



Management's Discussion and Analysis and Unaudited Financial Statements  
for the three and six months ended June 30, 2009 and 2008.

# **BLACKWATCH ENERGY SERVICES CORP.**

## **MANAGEMENT’S DISCUSSION AND ANALYSIS AT AUGUST 5, 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 three months and six months ended June 30, 2009. Statements in this MD&A are based on information available as at August 5, 2009. 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 three and six month periods ended June 30, 2009. 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.

### **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

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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 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.

**SUMMARY FINANCIAL INFORMATION**

(\$ thousands, except per share unit amounts)	Three months ended June 30,		Six months ended June 30,	
	2009	2008	2009	2008
Revenue from continuing operations	\$ 3,569	\$ 3,578	\$ 17,376	\$ 20,319
Gross margin <sup>1</sup> from continuing operations	\$ (167)	\$ (1,175)	\$ 3,843	\$ 4,148
EBITDA <sup>1</sup>	\$ (883)	\$ (2,147)	\$ 2,312	\$ 2,218
Loss from continuing operations	\$ (3,234)	\$ (4,687)	\$ (2,959)	\$ (3,369)
Per common share - basic and diluted	\$ (0.08)	\$ (0.14)	\$ (0.08)	\$ (0.10)

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

(\$ thousands)	As at June 30,		As at December 31,	
	2009	2008	2009	2008
Total assets	\$ 51,819	\$ 64,437		
Debt and capital lease obligations:				
Current	\$ 5,545	\$ 42,907		
Long-term	\$ 119	\$ 189		
Shareholders' equity	\$ 44,039	\$ 15,038		

In the three months ended June 30, 2009 revenues were consistent with the same quarter in 2008. Gross margin improved due to the Company's addition of one telescopic double drilling rig which worked under an existing take-or-pay contract at a higher day rate than achieved for our average fleet in 2008 and the Company's ability to reduce costs such as repairs and maintenance, fuel, sub contractor and other costs. The consistent revenues reflect lower revenue in our downhole, production and rentals divisions offset by higher revenue in our drilling division. The increase in revenue in our drilling division is due to the addition of a telescopic double in late 2008, which worked steadily in the quarter and was the major reason for the improvement in rig utilization from 3% in 2008 to 9% in 2009. It allowed BlackWatch to increase its utilization while industry drilling activity levels decreased from 19% in 2008 to 11% in 2009. The higher gross margin led to an increase in EBITDA for the three months ended June 30, 2009.

In the six months ended June 30, 2009 the Company had decreased revenues compared to 2008, which led to lower gross margin. EBITDA for the six months ended June 30, 2009 has improved because of lower selling, general and administration costs and improved margins within the drilling division.

Natural gas prices remained low during the three months ended June 30, 2009. Low commodity prices caused many producers to scale back their 2009 capital budgets. This reduced oil and gas industry activity in western Canada and demand for oilfield services, which had a negative effect on BlackWatch's results.

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On June 11, 2009 the company announced a series of steps that will position the Company to take advantage of opportunities available in the energy service industry. The Company agreed to issue 66.7 million shares at a price of \$0.15 per share for gross proceeds of \$10 million and convert its existing subordinated debt of approximately \$24.2 million into 37.2 million shares. BlackWatch also added two members to its management team: John King as President and Chief Executive Officer and Hank Swartout as Chairman of the Board of Directors. The restructured management team is developing a strategy to allow BlackWatch to capitalize on the experience and skills of these new members and explore international and domestic investment opportunities that are available in the current environment. The Company closed the share offering in the amount \$9.6 million and completed the subordinated debt conversion on June 29, 2009. The remaining share issuance of \$0.4 million closed on July 10, 2009. Proceeds from the share offering were used to reduce the Company's bank debt to \$5.4 million at June 30, 2009.

**RESULTS OF OPERATIONS**

(\$ thousands)	Three months ended June 30,		Six months ended June 30,	
	2009	2008	2009	2008
Revenue from continuing operations	3,569	3,578	\$ 17,376	\$ 20,319
Operating Expenses				
Labour	2,122	2,198	8,291	8,687
Fuel	239	384	1,070	1,744
Repairs and maintenance	224	617	748	1,581
Sub-contractors	88	250	358	597
Other	1,063	1,304	3,066	3,562
Expenses from continuing operations	3,736	4,753	13,533	16,171
Gross margin from continuing operations	\$ (167)	\$ (1,175)	\$ 3,843	\$ 4,148

*Quarter ended June 30, 2009*

Operating expenses from continuing operations as a percentage of revenue from continuing operations were 105% (2008 – 133%). Labour costs, which represent the most significant component of operating expenses, decreased to 59% (2008 – 61%) of revenue because of efforts to reduced fixed labour costs in reaction to the lower activity levels in our operating areas. Fuel costs decreased from 11% of revenues in 2008 to 7% in 2009, which reflects a decrease in the average price of gasoline and diesel fuel in 2009 compared to 2008. Repairs and maintenance declined from 17% of revenues in 2008 to 4% of revenues in 2009. In 2009 the Company continues 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 have decreased in all divisions as equipment utilization rates have decreased, reducing the Company's need to employee third party contractors. Other costs as a percentage of revenue declined in a manner consistent with revenues in 2009 compared to 2008 in all divisions except for downhole services. In anticipation of reduced utilization for the Company's e-line units BlackWatch has decommissioned several of these units and downsized operational staffing levels accordingly. The effects of these measures are that BlackWatch has significantly reduced other costs within the downhole services division.

*Six months ended June 30, 2009*

Overall operating expenses from continuing operations as a percentage of revenue from continuing operations were 78% (2008 – 80%). Labour costs, which represent the most significant component of operating expenses, increased to 48% (2008 – 43%) of revenue. Labour costs have a significant fixed component that do not decrease in proportion with revenues. Fuel costs decreased from 11% of revenues in 2008 to 7% in 2009, which reflects a decrease in the average price of gasoline and diesel fuel in 2009 compared to 2008. Repairs and maintenance declined from 17% of revenues in 2008 to 4% of revenues in 2009. In 2009 the Company continues 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

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maintenance expenses in the period and reduce unexpected repairs. Subcontractor and other costs as a percentage of revenue declined in a manner consistent with revenues in 2009 compared to 2008.

**DIVISIONAL RESULTS**

(\$ thousands)		For the three months ended June 30, 2009				
	Consolidated	Drilling	Downhole Services	Production Services	Rentals	
Revenue from continuing operations	\$ 3,569	\$ 2,304	\$ 211	\$ 450	\$ 604	
Operating Expenses						
Labour	\$ 2,122	\$ 1,047	\$ 433	\$ 287	\$ 355	
Fuel	239	142	20	38	39	
Repairs and maintenance	224	80	28	63	53	
Sub-contractors	88	46	-	3	39	
Other	1,063	337	336	216	174	
Total operating expenses from continuing operations	\$ 3,736	\$ 1,652	\$ 817	\$ 607	\$ 660	
Gross Margin from continuing operations	\$ (167)	\$ 652	\$ (606)	\$ (157)	\$ (56)	
Revenues and operating expenses are net of intercompany transactions						

(\$ thousands)		For the three months ended June 30, 2008				
	Consolidated	Drilling	Downhole Services	Production Services	Rentals	
Revenue from continuing operations	\$ 3,578	\$ 571	\$ 1,370	\$ 740	\$ 897	
Operating Expenses						
Labour	\$ 2,198	\$ 528	\$ 725	\$ 490	\$ 455	
Fuel	384	135	68	85	96	
Repairs and maintenance	617	373	83	74	87	
Sub-contractors	250	94	35	8	113	
Other	1,304	339	561	206	198	
Total operating expenses from continuing operations	\$ 4,753	\$ 1,469	\$ 1,472	\$ 863	\$ 949	
Gross Margin from continuing operations	\$ (1,175)	\$ (898)	\$ (102)	\$ (123)	\$ (52)	
Revenues and operating expenses are net of intercompany transactions						

(\$ thousands)		For the six months ended June 30, 2009				
	Consolidated	Drilling	Downhole Services	Production Services	Rentals	
Revenue from continuing operations	\$ 17,376	\$ 11,991	\$ 1,831	\$ 1,846	\$ 1,708	
Operating Expenses						
Labour	\$ 8,291	\$ 5,263	\$ 1,315	\$ 784	\$ 929	
Fuel	1,070	782	65	113	110	
Repairs and maintenance	748	449	55	110	134	
Sub-contractors	358	114	65	7	172	
Other	3,066	1,096	1,012	609	349	
Total operating expenses from continuing operations	\$ 13,533	\$ 7,704	\$ 2,512	\$ 1,623	\$ 1,694	
Gross Margin from continuing operations	\$ 3,843	\$ 4,287	\$ (681)	\$ 223	\$ 14	
Revenues and operating expenses are net of intercompany transactions						

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(\$ thousands)	For the six months ended June 30, 2008				
	Consolidated	Drilling	Downhole Services	Production Services	Rentals
Revenue from continuing operations	\$ 20,319	\$ 12,359	\$ 3,581	\$ 1,943	\$ 2,436
Operating Expenses					
Labour	\$ 8,687	\$ 4,911	\$ 1,668	\$ 1,072	\$ 1,036
Fuel	1,744	1,091	171	212	270
Repairs and maintenance	1,581	966	229	183	203
Sub-contractors	597	186	51	13	347
Other	3,562	1,353	1,360	447	402
Total operating expenses from continuing operations	\$ 16,171	\$ 8,507	\$ 3,479	\$ 1,927	\$ 2,258
Gross margin from continuing operations	\$ 4,148	\$ 3,852	\$ 102	\$ 16	\$ 178

Revenues and operating expenses are net of intercompany transactions

*Quarter ended June 30, 2009*

**Contract Drilling**

The drilling division generated revenues of \$2.3 million in the three months ended June 30, 2009 compared to \$571,000 in 2008. Gross margin was \$652,000 in 2009 compared to a negative \$898,000 in 2008. The increase in revenue and gross margin is the result of the addition of a telescopic double pad rig, which worked steadily throughout the quarter. The industry average rig utilization in the second quarter of 2009 was 11% compared to 19% in 2008. BlackWatch achieved an average utilization rate of 9% (3% - 2008) in this quarter on its eleven available rigs. BlackWatch has been able to obtain higher utilization rates in 2009 compared to the same quarter in 2008 because of the addition of its telescopic double pad rig.

Labour costs for rig crews decreased from 92% of revenues in 2008 to 45% in 2009, reflecting very low utilization in 2008 and the effect of the fixed component of labour costs. For the month of April 2009 direct wages were 10% higher than the same month in 2008 due to a recommended increase in wages by the Canadian Association of Oilwell Drilling Contractors (the "CAODC") that took effect October 1, 2008. Effective May 1, 2009 rig crew wages were reduced, consistent with an amended recommendation by the CAODC. The effect of this amended recommendation was to reduce direct wages for rig crews by approx 1% in 2009 compared to 2008 and by 9% compared to recommended October 2008 increase. Fuel decreased from 24% to 6% of revenue, reflecting the general decrease in fuel prices throughout the second quarter of 2009 compared to 2008, reduced indirect travel and the addition of the Company's telescopic double pad rig which has better fuel efficiency than BlackWatch's ten single rigs. Repairs and maintenance decreased from 65% to 3% for the quarter ended June 30, 2009 compared to the same period in 2008. Management has continued improving 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. Both fuel and repairs and maintenance expense have been reduced as a percentage of revenue in the period due to the increased utilization within the division in the three months ended June 30, 2009. Sub-contractors and other expenses remained consistent in the three months ended June 30, 2009 compared with the same period in 2008.

**Downhole Services**

The downhole services division generated revenues of \$211,000 in the three months ended June 30, 2009 compared to \$1.4 million in 2008. The introduction of pipe recovery services resulted in revenue of \$90,000 (2008 – nil) in the three months ended June 30, 2009. The reduction in revenue is primarily due to lower industry activity levels in our service areas. Fuel and repairs and maintenance costs as a percentage of revenues have increased between periods due to the low revenue levels offset by lower gasoline and diesel costs, better cost controls and logistics management. Labour and other operating expenses as a percentage of revenue have increased from 53% and 41% respectively in the three months ended June 30, 2008 to 205% and 159% for the three months ended June 30, 2009. This increase is the result of decreased revenue and the fixed component of costs 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. Other costs have been reduced in the three months ended June 2009 compared to 2008 because

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of reductions in insurance, communication, travel and materials and supplies costs. In anticipation of reduced utilization for the Company's e-line units BlackWatch has decommissioned several of these units and downsized operational staffing levels accordingly. The effects of these measures are that BlackWatch has significantly reduced other costs within the downhole services division.

#### **Production Services**

Production services revenue decreased to \$450,000 (\$740,000 – 2008) in the three months ended June 30, 2009. This decrease in revenue is the result of decreased industry activity in the operating areas of the division. Labour costs have decreased to 64% (2008 – 66%) of revenues because of a reduction in non-billable labour hours. Other costs have increased to 48% of revenues (2008 – 28%). This increase is due to higher product costs and increased office space costs, partially offset by lower costs for insurance and materials and supplies. Fuel decreased from 11% to 8% of revenues for the quarter ended June 30, 2009 compared to the same period in 2008, reflecting the general decrease in fuel prices.

#### **Rentals**

The rentals division revenue decreased to \$604,000 (\$897,000 – 2008) in the three months ended June 30, 2009. This decrease in revenue is the result of decreased industry activity in the core operating areas of the division. Fuel decreased from 11% to 6% of revenues for the quarter ended June 30, 2009 compared to the same period in 2008, reflecting the general decrease in fuel prices throughout the second quarter of 2009 compared to 2008. Sub-contractor costs have decreased from 13% to 6% of revenues reflecting a reduction in the divisions' reliance on outside services. All other operating costs within the rental division have remained generally consistent in 2009 compared to 2008.

*Six months ended June 30, 2009*

#### **Contract Drilling**

The drilling division generated revenues of \$12 million in the six months ended June 30, 2009 compared to \$12.4 million in 2008. Gross margin was \$4.3 million in 2009 compared to \$3.9 million in 2008. The decrease in revenue is the result of lower first quarter utilization offset by revenues from its telescopic double pad rig, which worked steadily throughout the first six months of 2009. The industry average rig utilization in the six months ended June 30, 2009 was 24% compared to 38% in 2008. BlackWatch achieved an average utilization rate of 28% (32% - 2008) in this period, based on eleven available drilling rigs.

Labour costs for rig crews increased from 40% of revenues in 2008 to 44% in 2009. This increase is the result of recommendations made by the CAODC in October of 2008 to increase hourly wages for rig crews by 10%, which increased labour costs throughout the first quarter of 2009. Effective May 1, 2009, the CAODC recommended decreasing hourly wages by 9% for rig crews, which had a small effect on labour costs in the second quarter of 2009. Fuel decreased from 9% to 7% of revenue, reflecting the general decrease in fuel prices and the addition of the Company's telescopic double pad rig which has better fuel efficiency than BlackWatch's ten single rigs. Repairs and maintenance decreased from 8% to 4% for the six months ended June 30, 2009 compared to the same period in 2008, reflecting lower activities and the benefit of major maintenance activities in the spring of 2008. Sub-contractors and other expenses remained consistent in the six months ended June 30, 2009 compared with the same period in 2008.

#### **Downhole Services**

The downhole services division generated revenues of \$1.8 million in the six months ended June 30, 2009 compared to \$3.6 million in 2008. The introduction of pipe recovery services resulted in revenue of \$456,000 (2008 – nil) in the six months ended June 30, 2009. The reduction in revenue is primarily due to lower industry activity levels in our service areas. Fuel and repairs and maintenance costs as a percentage of revenues have decreased between periods, which reflect lower gasoline and diesel costs, better cost controls, logistics management and reduced equipment utilization. Labour and other operating expenses as a percentage of revenue have increased from 47% and 38% respectively in the six months ended June 30, 2008 to 72% and 55% for the six months ended June 30, 2009. This increase is the result of decreased revenue and the fixed component of costs such as salaries and vehicle leases within this division. The downhole services division requires a high degree of specialization and as a result highly

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trained individuals are retained by BlackWatch throughout the year, which makes a significant portion of labour costs non-variable. Other costs have been reduced in the six months ended June 2009 compared to 2008 because of reductions in insurance, communication, travel and materials and supplies costs. In anticipation of reduced utilization for the Company’s e-line units BlackWatch has decommissioned several of these units and downsized operational staffing levels accordingly. The effects of these measures are that BlackWatch has significantly reduced other costs within the downhole services division.

**Production Services**

Production services revenue decreased to \$1.8 million (\$1.9 million – 2008) in the six months ended June 30, 2009. This decrease in revenue is the result of decreased industry activity in the operating areas of the division. Labour costs have decreased to 42% (2008 – 55%) of revenues through the reduction of non-billable hours. Other costs have increased to 33% of revenues (2008 – 23%). This increase is due to higher product costs which reduced the margins received on product sales and increased costs office space costs, partially offset by lower costs for insurance and materials and supplies. Repairs and maintenance decreased from \$183,000 to \$110,000 for the six months ended June 30, 2009 compared to the same period in 2008. Management has continued improving cost controls and expenditure approvals for repairs and maintenance programs. These controls, combined with the more robust preventative maintenance program allowed BlackWatch to limit repairs and maintenance expenses in the period and reduce unexpected repairs. Fuel decreased from 9% to 6% of revenues for the six months ended June 30, 2009 compared to the same period in 2008, reflecting the general decrease in fuel prices and a shift from equipment and fluid hauling to equipment rentals and product sales, which have a decreased vehicle usage.

**Rentals**

The rentals division revenue decreased to \$1.7 million (\$2.4 million – 2008) in the six months ended June 30, 2009. This decrease in revenue is the result of decreased industry activity in the division’s operating areas. Labour costs have increased to 54% (2008 – 43%) of revenues. This increase occurred because of the reduction in revenue and the significant fixed component of salary costs within the division. Fuel decreased from 11% to 6% of revenues for the six months ended June 30, 2009 compared to the same period in 2008, reflecting the general decrease in fuel prices throughout the first six months of 2009 compared to 2008. Sub-contractor costs have decreased from 14% to 10% reflecting a reduction in the divisions’ reliance on outside services. All other operating costs within the rental division have remained generally consistent in 2009 compared to 2008.

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

(\$ thousands, except where otherwise indicated)	Three months ended June 30,		Six months ended June 30,	
	2009	2008	2009	2008
Selling, general and administrative	\$ 716	\$ 972	\$ 1,531	\$ 1,930
Percentage of revenue from continuing operations	20%	27%	9%	9%

In the three and six months ended June 30, 2009 the Company’s selling, general and administrative expenses (“SG&A”) decreased by 26% and 21%, respectively, compared to 2008. The decrease in SG&A was achieved through the elimination of discretionary expenditures, the reduction of outsourced services, lower corporate administrative costs, and a reduction in labour related costs. Effective May 15, 2009 salaries and wages were rolled back between 5% and 7%, for all employees and certain employee benefits were eliminated. These cost reductions were slightly offset by increases in professional fees associated with the Company’s conversion from a trust to a corporation and costs associated with the discontinuation of its transportation division operations.

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)	Three months ended June 30,		Six months ended June 30,	
	2009	2008	2009	2008
Interest on debt	\$ 1,162	\$ 1,194	\$ 2,390	\$ 2,363
Other interest and bank charges	357	805	836	1,130
Total interest expense	\$ 1,519	\$ 1,999	\$ 3,226	\$ 3,493

*Quarter ended June 30, 2009*

Interest on debt for the three months ended June 30, 2009 remained consistent with the same period in 2008 because of similar debt levels and interest rates throughout the period. The average blended interest rate on the outstanding debt increased to 11.5% in 2009 (2008 – 11.1 %). Interest expense is expected to be lower in future quarters as a result of the Company's ability to reduce its debt senior and subordinated debt levels due to the completion of the private placement and subordinated debt conversion on June 29, 2009.

The Company has incurred interest on its senior credit facility of \$328,000 (2008 - \$353,000) in the three months ended March 31, 2009. The interest rate for this period ranged from 7.75% - 8% (2008 – 7.375% - 7.875%). The prime lending rate decreased from 2.5% to 2.25% in the three months ended June 30, 2009.

In the three months ended June 30, 2009 interest of \$823,000 (2008 - \$841,000) was incurred on the subordinated loan. The interest rate on the subordinated debt for 2009 was 15% (2008 - 15%). The subordinated lender converted the principal and accrued interest balance of \$24.2 million into common shares of the Company on June 29, 2009 at a price of \$0.65 per share and received 37.2 million shares

Other interest and bank charges have decreased in the three months ended June 30, 2009 compared to 2008, due to the reduction of fees associated with the extension of the senior credit facility and the subordinated debt facility.

In the three month period ended June 30, 2009 the Company paid a contractual exit fee of \$250,000 on the senior credit facility. On June 30, 2009 the Company obtained an extension of its credit facility until December 31, 2009. As part of this extension the borrowing limit was reduced to \$9 million from \$22.5 million and an extension fee of \$90,000 was paid. The Company is approved to spend up to \$500,000 on capital additions for the period of January 1, 2009 to December 31, 2009 without the prior written consent of the lender. The new agreement also amends the Companies EBITDA covenant calculation to include the periods beginning on January 1, 2009 and exclude all prior periods.

The Company is in compliance with all financial covenants under the senior credit agreement as at June 30, 2009.

*Six months ended June 30, 2009*

Interest for the six months ended June 30, 2009 compared to June 30, 2008 remained consistent because of similar interest rates and debt levels. The average blended interest rate on the outstanding debt decreased to 11.8% (2008 – 11.9%).

The Company has incurred interest on its senior credit facility of \$711,000 (2008 - \$849,000) in the six months ended June 30, 2009. The interest rate for this period ranged from 6.125% - 8.5% (2008 – 7.375% - 8.625%). The Company's interest rate increased from prime plus 2.625% to prime plus 5.5% under the terms of the amended credit facility that was entered into on January 22, 2009. The prime lending rate decreased from 3.50% to 2.25% in the six months ended June 30, 2009.

In the six months ended June 30, 2009 interest of \$1.7 million (2008 - \$1.5 million) was incurred on the subordinated loan. The interest rate on the subordinated debt for the period was 15% (2008 12% - 15%). Interest for the period was settled through the issuance of common shares as part of the conversion of the entire subordinated debt balance that occurred on June 29, 2009.

Other bank charges and interest have decreased in the six months ended June 30, 2009, due to the reduction of fees associated with the extension of the senior credit facility and the subordinated debt facility. and accretion expenses incurred for the conversion feature on the subordinated debt which were incurred in 2008.

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*Depreciation and Amortization*

(\$ thousands)	Three months ended June 30,		Six months ended June 30,	
	2009	2008	2009	2008
Depreciation of capital assets	\$ 761	\$ 1,776	\$ 2,185	\$ 4,170
Depreciation from discontinued operations	-	747	359	1,696
Depreciation and amortization from continuing operations	<u>\$ 761</u>	<u>\$ 1,029</u>	<u>\$ 1,826</u>	<u>\$ 2,474</u>

Depreciation and amortization from continuing operations has decreased by 26% in the three months and six months ended June 30, 2009 compared to 2008 because of lower net book values at June 30, 2009, reflecting depreciation charges in excess of additions and impairment write-downs at December 31, 2008, partially offset by the addition of the costs associated with the telescopic double pad rig.

**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 June 30, 2009. The excess of the net book value over related tax pools of property, plant and equipment indicates a future tax liability of approximately \$1.7 million, which is more then offset by a future income tax asset of \$10.2 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 earning future taxable income to utilize the non-capital loss carry forwards and share issue cost deductions..

**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 Company made no material capital purchases in the three and six months ended June 30, 2009. The senior credit facility restricted capital expenditures to no more than \$500,000 in aggregate for the period of January 1, 2009 to December 31, 2009 without the prior written consent of the Lender.

The Company's capital expenditures for the three and six months ended June 30, 2009 were funded from operating cash flows and amounts drawn on the senior credit facility.

**RELATED PARTY TRANSACTIONS**

During the three and six months ended June 30, 2009, the Company incurred expenses of \$122,000 and \$244,000 respectively (2008 - \$109,000 and \$238,000) relating to the rental of land, buildings and equipment owned by certain officers who are also shareholders of the Company. The Company has incurred legal fees in the amount of \$30,000 and \$126,000 (2008 - \$50,000 and \$109,000) in the three and six month periods ended June 30, 2009 with a legal firm in which one of the Company's directors is a partner. These fees relate to work completed on the debt renewal and general corporate matters. Of these fees \$39,000 (December 31, 2008 - \$34,000) is included in accounts payable as at June 30, 2009. The Company has also incurred \$822,000 and \$1,652,000 ( 2008 - \$841,000 and \$1,514,000) in interest charges on the subordinated debt in the three months and six months ended June 30, 2009 and an extension fee in the first quarter of \$100,000. These transactions were completed at exchange values which approximate fair values.

The Company completed the conversion of its existing subordinated debt which was held by an entity substantially owned by a director, into 37,161,749 common shares in the second quarter. As part of the private placement the Company issued 59 million shares for proceeds of \$8.8 million to directors and officers of BlackWatch.

**BLACKWATCH ENERGY SERVICES CORP.**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS AT AUGUST 5, 2009**

**LIQUIDITY AND CAPITAL RESOURCES**

As at June 30, 2009 the Company had drawn approximately \$5.4 million of its available \$9 million senior credit facility. \$311,000 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 of August 5, 2009 the Company had drawn approximately \$5.2 million on the senior credit facility.

On June 30 2009 the Company amended its \$22.5 million senior credit facility and fully converted its \$22.5 million subordinated facility into common shares. See further details within the *Interest Expense on Debt* section.

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

(\$ thousands)	Three months ended June 30,		Six months ended June 30,	
	2009	2008	2009	2008
Income from continuing operations	\$ (3,234)	\$ (4,687)	\$ (2,959)	\$ (3,369)
Add: Depreciation and amortization	761	1,029	1,826	2,474
Add: Interest	1,519	1,999	3,226	3,493
Add: Stock based compensation	50	93	87	203
Add: Income tax recovery	-	(65)	-	(65)
Add: Other Income	-	(16)	-	(16)
Add: Loss (gain) on sale of equipment	24	(500)	93	(502)
Add: Realized foreign exchange loss	(3)	-	39	-
EBITDA from continuing operations	\$ (883)	\$ (2,147)	\$ 2,312	\$ 2,218

The \$9 million available limit for the senior credit facility was set based on estimated operating cash flows to December 31, 2009 and assumes no significant capital acquisitions or changes to operating activities. If actual operating cash flows are significantly less than anticipated or BlackWatch makes any significant capital expenditures or corporate acquisitions, incremental equity or debt financing would be required. Additional borrowing capacity under the operating line will be required to fund incremental working capital requirements in the winter drilling season.

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

**SHAREHOLDERS' EQUITY**

As of August 5, 2009 the Company had issued 142,282,369 common shares and 2,414,500 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 July 2009 through November 2017.

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

(\$ thousands)	Payments due by fiscal year					
	Total	2009	2010	2011	2012	2013 - 2017
<b>Contractual obligations</b>						
Debt	\$ 5,353	\$ 5,353	\$ -	\$ -	\$ -	\$ -
Capital lease obligations	311	122	139	50	-	-
Operating leases	4,085	754	1,113	813	406	999
Purchase obligations	-	-	-	-	-	-
Other long term obligations	-	-	-	-	-	-
<b>Total contractual obligations</b>	\$ 9,749	\$ 6,229	\$ 1,252	\$ 863	\$ 406	\$ 999

**BLACKWATCH ENERGY SERVICES CORP.  
MANAGEMENT'S DISCUSSION AND ANALYSIS AT AUGUST 5, 2009**

**SUMMARY OF QUARTERLY RESULTS**

(\$ thousands, except per Share unit amounts)	2009		2008				2007	
	Q2	Q1 <sup>1</sup>	Q4	Q3	Q2	Q1	Q4 <sup>1</sup>	Q3
Revenue from continuing operations	\$ 3,569	\$ 13,807	\$ 11,326	\$ 8,359	\$ 3,578	16,741	\$ 6,720	\$ 7,519
Gross margin from continuing operations	\$ (167)	\$ 4,010	\$ 2,425	\$ 628	\$ (1,175)	\$ 5,323	\$ 825	\$ 1,461
Selling, general and administrative expenses	\$ 716	\$ 815	\$ 1,091	\$ 1,096	\$ 972	\$ 958	\$ 974	\$ 726
Net income (loss) from continuing operations	\$ (3,234)	\$ 275	\$ (7,524)	\$ (3,131)	\$ (4,687)	\$ 1,318	\$ (12,808)	\$ (1,311)
Per Share unit - basic	\$ (0.08)	\$ 0.01	\$ (0.21)	\$ (0.09)	\$ (0.14)	\$ 0.04	\$ (0.41)	\$ (0.05)
Per Share unit - diluted	\$ (0.08)	\$ 0.01	\$ (0.21)	\$ (0.09)	\$ (0.14)	\$ 0.04	\$ (0.41)	\$ (0.05)
Funds from continuing operations	\$ (1,342)	\$ 2,568	\$ 660	\$ (864)	\$ (2,426)	\$ 3,756	\$ (367)	\$ (363)
Per Share unit - basic	\$ (0.03)	\$ 0.07	\$ 0.02	\$ (0.02)	\$ (0.07)	\$ 0.11	\$ (0.01)	\$ (0.01)
Per Share unit - diluted	\$ (0.03)	\$ 0.07	\$ 0.02	\$ (0.02)	\$ (0.07)	\$ 0.11	\$ (0.01)	\$ (0.01)
Weighted average Common Shares - basic	39,594	38,392	36,011	35,053	34,110	32,174	31,320	27,482
Weighted average Common Shares - diluted	39,594	38,392	36,011	35,063	34,120	32,188	31,333	27,482
Common Shares, end of period	139,915	38,454	38,269	36,692	35,118	34,154	32,174	29,499

<sup>1</sup>The Company has revised its quarterly information to reflect the reclassification of interest accrued on the subordinated debt.

Variances between the quarters are primarily due to seasonality and levels of industry activity linked to commodity prices. Traditionally, second quarter results are the weakest for oil and gas services companies (see "Seasonality" below) and in 2008 and 2009 the sector experienced an early spring breakup. Demand for the Company's services have decreased in 2009 compared to 2008 and has resulted in a reduction of revenues quarter over quarter. The reduction in revenue in the second quarter of 2009 was offset by the addition of one telescopic double pad rig that worked steadily throughout the quarter, which increased equipment utilization rates within the drilling division in the second quarter of 2009.

**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 June 30, 2009.

**FINANCIAL INSTRUMENTS**

Financial instruments of the Company consist of accounts receivable, marketable securities, deposits, 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 AUGUST 5, 2009**

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

There was no change in the Company's internal control over financial reporting that occurred during the period beginning on January 1, 2009, and ended on June 30, 2009, that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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

The Canadian Accounting Standards Board confirmed in 2008 that the use of International Financial Reporting Standards (IFRS) by publicly accountable enterprises will be required in 2011. The Company will need to begin reporting under IFRS in the first quarter of 2011 with comparative data for the prior year. IFRS uses a conceptual framework similar to Canadian GAAP, but there could be significant differences in recognition, measurement and disclosures that will need to be addressed.

Position papers are being prepared on issue-specific accounting differences between Canadian GAAP and IFRS and the impact on financial reporting computer systems. These position papers will be reviewed with the Company's auditor in future quarters. As a number of the IFRS standards are changing, the position papers will be updated to reflect any changes resulting from the final standards. The Company has initiated changes to its financial reporting computer systems. The Company is also evaluating the impact of IFRS on financial covenants and internal control over financial reporting. Education sessions have been, and will continue to be, provided for employees and senior management to increase knowledge and awareness of IFRS and its impacts.

The Company reviews discussion papers, exposure drafts and standards released by the International Accounting Standards Board and the International Financial Reporting Interpretations Committee. The Company will continue to assess the impact of the proposed standards on its financial statements and disclosure as additional information becomes available. Financial impacts cannot be reasonably determined at this time.

Based on initial assessments, the Company has identified that the following areas have the greatest potential impact to the Company's accounting: property, plant and equipment and leases. There will also be a significant amount of effort to comply with the IFRS' requirements for initial adoption of IFRS.

### **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 due to declines in commodity prices and are impacted by deteriorating capital 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 AUGUST 5, 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. No impairment has been recorded on long term assets in the period ended June 30, 2009 as management believes there has been no material deterioration in the net realizable value of these assets since December 31, 2008.

### **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 crude oil and natural gas prices. The global economic recession has reduced energy demand and natural gas prices. This lower commodity price environment has led a significant number of oil and gas producers to reduce their capital budgets and planned exploration and development activities. As a result overall oil and gas service industry utilization rates have substantially decreased in the first six months of 2009 compared to 2008. Decreasing utilization rates create competitive pricing pressures on all of BlackWatch's services, which negatively affect the Company's margins. This downward pricing pressure is expected to continue for the foreseeable future. BlackWatch anticipates that the reduction in drilling activity in North America will eventually reduce natural gas supply which could improve natural gas prices and support a future recovery in drilling activity.

Despite record low drilling activity levels, BlackWatch has one rig under contract. This rig worked steadily until late in the second quarter and BlackWatch expects this rig to begin working again under this contract in the fourth quarter of 2009. BlackWatch has had several discussions with potential customers about utilizing this rig until it is required by the contracted customer in the fourth quarter. It is expected that because of pressures on day rates within the drilling rig market, any additional work awarded outside of the take-or-pay contract will be completed at lower day rates, which will negatively affect the results of the drilling division in future quarters. BlackWatch has successfully completed several drilling projects using casing drilling technology. Casing drilling continues to prove itself as one of the most cost-effective methods to drill certain types of shallow gas wells. This is reflected in the growing number of clients that have selected casing drilling over other drilling methods for shallow gas drilling.

Late last year the downhole services division participated in a borehole acoustic acquisition project with a third party technology provider. This project was designed to provide the client with seismic information for a horizontal, multi-stage completion operation. This project is part of a strategy to increase activity and revenue in the growing market for horizontal well technology and services.

In March 2009 the Alberta government announced a new incentive program for the oil and gas industry in Alberta, consisting of: 1) a royalty credit of \$200 per metre drilled for new conventional oil and natural gas wells; and 2) lower royalty rates for the first year on production from new oil or gas wells. These programs expire in March 2010. In addition the Alberta government established a \$30 million fund to encourage clean up of inactive oil and gas wells. In June 2009 the Alberta government extended the royalty credit and lower royalty rate incentive programs for an additional year until March 2011. These changes may have a positive effect on industry activity levels in Alberta and BlackWatch's utilization.

In April 2009 Fred Meyer joined BlackWatch as Vice President of Sales and Marketing. Fred has reorganized the marketing group and developed a more focused plan to build on the Company's first quarter drilling success and emphasizing our diverse product offerings. Fred has 25 years of domestic and international experience in various operational and business development roles at a large multi national oilfield service company, which includes assignments in Latin America and North Africa.

In June 2009 BlackWatch appointed two new members to the management team: John King is President and Chief Executive Officer and Hank Swartout as Chairman to the Board of Directors. In addition the Company agreed to issue 66.7 million shares at a price of \$0.15 per share for gross proceeds of \$10 million and convert its outstanding subordinated debt of approximately \$24.2 million into 37.2 million shares. The restructured management team is developing a strategy which they feel will capitalize on the experience and skill set of the new members of management as well as international and domestic investment opportunities available in the current environment.

## **BLACKWATCH ENERGY SERVICES CORP. MANAGEMENT'S DISCUSSION AND ANALYSIS AT AUGUST 5, 2009**

BlackWatch recognizes that significant challenges remain while the western Canadian oilfield market is experiencing such low activity levels. BlackWatch believes that ultimately, this market will recover. We have already taken steps to address the current challenges by trimming costs in an aggressive fashion and marketing new differentiated services to help improve the utilization of our existing equipment. However, we have not stopped there and are looking at other steps to grow profitable businesses both domestically and internationally while maintaining financial flexibility.

### **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 December 31, 2009 and the EBITDA covenant; plans to pay down senior debt; sources of funding; timing of implementation of changes in accounting policies, including conversion to IFRS; 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 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; 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

**BLACKWATCH ENERGY SERVICES CORP.  
MANAGEMENT’S DISCUSSION AND ANALYSIS AT AUGUST 5, 2009**

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.

**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.**  
John King  
President and Chief Executive Officer

Wiley Auch  
VP Finance and CFO

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Toronto Stock Exchange

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

(Unaudited)

(Stated in thousands of Canadian dollars)

As at June 30, 2009

As at December 31, 2008

**Assets**

## Current assets

Accounts receivable	\$	2,199	\$	7,723
Inventory		87		105
Prepaid expenses and deposits		452		470
Equipment held for sale (Note 13)		176		-
		<u>2,914</u>		<u>8,298</u>

## Inventory

962 1,167

## Equipment held for sale (Note 3)

3,946 4,243

## Property, plant and equipment (Note 3)

43,997 50,729

\$ 51,819 \$ 64,437**Liabilities**

## Current liabilities

Accounts payable and accrued liabilities	\$	2,116	\$	6,303
Debt (Note 4)		5,353		42,608
Current portion of obligations under capital leases		192		299
		<u>7,661</u>		<u>49,210</u>

## Obligations under capital leases

119 189

7,780 49,399

## Basis of presentation (Note 1)

## Subsequent events (Note 13)

**Shareholders' equity**

Common shares (Note 5)		290,518		256,394
Contributed surplus (Note 5)		1,284		1,197
Conversion option on subordinated debt (Note 4)		-		248
Deficit		<u>(247,763)</u>		<u>(242,801)</u>
		<u>44,039</u>		<u>15,038</u>
	\$	<u>51,819</u>	\$	<u>64,437</u>

See accompanying notes to the unaudited consolidated financial statements

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

(Stated in thousands of Canadian dollars, except per share amounts)	Three Months Ended		Six Months Ended	
	June 30, 2009	June 30, 2008	June 30, 2009	June 30, 2008
<b>Revenue</b>				
Service	\$ 3,329	\$ 3,086	\$ 16,395	\$ 19,107
Product	60	119	368	365
Rental	180	373	613	847
	<u>3,569</u>	<u>3,578</u>	<u>17,376</u>	<u>20,319</u>
<b>Expenses</b>				
Operating	3,736	4,753	13,533	16,171
Selling, general & administration	716	972	1,531	1,930
Depreciation and amortization	761	1,029	1,826	2,474
Realized foreign exchange loss (gain)	(3)	-	39	-
Stock based compensation	50	93	87	203
Interest on debt	1,162	1,194	2,390	2,363
Other interest, bank charges and financing charges	357	805	836	1,130
	<u>6,779</u>	<u>8,846</u>	<u>20,242</u>	<u>24,271</u>
<b>Loss before other items</b>	<b>(3,210)</b>	<b>(5,268)</b>	<b>(2,866)</b>	<b>(3,952)</b>
Other income	-	16	-	16
Gain (loss) on sale of equipment	(24)	500	(93)	502
<b>Loss from operations before income taxes</b>	<b>(3,234)</b>	<b>(4,752)</b>	<b>(2,959)</b>	<b>(3,434)</b>
<b>Income taxes (recovery)</b>				
Current	-	(65)	-	(65)
	<u>-</u>	<u>(65)</u>	<u>-</u>	<u>(65)</u>
<b>Loss from continuing operations</b>	<b>(3,234)</b>	<b>(4,687)</b>	<b>(2,959)</b>	<b>(3,369)</b>
Net loss from discontinued operations (Note 11)	(384)	(1,957)	(2,003)	(2,581)
<b>Comprehensive loss and net loss for the period</b>	<b>(3,618)</b>	<b>(6,644)</b>	<b>(4,962)</b>	<b>(5,950)</b>
<b>Deficit, beginning of period</b>	<b>(244,145)</b>	<b>(219,118)</b>	<b>(242,801)</b>	<b>(219,812)</b>
<b>Deficit, end of period</b>	<b>\$ (247,763)</b>	<b>\$ (225,762)</b>	<b>\$ (247,763)</b>	<b>\$ (225,762)</b>
Loss from continuing operations per share - basic and diluted (Note 5)	\$ (0.08)	\$ (0.14)	\$ (0.08)	\$ (0.10)
Loss from discontinued operations per share - basic and diluted (Note 5)	\$ (0.01)	\$ (0.05)	\$ (0.05)	\$ (0.08)
Comprehensive loss and net loss per share - basic and diluted (Note 5)	\$ (0.09)	\$ (0.19)	\$ (0.13)	\$ (0.18)

See accompanying notes to the unaudited consolidated financial statements

**BlackWatch Energy Services Corp.**  
**Consolidated Statements of Cash Flows**  
(Unaudited)

(Stated in thousands of Canadian dollars)	Three Months Ended		Six Months Ended	
	June 30, 2009	June 30, 2008	June 30, 2009	June 30, 2008
<b>Operating Activities</b>				
Loss for the period from continuing operations	\$ (3,234)	\$ (4,687)	\$ (2,959)	\$ (3,369)
Items not requiring an outlay of cash:				
Depreciation and amortization	761	1,029	1,826	2,474
Stock based compensation expense	50	86	87	187
Gain (loss) on sale of equipment	24	(500)	93	(502)
Non-cash interest expense	822	841	1,652	1,514
Amortization of financing charges	235	805	527	1,026
	<u>(1,342)</u>	<u>(2,426)</u>	<u>1,226</u>	<u>1,330</u>
Change in non-cash working capital	3,750	7,434	2,256	1,615
<b>Cash flows from continuing operations</b>	<u>2,408</u>	<u>5,008</u>	<u>3,482</u>	<u>2,945</u>
Net loss from discontinued operations	(384)	(1,957)	(2,003)	(2,581)
Items not requiring an outlay of cash:				
Depreciation and amortization	-	747	359	1,696
Impairment of property, plant and equipment	-	-	1,041	-
Loss on disposal of assets	93	95	95	97
Change in non-cash working capital	569	1,206	413	317
<b>Cash flows from (used in) discontinued operations</b>	<u>278</u>	<u>91</u>	<u>(95)</u>	<u>(471)</u>
<b>Financing Activities</b>				
Issue of common shares, net of issue costs	9,621	-	9,621	-
Repayment of capital lease obligations	(49)	(34)	(102)	(82)
Repayment of debt	(18,570)	(6,000)	(18,070)	(4,000)
Cash reclassified against debt	3,539	70	3,393	275
Financing charges	(135)	(55)	(505)	(92)
Change in non-cash working capital	(191)	(94)	(44)	(100)
<b>Cash flows used in continuing financing activities</b>	<u>(5,785)</u>	<u>(6,113)</u>	<u>(5,707)</u>	<u>(3,999)</u>
Repayment of capital lease obligations	(38)	(42)	(75)	(83)
<b>Cash flows used in financing activities of discontinued operations</b>	<u>(38)</u>	<u>(42)</u>	<u>(75)</u>	<u>(83)</u>
<b>Investing Activities</b>				
Purchase of property, plant and equipment	(1)	(1,490)	(10)	(2,547)
Proceeds on disposal of property, plant and equipment	198	1,764	200	2,077
Fee for take-or-pay contract	-	-	-	1,375
Change in non-cash working capital	(293)	19	(1,045)	78
<b>Cash flows from (used in) continuing investing activities</b>	<u>(96)</u>	<u>293</u>	<u>(855)</u>	<u>983</u>
Purchase of property, plant and equipment	-	(33)	-	(343)
Proceeds on disposal of property, plant and equipment	3,233	813	3,250	968
Change in non-cash working capital	-	(17)	-	-
<b>Cash flows from investing activities of discontinued operations</b>	<u>3,233</u>	<u>763</u>	<u>3,250</u>	<u>625</u>
<b>Change in cash</b>	-	-	-	-
<b>Cash at beginning of period</b>	-	-	-	-
<b>Cash at end of period</b>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>
<b>Supplementary cash flow information</b>				
Cash interest paid	\$ 340	\$ 353	\$ 738	\$ 849
Cash taxes paid	\$ -	\$ -	\$ -	\$ -

See accompanying notes to the unaudited 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.

These interim financial statements for BlackWatch were prepared using accounting policies and methods of their application consistent with those used in the preparation of the Company's consolidated audited financial statements for the year ended December 31, 2008. These interim financial statements do not conform in all respects to the requirements of generally accepted accounting principles in Canada for annual financial statements. As a result, these interim financial statements should be read in conjunction with the Company's consolidated financial statements for the year ended December 31, 2008. In the opinion of management, the accompanying unaudited interim consolidated financial statements include all adjustments necessary to present fairly the consolidated financial position as at June 30, 2009 and the consolidated results of its operations and cash flows for the three and six month period ended June 30, 2009 and 2008.

The Company's financial statements as at and for the three and six months ended June 30, 2009 were prepared on the same basis as the year end financial statements, which contemplates the realization of assets and the settlement of liabilities and commitments in the normal course of operations.

In the normal course of operations, the Company must generate sufficient income and cash flow to repay, or support refinancing, of its debt obligations as they come due, and to finance working capital and 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 operating cash flow to fully repay its senior debt obligations on or by December 31, 2009 and to finance capital investments.

**2. 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 January 1, 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 equivalent guidance 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



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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. Property, plant and equipment**

**As at June 30, 2009**

	<b>Cost</b>	<b>Accumulated Depreciation</b>	<b>Net Book Value</b>
Drilling rigs	\$ 39,115	\$ (8,081)	\$ 31,034
Field service equipment	17,171	(9,639)	7,532
Shop tools and equipment	1,229	(599)	630
Computer equipment	710	(464)	246
Transport vehicles	4,726	(3,383)	1,343
Furniture and fixtures	279	(114)	165
Buildings	656	(115)	541
Rental equipment	6,552	(4,074)	2,478
Leaseholds	40	(12)	28
	<b>70,478</b>	<b>(26,481)</b>	<b>43,997</b>
Equipment held for sale - long term	6,579	(2,633)	3,946
	<b>\$ 77,057</b>	<b>\$ (29,114)</b>	<b>\$ 47,943</b>

**As at December 31, 2008**

	<b>Cost</b>	<b>Accumulated Depreciation</b>	<b>Net Book Value</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
	<b>79,944</b>	<b>(29,395)</b>	<b>50,549</b>
Land	180	-	180
	<b>80,124</b>	<b>(29,395)</b>	<b>50,729</b>
Equipment held for sale	7,244	(3,001)	4,243
	<b>\$ 87,368</b>	<b>\$ (32,396)</b>	<b>\$ 54,972</b>



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At June 30, 2009, \$1.4 million (December 31, 2008, \$1.4 million) of equipment is subject to capital leases for which \$536,000 of accumulated depreciation was recognized (December 31, 2008, \$465,000). These assets under capital leases are included in the appropriate property, plant and equipment assets classes and depreciated based on the specified rate for that asset class.

In the second quarter of 2009, the Company liquidated the assets related to the transportation division for proceeds of \$3.2 million.

BlackWatch is attempting to sell certain assets in the downhole services division. These assets had a net book value of \$3.9 million as at June 30, 2009 and have been classified as held for sale in non-current assets. These assets are no longer subject to depreciation (*Note 13*).

**4. Debt**

	As at June 30,		As at December 31,
	2009		2008
Senior credit facility (i)	\$ 5,353	\$	20,108
Subordinated debt (ii)	-		22,500
Debt	\$ 5,353	\$	42,608

**(i) Senior credit facility**

The maximum amount available under the credit facility is \$9 million as of June 30, 2009, and the facility has a maturity date of December 31, 2009. Interest is payable on the balance at prime plus 5.5% (7.75% at June 30, 2009).

The Company's senior credit facility requires it to maintain: 1) a ratio of consolidated current assets to consolidated current liabilities excluding current portion of debt of not less than 1.25 to 1; and, 2) Cumulative adjusted consolidated earnings before interest, taxes, depreciation and amortization ("EBITDA"), less interest, taxes and lease payments equal or greater than zero. The Company was in compliance with these financial covenants at June 30, 2009.

**(ii) Subordinated debt**

On June 29, 2009 the subordinated lender converted the entire outstanding balance of \$24.2 million, including accrued interest of \$1.7 million, into 37,161,749 common shares of BlackWatch at \$0.65 per share (*Note 5*).

**5. 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.



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**Issued and Outstanding:**

Common shares	Shares	Amount
<b>Balance, December 31, 2008</b>	<b>38,268,768</b>	<b>\$ 256,394</b>
Common shares issued in the period <sup>1</sup>	101,646,253	33,900
Common share issue costs	-	(24)
Reclass of conversion feature on subordinated debt <sup>2</sup>	-	248
<b>Balance, June 30, 2009 <sup>3</sup></b>	<b>139,915,021</b>	<b>\$ 290,518</b>

<sup>1</sup>On June 29, 2009, the Company completed a private placement for 64,299,319 common shares at \$0.15 per share for total proceeds of approximately \$9.6 million and converted its existing subordinated debt of \$24.2 million into 37,161,749 common shares at \$0.65 per share. In addition, the Company issued 185,185 common shares as payment for a \$100,000 extension fee on its subordinated debt.

<sup>2</sup>On June 29, 2009 the subordinated lender converted the outstanding balance of the debt into common shares of BlackWatch, and as a result the outstanding conversion feature was transferred to the balance of common shares.

<sup>3</sup>Of the total common shares that are outstanding, 32,010 are held in escrow and have been released on August 4, 2009.

The basic and diluted weighted average numbers of common shares used in the calculation of loss per share for the three and six months ended June 30, 2009 and 2008 are summarized in the following table:

	For the three months ended June 30,		For the six months ended June 30,	
	2009	2008	2009	2008
Weighted average common shares - basic	39,593,965	34,109,831	38,990,773	33,123,634
Unit awards convertible to trust units	-	9,519	-	9,519
Weighted average common shares for diluted net earnings	39,593,965	34,119,350	38,990,773	33,133,153

For the calculation of the weighted average number of diluted common shares outstanding for the three and six months ended June 30, 2009, 2,664,500 (2008 – 2,386,250) stock options, nil (2008 – 9,519) unit awards, and nil (2008 – 3,000,000) warrants were excluded as they were determined to be anti-dilutive.

On April 4, 2009, the 3,000,000 warrants outstanding expired unexercised.

***Contributed surplus***

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

Balance as at December 31, 2008	\$	1,197
Stock based compensation expense		87
<b>Balance as at June 30, 2009</b>	<b>\$</b>	<b>1,284</b>

In the three and six months ended June 30, 2009 the Company recorded stock based compensation expense in the amount of \$50,000 and \$87,000 respectively (2008 - \$93,000 and \$203,000). The entire

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amount charged to stock based compensation expense is expected to be settled through the issuance of common shares.

**6. Segmented information**

On March 18, 2009, the Company ceased all operations related to the transportation division and the assets were sold in April 2009. The related results of operations of the transportation division 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 operates nine electric wireline units. 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. 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.

Drilling

The drilling division operates ten mobile truck mounted single drilling rigs and one telescopic double drilling 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. The telescopic double rig is 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 used in well drilling and completion operations. 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.

**Three months ended June 30, 2009**

	Downhole Services		Drilling		Production Services		Rentals	Corporate	Intersegment Eliminations	Total				
Revenue	\$	213	\$	2,304	\$	454	\$	631	\$	-	\$	(33)	\$	3,569
Operating costs		816		1,686		619		669		-		(54)		3,736
Depreciation and amortization		173		271		124		167		26		-		761
Other expenses (income)		(2)		-		33		(2)		2,277		-		2,306
Net income (loss) from continuing operations	\$	(774)	\$	347	\$	(322)	\$	(203)	\$	(2,303)	\$	21	\$	(3,234)
Capital purchases	\$	-	\$	1	\$	-	\$	-	\$	-	\$	-	\$	1



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**Three months ended June 30, 2008**

	Downhole Services	Drilling	Production Services	Rentals	Corporate	Intersegment Eliminations	Total
Revenue	\$ 1,370	\$ 574	\$ 741	\$ 925	\$ -	\$ (32)	\$ 3,578
Intersegment sales to discontinued operations	-	-	-	-	-	62	62
Operating costs	1,479	1,539	875	954	-	(94)	4,753
Depreciation and amortization	305	92	238	357	37	-	1,029
Other expenses (income)	(561)	(182)	69	5	3,090	-	2,421
Net income (loss) from continuing operations	\$ 147	\$ (875)	\$ (441)	\$ (391)	\$ (3,127)	\$ -	\$ (4,687)
Capital purchases	\$ 15	\$ 1,307	\$ 48	\$ 117	\$ 3	\$ -	\$ 1,490

**Six months ended June 30, 2009**

	Downhole Services	Drilling	Production Services	Rentals	Corporate	Intersegment Eliminations	Total
Revenue	\$ 1,831	\$ 11,990	\$ 1,862	\$ 1,810	\$ -	\$ (117)	\$ 17,376
Operating costs	2,513	7,846	1,634	1,703	-	(163)	13,533
Depreciation and amortization	353	837	248	333	55	-	1,826
Other expenses (income)	(3)	49	110	(2)	4,822	-	4,976
Net income (loss) from continuing operations	\$ (1,032)	\$ 3,258	\$ (130)	\$ (224)	\$ (4,877)	\$ 46	\$ (2,959)
Capital purchases	\$ -	\$ 5	\$ -	\$ 5	\$ -	\$ -	\$ 10

**Six months ended June 30, 2008**

	Downhole Services	Drilling	Production Services	Rentals	Corporate	Intersegment Eliminations	Total
Revenue	\$ 3,581	\$ 12,362	\$ 1,947	\$ 2,703	\$ -	\$ (274)	\$ 20,319
Intersegment sales in discontinued operations	-	-	-	-	-	(16)	(16)
Operating costs	3,478	8,735	1,945	2,271	-	(258)	16,171
Depreciation and amortization	657	587	438	713	79	-	2,474
Other expenses (income)	(562)	(193)	50	137	5,627	-	5,059
Net income (loss) from continuing operations	\$ 8	\$ 3,233	\$ (486)	\$ (418)	\$ (5,706)	\$ -	\$ (3,369)
Capital purchases	\$ 53	\$ 1,398	\$ 208	\$ 884	\$ 4	\$ -	\$ 2,547

**As at June 30, 2009**

	Downhole Services	Drilling	Production Services	Rentals	Corporate	Total
Net book value of property, plant and equipment	\$ 4,614	\$ 32,646	\$ 3,094	\$ 3,332	\$ 311	\$ 43,997
Equipment held for sale - current	176	-	-	-	-	176
Equipment held for sale - long term	3,946	-	-	-	-	3,946
Total assets	10,202	33,777	3,461	3,879	500	51,819

**As at December 31, 2008**

	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

**7. Financial risk management**

The Company is exposed to financial risk on financial instruments including accounts receivable, accounts payable and accrued liabilities, 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 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 from customers increases credit risk and is mitigated to the extent possible by limiting concentrations to credit worthy clients. At June 30, 2009 the largest customer accounted for 35% of the Company's accounts receivable balance and the five largest balances comprise 55% (December 31, 2008, 45%) of the overall balance. In the three and six months ended June 30, 2009, the top five customers of the Company accounted for approximately 84% and 62% respectively (2008 – 60% and 52%) of the reported revenues and its largest customer accounted for 63% and 25% (2008 – 39% and 19%) of reported revenues

The aging of trade receivables at the reporting date was:

	As at June 30, 2009	As at December 31, 2008
Not past due, under 30 days	\$ 1,375	\$ 4,047
Outstanding 31 - 60 days	430	2,223
Outstanding 61 - 120 days	70	1,014
More than 120 days	923	918
Total trade receivables	2,798	8,202
Impairment allowance	823	799
Net trade receivables	1,975	7,403
Other receivables	224	320
Total receivables	\$ 2,199	\$ 7,723

The Company assesses impairment of its financial assets quarterly. During the three and six month periods ended June 30, 2009, the Company recorded a recovery of \$23,000 and an impairment allowance of \$63,000 respectively. The amount of the expense is recognized in the statement of operations within operating expenses. Subsequent recoveries of amounts written off are credited against operating expenses in the period of settlement. The impairment allowance recognized during the period relates to collectability of accounts receivable. In calculating the provisions, management individually 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:

Opening impairment allowance - January 1, 2009	\$ 799
Impairment of receivables	86
Receivables written off as uncollectible	(39)
Recovery of receivables previously impaired	(23)
Ending impairment allowance - June 30, 2009	\$ 823

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



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### 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 \$9.0 million senior credit facility (*Note 4i*). As at June 30, 2009, the Company had drawn \$5.4 million against this credit facility. 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:

	Carrying amount	Contractual Cash flows	6 months or less	6 to 12 months	2010	2011
Senior credit facility	\$ 5,353	\$ 5,698	\$ 5,698	\$ -	\$ -	\$ -
Subordinated debt	-	-	-	-	-	-
Capital lease obligations	311	335	134	77	74	50
Accounts payable and accrued liabilities	2,116	2,116	2,116	-	-	-
<b>Total</b>	<b>\$ 7,780</b>	<b>\$ 8,149</b>	<b>\$ 7,948</b>	<b>\$ 77</b>	<b>\$ 74</b>	<b>\$ 50</b>

The Company is required to remain in compliance with various covenants in relation to its senior credit facility. If the Company has a breach in these covenants the lenders will have the ability to immediately call the loans 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 communication 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. Capital lease obligations have 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 three and six months ended June 30, 2009 by approximately \$42,000 and \$96,000 respectively. 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.



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## Fair Values

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

The net carrying values of accounts receivable, net of the impairment allowance, 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.

## 8. 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;
- 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 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 balances of each of these items as at June 30, 2009 and December 31, 2008 were as follows:

	As at June 30, 2009	As at December 31, 2008
Debt	\$ 5,353	\$ 42,608
Obligations under capital leases	311	488
Shareholders' equity	44,039	15,038
Total Capital	\$ 49,703	\$ 58,134

The Company is subject to two restrictive financial covenants under its senior credit facility (*Note 4i*).

As at June 30, 2009, the Company was in compliance with the externally imposed capital restrictions discussed in *Note 4*.

## 9. Related party transactions

During the three and six months ended June 30, 2009, the Company incurred expenses of \$122,000 and \$244,000 respectively (2008 - \$109,000 and \$238,000) relating to the rental of land, buildings and equipment owned by certain officers who are also shareholders of the Company. The Company has

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incurred legal fees in the amount of \$30,000 and \$126,000 (2008 - \$50,000 and \$109,000) in the three and six months ended June 30, 2009 with a legal firm in which one of the Company's directors is a partner. These fees relate to work completed on the debt renewal and general corporate matters. Of these fees \$39,000 (December 31, 2008 - \$34,000) is included in accounts payable as at June 30, 2009. The Company has also incurred \$822,000 and \$1,652,000 (2008 - \$841,000 and \$1,514,000) in interest charges on the subordinated debt in the three months and six months ended June 30, 2009 and an extension fee in the first quarter of \$100,000. These transactions were completed at exchange values which approximate fair values.

The Company completed the conversion of its existing subordinated debt which was held by an entity substantially owned by a director, into 37,161,749 common shares in the second quarter (*Note 4(ii)*). As part of the private placement (*Note 5*) the Company issued 59 million shares for proceeds of \$8.8 million to directors and officers of BlackWatch.

**10. Seasonality of operations**

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. Melting snow and rain in spring, affects 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.

**11. Discontinued operations**

Effective March 18, 2009 the Company ceased all operations relating to the transportation division and liquidated the assets related to this business unit. In October, 2008, the Company ceased all operations relating to the coil tubing business unit of the downhole services division. The pipeline construction business unit was sold effective August 31, 2007. The pipeline construction, coil tubing, and transportation business units have been classified as discontinued operations.

	For the three months ended June 30, 2009			
	Transportation	Coil Tubing	Pipeline	Total
Revenue	\$ -	\$ 6	\$ -	\$ 6
Operating costs	(236)	(61)	-	(297)
Gain (loss) on the sale of equipment	(16)	(77)	-	(93)
Net income (loss) from discontinued operations	\$ (252)	\$ (132)	\$ -	\$ (384)

  

	For the three months ended June 30, 2008			
	Transportation	Coil Tubing	Pipeline	Total
Revenue	\$ 503	\$ 198	\$ -	\$ 701
Operating costs	(1,048)	(768)	-	(1,816)
Amortization	(494)	(253)	-	(747)
Gain (loss) on the sale of equipment	2	(97)	-	(95)
Net loss from discontinued operations	\$ (1,037)	\$ (920)	\$ -	\$ (1,957)

**BlackWatch Energy Services Corp.****Notes to the Consolidated Financial Statements**

*As at and for the three and six month periods ended June 30, 2009 and 2008  
(tabular amounts in thousands of Canadian dollars, except common share and per share amounts)  
(Unaudited)*

	For the six months ended June 30, 2009			
	Transportation	Coil Tubing	Pipeline	Total
Revenue	\$ 1,151	\$ 68	\$ -	\$ 1,219
Operating costs	(1,556)	(180)	-	(1,736)
Amortization	(359)	-	-	(359)
Impairment of property, plant and equipment	(1,041)	-	-	(1,041)
Gain (loss) on the sale of equipment	(18)	(77)	-	(95)
Other income	-	9	-	9
Net loss from discontinued operations	\$ (1,823)	\$ (180)	\$ -	\$ (2,003)

	For the six months ended June 30, 2008			
	Transportation	Coil Tubing	Pipeline	Total
Revenue	\$ 3,280	\$ 1,501	\$ -	\$ 4,781
Operating costs	(3,256)	(2,257)	(56)	(5,569)
Amortization	(1,017)	(679)	-	(1,696)
Gain (loss) on the sale of equipment	2	(99)	-	(97)
Net loss from discontinued operations	\$ (991)	\$ (1,534)	\$ (56)	\$ (2,581)

**12. Commitments**

The Company is committed to future minimum payments of \$4.1 million under operating lease contracts for equipment, vehicles, office and shop space. The settlement dates of these obligations range from July 2009 to November 2017.

The required future commitment payments as at June 30, 2009 are as follows:

	Payments due by fiscal year					
	Total	2009	2010	2011	2012	2013-2017
Operating lease obligations	\$ 4,085	\$ 754	\$ 1,113	\$ 813	\$ 406	\$ 999

**13. Subsequent events**

On July 10, 2009 the Company closed its equity private placement through the issuance of an additional 2,367,348 common shares at \$0.15 per share, for additional proceeds of approximately \$355,102. The net sale proceeds were applied to BlackWatch's senior secured debt. Total gross proceeds from the private placement were \$10.0 million and net proceeds after costs were \$9,976,000.

Subsequent to June 30, 2009, The Company disposed of several downhole services assets with a book value of \$257,000 for proceeds of \$176,000. An impairment loss of \$81,000 was recorded in discontinued operations in the period ended June 30, 2009 to write the asset down to realized value.