Trust's operating environment changes.

While there are many estimates and assumptions made by management in the preparation of financial statements in accordance with GAAP, the following critical accounting estimates have been identified by management:

#### **Estimates of Collectability of Accounts Receivable**

BlackWatch makes an estimate of amounts of accounts receivable that may not be collected. The Company regularly reviews its customers' financial condition and accounts receivable balances and makes an allowance for collectability if it considers the collection of an accounts receivable balance doubtful. The actual collections of accounts receivable are uncertain and could differ materially from this estimate.

Most of BlackWatch's customers are oil and gas producers, who have experienced reduced cash flow and are impacted by deteriorating credit market conditions. This may cause a quick, unanticipated deterioration in customers' financial condition and affect the collectability of accounts receivable balances.

# **BLACKWATCH ENERGY SERVICES CORP.**

## **MANAGEMENT'S DISCUSSION AND ANALYSIS AT MARCH 20, 2009**

### **Estimates of Impairment of Property, Plant and Equipment**

BlackWatch assesses the fair market value of its property plant and equipment at least annually, often using external consultants. The estimate of fair market value is based on assumptions regarding market value of individual assets and future cash flows from the use of the asset, among other factors which are uncertain. A change in these factors could have a material effect on the estimate of impairment. Recent poor economic conditions have caused a significant reduction in market value of used oilfield equipment.

### **OUTLOOK**

The outlook for the western Canadian energy services sector for 2009 and beyond is largely dependant on capital spending by oil and natural gas explorers and producers which are in turn heavily influenced by North American oil and natural gas prices. The year ended December 31, 2008 saw a significant decline in crude oil and natural gas prices and industry sources have become less optimistic about oilfield activity improving in 2009. A significant number of oil and gas producers are reducing their capital budgets and planned activities, which will reduce overall industry utilization rates and revenues.

BlackWatch has undertaken several initiatives designed to provide service differentiation, to help it compete for work and diversify to a broader range of industry activity. For example, in the first quarter of 2008 BlackWatch added significant drilling activity through oilsands related drilling and coring work, allowing us to participate in the market for oilsands development. In September 2008 BlackWatch completed its telescopic double Rig #11 which has begun working under a take-or-pay contract with an intermediate oil and gas producer. That contract provides for a commitment of 200 days per year for two years. This newly constructed rig has the capability of working in many diverse areas such as oilsands, coal bed methane, shale gas and conventional reservoirs. In March 2008 BlackWatch acquired 148 flow-back tanks and related equipment which, when combined with its existing production services, completes its offering of fluid support services used for the completion, stimulation and production of oil and gas wells.

BlackWatch has tested and employed the capability to drill wells with casing which, in certain applications, eliminates the need for drill pipe and reduces drilling time. Casing drilling can increase drilling efficiency significantly and has the potential to reduce formation damage associated with fluid exposure and pressure surges. A number of BlackWatch's rigs are also well-suited to safely drill with air, as an alternative to conventional drilling using fluids. The design of our rigs allows this to be done without the addition of major equipment or service interfaces, resulting in very cost effective service versus typical air drilling operations. Drilling with air substantially increases drilling efficiency and imparts minimal formation damage, a critical issue in coal bed methane and shallow gas developments. We completed several well programs for a number of senior exploration and production companies with casing drilling methods. This technique resulted in significant improvements to drilling efficiency. In addition BlackWatch has also completed several wells using casing combined with air drilling which improves efficiencies further. These service differentiations and the Company's continued focus on reducing drilling costs for our clients will allow BlackWatch to pursue additional drilling programs and may have a positive effect on asset utilization.

In 2009, BlackWatch should continue to benefit from two new completion services that were added in late 2007: 1) proprietary propellant technology to enhance perforation performance for little incremental cost, using licensed technologies; and 2) pipe recovery equipment and expertise for both open-hole and cased-hole applications.

We believe that progressive actions such as these will improve the Company's performance.

BlackWatch recognizes that significant challenges remain, and we are taking a systematic approach to addressing them. We continue to take steps to stabilize the business financially and are addressing the opportunities available to us to position BlackWatch for success. Our goal is to create an entity that is viable during periods of low economic activity but which is able to take full advantage of a future recovery in industry activity levels. Management continues to believe in the long term viability of the western Canadian sedimentary basin.

# **BLACKWATCH ENERGY SERVICES CORP.**

## **MANAGEMENT'S DISCUSSION AND ANALYSIS AT MARCH 20, 2009**

### **FORWARD-LOOKING STATEMENTS**

The MD&A contains certain forward-looking information and statements relating to BlackWatch's plans, strategies, objectives, expectations and intentions. Expressions such as "may", "anticipate", "expect", "project", "believe", "hope", "estimate", "intend", "will", "continue" and "forecast" and similar expressions and statements are intended to identify forward looking statements. Such statements represent BlackWatch's internal projections, estimates or beliefs concerning, among other things, an outlook on the estimated amounts and timing of capital expenditures, anticipated future debt, revenues or other expectations, beliefs, plans, objectives, assumptions, intentions or statements about future events or performance. These statements are only predictions and actual events or results may differ materially. Although BlackWatch believes that the expectations reflected in the forward-looking statements are reasonable, it cannot guarantee future results, levels of activity, performance or achievement since such expectations are inherently subject to significant business, economic, competitive, political and social uncertainties and contingencies. Many factors could cause BlackWatch's actual results to differ materially from those expressed or implied in any forward-looking statements made by, or on behalf of, BlackWatch.

In particular, forward-looking statements included in this MD&A include, but are not limited to, statements with respect to the focus of capital expenditures; future operating and financial results; capital expenditure programs for 2009; amount of general and administrative expenses; effect of weaker natural gas prices and crude oil prices on the oil and gas industry; effect of the Alberta governments new royalty programs on the oil and gas industry in Alberta and on BlackWatch's business; disposal of underutilized assets and the use of proceeds; extension of the senior debt facility to June 1, 2009 and the increase of the amount of the facility and the EBITDA covenant; plans to pay down senior debt; extension of the subordinated debt facility to June 1, 2009; sources of funding; timing of implementation of changes in accounting policies, including conversion to IFRS; timing of implementation of a down-hole camera technology; future oil and gas service activity; specific events and trends in the oil and gas industry; and treatment under governmental regulatory regimes and tax laws.

These forward-looking statements are subject to numerous risks and uncertainties, certain of which are beyond BlackWatch's control, including the impact of general economic conditions; industry conditions; volatility of commodity prices; decreased demand for energy services; competition from other energy services providers; the lack of availability of qualified personnel or management; ability of BlackWatch to re-finance or extend the maturity date of its senior debt and its subordinated loan and generate positive cash flow; failure of counter-parties to perform on contracts; changes in income tax laws or changes in tax laws and incentive programs relating to the oil and gas industry; seasonality; loss of key customers; fluctuations in foreign exchange or interest rates and stock market volatility; supply and demand for oilfield services relating to the drilling, completion and maintenance of oil and gas wells as well as services related to pipeline construction, oilfield equipment rentals and production and ancillary services; liabilities and risks, including environmental liabilities and risks, inherent in oil and natural gas operations; uncertainties in weather and temperature affecting the duration of the service periods and the activities that can be completed; ability to access sufficient capital from internal and external sources and the other risks considered under "Risk Factors" in our annual information form for the year ended December 31, 2008 which is available on [www.sedar.com](http://www.sedar.com).

With respect to forward-looking statements contained in this MD&A, BlackWatch has made assumptions regarding: current commodity prices and royalty regimes; availability of skilled labour; timing and amount of capital expenditures; ability of BlackWatch to re-finance or extend the maturity date of its senior debt and its subordinated loan; future exchange rates; the price of oil and natural gas; the impact of increasing competition; conditions in general economic and financial markets; supply and demand for oilfield services relating to the drilling, completion and maintenance of oil and gas wells as well as services related to pipeline construction, oilfield equipment rentals and production and ancillary services; effects of regulation by governmental agencies; and future operating costs. Management has included the above summary of assumptions and risks related to forward-looking information provided in this MD&A in order to provide Shareholders with a more complete perspective on BlackWatch's future operations and such information may not be appropriate for other purposes. BlackWatch's actual results, performance or achievement could differ materially from those expressed in, or implied by, these forward-looking statements and, accordingly, no assurance can be given that any of the events anticipated by the forward-looking statements will transpire or occur, or if any of them do so, what benefits that BlackWatch will derive there from. Readers are cautioned that the foregoing lists of factors are not exhaustive. These forward-looking statements are made as of the date of in this MD&A and BlackWatch disclaims any intent or obligation to update publicly any forward-looking statements, whether as a result of new information, future events or results or otherwise, other than as required by applicable securities laws.

**BLACKWATCH ENERGY SERVICES CORP.  
MANAGEMENT’S DISCUSSION AND ANALYSIS AT MARCH 20, 2009**

**NON-GAAP MEASURES**

Throughout this MD&A, certain terms that are not specifically defined in Canadian generally accepted accounting principles (“GAAP”) are used to analyze operations. In addition to the primary measures of net earnings and net earnings per unit, as recognized under GAAP, Management believes that certain measures not recognized under GAAP assist management and the reader in assessing the Company’s performance and understanding the Company’s results. Each of these measures provides the reader with additional insight into the Company’s performance.

- Gross margin – This measure is considered a primary indicator of operating performance and is calculated as revenue less operating expenses.
- EBITDA (Earnings before interest, income taxes, depreciation and amortization and unit based compensation) – This measure is considered an indicator of the Company’s ability to generate funds in order to meet ongoing operating commitments, servicing of debt, funding for capital programs and distributions.
- Working capital – This term is defined as current assets less current liabilities excluding the current portion of long-term debt and lease and finance contract obligations.

The above noted measures are not recognized under GAAP. As a result, the method of calculation may not be comparable with other companies or trusts. These measures should not be considered alternatives to net earnings and net earnings per unit as calculated in accordance with GAAP.

**BlackWatch Energy Services Corp.**  
Travis Robertson  
President and Chief Executive Officer

Wiley Auch  
VP Finance and CFO

**Units Listed – Symbol: BWT**  
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## Auditors' Report

To the Shareholders of  
**BlackWatch Energy Services Corp.**  
**(formerly BlackWatch Energy Services Trust):**

We have audited the consolidated balance sheets of **BlackWatch Energy Services Corp.** as at December 31, 2008 and 2007 and the consolidated statements of operations, comprehensive loss and deficit and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2008 and 2007 and the results of its operations and its cash flow for the years then ended in accordance with Canadian generally accepted accounting principles.

March 16, 2009

A handwritten signature in black ink that reads "Deloitte &amp; Touche LLP". The signature is written in a cursive, flowing style.

Chartered Accountants

**BlackWatch Energy Services Corp.**  
**Consolidated Balance Sheets**

(Stated in thousands of Canadian dollars)	As at December 31, 2008	As at December 31, 2007
<b>Assets</b>		
Current assets		
Marketable securities (Note 3)	\$ -	\$ 48
Accounts receivable	7,723	6,345
Inventory (Note 4)	105	-
Prepaid expenses and deposits	470	821
	<u>8,298</u>	<u>7,214</u>
Inventory (Note 4)	1,167	2,108
Equipment held for sale (Note 5)	4,243	-
Property, plant and equipment (Note 5)	50,729	72,572
	<u>\$ 64,437</u>	<u>\$ 81,894</u>
<b>Liabilities</b>		
Current liabilities		
Accounts payable and accrued liabilities	\$ 6,303	\$ 3,978
Taxes payable	-	65
Debt (Note 7)	42,608	43,363
Current portion of obligations under capital leases (Note 8)	299	363
	<u>49,210</u>	<u>47,769</u>
Obligations under capital leases (Note 8)	189	475
	<u>49,399</u>	<u>48,244</u>
Basis of presentation (Note 1)		
Commitments (Note 16)		
Subsequent events (Note 20)		
<b>Shareholders' equity</b>		
Common shares (Note 10)	256,394	-
Trust and exchangeable units (Notes 1 and 10)	-	252,573
Contributed surplus (Note 10)	1,197	889
Conversion option on subordinated debt (Note 7(ii))	248	-
Deficit	(242,801)	(219,812)
	<u>15,038</u>	<u>33,650</u>
	<u>\$ 64,437</u>	<u>\$ 81,894</u>

*See accompanying notes to audited consolidated financial statements*

Approved by the board of directors:

Signed "Howard J. Crone"  
Howard J. Crone  
Director

Signed "David J. Rain"  
David J. Rain  
Director

**BlackWatch Energy Services Corp.**  
**Consolidated Statements of Operations and Comprehensive Loss and Deficit**

(Stated in thousands of Canadian dollars, except per share amounts)	For the years ended	
	December 31, 2008	December 31, 2007
<b>Revenue</b>		
Service	\$ 43,050	\$ 34,256
Product	1,146	1,042
Rental	2,035	2,349
	<u>46,231</u>	<u>37,647</u>
<b>Expenses</b>		
Operating	39,134	34,231
Selling, general & administration	4,117	4,432
Depreciation and amortization	6,765	12,634
Impairment of property, plant and equipment (Note 5)	6,959	6,483
Impairment of goodwill (Note 6)	-	6,289
Unrealized foreign exchange loss	123	-
Unit based compensation	246	93
Interest on debt	4,764	4,082
Other interest, bank charges and financing charges	1,868	2,275
	<u>63,976</u>	<u>70,519</u>
<b>Loss before other items</b>	<b>(17,745)</b>	<b>(32,872)</b>
Other income	21	30
Gain (loss) on sale of equipment	507	(472)
<b>Loss from operations before income taxes</b>	<b>(17,217)</b>	<b>(33,314)</b>
<b>Income taxes (recovery)</b>		
Current	(65)	169
<b>Loss from continuing operations</b>	<b>(17,152)</b>	<b>(33,483)</b>
Net loss from discontinued operations (Note 19)	(5,837)	(10,600)
<b>Loss and comprehensive loss for the year</b>	<b>(22,989)</b>	<b>(44,083)</b>
<b>Deficit, beginning of year</b>	<b>(219,812)</b>	<b>(174,118)</b>
Distributions for the year	-	(1,611)
<b>Deficit, end of year</b>	<b>\$ (242,801)</b>	<b>\$ (219,812)</b>
Loss from continuing operations per share - basic and diluted (Note 10)	\$ (0.50)	\$ (1.22)
Loss from discontinued operations per share - basic and diluted (Note 10)	\$ (0.17)	\$ (0.38)
Loss and comprehensive loss per share - basic and diluted (Note 10)	\$ (0.67)	\$ (1.60)

See accompanying notes to audited consolidated financial statements

**BlackWatch Energy Services Corp.**  
**Consolidated Statements of Cash Flows**

(Stated in thousands of Canadian dollars)	For the years ended	
	December 31, 2008	December 31, 2007
<b>Operating Activities</b>		
Loss for the year from continuing operations	\$ (17,152)	\$ (33,483)
Items not requiring an outlay of cash:		
Depreciation and amortization	6,765	12,634
Impairment of property, plant and equipment	6,959	6,483
Impairment of goodwill	-	6,289
Unit based compensation expense	308	90
Issuance of warrants	-	134
Loss (gain) on sale of equipment	(507)	472
Non cash interest expense	3,216	521
Amortization of financing charges	1,432	2,068
	<u>1,021</u>	<u>(4,792)</u>
Change in non-cash working capital (Note 18)	(749)	1,316
Cash flows from (used in) continuing operations	<u>272</u>	<u>(3,476)</u>
Net loss from discontinued operations	(5,837)	(10,600)
Items not requiring an outlay of cash:		
Depreciation and amortization	936	4,183
Impairment of property, plant and equipment	3,001	3,980
Loss (gain) on disposal of assets	115	(1,131)
Change in non-cash working capital (Note 18)	1,182	1,504
Cash flows used in discontinued operations	<u>(603)</u>	<u>(2,064)</u>
<b>Financing Activities</b>		
Issue of trust units, net of issue costs	-	7,838
Repayment of capital leases	(187)	(463)
Increase (decrease) in debt	(1,000)	3,325
Cash reclassified against debt	(152)	275
Distributions to unitholders	-	(3,881)
Financing charges	(182)	(935)
Change in non-cash working capital (Note 18)	(76)	120
Cash flows from (used in) continuing financing activities	<u>(1,597)</u>	<u>6,279</u>
Repayment of capital lease obligations	(163)	(346)
Cash flows used in financing activities of discontinued operations	<u>(163)</u>	<u>(346)</u>
<b>Investing Activities</b>		
Purchase of property, plant and equipment	(7,475)	(8,128)
Proceeds on disposal of property, plant and equipment	2,662	422
Fee for take-or-pay contract (Note 5)	2,750	-
Change in non-cash working capital (Note 18)	1,760	328
Cash flows used in continuing investing activities	<u>(303)</u>	<u>(7,378)</u>
Purchase of property, plant and equipment	(26)	(214)
Proceeds on disposal of property, plant and equipment	2,420	3,626
Change in non-cash working capital (Note 18)	-	(385)
Cash flows from investing activities of discontinued operations	<u>2,394</u>	<u>3,027</u>
<b>Decrease in cash</b>	<b>-</b>	<b>(3,958)</b>
<b>Cash at beginning of year</b>	<b>-</b>	<b>3,958</b>
<b>Cash at end of year</b>	<b>\$ -</b>	<b>\$ -</b>
Supplementary cash flow information		
Cash interest paid	\$ 1,548	\$ 4,252
Cash taxes paid	\$ -	\$ 3,198

See accompanying notes to audited consolidated financial statements



## **1. Nature of operations and basis of presentation**

BlackWatch Energy Services Corp. (“NewCo”) was incorporated on October 14, 2008 as a wholly owned subsidiary of BlackWatch Energy Services Trust (the “Trust”), a publicly traded, open-ended, unincorporated investment trust. On December 31, 2008 the unitholders of the Trust exchanged their units for common shares of NewCo. (on a one-for-one basis) as part of a plan of arrangement (the “Reorganization”). The plan of arrangement resulted in the Trust becoming wholly owned by NewCo. These transactions are accounted for on a continuity of interest basis and accordingly, the consolidated financial statements reflect the financial position, results of operations and cash flows of NewCo consolidated with the Trust and all its acquired subsidiaries (the “Company” or “BlackWatch”) as if NewCo had always held the units of the Trust and carried on the business formerly carried on by the Trust and its subsidiaries. The Company trades on the Toronto Stock Exchange under the symbol BWT and provides a range of oilfield services to customers operating in the western Canadian sedimentary basin.

The financial statements of the Company have been prepared in accordance with Canadian generally accepted accounting principles (GAAP). Because a precise determination of many assets and liabilities is dependent upon future events, the preparation of financial statements involves the use of estimates and approximations based on information available as of the date of the disclosure of assets and liabilities and revenues and expenses for the period reported. The financial statements have, in the Company’s opinion, been properly prepared within reasonable limits of materiality and within the framework of the Company’s accounting policies as summarized below.

### **Going concern**

The Company’s financial statements as at and for the years ended December 31, 2008 and 2007 were prepared on a going concern basis, which contemplates the realization of assets and the settlement of liabilities and commitments in the normal course of operations. In the year ended December 31, 2008, the Company incurred a significant loss and generated nominal cash flow from operations. In order to continue as a going concern, the Company must generate sufficient income and cash flow to repay its debt obligations, finance working capital and fund capital investments. Continuing weak demand for energy services in western Canada increases the uncertainty as to the Company’s ability to improve its financial performance and generate sufficient cash flow to service its debt obligations and continue operations.

BlackWatch’s senior and subordinated debt facilities both mature on June 1, 2009. In order to continue as a going concern, the Company requires the continued support of both its senior and subordinated lenders to renew the facilities. The Company’s weak financial results, combined with poor general credit market conditions, make it uncertain that it will be able to renew these facilities beyond June 1, 2009, or otherwise refinance the debt obligations.

The financial statements do not include any adjustments, which could be material, required if the going concern assumption were not appropriate.

## **2. Significant accounting policies**

### **a) Use of estimates**

The most significant estimates used in the preparation of the financial statements relate to the impairment of long lived assets, the allowance for doubtful accounts and the going concern assumption. These estimates rely on significant judgments made by management and are subject to measurement uncertainty. Accordingly, actual results could differ from these and other estimates, the effect of which would be recorded in future periods and could be material.

### **b) Principles of consolidation**

These consolidated financial statements include the accounts of the Company and all of its subsidiaries. All inter-entity transactions and balances have been eliminated upon consolidation.



**c) Marketable securities**

Marketable securities are comprised of securities that were acquired by the Company from certain customers as settlement of accounts receivable. Marketable securities were classified as held for trading as it was the Company's intention to dispose of all shares. All marketable securities were measured at fair value with changes in those fair values being recognized in net earnings.

**d) Inventory**

Inventory is initially recorded at cost and is subsequently valued at the lower of cost and net realizable value. Cost is determined using the weighted average method.

**e) Property, plant and equipment**

Property, plant and equipment are recorded at cost. The table below details the depreciation rates that are applied against the various asset classes recorded by the Company.

<u>Asset Class</u>	<u>Rate</u>
Drilling rigs	Unit of production based on 3,300 drill days
Coil tubing stands	20% declining balance
Field service equipment	15% declining balance
Shop tools and equipment	20% declining balance
Computer equipment	40% declining balance
Transport vehicles	30% declining balance
Furniture and fixtures	20% declining balance
Buildings	4% declining balance
Rental equipment	15% declining balance
Leaseholds	Straight line over the term of the lease

Assets recorded in property, plant and equipment as part of capital lease transactions are included in the appropriate property, plant and equipment assets class and depreciated based on the rate specified for that asset class.

**f) Impairment of long lived assets**

The Company performs impairment testing on its property, plant and equipment at least annually and whenever events or changes in circumstances indicate that the carrying value of an asset, or group of assets, may not be recoverable. Long lived assets are tested for impairment by comparing the estimate of undiscounted future cash flows to the carrying amount of the assets or group of assets. If the carrying value is not recoverable from undiscounted future expected cash flows, any loss is measured as the amount by which the asset's carrying value exceeds fair value, and recorded in the period.

**g) Goodwill**

Goodwill represents the excess of the purchase price of acquired businesses over the fair value of net tangible and identifiable intangible assets acquired and is not subject to amortization. Goodwill was tested for impairment at least annually to determine if events or circumstances indicated the asset might



be impaired. The impairment test included the application of a fair value test, with an impairment loss recognized when the carrying value of goodwill exceeded its estimated fair value. Impairment provisions are not reversed if there is a subsequent increase in the fair value of goodwill.

**h) Revenue recognition**

The Company recognizes revenue: (1) from oilfield hauling upon delivery of hauled product to the contracted destination; (2) on the sale of products when title and ownership are transferred upon delivery; and, (3) for all other services when services are performed.

**i) Income taxes**

The Company follows the liability method to account for income taxes. Under this method, future tax assets and liabilities are determined based on differences between the carrying value and the tax bases of assets and liabilities together with any loss carry forwards available for tax purposes, and are measured using the substantively enacted tax rates expected to be in effect when the differences are expected to reverse or the losses utilized. Changes to these balances are recognized in net earnings in the period in which they occur. The amount of any future income tax assets recognized is limited to the amount that is more likely than not to be realized.

**j) Stock-based compensation**

The Company has a stock based compensation plan that uses the fair-value method to record compensation expense with respect to stock options granted. The fair value of each option granted is estimated on the date of grant and a provision is reflected as contributed surplus over the term of the option agreement. The consideration received by the Company on the exercise of share options is recorded as an increase to share capital together with corresponding amounts previously recognized in contributed surplus. Forfeitures are accounted for as they occur, which could result in recoveries of the compensation expense. Under the terms of the share based compensation plan, the exercise price of rights granted may be reduced in future periods based on dividends paid to shareholders.

The Company determined compensation expense for the unit award incentive plan (*Note 9*) recognizing the fair value in income and liabilities over the vesting period. After the rights vested, further changes in the fair value were recognized in income and liabilities in the period of change. As the expense was determined based on the period end price, large fluctuations, even recoveries, in compensation expense could occur. If the rights were exercised, any unit issuances would have been reflected as increases to unitholders' equity.

**k) Foreign currency translation**

Monetary assets and liabilities relating to foreign denominated transactions are initially recorded at the rate of exchange in effect at the transaction date. Gains and losses resulting from subsequent changes in foreign exchange rates are recorded in earnings for the period.

**l) Earnings per share**

Basic earnings (loss) per common share is calculated using the weighted average number of common shares outstanding during the period. Diluted per share amounts reflect the dilutive effect of the conversion feature on the subordinated debt, warrants, stock options and unit awards outstanding. Diluted earnings per share is calculated using the treasury stock method for options, warrants and unit awards, which assumes that any proceeds obtained on exercise of options and warrants would be used to purchase common shares at the average market price during the periods, and the if-converted method for the convertible debentures. The weighted average number of common shares outstanding is then increased by this change.



**m) Adoption of new accounting policies**

- (i) As of January 1, 2008, the Company adopted the Canadian Institute of Chartered Accountants ("CICA") Handbook Section 1535, Capital Disclosures, which requires entities to disclose their objectives, policies and processes for managing capital, and in addition, whether the entity has complied with any externally imposed capital requirements. The only impact of this change is the disclosure contained in *Note 15*.
- (ii) As of January 1, 2008, the Company adopted CICA Handbook Section 3031, Inventory. This new standard is effective for interim and annual financial statements relating to fiscal years beginning on or after July 1, 2007. This new standard has no effect on the Company's consolidated financial statements because the Company's existing accounting policies comply with the standard and inventory was already recorded at the lower of cost and net realizable value.
- (iii) As of January 1, 2008, the Company adopted CICA Handbook Section 3862, Financial Instruments – Disclosures, and Section 3863, Financial Instruments – Presentations. The only significant effect on the Company's consolidated financial statements is the incremental disclosures in *Note 14* regarding the significance of financial instruments to the Company's financial position and performance, and the nature, extent and management of risks arising from financial instruments to which the Company is exposed.
- (iv) As of October 1, 2008, the Company has early adopted CICA Handbook Section 3064, Goodwill and intangible assets. This new standard has no effect on the Company's consolidated financial statements as the Company's policies already complied with the new standard.

**n) Recent accounting pronouncements**

In January 2006, the CICA Accounting Standards Board ("AcSB") adopted a strategic plan for the direction of accounting standards in Canada. As part of that plan, accounting standards in Canada for public companies are expected to converge with International Financial Reporting Standards ("IFRS") by the end of 2011. The Company continues to monitor and plan for the convergence of Canadian GAAP and IFRS.

In January 2009, the CICA issued three new accounting standards: Section 1582, Business Combinations, Section 1601, Consolidated Financial Statements, and Section 1602, Non-controlling interests. These new standards will be effective for fiscal years beginning on or after January 1, 2011. The Company is in the process of evaluating the requirements of the new standards. Section 1582 replaces Section 1581, and establishes standards for business combination accounting. It provides the Canadian equivalent to the International Financial Reporting Standard IFRS 3 – Business Combinations. The Section applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after January 1, 2011. Sections 1601 and 1602 together replace 1600 – Consolidated Financial Statements. Section 1601 establishes standards for the preparation of consolidated financial statements. Section 1601 applies to interim and annual consolidated financial statements relating to fiscal years beginning on or after January 1, 2011. Section 1602 establishes standards for accounting for a non-controlling interest in a subsidiary in consolidated financial statements subsequent to a business combination. It is equivalent to the International Financial Reporting Standard IAS 27 – Consolidated and Separate Financial Statements and applies to interim and annual consolidated financial statements relating to fiscal years beginning on or after January 1, 2011.

**3. Marketable securities**

Marketable securities of \$nil (2007 - \$48,000) were comprised of securities acquired by the Company from certain customers as settlement of accounts receivable.



**4. Inventory**

Inventory is valued at lower of cost and net realizable value. Cost is determined using the weighted average method. Inventory is comprised of:

(\$ thousands)	<b>As at December 31,</b>	
	<b>2008</b>	<b>2007</b>
Coil tubing	1,167	2,108
Potassium chloride	56	-
Methanol	49	-
	1,272	2,108

The following table represents the recognized expense by classification for the years ended December 31, 2007 and 2008.

(\$ thousands)	<b>Year ended December 31,</b>	
	<b>2008</b>	<b>2007</b>
Coil tubing	982	343
Potassium chloride	187	321
Methanol	333	135
	1,502	799

All coil tubing inventory has been classified as long term. In the year, the Company wrote off \$420,000 (2007, \$453,000) of inventory as it was determined that the material is no longer usable or saleable. Inventory is pledged as security for the senior credit facility (*Note 7(i)*).

**5. Property, plant and equipment**

**As at December 31, 2008**

(\$ thousands)	<b>Cost</b>	<b>Accumulated Depreciation</b>	<b>NBV</b>
Drilling rigs	\$ 39,110	\$ (7,369)	\$ 31,741
Field service equipment	17,542	(9,235)	8,307
Shop tools and equipment	1,230	(529)	701
Computer equipment	716	(411)	305
Transport vehicles	13,818	(7,763)	6,055
Furniture and fixtures	280	(96)	184
Buildings	656	(104)	552
Rental equipment	6,552	(3,879)	2,673
Leaseholds	40	(9)	31
	\$ 79,944	\$ (29,395)	\$ 50,549
Land	180	-	180
	\$ 80,124	\$ (29,395)	\$ 50,729
Equipment held for sale	7,244	(3,001)	4,243
	\$ 87,368	\$ (32,396)	\$ 54,972



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**As at December 31, 2007**

(\$ thousands)	Cost	Accumulated Depreciation	NBV
Drilling rigs	\$ 30,449	\$ (6,305)	\$ 24,144
Coil tubing stands	411	(99)	312
Field service equipment	36,225	(11,231)	24,994
Shop tools and equipment	1,687	(392)	1,295
Computer equipment	850	(294)	556
Transport vehicles	13,690	(4,423)	9,267
Furniture and fixtures	384	(98)	286
Buildings	627	(32)	595
Rental equipment	5,992	(1,045)	4,947
Leaseholds	49	(13)	36
	<b>\$ 90,364</b>	<b>\$ (23,932)</b>	<b>\$ 66,432</b>
Land	258	-	258
Assets under construction	5,882	-	5,882
	<b>\$ 96,504</b>	<b>\$ (23,932)</b>	<b>\$ 72,572</b>

At December 31, 2008, \$1.4 million (2007, \$1.3 million) of equipment is under capital leases for which \$465,000 of accumulated depreciation was recognized (2007, \$211,000). These capital assets are included in the appropriate property, plant and equipment assets classes and depreciated based on the specified rate for that asset class.

In 2008, the Company received a fee of \$2.75 million under a contract that was renegotiated on an asset under construction. The funds received have been recorded as a reduction to the cost of the asset.

As a result of low utilization, management has decided to sell certain underutilized assets in the downhole services division. These assets had a net book value of \$4.2 million after an impairment of \$3.0 million (2007 - \$4.0 million) was recognized at December 31, 2008 to reflect estimated net realizable value. These assets have been classified as held for sale as at December 31, 2008 and management is actively seeking potential buyers.

In 2008, the Company determined that due to the reduced oilfield activity in the western Canadian sedimentary basin, and lower demand and utilization of the Company's services, property, plant and equipment have become impaired by \$7.0 million (2007 - \$6.5 million). This impairment charge was recorded in addition to the \$3.0 million impairment recorded on the coil tubing assets. The fair value of property, plant and equipment is derived from an independent appraisal and the Company's performance of an asset recoverability test using undiscounted cash flows based on internal projections for revenues, expenses and utilization. These internal projections are management's best estimates of expected future revenues and costs. Such estimates by their nature are subject to measurement uncertainties and continuing uncertainties regarding the amount and timing of cash flows, and changes in these estimates could give rise to a change in fair value of the Company's tangible assets, which could have a material impact on the Company's future earnings.



**6. Goodwill**

As at December 31, 2007 (\$ thousands)	Cost	Impairment Write-down	NBV
Goodwill	\$ 6,289	\$ (6,289)	\$ -
	<b>\$ 6,289</b>	<b>\$ (6,289)</b>	<b>\$ -</b>

During 2007, the Company determined that goodwill was impaired as the estimated future cash flows were unable to support the value of these assets. In 2007, impairment of goodwill of \$6 million was recorded.

**7. Debt**

(\$ thousands)	As at December 31,	
	2008	2007
Senior credit facilities(i)	\$ 20,108	\$ 20,863
Subordinated debt (ii)	22,500	22,500
Debt	\$ 42,608	\$ 43,363

**(i) Senior credit facility**

At December 31, 2008, the Company's credit facility had a maximum borrowing capacity of \$22.5 million (2007 - \$35 million) with a syndicate led by a Canadian chartered bank. This credit facility is secured by all assets of the Company. The facility matured on December 31, 2008 and has subsequently been extended to June 1, 2009 (*Note 20*). Advances are available to the Company at an interest rate of prime plus 2.625% (6.125% at December 31, 2008). The Company's credit facility had the following two financial statement covenants:

1. Consolidated current assets to consolidated current liabilities is not less than 1.25 to 1;
2. Cumulative adjusted consolidated EBITDA, (earnings before interest, taxes, depreciation and amortization) less interest, taxes and lease payments, must be greater than zero.

The Company was not in compliance with its EBITDA covenant as at December 31, 2008 but the breach was waived as part of the extension of the facility in January 2009 (*Note 20*). These financial covenants have not changed as part of the extension to June 1, 2009 (*Note 20*).

**(ii) Subordinated debt**

At December 31, 2008, the Company's subordinated debt facility had a maximum borrowing amount of \$27.5 million (2007 - \$22.5 million) with an entity substantially owned by a Director of the Company. \$5 million of the maximum borrowing amount is available for strategic acquisitions at the discretion of the lender. The subordinated debt is subordinated to the senior credit facility and bears interest of 15%. Interest costs are to be paid quarterly through the issuance of common shares or cash. The subordinated debt matured on December 31, 2008 and has subsequently been extended to June 1, 2009 (*Note 20*). The Company is in compliance with the covenants associated with this debt, which are of a non-financial nature, as at December 31, 2008.

The subordinated debt has a conversion feature that grants the lender the right to convert up to 15% of the outstanding loan balance to Company shares at a conversion price of \$0.80 per share, until the facility is repaid in full. The maximum number of shares issuable for these warrants is 4,218,750 and the fair value of the conversion option was determined to be \$248,000 based on the following variables:



Risk-free interest rate (%)	2.87
Expected life (Months)	5
Expected volatility (%)	50
Expected dividend yield	-
Fair value of conversion option (\$/Unit)	0.0589

At December 31, 2008, the full value of the conversion feature had been accreted to the balance of the subordinated debt.

#### 8. Obligation under capital leases and financing agreements

The Company leases vehicles and equipment under capital lease agreements with expiry dates ranging from February 2009 to June 2011. These contracts have various required monthly payments ranging from \$746 to \$12,309 per month. In addition, the contracts have varying interest rates that range from non-interest bearing to 10%. As at December 31, 2008, the principal and interest repayments on obligations under capital leases and financing agreements in each of the next five years are:

\$ thousands	Payments due by period					
	Total	2009	2010	2011	2012	2013
Capital lease obligations						
Total future payments	532	330	151	51	-	-
Interest	44	31	12	1	-	-
Principal	488	299	139	50	-	-

#### 9. Employee option incentive plans

##### a) Stock Based Compensation Plans

The new stock based compensation plan was approved as part of the Reorganization and provides that the maximum number of common shares reserved for issuance from time to time pursuant to the rights granted and outstanding thereunder at any time shall not exceed a number of common shares equal to 10% of the aggregate number of (i) issued and outstanding common shares; plus (ii) the number of common shares issuable upon exchange or conversion of outstanding exchangeable securities. Options under the plan vest equally over three years, commencing with the first anniversary of the grant date and have a term of 5 years from the grant date. Under the new plan 2,572,000 options with an exercise price of \$0.12 per share were issued on February 5, 2009.

As part of the Reorganization, all outstanding trust unit options of the Trust were repurchased by the Trust for nominal consideration. During 2008, 565,000 (2007 – 2,146,000) trust unit options were granted to officers, directors and employees. These trust unit options vested equally over four years commencing on the first anniversary of the grant date. In 2007, 1,467,000 of the trust unit options issued were granted with an immediate vesting of 10% on the date of grant, with the remaining 90% vested evenly over the next four years, on the anniversary of the grant.

The exercise price of the old trust unit options granted were reduced by an amount up to the amount of cash distributions made on the trust units subsequent to the date of grant, provided the Trust's net operating cash flow for the month exceeded 0.833% of the Trust's recorded cost of capital assets less all debt, working capital deficiency (surplus) or debt equivalent instruments, depletion, depreciation and amortization charges, asset retirement obligations and any future income tax liability associated with such capital assets at the end of the month.

The fair value of each option granted is estimated on the date of grant using the Black-Scholes option pricing model with weighted average assumptions for grants as follows:



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	<b>2008</b>	<b>2007</b>
Risk-free interest rate (%)	3.6 to 4.0	3.94
Expected life (years)	5.00	5.00
Expected volatility (%)	50	50
Expected dividend yield	-	-
Fair value of options granted during the year (\$/option)	0.31 to 0.39	0.34 to 0.36

As part of the Reorganization, the trust unit incentive plan was cancelled and all remaining options were acquired by the Company on December 31, 2008 for cash consideration of \$0.01 per option outstanding, for a total payout of \$18,420. Subsequent to year end, new stock options were issued in place of the cancelled options (*Note 20*).

The following summarizes the option activity under the old trust unit incentive plan.

(thousands, except weighted average exercise price)	<b>Options Outstanding (000's)</b>	<b>Weighted Average Exercise Price</b>
Trust unit options outstanding as at January 1, 2007	2,161	9.58
Granted <sup>1</sup>	2,146	0.97
Exercised	-	-
Forfeited or cancelled <sup>1</sup>	(2,300)	8.16
Outstanding December 31, 2007	2,007	2.00
Trust unit options outstanding as at January 1, 2008	2,007	2.00
Granted	565	0.83
Exercised	-	-
Forfeited or cancelled <sup>2</sup>	(730)	4.12
	1,842	0.80
Price adjustment on modification <sup>3</sup>		(0.68)
Replacement options to be issued as at December 31, 2008 <sup>2</sup>	1,842	0.12

**As at December 31, 2007 <sup>2</sup>**

Exercise price	Number outstanding at December 31, 2007	Options exercisable	Weighted average remaining life (years)
\$0.74 - \$0.77	1,742	147	5.0
\$9.48 - \$9.66	265	66	3.6
\$ .74 to \$ 9.73	2,007	213	4.8

The Company recorded unit-based compensation expense and contributed surplus in respect of trust unit options of \$246,000 (2007 \$90,000) for the year.

<sup>1</sup> Included in the weighted average exercise prices is the reduction due to the January 2007 distribution that was declared by the Company in the amount of \$.065 per unit. Of the 2.3 million cancelled options, 1.9 million received the exercise price reduction and the remaining 400,000 did not as they were granted subsequent to January 2007. There has been no reduction in exercise price for any options that have been granted in the year ended December 31, 2007.

<sup>2</sup> Forfeitures in the year were 684,000 and the remaining 1,888,000 were acquired for \$0.01 per option and cancelled as part of the Reorganization. Of the 1,888,000 acquired, 1,842,000 were considered modifications for accounting purposes as new stock options were issued subsequent to year end (*Note 20*) and 46,000 were



cancelled.

<sup>3</sup> The weighted average exercise price of the trust unit options prior to the Reorganization was \$0.80 per option. Subsequent to year end, the Company issued new stock options at an exercise price of \$0.12 per option. For accounting purposes, the new issuance in 2009 was considered a modification to the old trust unit options.

**b) Unit award incentive plan**

As at December 31, 2008, the Unit award incentive plan was cancelled and all outstanding unit awards were acquired by the Company for a nominal payment of \$0.08 per each vested award and \$0.01 for each unvested award, for a total payout of \$400.

As at December 31, 2008, a total of nil (2007 – 13,000) awards (“Unit Awards”) were outstanding under the unit award incentive plan. The unit award incentive plan provided for the issuance of up to 0.5% of the aggregate number of issued and outstanding trust units. Unit awards vested annually over a four year period and upon vesting, entitled the holder to receive the number of trust units subject to the award or the equivalent cash amount. The number of trust units to be issued was adjusted at each distribution date for an amount approximately equal to the foregone distribution. The fair value associated with the trust units granted under the unit award incentive plan was expensed in the statement of operations and deficit over the vesting period.

The following summarizes the changes in awards under the unit award incentive plan.

(thousands)	<b>Options Outstanding (000's)</b>
Outstanding as at January 1, 2007	30
Granted	-
Exercised	-
Cancelled	(17)
Outstanding December 31, 2007	13
Granted	-
Exercised	-
Cancelled	(13)
Outstanding December 31, 2008	-

**10. Shareholders' equity**

*Common shares*

**Authorized:**

The authorized share capital of the Company consists of an unlimited number of common shares without nominal or par value and an unlimited number of first preferred shares.

**Issued and Outstanding:**

Common shares (thousands)	<b>Shares</b>	<b>Amount</b>
<b>Balance, December 31, 2007 (Note 1)</b>	- \$	-
Common shares issued on the Reorganization <sup>1</sup>	36,693	255,543
Common shares to be issued for interest <sup>2</sup>	1,576	851
<b>Balance, December 31, 2008</b>	<b>38,269 \$</b>	<b>256,394</b>



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Trust units		
(thousands)	Units	Amount
<b>Balance, January 1, 2007</b>	<b>18,034</b>	<b>\$ 176,280</b>
Conversion of exchangeable units	2,126	18,954
Units issued in the period	6,649	9,256
Trust units returned to treasury	(33)	(329)
Trust units issued for interest	792	521
Unit issue costs	-	(168)
<b>Balance, December 31, 2007</b>	<b>27,568</b>	<b>\$ 204,514</b>
Conversion of exchangeable units	1,011	10,108
Units issued in the period <sup>3</sup>	4,519	2,984
Unit issue costs	-	(14)
Cancellation of trust units on the Reorganization	(33,098)	(217,592)
<b>Balance, December 31, 2008</b>	<b>-</b>	<b>\$ -</b>
Exchangeable units		
(thousands)	Units	Amount
<b>Balance, January 1, 2007</b>	<b>6,747</b>	<b>\$ 67,159</b>
Exchangeable units returned to treasury	(15)	(146)
Conversion of exchangeable units	(2,126)	(18,954)
<b>Balance, December 31, 2007</b>	<b>4,606</b>	<b>\$ 48,059</b>
Conversion of exchangeable units	(1,011)	(10,108)
Cancellation of exchangeable units on the Reorganization	(3,595)	(37,951)
<b>Balance, December 31, 2008</b>	<b>-</b>	<b>\$ -</b>

<sup>1</sup> Of the total common shares that were issued, 32,010 were held in escrow and will be released on August 4, 2009.

<sup>2</sup> On January 30, 2009, the Company issued 1,575,342 common shares to settle interest charges on the subordinated debt related to the fourth quarter of 2008. See *Note 20*.

<sup>3</sup> Issued 4,518,622 units to settle the commitment fee associated with the subordinated loan extension and to settle interest charges on the subordinated debt related to obligations in 2008.

In connection with the issuance of the subordinated loan in 2007, the Company granted 3 million warrants to the provider of the subordinated loan, an affiliate of a director. These warrants have an exercise price of \$1.68 per common share and expire in April 2009. The Company has calculated the fair value of the warrants using the Black-Scholes model. The expense and the corresponding increase in contributed surplus that was recorded in 2007 is \$134,000.



The basic and diluted weighted average number of common shares used in the calculation of loss per share for the year is 34,479,615. For the purposes of calculating weighted average shares, it was assumed that BlackWatch operated as a corporation since inception. The following summarizes the calculation of the denominator for basic and diluted weighted average shares:

(\$ thousands)	<b>For the years ended December 31,</b>	
	<b>2008</b>	<b>2007</b>
Weighted average common shares - basic	34,480	27,482
Unit awards convertible to Trust units	-	13
<b>Weighted average common shares for diluted net earnings</b>	<b>34,480</b>	<b>27,495</b>

For the calculation of the weighted average number of diluted common shares outstanding for 2008, 1,842,000 (2007 – 2,000,000) options, nil (2007 – 13,000) unit awards, 3,000,000 warrants (2007 – 3,000,000), and the conversion feature on the subordinated debt were excluded, as they were anti-dilutive.

***Contributed surplus***

During the period the Company's contributed surplus increased as follows:

(\$thousands)	
Opening contributed surplus, January 1, 2007	190
Fair value of warrants issued	134
Fair value of trust unit options issued	90
Trust units and exchangeable units returned to treasury	475
<b>Ending balance as of December 31, 2007</b>	<b>889</b>
Fair value of trust unit options issued	308
<b>Ending balance as of December 31, 2008</b>	<b>1,197</b>

**11. Cash distributions**

The Company ceased cash distributions in February of 2007 and had no distributions in 2008. In 2007, the Company declared one distribution of cash to unitholders and exchangeable unitholders of record as at the close of business on the distribution record date, as follows:

(\$thousands, except per unit amounts)				
<b>Distribution Period 2007</b>	<b>Record Date</b>	<b>Distribution Date</b>	<b>Per Unit</b>	<b>Total</b>
January 1 to January 31	January 31, 2007	February 15, 2007	0.065	1,611
Accumulated distributions, January 1, 2007				11,246
<b>Accumulated distributions, December 31, 2008</b>				<b>12,857</b>



## **12. Segmented information**

During the fourth quarter of 2008, the Company ceased all operations related to the coil tubing business unit of the downhole services division. The property, plant and equipment relating to coil tubing has been reclassified as held for sale and the related results of operations have been treated as discontinued operations. All remaining operating segments operate in one geographic region, being western Canada. The Company has identified reportable segments based on the type of services performed. Revenue is generated in the identifiable segments from the following services:

### Downhole Services

The downhole services division operated coil tubing, electric wireline and swabbing units in the year ended December 31, 2008. The electric wireline units are used in the well completion process to deliver cased-hole logging tools and perforating guns or to install mechanical plugs in well bores. Coil tubing units were used to deploy and retrieve downhole tools such as plugs, valves, drill bits and fishing tools or to circulate or place stimulation and/or clean out fluids or gases relating to the well completion or workover process. Swabbing units were used to remove fluids from well bores and to deploy and retrieve downhole tools. The business of operating coil tubing units was discontinued during the fourth quarter of 2008.

### Transportation

The transportation division operates a fleet of heavy transport units providing a variety of oilfield hauling services, including rig moving, heavy equipment transportation and specialized hauling. In March 2009, the Company discontinued the operations of the transportation division (*Note 20*).

### Drilling

The drilling division operates ten mobile truck mounted single drilling rigs capable of drilling to depths of up to 1,700 meters and one telescopic double drilling rig capable of drilling to depths of 3,400 meters.

### Production Services

The production services division provides a range of services focused on the supply, storage, handling, treatment and disposal of various oilfield fluid products used primarily in gas drilling and production operations for well completion, stimulation and workover. The division dispatches and retrieves these fluid products for re-use, storage or disposal using a fleet of vacuum trucks, hot oilers and tank trucks.

### Rentals

The rental division maintains an inventory of rental equipment such as rig mats, swamp matting, flare tanks, storage tanks, premix tanks, shale bins, flock tanks, invert systems and other equipment. It also provides transportation equipment to support the deployment of its rental equipment to client locations.

### Corporate

Provides support services for each of the divisions in areas such as legal, operational, regulatory and financial reporting.



**BlackWatch Energy Services Corp.**  
**Notes to the Consolidated Financial Statements**  
*As at and for the years ended December 31, 2008 and 2007*

**Year ended December 31, 2008**

(\$ thousands)	Downhole Services	Transportation	Drilling	Production Services	Rentals	Corporate	Intercompany Eliminations	Total
Net income (loss) from continuing operations	\$ (2,656)	\$ (1,977)	\$ 4,273	\$ (2,608)	\$ (3,066)	\$ (11,118)		\$ (17,152)
Revenue	6,702	6,458	22,833	5,149	5,668	-	(579)	46,231
Operating costs	7,095	6,535	17,141	4,345	4,597	-	(579)	39,134
Depreciation and amortization	1,178	1,883	1,350	921	1,289	144		6,765
Interest on debt	-	-	-	-	-	4,764		4,764
Other interest and bank charges	-	(4)	(6)	31	-	1,847		1,868
Impairment of plant, property and equipment	1,655	-	-	2,423	2,881	-		6,959
Capital purchases	91	318	5,948	218	896	4		7,475

**Year ended December 31, 2007**

(\$ thousands)	Downhole Services	Transport	Drilling	Production Services	Rentals	Corporate	Intercompany Eliminations	Total
Net income (loss) from continuing operations	\$ (4,687)	\$ (3,925)	\$ (6,256)	\$ (2,223)	\$ (5,574)	\$ (10,818)		(33,483)
Revenue	9,370	6,201	10,866	5,919	5,743	-	(452)	37,647
Operating costs	8,471	5,664	10,758	5,121	4,669	-	(452)	34,231
Depreciation and amortization	1,995	3,922	919	2,752	2,857	189		12,634
Interest on debt	-	-	-	-	-	4,082		4,082
Other interest and bank charges	25	1	(3)	58	4	2,190		2,275
Impairment of goodwill	2,620	-	-	-	3,669	-		6,289
Impairment of plant, property and equipment	974	16	5,299	89	105	-		6,483
Capital purchases	383	987	3,282	1,520	1,710	246		8,128

**As at December 31, 2008**

(\$ thousands)	Downhole Services	Transportation	Drilling	Production Services	Rentals	Corporate	Total
Net book value of property, plant and equipment	4,967	5,039	33,478	3,354	3,533	358	50,729
Equipment held for sale - long term	4,243	-	-	-	-	-	4,243
Total assets	11,426	5,636	37,987	4,213	4,615	560	64,437

**As at December 31, 2007**

(\$ thousands)	Downhole Services	Transport	Drilling	Production Services	Rentals	Corporate	Total
Net book value of property, plant and equipment	20,305	7,001	31,703	5,646	7,419	498	72,572
Total assets <sup>1</sup>	24,079	7,618	33,864	6,639	8,232	965	81,397

<sup>1</sup> The pipeline division that was sold in August 2007 had total assets of \$497,000 as of December 31, 2007, consisting of accounts receivable not collected.



**13. Income taxes**

As a result of the Reorganization described in *Note 1*, the Company is now a taxable entity. The following are the future income tax assets and liabilities:

(\$ thousands)	<b>As at December 31,</b>	
	<b>2008</b>	<b>2007</b>
Property, plant and equipment	\$ 2,421	\$ 6,717
Issue costs	(1,076)	(1,280)
Loss carry forward	(9,241)	(7,825)
	(7,896)	(2,388)
Valuation allowance	7,896	2,388
Future income tax asset	\$ -	\$ -

The Company has recorded a valuation allowance for the income tax asset noted above as the Company has determined that it is not currently more likely than not that sufficient future taxable income will be available to allow for the tax asset to be realized.

(\$ thousands)	<b>Years ended December 31,</b>	
	<b>2008</b>	<b>2007</b>
Loss before income taxes	\$ (23,054)	\$ (43,914)
Federal and provincial statutory rates	29.5%	31.5%
Expected income tax recovery	(6,801)	(13,833)
Adjusted for the effects of:		
Change in valuation allowance	5,508	2,388
Expected change due to decrease in tax rates	1,037	-
Non-deductible expenses	157	116
Other	34	(208)
Impairment of goodwill and non taxable portion of capital gains	-	3,982
Initial recognition of Company's temporary differences	-	7,724
Actual income tax expense (recovery)	\$ (65)	\$ 169

The following are the Company's non capital loss tax pools:

(\$ thousands)	<b>For the years ended December 31,</b>	
	<b>2008</b>	<b>2007</b>
Undepreciated capital costs	\$ 45,108	\$ 39,562
Loss carryforwards <sup>1</sup>	36,963	31,317
Equity issue costs	1,765	2,455
Debt issue costs	2,209	2,116

<sup>1</sup> These tax loss carryforwards expire in the taxation years ending December 31, 2026 - 2028.



#### 14. Financial risk management

The Company is exposed to financial risk on financial instruments including accounts receivable, accounts payable and accrued liabilities, taxes payable, debt and obligations under capital leases. The Company manages its exposure to financial risks by operating in a manner that minimizes these exposures to the extent practical. The main financial risks affecting the Company are discussed below:

##### **Credit Risk**

Credit risk arises from the possibility that a counterparty to which the Company provides goods or services is unable or unwilling to fulfill their financial obligations. This could reduce the amount of future cash inflows from financial assets such as accounts receivable. The objective of managing counterparty credit risk is to prevent losses relating to financial assets. The majority of the Company's revenues and trade accounts receivable are from entities in the oil and gas industry and, as such, the Company is exposed to many of the risks associated with that industry. The Company utilizes regular credit monitoring processes, such as credit checks and customer deposits to mitigate credit risks. Concentration of accounts receivable with certain customers increases credit risk and is mitigated to the extent possible by limiting concentrations to credit worthy clients. At December 31, 2008, the largest customer accounted for 9% (2007 – 10%) of the Company's accounts receivable balance and the five largest balances comprise 45% (December 31, 2007, 46%) of the overall balance. The top five customers of the Company accounted for approximately 36% (2007 – 53%) of the reported revenues and its largest customer accounted for 16% (2007 – 33%) of reported revenues in the year ended December 31, 2008.

The aging of trade receivables at the reporting date was:

(thousands of Canadian dollars)	As at December 31,	
	2008	2007
Not past due, under 30 days	\$ 4,047	\$ 3,269
Outstanding 31 - 60 days	2,223	1,749
Outstanding 61 - 120 days	1,014	300
More than 120 days	918	884
<b>Total trade receivables</b>	<b>8,202</b>	<b>6,202</b>
Impairment allowance	799	438
<b>Net trade receivables</b>	<b>7,403</b>	<b>5,764</b>
Other receivables	320	581
<b>Total receivables</b>	<b>\$ 7,723</b>	<b>\$ 6,345</b>

The other receivables balance is comprised mainly of accrued receivables as at December 31, 2007 and 2008.



On a quarterly basis, the Company assesses if there is any impairment of its financial assets. During the year ended December 31, 2008, the Company recorded an impairment expense of \$513,000 against accounts receivable. The amount of the loss is recognized in the statement of operations within operating expenses. Subsequent recoveries of amounts provided for are credited against operating expenses in the period of settlement. The impairment allowance recognized during the year relates to collectability of accounts receivable. In estimating the provision, management reviewed all balances greater than 90 days old and applied a general provision based on historical loss rates for amounts less than 90 days old. The changes in the impairment allowance were as follows:

(thousands of Canadian dollars)	<b>2008</b>
Opening impairment allowance	438
Impairment of receivables	513
Collection of receivables previously written off as uncollectible	(152)
Ending impairment allowance	799

The carrying value of accounts receivable approximates their fair value due to the relatively short periods to maturity on these instruments. The maximum exposure to credit risk is represented by the net carrying value.

### Liquidity Risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they fall due. The Company's approach to managing liquidity is through regular monitoring of cash requirements by preparing short-term and long-term cash flow analyses. The Company maintains a \$22.5 million senior credit facility (*Note 7i*). As at December 31, 2008, the Company had drawn \$20.1 million against this credit facility. In addition the Company has a subordinated debt facility with \$22.5 million outstanding as of December 31, 2008 (*Note 7ii*). Subsequent to year end, the Company negotiated a temporary increase to the senior credit facility in the amount of \$5 million to fund expanded working capital needs during the busier winter season. The Company's objective in managing liquidity is to maintain sufficient readily available reserves in order to meet its liquidity requirements at any point in time.

The following are the contractual maturities of financial liabilities, including interest payments to maturity:

(\$ thousands)	Carrying amount	Contractual Cash flows	6 months or less	6 to 12 months	2010	2011
Senior credit facility	\$ 20,108	\$ 20,784	\$ 20,784	\$ -	\$ -	\$ -
Subordinated debt	22,500	23,896	23,896	-	-	-
Capital lease obligations	488	532	195	134	151	52
Accounts payable and accrued liabilities	6,303	6,303	6,303	-	-	-
Total	\$ 49,399	\$ 51,515	\$ 51,178	\$ 134	\$ 151	\$ 52

The Company is required to remain in compliance with various covenants in relation to its senior credit facility and subordinated debt (*Note 7*). If the Company has a breach in these covenants, the lenders will have the ability to immediately call the loan and require repayment. When there is a risk based on expected results that the Company will be in non-compliance of any covenants, the Company manages this risk through regular communications with its lenders.

### Market Risk

#### (i) Foreign Exchange Risk

The Company is exposed to foreign currency fluctuations as certain expenses are denominated in U.S. dollars. Both realized foreign exchange gains and losses and the unrealized gains and losses on the translation of liabilities are included in net earnings.



(ii) Interest Rate Risk

Interest rate risk refers to the risk that the value of a financial instrument or cash flows associated with the instrument will fluctuate due to changes in market interest rates. Subordinated debt and capital lease obligations are based on fixed interest rates. The Company is exposed to interest rate risk on funds borrowed under its senior credit facility at a floating interest rate. The Company does not use interest rate hedges or fixed interest rate contracts to manage its exposure to interest rate fluctuations.

A 1% increase or decrease in interest rates would have changed the cash flow of the Company during the year ended December 31, 2008 by approximately \$421,000. This analysis assumes that all other variables remain constant.

(iii) Commodity risk

The Company's revenue is indirectly sensitive to changes in commodity prices for crude oil and natural gas because the price variation affects activity levels of our customers and therefore the demand for services. This indirect impact is not quantifiable.

***Fair Values***

Financial instruments of the Company consist of accounts receivable, accounts payable and accrued liabilities, taxes payable, obligations under capital leases and debt.

The net carrying values of accounts receivable, net of the allowance for doubtful accounts and accounts payable and accrued liabilities, approximate fair value due to the short-term nature of these instruments. The carrying values of the Company's debt and obligations under capital leases approximate their fair value as they bear interest at rates consistent with current market lending rates for similar instruments.

**15. Capital disclosures**

The Company manages its capital on a basis consistent with the risks of its business activities and the assets it holds. All sources of financing are analyzed by management and approved by the board of directors.

The Company's objectives when managing capital are:

- To safeguard the Company's ability to continue as a going concern, so that it can provide a return for shareholders;
- To maintain a capital structure that optimizes the overall cost of capital in the context of its financial situation, capital demands and the risks inherent in the business; and,
- To maintain appropriate levels of liquidity for operations and provide funding for investment to maintain existing business activities and allow investment in profitable new opportunities.

The Company meets its objectives for managing capital through short-term and long-term cash flow forecasting to anticipate liquidity needs, detailed review and analysis of financial results and balances and detailed review of projected costs and cash flows for investment opportunities.

The Company manages the capital structure and makes adjustments to it in light of changes in economic conditions and the risk characteristics of the underlying assets. In order to maintain or adjust the capital structure, the Company may sell selected assets, issue shares, issue new debt and/or issue new debt to replace existing debt with different characteristics.



The Company's capital consists of debt, obligations under capital leases and shareholders' equity. The balance of each of these items as at December 31, 2008 and December 31, 2007 were as follows:

(\$ thousands)	<b>As at December 31,</b>	
	<b>2008</b>	<b>2007</b>
Debt	42,608	43,363
Obligations under capital leases	488	838
Shareholders' equity	15,038	33,650
Total Capital	58,134	77,851

The Company is subject to two restrictive financial covenants under its senior credit facility (*Note 7*).

As at December 31, 2008, the Company was in compliance with one of the two externally imposed capital restrictions discussed in *Note 7*. The covenant violation was waived as part of the loan extension to June 1, 2009 (*Note 20*).

## 16. Commitments

The Company is committed to future minimum payments under operating lease contracts for equipment, vehicles, office and shop space of \$5.2 million. The expiry dates of these obligations range from January 2009 to November 2017.

The required future commitment payments as at December 31, 2008 are as follows:

\$ thousands	Payments due by period					
	Total	2009	2010	2011	2012	2013 - 2017
Operating lease obligations	5,215	1,622	1,314	814	336	1,129

## 17. Related party transactions

During 2008, the Company incurred expenses of \$466,000 (2007, \$462,000) relating to the rental of land, buildings and equipment owned by certain officers who are also shareholders of the Company. In 2007, the Company incurred expenses of \$12,500 in the normal course of business related to accounting services performed by principals and officers of the Company. The Company has incurred legal fees with a legal firm in which one of the Company's directors is a partner in the amount of \$566,000 (2007, \$496,000). These fees relate to work completed for strategic initiatives, banking matters, conversion from a trust to a corporation and general corporate matters. Of these fees, \$217,000 (2007, \$36,000) are included in accounts payable as at December 31, 2008. The amounts of these transactions were completed at exchange values which approximate fair values.

The Company has also entered into a \$22.5 million subordinated loan with an entity substantially owned by a Director (*Note 7*). As at December 31, 2008, the outstanding balance of this loan is \$22.5 million. Accrued interest of \$851,000 (2007 - \$521,000) is outstanding as at December 31, 2008 which was settled through the issuance of common shares of the Company on January 30, 2009 (*Note 10*). Additionally, the subordinated lender has provided the Company's senior lender with a letter of credit securing the bulge facility, at no additional cost to the Company (*Note 20*).



**18. Supplementary cash flow information related to the statements of cash flows**

(\$ thousands)	<b>Year ended December 31,</b>	
<u>Changes in non-cash working capital relating to continuing operating activities</u>	<b>2008</b>	<b>2007</b>
Accounts receivable	\$ (1,801)	\$ 11,048
Inventory	(105)	87
Prepaid expenses and deposits	256	(204)
Marketable securities	48	(48)
Other current assets	-	1,310
Accounts payable and accrued liabilities	918	(7,706)
Income taxes payable	(65)	(3,171)
	<u>\$ (749)</u>	<u>\$ 1,316</u>

(\$ thousands)	<b>Year ended December 31,</b>	
<u>Changes in non-cash working capital relating to discontinued operating activities</u>	<b>2008</b>	<b>2007</b>
Accounts receivable	\$ 423	\$ 1,594
Inventory	941	223
Prepaid expenses and deposits	95	(104)
Accounts payable and accrued liabilities	(277)	(351)
Income taxes payable	-	142
	<u>\$ 1,182</u>	<u>\$ 1,504</u>

(\$ thousands)	<b>Year ended December 31,</b>	
<u>Changes in non-cash working capital relating to continuing financing activities</u>	<b>2008</b>	<b>2007</b>
Accounts payable	\$ (76)	\$ 120
	<u>\$ (76)</u>	<u>\$ 120</u>

(\$ thousands)	<b>Year ended December 31,</b>	
<u>Changes in non-cash working capital relating to continuing investing activities</u>	<b>2008</b>	<b>2007</b>
Accounts payable	1,760	328
	<u>\$ 1,760</u>	<u>\$ 328</u>

(\$ thousands)	<b>Year ended December 31,</b>	
<u>Changes in non-cash working capital relating to discontinued investing activities</u>	<b>2008</b>	<b>2007</b>
Accounts payable	\$ -	\$ (385)
	<u>\$ -</u>	<u>\$ (385)</u>



## 19. Discontinued operations

Effective October 14, 2008, the Company ceased all operations relating to the coil tubing business unit of the downhole services division. Management is committed to a plan to sell the assets of the division and an active program to locate a buyer is in place.

The pipeline construction division was sold effective August 31, 2007. Both the pipeline construction and the coil tubing business units have been classified as discontinued operations.

(\$ thousands)	For the year ended December 31, 2008		For the year ended December 31, 2007	
	Coil Tubing	Pipeline	Coil Tubing	Pipeline
Revenue	1,928	-	6,715	4,572
Operating costs	(3,687)	(26)	(9,352)	(5,503)
Amortization	(936)	-	(3,899)	(284)
Impairment of property, plant and equipment	(3,001)	-	(3,980)	-
Gain (loss) on the sale of equipment	(85)	(30)	30	1,101
Net loss from discontinued operations	(5,781)	(56)	(10,486)	(114)

## 20. Subsequent events

a) Effective March 18, 2009 BlackWatch discontinued the operations of its transportation division. Management has entered into an agreement to liquidate the transportation assets in April 2009. Proceeds from the disposition of the assets will be used to reduce the senior debt. The results of operations and assets and liabilities of the transportation division are as follows:

(\$ thousands)	For the year ended December 31,	
	2008	2007
Net loss from continuing operations	(1,977)	(3,925)
Revenue	6,458	6,201
Operating costs	6,535	5,664
Depreciation and amortization	1,883	3,922

  

(\$ thousands)	As at December 31,	
	2008	2007
Current assets	597	617
Net book value of property, plant and equipment	5,039	7,001
Total assets	5,636	7,618
Total liabilities	302	273

b) On January 21, 2009, the Company reached an agreement with its subordinated lender to extend the maturity date of the facility to June 1, 2009. As part of this extension, an amendment fee of \$100,000 was paid to the lender through the issuance of 185,185 common shares on January 30, 2009.

c) On January 21, 2009, the maturity date of the senior credit facility was extended to June 1, 2009, with interest payable at prime plus 5.5%. The Company has negotiated a temporary increase to the senior credit facility in the amount of \$5 million to fund expanded working capital needs during the busier winter season. This working capital bulge facility bears interest at prime plus 1.25%. The Company paid an extension fee of \$125,000, and should a renewal be negotiated on or before June 1, 2009, an additional exit fee of \$250,000 will become payable. The Company can only withdraw funds under the bulge facility with written consent of subordinated lender, such consent not to be unreasonably withheld or delayed if such drawdown is for working capital purposes. The bulge facility is guaranteed by a letter of credit provided by the subordinated lender.

The senior lenders have waived the covenant breach as of December 31, 2008.



d) On February 5, 2009, the Company's board of directors authorized the issuance of 2,572,000 options at an exercise price of \$0.12 to employees and directors to replace the trust unit options cancelled on completion of the Reorganization.