MANAGEMENT'S DISCUSSION AND ANALYSIS

AND

FINANCIAL STATEMENTS FOR THE YEAR ENDED

DECEMBER 31, 2008

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TETHYS PETROLEUM LIMITED

MANAGEMENT'S DISCUSSION AND ANALYSIS

for the year ended December 31, 2008

Introduction

Tethys Petroleum Limited ("Tethys" or the "Company") (name changed from Tethys Petroleum Investments Limited in September 2006) was incorporated in Guernsey on August 12, 2003, to hold certain interests of CanArgo Energy Corporation ("CanArgo") in Central Asia. CanArgo, a US public oil and gas company, listed on both the NYSE Alternext US LLC in New York and the Oslo Stock Exchange in Norway, with operations primarily in the Republic of Georgia. In January 2006 CanArgo obtained convertible debt which was ring-fenced for use on Tethys and which could be converted into either CanArgo or Tethys equity effectively establishing Tethys as a separately financed entity within the CanArgo Group. Later in 2006 the CanArgo board made a decision to spin-out Tethys as an independent entity and in January 2007 Tethys closed a private placement resulting in proceeds of approximately US$17.4 million. Tethys then sought a listing on the main list of the Toronto Stock Exchange ("TSX") and on June 27, 2007, the Company completed an Initial Public Offering (IPO) raising gross proceeds of US$50 million and the Company's ordinary shares commenced trading on the TSX. In July 2007 CanArgo sold its remaining Tethys shares leaving the Company completely independent. On June 27, 2008 Tethys successfully completed a Public Offering ("PO") raising a further US$50 million (gross). On July 17, 2008 the Company moved its domicile from Guernsey, British Isles, to the Cayman Islands.

Tethys is an oil and gas exploration and production company focused on projects in Central Asia. Currently the Company has projects in Kazakhstan and Tajikistan and has entered into an agreement to acquire a project in Uzbekistan. In Kazakhstan, the Company's oil and natural gas interests relate to three contract areas, namely the Kyzyloi natural gas field and the Akkulka and Kul-Bas exploration blocks, located in three contiguous blocks in an area of Kazakhstan to the west of the Aral Sea, in a geological area known as the North Ustyurt basin. In Tajikistan, the Company's projects are located in the south of the country, in a geologic basin known as the Afghan-Tajik Basin which is the easterly extension of the Amu-Darya Basin which is productive in Uzbekistan and Turkmenistan.

In Kazakhstan, the Company owns its current interests through a wholly owned Kazakh limited liability partnership named Tethys Aral Gas LLP (TAG), previously named BN Munai LLP. As a result of this ownership, the Company currently has a 100% interest in, and is operator of, a proven shallow gas field (the Kyzyloi Field). TAG also has a 100% interest in the surrounding Akkulka Exploration Licence and Contract area (which has proven gas reserves), and a 100% interest in the Kul-Bas Exploration and Production Contract area. These lands are all within the Aktobe Region of western Kazakhstan. An independent reserve report carried out by McDaniel & Associates Consultants Ltd., of Calgary, Alberta, Canada (the "McDaniel Reserve Report") estimated that Tethys had net proved plus probable reserves of 71.4 billion cubic feet (Bcf) (2.03 billion cubic metres (Bcm)) of natural gas in the Kyzyloi Field and the Akkulka Block as at December 31, 2008. The Kyzyloi Field commenced production on December 19, 2007. Tethys completed construction of a 35 mile (56 km) 325 mm (12.8 inch) diameter export pipeline from the Kyzyloi Field gathering station to the main Bukhara–Urals gas trunkline, where a compressor station has been constructed (known as the Booster Compression Station or "BCS") and with gas flowing into the main trunkline which is owned by Intergas Central Asia, a division of the Kazakh state natural gas company KazTransGas.

In Tajikistan the Company through its subsidiary Kulob Petroleum Limited (KPL) is the Contractor under a Production Sharing Contract with the Government of Tajikistan covering the Bokhtar area of the south western region of Tajikistan (Bokhtar PSC). In December 2007 the Company announced that it had signed an agreement to take a partner on these projects in Tajikistan that would have given the Company a 51% operating interest in these projects that includes the Bokhtar PSC. At December 31, 2008 this partnership had not completed and as such the Company currently owns 100% of the operating interest, but discussions are currently underway with the partners as to certain issues relating to the possible completion of this agreement.

This Management's Discussion and Analysis ("MD&A") for the Company is dated March 31, 2009 and should be read in conjunction with the Company's audited Consolidated Financial Statements and related notes for the year ended December 31, 2008. The accompanying financial statements of the Company have been prepared by management and approved by the Company's Audit Committee and Board of Directors. These financial statements have been prepared in accordance with USA Generally Accepted Accounting Principles ("US GAAP"). Additional information relating to the

Company can be found on the SEDAR website at *www.sedar.com*. Readers should also read the "Forward-Looking Statements" legal advisory contained at the end of this MD&A and also the Company's AIF

Selected Annual Information $000's

	2,008	**2,007**	**2,006**
Revenue	5,360	194	-
Net Loss	(22,627)	(41,779)	(6,943)
Basic and diluted loss ($) per share	(0.40)	(1.27)	(0.49)
Total Assets	105,814	71,656	19,587
Long Term Liabilities	(6,052)	(1,437)	(4,898)
Cash dividends	-	-	-

Summary of Quarterly Results

	Three months ended							
	March 31 2007	**June 30 2007**	**Sept 30 2007**	**Dec 31 2007**	**March 31 2008**	**June 30 2008**	**Sept 30 2008**	**Dec 31 2008**
Financials ($000's)								
Revenue	-	-	-	194	1,431	1,566	1,485	878
Net loss	(2,321)	(20,117)	(2,969)	(16,372)	(4,701)	(5,280)	(6,551)	(6,095)
Basic and diluted loss ($) per share	(0.14)	(0.95)	(0.07)	(0.36)	(0.10)	(0.11)	(0.10)	(0.11)
Capital Expenditure	2,285	20,249	3,845	11,622	3,541	9,565	14,152	15,085
Total Assets	33,751	89,648	85,749	71,656	73,546	115,957	109,422	105,814
Cash and working capital surplus	11,901	43,205	37,161	25,773	23,762	57,558	36,921	21,489

The three months ended December 31, 2008 compared to the three months ended December 31, 2007

	Three months ended December 31		
	2008	**2007**	**% Change**
Financials ($000's)			
Revenue	878	194	352
Net Loss	(6,095)	(16,372)	(63)
Capital Expenditure	15,085	11,622	30
Total Assets	105,814	71,656	48
Cash and working capital surplus	21,489	25,773	(17)

Highlights

- Revenue generated in the three months to December 31, 2008 was $878,000 compared to $194,000 in the same period of 2007.
- A net loss of $6,095,000 was recorded in the three months to December 31, 2008 compared to a loss of $16,372,000 for the same period in 2007.

- Capital expenditure of $15,085,000 was incurred as the Company pursued its objectives of initiating Phase 2 gas production from the Akkulka field and drilling a deep well in Kazakhstan, plus pursuing its objectives in Tajikistan and the acquisition of drilling, production and related equipment

Net Loss

A net loss of $6,095,000 was recorded in the three months to December 31, 2008, compared to $16,372,000 in the three months to December 31, 2007. The principal differences between the two periods were:

- Revenue generated in Q4 2008 was $878,000 compared to $194,000 in Q4 2007.
- Operating costs for the three months to December 31, 2008 were $797000 compared to $19,000 for the same period in 2007.
- Depletion on proved properties in Q4 2008 was $524,000 compared to $12,975,000 in the same period of 2007. The 2007 figure included $12,800,000 impairment as a result of a Ceiling Test deficit.
- Stock based compensation costs in Q4 2008 were $853,000 compared to $368,000 in Q4 2007.
- General & Administration costs incurred in Q4 2008 were $3,906,000 compared to $3,316,000 in the same period in 2007.
- Exchange rates moved significantly in the three months to December 31, 2008 resulting in an exchange rate loss of $1,669,000 compared to $4,000 in Q4 2007. The loss was attributable to Euros which were held for equipment purchases and British Pounds Sterling and Canadian dollars (the currency in which much of the June 2008 Private Placement was raised), which were held to meet the requirements to fund ongoing general and administrative and other spending requirements in these currencies

Capital Expenditure

Capital expenditure in the three months to December 31, 2008 was $15,085,000 compared to $11,622,000 in the same period of 2007. Prepayments to contractors decreased from $6,754,000 to $1,514,000 in Q4 2008. The major items of expenditure were:

- Drilling and testing of successful well Akkulka 16, (AKK16).
- Costs in commencing drilling of a deep well in Akkulka (AKD01).
- Costs of compressors for Phase 2 gas production.
- Costs of pipeline for additional Kyzyloi wells.
- Costs of pipeline for Akkulka Phase 2 gas production.
- Drilling of third well on Kul-Bas (KB003) plus additional seismic work.
- Purchase of drilling equipment.
- Well rehabilitation and workovers in Tajikistan.

Revenue

The Revenue (net of royalties) realised in Q4 2008 was $878,000 compared to $194,000 in the same period of 2007.

On January 5, 2006 Tethys' Kazakh subsidiary, TAG, executed a natural gas supply contract with Gaz Impex S.A. ("Gaz Impex") relating to gas sales from TAG's Kyzyloi field in Kazakhstan. In December 2007 this contract was assigned to Kazakhstani Petrochemical Company Kemikal LLP ("KNK"), who will utilise the gas in the domestic Kazakh market (the "Gas Supply Contract") The agreed price is US$0.90 per thousand cubic feet (Mcf) (US$32 per thousand cubic metres (Mcm)) plus VAT which was 13% in 2008 moving to 12% in 2009. The VAT receipts can be offset against VAT costs incurred on the Kyzyloi project. The Gas Supply Contract, which has a term until the earlier of December 1, 2012, the date on which all contracts and licences pursuant to which the gas to be delivered under the Gas Supply Contract terminate, or when 850 thousand cubic metres (Mcm) (approximately 30Bcf) has been delivered, is based on a take–or–pay principle and covers all gas produced from the Kyzyloi Field Licence and Production Contract area up to termination. To the end of Q4 2008 17.55% of the maximum contract volume under the Gas Supply Contract had been delivered.

Average field production achieved in the two months to November 27, 2008 was 17.3 million cubic feet per day (MMcfpd) (~491 thousand cubic metres per day (Mcmpd)) and gas sales in the three months to December 31, 2008 totalled 28.21 million cubic metres (MMcm) (0.8 Bcf). These figures take no account of shut-downs for maintenance or compression work prior to November 27, 2008.

On November 28, 2008 InterGas Central Asia initiated necessary maintenance work on the Bukhara-Urals trunk line to the north of Tethys's tie-in point which resulted in the trunk-line being shut down for a period. Tethys decided to use this time to carry out maintenance on its own compressors at the BCS and to begin installation of compression for the Akkulka Phase 2 Development following the arrival on site of both the compressors and the installation engineers. Unfortunately because of extreme weather conditions this process took a lot longer to complete than was anticipated with the result that there was no production and consequently no revenue generated in the month of December.

Royalties

The Royalty on the Kyzyloi gas field is set at 2%. Royalties were anticipated to be in the range of 2% to 6% under the Akkulka Exploration License and Contract with the rate to be set thirty days before the commencement of production and being dependent on the level of reserves. With the introduction of the new Kazakh tax regime in 2009 the Akkulka contract may now be liable to the Mineral Extraction Tax (MET) rather than royalties. MET is expected to be 0.5% to 1.5% of revenue for domestic sales and 10% for exports. MET is also expected to apply to production from the Kul-Bas Exploration and Production Contract.

Operating costs

Operating cost in Q4 2008 were $797,000 compared to $19,000 in the same period of 2007. In 2007 there was only production for the last twelve days of the year. The Q4 2008 figure included work done on two wells in the Kyzyloi field in anticipation of them commencing production in early 2009 plus $312,000 of costs directly attributable to the Akkulka contract, encompassing well insurance and property tax.

General and Administrative Expenses

General & Administration costs incurred in Q4 2008 were $3,906,000 compared to $3,316,000 in the same period in 2007. The main areas of difference between Q4 in 2008 and Q4 in 2007 were:

- Additional staff related costs as staff numbers have grown particularly in Kazakhstan and in the second half of the year in Tajikistan.
- A number of obligatory education and social contributions were made in Kazakhstan.
- Extensive travel related to pursuing the Company's gas production objectives in Kazakhstan, developing the Bokhtar PSC in Tajikistan and business development activities in Central Asia.
- Increase in office related costs notably in Kazakhstan.

Stock based compensation

The stock compensation costs of the options issued under the 2007 Long Term Stock Incentive Plan was $853,000 in Q4 of 2008 compared to $368,000 in Q4 2007.

Interest

In the quarter to December 31, 2008 the Company earned $207,000 in interest on its own funds compared to $378,000 the same period in 2007 reflecting the reduction in interest rates in that period.

Depletion, Depreciation and Accretion (DD&A)

The total DD&A charge for the quarter to December 31, 2008 was $733,000 which was primarily made up of the $524,000 for the depletion of proved property costs, on a unit of production basis. The DD&A charge for the same period of 2007 was $13,057,000 made up primarily of an impairment charge of $12,800,000 plus $175,000 depletion of proved properties.

Taxes

As at December 31, 2008 Tethys' principal executive office was in Guernsey, British Isles. The continuance of the Company from the laws of Guernsey to the laws of the Cayman Islands was completed on July 17, 2008. No income or capital taxes are levied in the Cayman Islands.

At December 31, 2008 the Company's Kazakhstan based subsidiary Tethys Aral Gas LLP had net operating loss carry forwards ("NOLs") for income tax purposes of approximately US$4,393,500. If the NOLs are not utilized to reduce taxable income in future periods, they will expire in various amounts from 2012 through 2015. The Company has established a valuation allowance for deferred taxes equal to its entire net deferred assets as management currently believes that it is more likely than not that these losses will not be utilized.

Under the Bokhtar PSC in Tajikistan, the State's production share includes all Tajik taxes, levies and duties however no revenue was generated from the Company's Tajikistan operations in 2008.

For the year ended December 31, 2008 compared to the year ended December 31, 2007

	Year ended December 31,		
	2008	**2007**	**% Change**
Financials ($000's)			
Revenue	5,360	194	2,663
Net Loss	(22,627)	(41,779)	(43)
Basic and diluted loss ($) per share	(0.40)	(1.26)	
Capital Expenditure	42,343	23,001	84
Total Assets	105,814	71,656	47
Cash and working capital surplus	21,489	25,773	(15)

Highlights

- In January 2008 the Company received its first payment for commercial gas sales.
- In March 2008 the Company secured loan financing from a group of accredited investors in the amount of $5,300,000 toward the purchase of a new drilling rig from China. This was followed in December 2008 by a second loan in the amount of $2,130,000 towards the purchase of a second rig from China.
- On June 27, 2008 the Company completed a public offering raising gross proceeds of $50,000,000. (Net proceeds to the Company were $45,754,000 after deduction of brokers' commission and professional fees.).
- On June 13, 2008 the Company announced that it had signed the first ever Production Sharing Contract (PSC) awarded in Tajikistan covering a large part of the south west region of Tajikistan known as Bokhtar Area.
- Revenue generated in the year to December 31, 2008 was $5,360,000 compared to $194,000 in the same period of 2007.
- A net loss of $22,627,000 recorded in the year to December 31, 2008 compared to a net loss of $41,779,000 for the year to December 31, 2007.

- The year to December 31, 2008 loss included non-cash items of $3,945,000 relating to the US GAAP required treatment of costs associated with stock based compensation compared to a figure of $17,624,000 for same period in 2007.

Net (Loss)

A net loss of $22,627,000 was recorded in the year to December 31, 2008, compared to $41,779,000 in the year to December 31, 2007. The principal differences between the two periods were:

- Revenue generated in the year to December 31, 2008 was $5,360,000 compared to $194,000 in the same period of 2007.
- Stock based compensation costs to December 31, 2008 were $3,945,000 compared to $17,018,000 in the same period of 2007.
- Operating costs to December 31, 2008 of $1,334,000 compared to $19,000 in 2007.
- G & A costs in 2008 were $13,421,000 compared $9,480,000 in 2007.
- Depletion on proved properties in 2008 was $6,469,000 compared $13,057,000 in the same period of 2007. The 2007 figure was made up primarily of an impairment following the ceiling test of $12,800,000.
- Exchange rates moved significantly in the second half 2008 resulting in an exchange rate loss for the year of $3,060,000 compared to $96,000 in the year to December 31, 2007. The loss was attributable to Euros which were held for equipment purchases and British Pounds Sterling and Canadian dollars (the currency in which much of the June 2008 Private Placement was raised), which were held to meet the requirements to fund ongoing general and administrative and other spending requirements in these currencies.

Capital Expenditure

Capital expenditure in the period to December 31, 2008 was $42,343,000 compared to $ 23,001,000 in 2007. The primary movements were as follows:

- Kul-Bas/Akkulka Block – shallow drilling and infrastructure.
- Preparation and commencement of drilling of deep well AKD01.
- Well workovers.
- Seismic in Kul-Bas and Akkulka.
- Well rehabilitation and workovers in Tajikistan.
- Drilling of AKK16.
- The second and third installments with a combined total of $4,071,000 were paid in relation to the purchase of the ZJ70 drilling rig, Telesto, leaving only the final payment of 5% due on delivery outstanding.
- The acquisition of drill strings and ancillary equipment for the Telesto rig.
- The first two installments of the ZJ30 drilling rig, Tykhe.
- The acquisition of drill strings and ancillary equipment for the Tykhe rig...
- Purchase of other drilling equipment.
- Creation of Bozoi base in Kazakhstan close to the Akkulka / Kyzyloi operations plus capital spares.

Revenue

On January 5, 2006 Tethys' Kazakh subsidiary, TAG, executed a natural gas supply contract with Gaz Impex S.A. ("Gaz Impex") relating to gas sales from TAG's Kyzyloi field in Kazakhstan. In December 2007 this contract was assigned to Kazakhstani Petrochemical Company Kemikal LLP ("KNK"), who will utilise the gas in the domestic Kazakh market

(the "Gas Supply Contract") The agreed price is US$0.90 per thousand cubic feet (Mcf) (US$32 per thousand cubic metres (Mcm)) plus VAT which was 13% in 2008 moving to 12% in 2009. The VAT receipts can be offset against VAT costs incurred on the Kyzyloi project. The Gas Supply Contract, which has a term until the earlier of December 1, 2012, the date on which all contracts and licences pursuant to which the gas to be delivered under the Gas Supply Contract terminate, or when 850 Mcm (approximately 30 Bcf) has been delivered, is based on a take–or–pay principle and covers all gas produced from the Kyzyloi Field Licence and Production Contract area up to termination. To the end of Q4 2008 17.55% of the maximum contract volume under the Gas Supply Contract had been delivered.

Average field production achieved in the eleven months to November 27, 2008 was 18.4 MMcfpd (~520 Mcmpd) and gas sales for the year ended December 31, 2008 totalled 6.1 Bcf (171.3 MMcm). These figures take no account of shut-downs for maintenance or compression work prior to November 27, 2008.

On November 28, 2008 InterGas Central Asia initiated necessary maintenance work on the Bukhara-Urals trunk line to the north of Tethys' tie-in point which resulted in the trunk-line being temporarily shut down. Tethys decided to use this time to carry out maintenance on its own compressors at the BCS and to begin installation of compression for the Akkulka Phase 2 Development following the arrival on site of both the compressors and the installation engineers. Unfortunately because of extreme weather and safety concerns this process took longer to complete than was anticipated with the result that there was no production and consequently no revenue generated in the month of December 2008. This unplanned shut-down resulted in an interruption in payments from the Company's gas buyer. Gas production did not recommence until March 2009 after the major work on the Phase 2 equipment installation was completed.

Royalties

The Royalty on the Kyzyloi gas field was set at 2% in 2008. Royalties were anticipated to fall in the range of 2% to 6% under the Akkulka Exploration License and Contract with the rate to be set thirty days before the commencement of production and being dependent on the level of reserves. With the introduction of the new Kazakh tax regime in 2009 the Akkulka contract may now liable to the Mineral Extraction Tax (MET) rather than royalty with no royalty payable. MET is expected to be in the range 0.5% to 1.5% of revenue for domestic sales and 10% for exports. MET is also expected to apply to production from the Kul-Bas field.

Operating costs

Operating costs in the year to December 31, 2008 were $1,334,000 compared to $19,000 in the same period of 2007. In 2007 there was only production for the last twelve days of the year. In addition to routine operating costs in the year to December 31, 2008; the total also included costs relating to the optimization of the compression and well regimes, work done on two wells in the Kyzyloi field in anticipation of them commencing production in early 2009 plus $312,000 of costs directly attributable to the Akkulka contract, encompassing well insurance and property tax.

General and Administrative Expenses

General & Administration costs incurred in the year to December 31, 2008 were $13,421,000 compared to $9,480,000 in the same period in 2007. The two primary areas of increase were in staff and travel costs.

- Increased salary cost both in terms of staff numbers and salary inflation in Kazakhstan.
- Growth in staff related costs including medical insurance and increased costs relating to vacation accrual.
- Increased obligatory education and social contributions
- Increased travel costs inside Kazakhstan in terms of travel to the operating fields.
- Extensive travel related to pursuing the Company's gas production objectives in Kazakhstan, developing the PSC opportunities in Tajikistan and looking for further prospects in Central Asia and looking for new projects in Central Asia.
- Increased marketing and travel costs involved in the 'road show' prior to the successful PO in June 2008.
- Increased professional fees
- Increase in office related costs notably in Kazakhstan.

Stock based compensation

In the year to December 31, 2008 $3,945,000 of costs were incurred that related to the issuing of share options and share warrants to employees compared to $17,624,000 in the same period of 2007. *Please see "Note 16 – Stock Based Compensation" per the Company's 2007 audited Consolidated Financial Statements for full details.*

Interest

In the year to December 31, 2008 the Company earned $756,000 in interest on its own funds. For the same period in 2007 there was a net interest charge of $1,437, 000.

Depletion, Depreciation and Accretion (DD&A)

The total DD&A charge for the year to December 31, 2008 was $6,449,000 which was primarily made up of the $6,085,000 for the depletion of proved property costs, on a unit of production basis. The DD&A charge for the same period of 2007 was $13,057,000 made up primarily of an impairment charge of $12,800,000 plus $175,000 depletion of proved properties.

Taxes

As at December 31, 2008 Tethys' principal executive office was in Guernsey, British Isles. The continuance of the Company from the laws of Guernsey to the laws of the Cayman Islands was completed on July 17, 2008. No income or capital taxes are levied in the Cayman Islands.

At December 31, 2008 the Company's Kazakhstan based subsidiary Tethys Aral Gas LLP had net operating loss carry forwards ("NOLs") for income tax purposes of approximately US$4,393,500. If the NOLs are not utilized to reduce taxable income in future periods, they will expire in various amounts from 2012 through 2015. The Company has established a valuation allowance for deferred taxes equal to its entire net deferred assets as management currently believes that it is more likely than not that these losses will not be utilized. Please refer to Note 12 to the audited financial statements to December 31, 2008.

Under the Bokhtar PSC in Tajikistan, the State's production share includes all Tajik taxes, levies and duties however no revenue was generated from the Company's Tajikistan operations in2008.

Financial position

The following table outlines significant movements in the consolidated balance sheets from December 31, 2007 to December 31, 2008:

	Dec 31, 2008	**Dec 31, 2007**	**Movement**	**Movement Details**
Cash	22,200	26,692	(4,492)	See Cashflow Statement in 2008 audited Financial Statements
Prepayments	900	351	549	Various insurance contracts plus London office rent deposit
Accounts Receivable	1,124	219	905	2008 represents two months of revenue receivable while the 2007 represents only twelve days.
Non-current Prepayments	1,514	3,062	(1,548)	Wells that had been prepaid at the end of 2007 were drilled in 2008 and moved into capital expenditure.
Value added tax	4,843	2,752	2,091	Vat on capital expenditure that was incurred in 2008. This balance should be recovered in due course when Phase 2 gas sales commence from the Akkulka field.
Accrued & other liabilities	1,516	891	625	The prime cause of the increase relates to commission due on the rig loans which is still outstanding.

Long term debt	5,096	0	5,096	The 2008 balance consists of the amounts due in more than twelve months on the two loans raised to help finance the rig purchases less net finance costs.
Share capital	145,237	99,483	45,754	Net funds raised on the Po completed on June 27, 2008.
Contributed Surplus	7,472	3,527	3,945	Stock based compensation
Warrants	17,717	16,555	1,162	Warrants issued in connection with rig loans
Accumulated deficit	(74,251)	(51,624)	(22,627)	Loss for the year

Liquidity and Capital Resources

As at December 31, 2008 the Company had a working capital surplus, including cash, of $21,489,000 while at December 31, 2007 the working capital surplus was $25,773,000.

Liquidity Risk

Since inception, the Company has incurred significant losses from operations and negative cash flows from operating activities, and has an accumulated deficit at December 31, 2008. Also as described in *Note 11 to the audited financial statements to December 31, 2008*, the Company has significant short-term and longer term contractual commitments that will necessitate cash outflows. The ability of the Company to successfully carry out its business plan is primarily dependent upon its ability not only to maintain the current level of gas production but also to achieve further production of commercial oil and gas and to control the costs of operating and capital expenditures. While these factors create doubt about the Company's ability to continue as a going concern, as discussed in Note 1 to the Consolidated Financial Statements to December 31, 2008, management is confident of achieving the Company's short term plans.

Capital Management

The Company's objectives when managing capital is to maintain adequate financial flexibility to preserve its ability to meet financial obligations, both current and long term. The capital structure of the Company is managed and adjusted to reflect changes in economic conditions.

The Company funds its expenditures on commitments from existing cash and cash equivalent balances, primarily received from issuances of shareholders equity. During the year, the Company also entered into long term debt agreements to finance the purchase of two drilling rigs. These loans are not subject to any externally imposed capital requirements.

As the Company is engaged in acquiring properties and exploring for crude oil and natural gas, it does not currently have sufficient revenue generating activities to fund all of the company's commitments. The Company is therefore required to fund a significant portion of its commitments from existing cash and cash equivalent balances or seek additional financing through debt issuances or equity markets (refer note 1).

Financing decisions are made by Management and the Board of Directors based on forecasts of the expected timing and level of capital and operating expenditure required to meet the Company's commitments and development plan. Factors considered when determining whether to issue new debt or to seek equity financing include the amount of financing required, the availability of financial resources, the terms on which the financing is available and in consideration of the balance between shareholder value creation and prudent financial risk management.

Debt levels are monitored by using the non-GAAP financial metric of Net Debt to Capitalization. Net Debt is calculated as the sum of long term debt balances (including the current portion) less the balance of cash and cash equivalents. There was no Net Debt at December 31, 2008 as the cash and cash equivalents significantly exceeded the total of long term loans. The Company had no outstanding loans at December 31, 2007.

Cash Generation

In 2008 the monthly revenue being generated from current gas production levels in Kazakhstan was close to US$500,000 (US$565,000 including VAT) and this is not anticipated to increase significantly under the existing Gas Sales Contract.

On March 5, 2009 the Company announced that Kyzyloi was now producing from eight wells, an increase of two wells on the prior production. With the benefit of these additional wells and the commencement of Phase 2 gas production on Akkulka in Q2 2009 there could be a doubling of the 2008 daily production. While the Phase 2 gas price has yet to be fixed, the Company is hopeful of obtaining a significantly better price than the existing Kyzyloi contract. If the price realised for Phase 2 production in Kazakhstan is at similar levels to the Tajikistan contract then by keeping costs at or around their 2008 level Kazakhstan should be generating funds surplus to what is required to meet the minimum work programme and both the Company's operating and G&A costs in that country. (See below *Capital Expenditure – Contractual Commitments*.)

On January 11, 2009 the Company signed a one year sales contract to supply up to 65 Mcm of gas per day to the town of Kulob in Tajikistan. The contract price is 300 Somoni (US$86) per Mcm.

***Public Offering* ("PO")**
On June 27, 2008 Tethys successfully completed a public offering having placed 21,276,596 shares at a price of $2.35 raising $ 50,000,000 (gross), $45,754,000 (net). The Ordinary Shares are listed on the Toronto Stock Exchange.

Secondary Listing on Kazakhstan RFCA
On May 22, 2008, the Company announced that it had been included in the official list of Companies listed on the Regional Financial Centre of the Almaty Special Trading Floor (the "RFCA") operated by the Kazakhstan Stock Exchange JSC. This is a secondary listing to the Company's primary listing on the TSX and as of today's date no shares have traded on the RFCA because of structural issues relating to transfers of shares between the two markets. The Company is working on this issue but so far without success.

Rig Financing
On March 19, 2008 the Company announced that it had completed a financing arrangement for funds of $5,300,000 to assist with the purchase of a deep drilling rig (Telesto) by means of a three year loan with monthly payments of interest and capital and a final balloon payment. The interest payable on the borrowed funds was 12% per annum. In addition 795,000 warrants to purchase Tethys shares were also issued to the lenders with a term of three years and an exercise price of CAD$3.25. The Company has recorded a discount to the loan in the amount of $980,394 based on the fair value of the warrants. To December 31, 2008 Tethys Petroleum Incorporated had incurred $5,949,850 of costs with respect to this rig and a further $3,542,000 on drill strings, other ancillary equipment and loan interest. While Telesto is currently owned by TPI it will be transferred to a new single purpose subsidiary of AOE in the near future.

The loan is to be repaid with monthly payments of interest and capital over a 36 month period and a final balloon payment at the end of this period. The balance of $3,871,000 represents the principal amount total payments due beyond December 2009.

At December 31, 2008 the Company had received funds of $2,130,000 relating to a financing arrangement to assist with the purchase of a second drilling rig (Tykhe) by means of a three year loan with quarterly interest payments only in year one followed in years two and three by monthly payments of interest and capital and a final balloon payment at the end of year three. The interest payable on the borrowed funds was 15% per annum. In addition 638,298 warrants to purchase Tethys shares were also to be issued to the lenders with a term of 3 years and an exercise price of CAD$1.25. These warrants were not issued until March 14, 2009 but the Company accrued for the costs of these warrants in the year to December 31, 2008 as the funds were received in December 2008. The Company recorded a discount to the loan in the amount of $182,234 based on the fair value of the warrants. Lenders will have security over the shares of AOE Tykhe SA, a newly created company which will have no other assets except the drilling rig. In addition Tethys has provided a guarantee to cover any shortfall in the event that the direct security is insufficient to cover any outstanding debt. To December 31, 2008 Tethys had incurred $3,210,000 of costs with respect to this rig and a further $2,765,000 on drill strings, other ancillary equipment.

The loan is to be repaid with quarterly interest in year one followed by payments of interest and capital over a 24 month period and a final balloon payment at the end of this period. The balance of $2,130,000 represents the principal amount total payments due beyond December 2009.

Use of Funds

Set out below is a comparison of the actual use of funds to date and remaining to be expended against what was projected in the prospectus dated June 18, 2007. The primary differences were in relation to:

- The planned Aral Vostochniy acquisition in Kazakhstan where the deal did not proceed because the vendor did not believe that it could meet its obligations.
- No suitable property with proven reserves has yet been identified for acquisition although the Company continues to look for suitable opportunities.
- The overspend on the shallow drilling is the result of discovery of further gas and inclusion of additional pipeline and tie-in costs for gas development.
- In Q3 of 2007 the Company placed an order for a drilling rig – *see 'Rig financing' above*
- The exploration well planned for the Akkulka block was included in the 'Use of Funds' at $11.0 million but making use of the purchased rig the anticipated expenditure is now $7.7 million.

	Per June 18, 2007 Prospectus	**Incurred to Dec 31, 2008**	**Planned in 2009**
Kazakhstan			
Shallow drilling plan, compressors for Phase 2, exploration well, acquisition opportunities, Aral Vostochniy and well workovers	33,000	31,200	3,000
Tajikistan			
Seismic surveys, well rehabilitation and Alimtai exploration well	7,500	2,300	
Repayment of Short Term Loan	5,000	5,000	
Working Capital	500	1,650	
	46,000	40,150	3,000

Set out below is a comparison of the actual use of funds to date and remaining to be expended against what was projected in the prospectus dated June 19, 2008. The primary differences were in relation to:

- The Company ordered a second drilling rig for use in Tajikistan – *see 'Rig financing' above*
- Further drilling and related equipment was purchased for use on the shallow drilling and production programme in Kazakhstan and in Tajikistan.
- Work has not yet commenced on the West Kul-Bas deep well.
- Unplanned expenditure on a supply and storage base at Bozoi, Kazakhstan, and additional capital spares
- Although new projects have been considered none has yet been considered suitable.

	Per June , 2008 Prospectus	Incurred to Dec 31, 2008	Planned in 2009
Kazakhstan			
Shallow Wells and Tie-Ins, deep well, additional seismic and infrastructure	28,100	4,500	
Tajikistan			
Horizontal drilling, seismic, deepening potential gas exploration well plus infrastructure	8,415	1,500	5,500
Infrastructure			
Deepening Potential gas Exploration Well			
Drilling rigs plus ancillary equipment	5,000	12,350	3,500
New Projects	3,500	500	
Working Capital and General Corporate Purposes	1,385	2,500	
	46,400	21,350	9,000

Capital Expenditure - Contractual Commitments

There are items in the previous schedules that refer to planned expenditure but as at December 31, 2008 the Company's contractual commitments in terms of capital expenditure were as follows:

Kazakhstan minimum work programmes for 2009	$ 1,976,500
Tajikistan seismic contract	$ 4,925,300
Drilling rigs plus ancillary equipment	$ 3,483,500
	$10,385,300

For further details please refer to Note 11 *Commitments and Contingencies* in the 2008 audited financial statements.

Contractual obligations and liabilities

The Company's contractual obligations and liabilities as at December 31, 2008 were:

Contractual Obligations	Payments Due by Period				
	Total	Less than 1 Year	1 - 3 Years	4 - 5 Years	After 5 years
Long term debt	$8,683,715	$1,693,715	$6,990,000	-	-
Operating leases	$847,956	$645,852	$202,104	-	-
Purchase obligations	$10,385,300	$10,385,300	-	-	-
Other long term obligations *	$908,000	$173,000	$519,000	$216,000	-
Total contractual obligations	$20,824,971	$12,897,867	$7,711,104	$216,000	-

Operating leases consist primarily of leases for offices

* Under the terms of Kyzyloi Field Licence and Production Contract, historic costs totaling $1,211,000 are payable in equal portions of $43,244 on a quarterly basis to the Kazakhstan government from the third year of production. Seven quarterly payments had been paid to December 31, 2008, totaling $303,000 leaving an outstanding balance of $908,000. The quarterly payments are due to continue until March 2014. (*See Note 8 in the audited 2008 financial statements).*

Future growth

As under "*Cash Generation*", funds from the Company's Kazakhstan operations are expected to be sufficient to fund the Company's work programs, current operating costs and G&A costs. However in order not only to maintain the Company's current capacity but to meet the Company's planned growth objectives, which include funding planned development activities, the Company would require additional capital. Possible sources of funding include an issue of new shares and new debt arrangements. The Company is aware, particularly in the current market conditions, that there can be no assurances that equity financing will be available when required or that it will be sufficient to meet all of those requirements, or for other corporate purposes, or if the equity or debt financing is available, that it will be on terms that is acceptable to the Company. The inability of the Company to access sufficient capital for its growth objectives would impact on the Company's preferred planned growth targets.

While the Company acknowledges that current market conditions are undoubtedly more challenging than at the end of 2007 it believes that that there does remain fund raising opportunities that it could pursue to fund growth objectives which the Company believes could add additional cash flow. However any additional sale of equity is likely to be at significantly lower prices compared to 2008.

The Company is also actively seeking partners in certain projects, preferably strategic partners who may bring capital into specific projects and assist the Company in building its business in Central Asia.

Stockholder Equity

At the AGM on April 24, 2008 the authorized share capital of the Company was increased by an additional 200,000,000 Ordinary Shares and 50,000,000 Preference Shares. The Preference Shares have the rights as set out in the Memorandum and Articles of Association approved at the AGM on April 24, 2008. Significant terms related to preference shares are summarized below:

1. may be issued in one or more series;
2. are entitled to any dividends in priority to the Ordinary Shares;
3. confer upon the holders thereof rights in a winding-up in priority to the Ordinary Shares;
4. and may have such other rights, privileges and conditions (including voting rights) as the Board may determine prior to the first allotment of any series of Preference Shares, provided that if a series of Preference Shares has no or limited voting rights it shall be designated as such by the Board.

As at December 31, 2008 the Company had authorized share capital of 700,000,000 Ordinary Shares of which 66,393,292 had been issued and 50,000,000 preference shares of which none had yet been issued. In the period between December 31, 2008 and the date of this MD&A a further 1,400,000 Ordinary Shares were issued in connection with the purchase of a coiled tubing unit giving a total of 67,793,292 Ordinary Shares in issue. As at the date of this MD&A, there are 7,005,000 stock options and 11,636,956 warrants to purchase ordinary shares in the company issued and outstanding.

Environmental

The Company's operations are subject to environmental regulations in the jurisdictions in which it operates and the Company carries out its activities and operations in material compliance with all relevant and applicable environmental regulations and pursuant to best industry practices. In Kazakhstan, quarterly reports are required to be submitted by the Company to the Shalkar (Bozoi) Tax Committee. Payments made by the Company to date have been very small and have been made on a quarterly basis; in 2007, the Company paid $450 in each of Q4 and Q3 and $1,200 in Q2 for minor emissions. Payments made in 2008 by TAG totalled $35,154, with $2,804 allocated to Kul-Bas. The Company is also required to prepare reports on any pollution of air, toxic waste and current expenses on environmental protection which have been made by the Company and which are submitted to the appropriate Kazakh authorities. Reports are submitted on semi-annual basis for information purposes and no payments are applicable.

Under the Bokhtar PSC in Tajikistan, any Development Plan shall also include an abandonment and site restoration programme together with a funding procedure for such programme. All funds collected pursuant to the funding procedure shall be allocated to site restoration and abandonment and will be placed in a special interest bearing account by KPL which shall be held in the joint names of the State and the KPL or their respective nominees, or its designee.

KPL's responsibilities for environmental degradation, site restoration and well abandonment obligations, and any other actual contingent and potential activity associated with the environmental status of the Development Area shall be limited to the obligation to place the necessary funds in the approved account. In addition any relinquished areas must be brought into the same condition as they were prior to their transfer to KPL (soil fertility condition, quality of the ground and environment). All expenditures incurred in abandonment and site restoration are cost recoverable. An independent environmental base line study has been carried out on the Beshtentak oilfield.

At present, the Company believes that it meets all applicable environmental standards and regulations, in all material respects, and has included appropriate amounts in its capital expenditure budget to continue to meet its environmental obligations.

OUTLOOK

Management has assessed the impact of the recent significant changes in the world economic situation, including the significant decline in energy prices and the decline in the market price for the Company's shares, on its current and planned projects and currently does not have plans to curtail any project that had commenced in the course of 2008 or that are included in the commitment capital expenditure listings above, following this assessment. Uncommitted capital expenditure is constantly under review. As a result of the regular review approach adopted by Management some growth plans previously considered have been put on hold until such time as the position of the markets becomes clearer particularly with regard to future gas pricing, production revenues and fund raising opportunities that may be available to the Company. The overall focus of the short-term work programs are aimed primarily at development and production enhancement projects which will enhance short to medium term cash flow rather than pure exploration projects.

In Kazakhstan, the Company's current plans are limited to satisfying the 2009 Minimum Work Programme for each of the three contracts.

In Tajikistan, the Company will initiate its exploration work with an extensive seismic survey while carrying out rehabilitation and workover activities on existing deposits, to construct field reservoir models and consider horizontal and inclined drilling, field pressure support and similar techniques to increase production of oil and gas, and to look at cost effective approaches to deepening existing wells to test exploration targets.

The Company's experience to date, operating as it does in remote areas, has convinced the Company of the benefit of having its own drilling, production and related equipment to enable it to optimize its operating capabilities leading to an overall cost benefit and the ability to meet the Company's targets and objectives.

The Company is also considering several opportunities for new project acquisitions in the Central Asian area and would look to procure funding for this as appropriate, in addition to the potential for third party funding.

Sensitivities

The price of gas sales from gas produced from the Kyzyloi gas field under the Gas Supply Contract is fixed in US dollars and consequently there is no sensitivity to currency movements or market movements in the gas price. The price of Phase 2 gas sales from gas produced from the Akkulka Block has yet to be agreed and therefore could be sensitive to movements in the market price of gas. The price of the contract signed with the town of Kulob in Tajikistan at 300 Somoni (US$86) per Mcm would be subject to plus or minus movement in sales revenue of $20,400 per annum for every 1% movement in the exchange rate

Transactions with Related Parties

Vazon Energy Limited ("Vazon") is a corporation organized under the laws of the Bailiwick of Guernsey, of which Dr. David Robson, Chief Executive Officer, is the sole owner and managing director. Tethys has a management services contract with Vazon that came into effect from June 27, 2007 whereby the services of Dr. Robson and other Vazon employees are provided to the Company. The total cost charged to Tethys for services from Vazon in the fiscal year ended December 31, 2008 was US$1,070,156 (2007 - US$522,237).

Kraken Financial Group (KFG) has a common director with the Company. In 2008, KFG was engaged by the Company to assist in obtaining loan financing in relation to the purchase of both Telesto and Tykhe drilling rigs. As a result of the services provided in connection with the Telesto transaction, KFG received 6% commission of the funds it was responsible for introducing to the Company. This commission is to be taken in the form 81,447 shares, which were yet to

be issued at year end. As a result the Company has recognized a liability for US$234,000 (2007 - US$Nil). In relation to similar services provided in connection with the loan financing of the Tykhe drilling rig, KFG received commission of US$21,000 (2007 - US$Nil).

KFG also acted as broker for Tethys in the placement of various insurance policies, including Directors & Officers, for which the combined annual premiums were US$112,615 (2007 - US$112,000).

Oilfield Production Consultants (OPC) Ltd and Oilfield Production Consultants (OPC) USA LLC, both of which have one common director with the company, has charged Tethys a monthly retainer fee for engineering expertise, provided services relating to the optimization of the existing compressors and those to be installed as part of Phase 2 gas production from Akkulka, and has consulted on certain reservoir modelling work on projects in Tajikistan. Total fees in the fiscal year ended December 31, 2008 were US$395,531 (2007- US$Nil).

Transactions with affiliates or other related parties including management of affiliates are to be undertaken on the same basis as third party arms-length transactions.

Financial Instruments and Risk Management

Financial Risks

Financial instruments of the Company consist of cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities. The Company's cash and cash equivalents are designated as held-for-trading and are measured at carrying value, which approximates fair value due to the short-term nature of these instruments. Accounts receivable are designated as loans and receivables and recorded at amortized cost, which approximates fair value due to the short term nature of the instrument. Accounts payable and accrued liabilities are designated as other liabilities and are recorded at cost. The fair value of accounts payable and accrued liabilities approximate their carrying values due to the short term nature of these instruments.

The Company is exposed to credit risk, commodity price risk currency exchange, liquidity and funding risk. The following is a description of those risks and how the Corporation manages exposure to them:

Credit Risk
Credit risk is the risk of loss associated with counterparty's inability to fulfil its payment obligations. The Company is currently exposed to credit risk on its cash and cash equivalents, to the extent that these balances are deposited with a number of banking institutions. Cash and cash equivalents can only be placed with banks with the appropriate credit rating as decided upon by the board of directors.

Commodity Price Risk
Commodity price risk arises from the effect that fluctuations of future commodity process may have on the price received for sales of gas products. The marketability and price of natural gas that is produced and may be discovered by the Company will be affected by numerous factors that are beyond the control of the Company.

Natural gas prices are subject to wide fluctuations, The Company has entered into a fixed price contract for sales of gas from the Kyzyloi field. However, any material decline in natural gas prices could result in a reduction of Tethys' future net production revenues and impact on the commercial viability of the Company's existing and future oil and gas discoveries. It may become uneconomic to produce from some wells as a result of lower prices, which could result in a reduction in the volumes and the value of Tethys' gas reserves. Tethys might also elect not to produce from certain wells at lower prices.

Interest Rate
Interest rate risk is the risk that the value of a financial instrument will be affected by changes in market interest rates. Both of the existing loans from private investors are at a fixed rate and so have no exposure to changes in market interest rates. The Company is exposed to interest rate risk to the extent that reduction in market interest rates, such as have been made in recent months, will impact on the interest earned on the Company's cash and cash equivalent. As an example if the Company could maintain the cash and cash equivalent as at December 31, 2008 for a whole year then a change in interest rates of 1% would increase/decrease the interest earned by an amount of approximately $200,000.

Foreign Currency Exchange
The Company's operations and expenditures are to a large extent paid in currencies other than U.S. dollar. As a result, the Company is exposed to market risks resulting from fluctuations in foreign currency exchange rates. A material drop in the value of any such foreign currency could result in a material adverse effect on the Kazakhstan cash flow and revenues. Currently, there are no significant restrictions on the repatriation of capital and distribution of earnings from Kazakhstan to foreign entities. There can be no assurance, however, that restrictions on repatriation of capital or distributions of earnings from Kazakhstan will not be imposed in the future. Amendments to current taxation laws and regulations which alter tax rates and/or capital allowances could have a material adverse impact on Tethys.

To the extent revenues and expenditures denominated in or strongly linked to the U.S. dollar are not equivalent; the Company is exposed to exchange rate risk. The Company is exposed to the extent U.S. that dollar revenues do not equal U.S. dollar expenditures. In addition, a portion of expenditures in Kazakhstan are denominated in Tenge and in Tajikistan in Somoni, which are difficult to hedge. The Company is not currently using exchange rate derivatives to manage exchange rate risks but is attempting to negotiate exchange rate stabilization conditions in new local Tenge denominated service and supply contracts in Kazakhstan. Due to the small amount of Tenge and Somoni held at December 31, 2008 had the United States dollar changed by 1% against the Kazakhstan Tenge or Somoni, with all other variables held constant, the Company's foreign exchange gain or loss would have been negligible. On February 4, 2009 it was announced that Kazakhstan's central bank had devalued the Tenge by 18 percent, joining Russia, Ukraine and Belarus in abandoning attempts to prop up exchange rates. If this new rate is maintained then the $ value of the costs incurred by the Company in Kazakhstan in Tenge will show a significant reduction.

While the Company holds the majority of its cash and cash equivalents in U.S. dollars it does hold other balances, mainly British Pounds Sterling ("GBP") and Canadian dollars ("CDN"), to meet the requirements to fund ongoing general and administrative and other spending requirements in these currencies. In addition a significant portion of the funds received in the June 2008 PO were received in CDN. In 2008 the Company had a policy of holding Euros to meet anticipated costs of purchasing oil & gas drilling equipment, casing, drill pipe and similar (as these items were priced at that time in Euros) but this practice ceased prior to December 31, 2008. With regard to the GBP, had the $ changed by 1% at December 31, 2008 with all other variables held constant, the Company's foreign exchange gain or loss would have been affected by $23,000 and for CDN had the $ changed by 1% the exchange gain or loss would have been affected by $35,000.

In order to reduce its exposure to currency risk the Company has decided to hold only $ and GBP. As at the end of 2008 the Company no longer held any Euros and it is the intention that by the end of Q1 in 2009 it will also no longer hold CDN. Should the situation arise in 2009 where a substantial sum is to be settled in a currency other than $ or GBP the Company will pursue the option of hedging.

In addition, the Company's results are reported in $ and foreign currency denominated monetary balances could result in gains and losses that may increase the variability of earnings. Moreover, the Company's ordinary shares trade in CDN on the TSX.

Critical Accounting Policies and Estimates

The Company's financial statements are prepared in accordance with US GAAP, which require management to make judgments, estimates and assumptions which may have a significant impact on the financial statements. A summary of the Company's significant accounting policies can be found in Note 2 to its audited consolidated financial statements for the year ended December 31, 2007. The following is a discussion of those accounting policies and estimates that are considered critical in the determination of the Company's financial results.

Oil & Gas Properties — Full Cost Accounting
The Company follows the full cost method of accounting as described in Note 2 to its audited consolidated financial statements for the year ended December 31, 2008.

Under the full cost method of accounting, capitalized costs are subject to a country–by–country cost centre impairment test. Under the successful efforts method of accounting, the costs are aggregated on a property–by–property basis and the carrying value of each property is subject to an impairment test. These policies may result in a different carrying value for capital assets and different net Revenue. The Company has elected to follow the full cost method and it is the method

most commonly followed in the oil and gas industry. The Company applies a ceiling test to the capitalized cost in the full cost pool. The ceiling test limits such costs to the estimated present value, using a ten percent discount rate, of the future net revenue from proved reserves, based on current economic and operating conditions. *(See Note 6 in the 2009 audited Financial Statements)*

Reserve Estimates
Reserve estimates can have a significant impact on net Revenue and the carrying value of capital assets. The Company engaged independent third party specialists in reserve engineering, McDaniel & Associates Consultants Ltd ("McDaniel"), to evaluate the recoverable reserves of all of the Company's contracts in Kazakhstan as at December 31, 2008 in accordance with NI 51-101. The process of estimating reserves requires significant judgment based on available geological, geophysical, engineering, and economic data, projected rates of production, estimated commodity price forecasts and the timing of future expenditures, all of which are subject to interpretation and uncertainty. Reserve estimates can impact net Revenue through depletion expense and the application of impairment tests. Revisions or changes in reserve estimates can have either a positive or a negative impact on net Revenue and can impact the carrying amount of capital assets. (*See Risk Factors.)*

Production variances from Reported Reserves
Potential lenders may also use reserve estimates to assess the allowable borrowing base under a secured credit facility. Changes to the reserve estimates can result in borrowing base increases or decreases, which could impact the Company's financial position.

Asset Retirement Obligations
The Company recognizes liabilities for asset retirement obligations associated with tangible long–lived assets, such as producing well sites, with a corresponding increase in the related long–lived asset. Prior to December 31, 2008 the Company had estimated the liability based on the estimated costs to abandon and reclaim its net ownership in tangible long–lived assets and the estimated timing of the costs to be incurred in future periods. In early 2009 the Company actually carried out the exercise of liquidating three wells as a result of which the Company decided to reduce the estimated liability. The Company's asset retirement obligations consist of costs related to the plugging of wells, the removal of facilities and equipment, and site restoration on oil and gas properties. Actual future payments to settle the obligations may differ from estimated amounts.

CHANGES TO ACCOUNTING POLICIES

There were no changes in accounting policies during the course of the 2008 other than the adoption of the following pronouncements:

Recently Adopted Pronouncements

Fair Value Measurements

In September 2006, the FASB issued SFAS No. 157, *"Fair Value Measurements."* This Statement replaces multiple existing definitions of fair value with a single definition, establishes a consistent framework for measuring fair value and expands financial statement disclosures regarding fair value measurements. This Statement applies only to fair value measurements that already are required or permitted by other accounting standards and does not require any new fair value measurements. SFAS No. 157 is effective for fiscal years beginning subsequent to November 15, 2007. The Company adopted this Statement with effect from January 1, 2008 and it did not have a material impact on its financial position or results of operations.

The Fair Value Option for Financial Assets and Financial Liabilities

In February 2007, the FASB issued SFAS No. 159, "*The Fair Value Option for Financial Assets and Financial Liabilities*," which permits an entity to measure certain financial assets and financial liabilities at fair value. The objective of SFAS No. 159 is to improve financial reporting by allowing entities to mitigate volatility in reported earnings caused by the measurement of related assets and liabilities using different attributes, without having to apply complex hedge accounting provisions. Under SFAS No. 159, entities that elect the fair value option (by instrument) will

report unrealized gains and losses in earnings at each subsequent reporting date. The fair value option election is irrevocable, unless a new election date occurs. SFAS No. 159 establishes presentation and disclosure requirements to help financial statement users understand the effect of the entity's election on its earnings, but does not eliminate disclosure requirements of other accounting standards. Assets and liabilities that are measured at fair value must be displayed on the face of the balance sheet. The adoption of SFAS 159 did not have a material impact on the Company's financial condition or results of operations as the Company did not make any such election under this fair value option.

Recently Issued Accounting Pronouncements

In December 2007, the FASB issued SFAS No. 141 (revised 2007), ―Business Combinations (―SFAS No. 141R), which replaces FASB Statement No. 141. SFAS No. 141R will change how business acquisitions are accounted for and will impact financial statements both on the acquisition date and in subsequent periods. SFAS No. 141R requires the acquiring Company to measure almost all assets acquired and liabilities assumed in the acquisition at fair value as of the acquisition date. SFAS No. 141R is effective for fiscal years beginning on or after December 15, 2008 (fiscal year 2009 for the Company) and should be applied prospectively with the exception of income taxes which should be applied retrospectively for all business combinations. Early adoption is prohibited. The Company is switching to IFRS with effect from January 1, 2009 and so adoption of SFAS 141 will not be applicable.

In March 2008, the FASB issued SFAS No. 161, ―Disclosures about Derivative Instruments and Hedging Activities, (―SFAS No. 161), an amendment to SFAS No. 133, ―Accounting for Derivative Instruments and Hedging Activities. SFAS No. 161 requires enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. This Statement would be effective for the Company's interim and annual consolidated financial statements beginning in fiscal year 2010. This Statement encourages, but does not require, comparative disclosures for earlier periods at initial adoption. The Company is switching to IFRS with effect from January 1, 2009 and so adoption of SFAS 141 will not be applicable.

FUTURE CHANGES IN ACCOUNTING POLICY

The Accounting Standards Board ("AcSB") confirmed in February 2008 that International Financial Reporting Standards ("IFRS") will be used for Canadian publicly accountable enterprises for financial periods beginning on and after January 1, 2011 but as a foreign issuer, Tethys has taken the decision to do so for periods beginning January 1, 2009 and prepare its first financial statements in accordance with IFRS for the three month period ended March 31, 2009.

To implement this decision the Company had its auditors, PwC, prepare a diagnostic which was submitted to the Company's Audit Committee, and it has acquired the services of an external consultant and has set a team headed up by the CFO to co-ordinate and implement this transfer.

Impact of adoption of IFRS

IFRS are premised on a conceptual framework similar to US GAAP, however, significant differences exist in certain matters of recognition, measurement and disclosure. The following paragraphs outline the significant accounting policies which are required or are currently expected to be applied by the Company on its adoption of IFRS that will be significantly different than its US GAAP accounting policies. While the adoption of IFRS will not have a material impact on the reported cash flows of the Company, it will have a material impact on the Company's consolidated balance sheet and statement of operations and will require additional disclosures. The Company has identified that the following areas have the greatest potential impact to the Company's accounting: capital assets and stock-based compensation.

Property plant and equipment

Tethys accounts for oil and gas properties and interests in accordance with the full cost accounting method. Under the full cost method, all directly attributable acquisition, exploration and development costs associated with oil and gas properties are capitalized on a country by country cost centre basis. Capitalized costs include the cost of drilling and equipping productive wells, including the estimated costs of dismantling and abandoning these assets, dry hole costs,

lease acquisition costs, seismic and other geological and geophysical costs, delay rentals and costs related to such activities. General and administrative costs directly attributable to the exploration and development of oil and gas properties are also capitalised.

Under IFRS the Company will follow the guidance in IFRS 6 ("Exploration for and Evaluation of Mineral Resources" under which all license acquisition, geological and geophysical exploration and appraisal costs are initially capitalized to well, field or specific exploration licenses as appropriate, pending determination of the existence of economically viable commercial reserves. Expenditure incurred during the various exploration and appraisal phases will then be written off unless commercial reserves have been established.

Impairment
Under US GAAP an impairment loss is recognized when the carrying amount of a cost centre (country) is not recoverable and the carrying amount of the cost centre exceeds the sum of the discounted cash flows from proved reserves. The discounted cash flow calculation assumes constant pricing, discounts the cash-flows at 10% and takes into account the expected future costs to develop proved reserves, estimated operating expenses and income taxes (the "ceiling amount"). If the ceiling amount is less than the carrying amount, an impairment loss is recognized in the amount of such deficiency. Under IFRS the calculation of future cash flows can be based on proved plus probable reserves and are done on the basis of Cash Generating Units (contracts). Also contrary to US GAAP under IFRS previous impairment calculations, such as that in Company's 2007 results, could be reversed should they prove to be no longer necessary. IFRS based impairment test will be carried out as at the transition date for any potential area of impairment.

Stock-based compensation
The Company issues stock-based awards in the form of stock options that vest evenly over a three year period. Under US GAAP the Company recognizes the fair value of the award, determined at the time of the grant, on a straight-line basis over the weighted average of all grants. Under IFRS the fair value of each tranche of the award is considered a separate grant based on the vesting period with the fair value of each tranche determined separately and recognized as compensation expense over the term of its respective vesting period. Accordingly, this will result in a higher amount of each grant being recognized in income at a faster rate than under US GAAP.

First time adoption of IFRS
The Company's adoption of IFRS will require the application of IFRS 1 First-time adoption of International Financial Reporting Standards ("IFRS 1"), which provides guidance for an entity's initial adoption of IFRS. IFRS 1 generally requires that an entity apply all IFRS effective at the end of its first IFRS reporting period retrospectively. However, IFRS 1 does require certain mandatory exceptions and limited optional exemptions in specified areas of certain standards from this general requirement. The following are the optional exemptions available under IFRS 1 that the Company expects to apply in preparing its first financial statements under IFRS:

Business combinations
IFRS 1 allows for IFRS 3 ("Business Combination") to be applied either retrospectively or prospectively. Retrospective application would require that the Company restate all business combinations occurring before the date of its transition to IFRS. Tethys intends to adopt IFRS 3 prospectively.

Decommissioning liabilities
The Company intends to make use of the exemption allowed under IFRS1 relating to the treatment of changes in the Decommissioning, Restoration or Similar Liabilities prior to the date of transition to IFRS.

As at the date of this report the Company had yet to complete the quantification of the impact of the switch to IFRS on its financial statements. Full details will be provided in the first interim MD&A completed under the new standards in 2009.

Accounting systems
The Company makes use of Sun Systems accounting software package to meet its accounting requirements. This is well established package which will enable the Company to meet all of the accounting requirements under IFRS.
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Internal Controls over Financial Reporting
The Company has in place appropriate control systems to satisfy the control and reporting requirements of US GAAP. The Company will be implementing the appropriate changes to such controls to ensure continuing effectiveness under IFRS Framework.

Financial reporting expertise and training requirements
As previously stated , the Company to assist in the implementation of IFRS is making use of an external consultant. This consultant has experience of both US GAAP and IFRS and part of his remit is to ensure that the accounting staff are appropriately trained to meet the new requirements. The Company's approach to the implementation also makes considerable use of the diagnostic completed earlier

INTERNAL CONTROLS OVER FINANCIAL REPORTING

The Chief Executive Officer (CEO) and the Chief Financial Officer (CFO) of Tethys are responsible for establishing and maintaining internal control over financial reporting (ICFR) as that term is defined in National Instrument 52-109 – Certification of Disclosure in Annual and Interim Filings. The CEO and the CFO of Tethys are responsible for designing a system of internal controls over financial reporting, or causing them to be designed under their supervision, in order to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external reporting purposes in accordance with both Canadian regulatory requirements and in accordance with US GAAP.

Management of Tethys has designed and implemented, under the supervision of its CEO and CFO, a system of internal controls over financial reporting as of December 31, 2008 which it believes is effective for a company of its size. There were no changes in Tethys' internal control over financial reporting that occurred during the quarter ended December 31, 2008 that has materially affected or that is reasonably likely to affect, Tethys' control over financial reporting. The Company's control system and procedures are reviewed periodically and adjusted or updated as necessary. In addition where any new or additional risks have been identified either by Company personnel or on advice from the company auditors then the management of Tethys has put in place appropriate procedures to mitigate these risks.

Under the supervision of the CEO and the CFO, Management conducted an evaluation of the effectiveness of internal control over financial reporting based on "Internal Control – Integrated Framework" issued by the Committee of Sponsoring Organisations of the Treadway Commission. Based on this evaluation, management concluded that the Company's internal control over financial reporting was effective as at December 31, 2008. No material weakness relating to the design of the Company's system of ICFR or relating to the Company's operations as at December 31, 2008 have been identified.

DISCLOSURE CONTROLS AND PROCEDURES

The CEO and the CFO are responsible for establishing and maintaining disclosure controls and procedures (DC+P) as that term is defined in NI 52-109. Disclosure controls and procedures have been designed by the Tethys Management, under the supervision of the CEO and CFO, to ensure that information required to be disclosed by the Company is accumulated, recorded, processed and reported to the Company's management as appropriate to allow timely decisions regarding disclosure. The Company's CEO and CFO have concluded,, based on their evaluation as of the end of the period covered by this MD&A, that the Company's disclosure controls and procedures as of the end of such period are effective to provide reasonable assurance that material information related to the company, including its consolidated subsidiaries, is communicated to them as appropriate to allow timely decisions regarding required disclosure.

An evaluation was performed under the supervision of the CEO and CFO, of the effectiveness of the Company's disclosure controls as defined in Multilateral Instrument 52-109. Based on that evaluation the CEO and CFO concluded that the design and operation of the Company's disclosure controls and procedures were effective as at December 31, 2008.

FORWARD-LOOKING STATEMENTS

In the interest of providing Tethys' shareholders and potential investors with information regarding the Company and its subsidiaries, including management's assessment of Tethys' and its subsidiaries' future plans and operations, certain statements contained in this MD&A constitute forward-looking statements or information (collectively referred to herein as "forward-looking statements") within the meaning of the "safe harbour" provisions of applicable securities legislation. Forward-looking statements are typically identified by words such as "anticipate", "believe", "expect", "plan", "intend", "forecast", "target", "project" or similar words suggesting future outcomes or statements regarding an outlook. Forward looking statements in this MD&A include, but are not limited to, statements with respect to: the projected 2009 capital investments projections, and the potential source of funding therefore. Readers are cautioned not to place undue reliance on forward-looking statements, as there can be no assurance that the plans, intentions or expectations upon which they are based will occur. By their nature, forward-looking statements involve numerous assumptions, known and unknown risks and uncertainties, both general and specific, that contribute to the possibility that the predictions, forecasts, projections and other forward-looking statements will not occur, which may cause the Company's actual performance and financial results in future periods to differ materially from any estimates or projections of future performance or results expressed or implied by such forward-looking statements. These risks, uncertainties and assumptions include, among other things: volatility of and assumptions regarding oil and gas prices; fluctuations in currency and interest rates; ability to successfully complete proposed equity financing; product supply and demand; market competition; ability to realize current market gas prices; risks inherent in the Company's and its subsidiaries' marketing operations, including credit risks; imprecision of reserve estimates and estimates of recoverable quantities of oil and natural gas and other sources not currently classified as proved; the Company's and its subsidiaries' ability to replace and expand oil and gas reserves; unexpected cost increases or technical difficulties in constructing pipeline or other facilities; unexpected delays in its drilling operations; delays in the delivery of its drilling rigs; unexpected difficulties in, transporting oil or natural gas; risks associated with technology; the Company's ability to generate sufficient cash flow from operations to meet its current and future obligations; the Company's ability to access external sources of debt and equity capital; the timing and the costs of well and pipeline construction; the Company's and its subsidiaries' ability to secure adequate product transportation; changes in royalty, tax, environmental and other laws or regulations or the interpretations of such laws or regulations; political and economic conditions in the countries in which the Company and its subsidiaries operate; the risk of international war, hostilities, civil insurrection and instability affecting countries in which the Company and its subsidiaries operate and terrorist threats; risks associated with existing and potential future lawsuits and regulatory actions made against the Company and its subsidiaries; and other risks and uncertainties described from time to time in the reports and filings made with securities regulatory authorities by Tethys.

With regard to forward looking information contained in this MD&A, the Company has made assumptions regading, amongst other things, the continued existence and operation of existing pipelines; future prices for natural gas; future currency and exchange rates; the Company's ability to generate sufficient cash flow from operations and access to capital markets to meet its future obligations; the regulatory framework representing mineral extraction taxes, royalties, taxes and environmental matters in the countries in which the Company conducts its business: gas production levels; and the Company's ability to obtain qualified staff and equipment in a timely and cost effective manner to meet the Company's demands. Statements relating to "reserves" or "resources" or "resource potential" are deemed to be forward-looking statements, as they involve the implied assessment, based on certain estimates and assumptions that the resources and reserves described exist in the quantities predicted or estimated, and can be profitably produced in the future. Although Tethys believes that the expectations represented by such forward-looking statements are reasonable, there can be no assurance that such expectations will prove to be correct. Readers are cautioned that the foregoing list of important factors is not exhaustive. Furthermore, the forward-looking statements contained in this MD&A are made as of the date of this MD&A, and except as required by law Tethys does not undertake any obligation to update publicly or to revise any of the included forward looking statements, whether as a result of new information, future events or otherwise. The forward-looking statements contained in this MD&A are expressly qualified by this cautionary statement.

RISK FACTORS

The risks and uncertainties below are in addition to the 'Financial Risks' on page 14 and are not the only ones the Company is facing. There are additional risks and uncertainties of which the Company is not presently aware or that the Company currently considers immaterial but which may also impair the Company's business operations and cause the

price of the Ordinary shares to decline. If any of the following risks actually occur, the Company's business may be harmed and the Company's financial condition and results of operations may suffer significantly.

The risks have been set out in two groupings. The first grouping relates to the Company as a whole which is then followed by a listing of risks specifically related to Kazakhstan and Tajikistan.

Risks Related to the Company and its Business

Competition

The oil and gas industry is intensely competitive. Competition is particularly intense in the acquisition of prospective oil properties and oil and gas reserves. Tethys' competitive position depends on its geological, geophysical and engineering expertise, its financial resources, its ability to develop its properties and its ability to select, acquire and develop proved reserves. Tethys competes with a substantial number of other companies having larger technical staff and greater financial and operational resources. Many such companies not only engage in the acquisition, exploration, development and production of oil and gas reserves, but also carry on refining operations and market refined products. Tethys also competes with major and independent oil and gas companies and other industries supplying energy and fuel in the marketing and sale of oil and gas to transporters, distributors and end users, including industrial, commercial and individual consumers. Tethys also competes with other oil and gas companies in attempting to secure drilling rigs and other equipment necessary for drilling and completion of wells. Such equipment may be in short supply from time to time, particularly in times when the oil price is high. To mitigate this risk the Company has acquired several drilling rigs and ancillary equipment. In addition, equipment and other materials necessary to construct production and transmission facilities may be in short supply from time to time. Finally, companies not previously investing in oil and gas may choose to acquire reserves to establish a firm supply or simply as an investment. Such companies will also provide competition for Tethys.

Marketability of Production

The marketability and ultimate commerciality of oil and gas acquired or discovered is affected by numerous factors beyond the control of Tethys. These factors include reservoir characteristics, market fluctuations, the proximity and capacity of oil and gas pipelines and processing equipment and government regulation. Oil and gas operations (exploration, production, pricing, marketing and transportation) are subject to extensive controls and regulations imposed by various levels of government, which may be amended from time to time. Restrictions on the ability to market the Company's production could have a material adverse effect on the Company's revenues and financial position.

Commodity Price Fluctuations

Oil and gas prices are unstable and are subject to fluctuation. Any material decline in natural gas prices could result in a reduction of the Company's net production revenue and overall value and could result in ceiling test write downs. It may become uneconomic to produce from some wells as a result of lower prices, which could result in a reduction in the volumes and value of the Company's reserves. The Company might also elect not to produce from certain wells at lower prices. All of these factors could result in a material decrease in the Company's net production revenue causing a reduction in its acquisition and development activities. A substantial material decline in prices from historical average prices could reduce the Company's ability to borrow funds.

Nature of the Oil and Gas Business

An investment in Tethys should be considered speculative due to the nature of the Company's involvement in the exploration for, and the acquisition, development and production of, oil and natural gas in Kazakhstan. The volume of production from oil and natural gas properties generally declines as reserves are depleted, with the rate of decline depending on reservoir characteristics. The Company's proved reserves will decline as reserves are produced from its properties unless it is able to acquire or develop new reserves. The business of exploring for, developing or acquiring reserves is capital intensive. To the extent cash flow from operations is reduced and external sources of capital become limited or unavailable, the Company's ability to make the necessary capital investment to maintain or expand the Company's asset base of oil and natural gas reserves will be impaired. In addition, there can be no assurance that even if the Company is able to raise capital to develop or acquire additional properties to replenish the Company's reserves, the Company's future exploration, development and acquisition activities will result in additional proved reserves or that the Company will be able to drill productive wells at acceptable costs.

The cost of drilling, completing and operating wells is often uncertain, and drilling operations may be curtailed, delayed or cancelled as a result of a variety of factors, including unexpected drilling conditions, pressure or irregularities in formations, equipment failures or accidents, adverse weather conditions, compliance with governmental requirements and shortages or delays in the availability of drilling rigs and the delivery of equipment.

Management Services Provided by Vazon and Dependence on Key Personnel

The services of the President and Chief Executive Officer, the Executive Vice President, Vice President Technical and Vice President Commercial are provided under the terms of two management services agreements with a corporate entity, Vazon. As a result, these executive officers of the Company, although officers of the Company, are not employed directly by the Company but rather by Vazon. Vazon is a corporation wholly owned by Dr. David Robson, the Company's Chairman, President and Chief Executive Officer. Either management services agreement may be terminated on up to six months' notice by Vazon or the Company. Should Vazon (acting through Dr. Robson) determine to terminate either or both management services agreements, the Company would be required to enter into an employment or other relationship directly with these executive officers or, failing which, would be required to retain the services of alternate executive officers. There is no certainty that the Company would be able to attract and retain suitable candidates should either of the management services agreements be terminated and the executive officers choose not to be employed or retained by the Company. Any such termination may materially and adversely affect the Company. Moreover, the Company is dependent on its ten executive officers to manage its affairs and operations. The departure of any one executive officer may negatively impact on certain of the Company's operations until a suitable replacement candidate is appointed.

Hedging Activities

The Company's subsidiary, TAG, has entered into the Gas Supply Contract and from time to time the Company may enter into agreements to receive fixed prices on its oil and natural gas production to offset the risk of revenue losses if commodity prices decline; however, if commodity prices increase beyond the levels set in such agreements, the Company will not benefit from such increases. Similar risks will apply to any hedging agreements the Company may enter into to set exchange rates or fix interest rates on its debt.

Financial Resources

The Company's cash flow from operations may not be sufficient to fund its ongoing activities and implement its business plans. From time to time the Company may enter into transactions to acquire assets or the shares of other companies. These transactions along with the Company's ongoing operations may be financed partially or wholly with debt, which may increase the Company's debt levels above industry standards and lead to increased borrowing costs, reducing the Company's income. Depending on future exploration and development plans, the Company may require additional financing, which may not be available or, if available, may not be available on favourable terms. Failure to obtain such financing on a timely basis could cause the Company to forfeit or forego various opportunities that would otherwise be beneficial to the Company and its shareholders. (*See Liquidity and Financial Resources on page 9 and Future Growth on page 12.)*

International Operations

International operations are subject to political, economic and other uncertainties, including but not limited to, risk of terrorist activities, revolution, border disputes, expropriation, renegotiations or modification of existing contracts, import, export and transportation regulations and tariffs, taxation policies, including royalty and tax increases and retroactive tax claims, exchange controls, limits on allowable levels of production, currency fluctuations, labour disputes and other uncertainties arising out of foreign government sovereignty over the Company's international operations. The Company's operations may also be adversely affected by applicable laws and policies of Kazakhstan, Tajikistan or other countries in which it operates in the future, the effect of which could have a negative impact on the Company.

Foreign Currency and Fiscal Matters

See Financial Risks page 14

Political and Regulatory

The oil and gas industry in general is subject to extensive government policies and regulations, which result in additional cost and risk for industry participants. Environmental concerns relating to the oil and gas industry's operating practices are expected to increasingly influence government regulation and consumption patterns which favour cleaner burning

fuels such as natural gas. The Company is uncertain as to the amount of operating and capital expenses that will be required to comply with enhanced environmental regulation in the future. The Company is also subject to changing and extensive tax laws, the effects of which cannot be predicted. Among other things, the Company and TKL are subject to regulatory filings with respect to the repatriation of funds to its shareholders which must be complied with to avoid sanctions. Legal requirements are frequently changed and subject to interpretation, and the Company is unable to predict the ultimate cost of compliance with these requirements or their effect on its operations. Existing laws or regulations, as currently interpreted or reinterpreted in the future, or future laws or regulations may change in the future and materially adversely affect the Company's results of operations and financial condition.

The Company is conducting exploration and development activities in Kazakhstan and Tajikistan, and is dependent on receipt of government approvals or permits to develop its properties. Based on past performance, The Company believes that the governments of Kazakhstan and Tajikistan support the exploration and development of its oil and gas properties by foreign companies. Nevertheless, there is no assurance that future political conditions in Kazakhstan and/or Tajikistan will not result in the government adopting different policies respecting foreign development and ownership of oil and gas, environmental protection and labour relations. This may affect the Company's ability to undertake exploration and development activities in respect of present and future properties, as well as its ability to raise funds to further such activities. Any delays in receiving government approvals or permits or no objection certificates may delay the Company's operations or may affect the status of the Company's contractual arrangements or its ability to meet its contractual obligations. Similar risks apply in other countries in which the Company may operate in the future.

Legal Systems

The Company is governed by the laws of the Cayman Islands and the Company's principal subsidiaries are incorporated under the laws of Guernsey, Jersey, Kazakhstan and the Netherlands. The Company through its subsidiaries carries on operations in Kazakhstan and Tajikistan. Accordingly, the Company is subject to the legal systems and regulatory requirements of a number of jurisdictions with a variety of requirements and implications for shareholders of the Company. Shareholders of the Company will not have rights identical to those available to shareholders of a corporation incorporated under the federal laws of Canada. Moreover, in certain circumstances, the Company may require a shareholder to divest itself of its Ordinary Shares if the ownership or holding of such Ordinary Shares would be in breach of laws or a legal requirement of any country or if such shareholder is not qualified to hold the Ordinary Shares and if such ownership or holding would in the reasonable opinion of the Board of Directors cause a pecuniary or tax disadvantage to the Company or any other shareholder.

Exploration and development activities outside Canada may require protracted negotiations with host governments, national oil and gas companies and third parties. Foreign government regulations may favour or require the awarding of drilling contracts to local contractors or require foreign contractors to employ citizens of, or purchase supplies from, a particular jurisdiction. If a dispute arises with foreign operations, the Company may be subject to the exclusive jurisdiction of foreign courts or may not be successful in subjecting foreign persons, especially foreign oil and gas ministries and national oil and gas companies, to the jurisdiction of the Canada.

Kazakhstan and Tajikistan may have a less developed legal system than jurisdictions with more established economies, which may result in risks such as: (i) effective legal redress in the courts of such jurisdictions, whether in respect of a breach of law or regulation or in an ownership dispute, being more difficult to obtain; (ii) a higher degree of discretion on the part of governmental authorities; (iii) the lack of judicial or administrative guidance on interpreting applicable rules and regulations; (iv) inconsistencies or conflicts between and within various laws, regulations, decrees, orders and resolutions; or (v) relative inexperience of the judiciary and courts in such matters. In certain jurisdictions the commitment of local business people, government officials and agencies and the judicial system to abide by legal requirements and negotiated agreements may be more uncertain, creating particular concerns with respect to licences and agreements for business. These may be susceptible to revision or cancellation and legal redress may be uncertain or delayed. There can be no assurance that joint ventures, licences, licence applications or other legal arrangements will not be adversely affected by the actions of government authorities or others and the effectiveness of and enforcement of such arrangements in these jurisdictions cannot be assured. (*See Risks related to the Republics of Kazakhstan and Tajikistan page 25.)*

Production Variances from Reported Reserves

The Company's reserve evaluations have been prepared in accordance with NI 51-101. There are numerous uncertainties inherent in estimating quantities of reserves and cash flows to be derived there from, including many factors that are beyond the control of the Company. The reserves information set forth in the Company's Annual Information Form

represents estimates only. The reserves from the Company's properties have been independently evaluated by McDaniel in the McDaniel Reserve Report. The McDaniel Reserve Report includes a number of assumptions relating to factors such as initial production rates, production decline rates, ultimate recovery of reserves, timing and amount of capital expenditures, marketability of production, future prices of natural gas, operating costs and royalties and other government levies that may be imposed over the producing life of the reserves. These assumptions were based on price forecasts in use at the date the relevant evaluations were prepared and many of these assumptions are subject to change and are beyond the control of the Company. Actual production and cash flows derived there from will vary from these evaluations, and such variations could be material. These evaluations are based, in part, on the assumed success of exploitation activities intended to be undertaken in future years. The reserves and estimated cash flows to be derived therefrom contained in such evaluations will be reduced to the extent that such exploitation activities do not achieve the level of success assumed in the evaluations.

Availability of Equipment and Access Restrictions

Oil and gas exploration and development activities are dependent on the availability of drilling and related equipment in the particular areas where such activities will be conducted. Demand for such limited equipment or access restrictions may affect the availability of such equipment to the Company and may delay exploration and development activities. There can be no assurance that sufficient drilling and completion equipment, services and supplies will be available when needed. Shortages could delay the Company's proposed exploration, development, and sales activities and could have a material adverse effect on the Company's financial condition. If the demand for, and wage rates of, qualified rig crews rise in the drilling industry then the oil and gas industry may experience shortages of qualified personnel to operate drilling rigs. This could delay the Company's drilling operations and adversely affect the Company's financial condition and results of operations. To the extent Tethys is not the operator of its oil and gas properties, Tethys will be dependent on such operators for the timing of activities related to such properties and will be largely unable to direct or control the activities of the operators.

Operating Hazards

Oil and gas exploration, development and production operations are subject to all the risks and hazards typically associated with such operations, including hazards such as fire, explosion, blowouts and oil spills, each of which could result in substantial damage to oil wells, production facilities, other property and the environment or in personal injury. In accordance with industry practice, the Company is not fully insured against all of these risks, nor are all such risks insurable. Although Tethys maintains liability insurance in an amount that it considers adequate and consistent with industry practice, the nature of these risks is such that liabilities could exceed policy limits, in which event Tethys could incur significant costs that could have a material adverse effect upon its financial condition. Oil and gas production operations are also subject to all the risks typically associated with such operations, including premature decline of reservoirs and the invasion of water into producing formations.

Seasonality and Weather Patterns

The level of activity in the Central Asia oil and gas industry is influenced by seasonal and unexpected weather patterns which may lead to declines in production and exploration activity. Harsh winter conditions may impede access to remote locations and drilling activities and limit the Company's ability to perform maintenance on equipment. Also, certain oil and gas producing areas may be located in areas that are inaccessible other than during the winter months because the ground surrounding the sites in these areas consists of swampy terrain. Moreover, wet weather and spring thaw may make the ground unstable. Consequently, the movement of rigs and other heavy equipment may be restricted, thereby reducing activity levels.

Gas Pipeline

The Company is economically dependent on the pipeline from the Kyzyloi Field to the BCS and the onward Bukhara-Urals trunk line in that should anything adverse happen to these pipelines then the sales revenue would cease. Although the trunkline is owned by Intergas Central Asia, currently a Kazakh State company, and no problems are currently envisaged with respect to exporting the Company's gas through this system, it may be that in the future the trunkline owners refuse to take the Company's gas, impose excessively high transportation charges, or that the trunkline capacity may be reached. Although the Company does not regard these risks as significant at present there is a possibility that they may occur in the future. The trunkline carries gas from Central Asia through Kazakhstan and into the Russian export system and consequently as any problems would have adverse implications for the economy of Uzbekistan in particular and to a lesser

extent the Russian economy, it is anticipated that there would be significant efforts to minimize any break in supply. However there are external factors that may affect this. For example in December 2008 – January 2009 a dispute between the Russian gas company RAO GazProm and Ukraine resulted in a temporary closure of the Russian gas export system to Europe which, although not directly related, did have a significant knock-on effect of the whole export system, including gas flowing through the Central Asian gas trunkline network.

Environmental

All phases of the oil business present environmental risks and hazards and are subject to environmental regulation pursuant to a variety of international conventions and state and municipal laws and regulations. Environmental legislation provides for, among other things, restrictions and prohibitions on spills, releases or emissions of various substances produced in association with oil and gas operations. The legislation also requires that wells and facility sites be operated, maintained, abandoned and reclaimed to the satisfaction of applicable regulatory authorities. Compliance with such legislation can require significant expenditures and a breach may result in the imposition of fines and penalties, some of which may be material. Environmental legislation is evolving in a manner expected to result in stricter standards and enforcement, larger fines and liability and potentially increased capital expenditures and operating costs. The discharge of oil, natural gas or other pollutants into the air, soil or water may give rise to liabilities to foreign governments and third parties and may require the Company to incur significant costs to remedy such discharge. No assurance can be given that changes in environmental laws or their application to the Company's operations will not result in a curtailment of production or a material increase in the costs of production, development or exploration activities or otherwise adversely affect the Company's financial condition, results of operations or prospects.

Reliance on Third Party Operators and Key Personnel

To the extent that the Company is not the operator of its properties, as the Company will be dependent upon other guarantors or third parties' operations for the timing of activities and will be largely unable to control the activities of such operators. In addition, the Company's success depends, to a significant extent, upon management and key employees. The loss of key employees could have a negative effect on the Company. Attracting and retaining additional key personnel will assist in the expansion of the Company's business. The Company faces significant competition for skilled personnel. There is no assurance that the Company will successfully attract and retain personnel required to continue to expand its business and to successfully execute its business strategy.

Cost of New Technologies

The oil and gas industry is characterized by rapid and significant technological advancements and introductions of new products and services utilizing new technologies. Other oil and gas companies may have greater financial, technical and personnel resources that allow them to enjoy technological advantages and may in the future allow them to implement new technologies before the Company does. There can be no assurance that the Company will be able to respond to such competitive pressures and implement such technologies on a timely basis or at an acceptable cost. One or more of the technologies currently utilized by the Company or implemented in the future may become obsolete. In such case, the Company's business, financial condition and results of operations could be materially adversely affected. If the Company is unable to utilize the most advanced commercially available technology, the Company's business, financial condition and results of operations could be materially adversely affected.

Production Delays

There is a possibility of delays in obtaining the necessary governmental approvals to commence or increase production. Any such delays could reduce the Company's revenues and income below those anticipated in the Company's business plan.

Property Interests and Governmental Approvals

The interest of the Company's subsidiaries in the Kyzyloi gas field, Akkulka Block and Kul-Bas Block are represented by contracts and licenses with Kazakhstan governmental agencies (the "**Kazakh Contracts**") which grant the holder the exploration and production rights over a defined area. Ownership of the land covered by the Kazakh Contracts remains with the relevant governmental agencies. The Kazakh Contracts to which the Company's subsidiaries are a party, and pursuant to which a licence(s) is granted to the Company's subsidiaries, are subject to certain conditions, including minimum expenditure and reimbursement requirements, and requirements to minimum contributions to socio-economic

development funds. In addition, the Kazakh Contracts are subject to periodic renewal. While the Company expects that the Kazakh Contracts will be renewed in the ordinary course throughout the life of the relevant area, there is a risk that the Kazakh Contracts may not be renewed on a timely basis or may not be renewed on terms satisfactory to the Company. There is also a risk that prior renewals or extensions of the Kazakh Contracts may be challenged by third parties as a result of delayed renewals or extensions. Moreover, as any transfer of the Kazakh Contracts requires governmental consent, the ability of the Company to transfer the Kazakh Contracts in the future or use the Kazakh Contracts as a security for future borrowing may be restricted. There is also a risk that governmental agencies may seek compensation for foregone revenue resulting from prior delays in execution of certain of the Kazakh Contracts, including the Kyzyloi gas field Licence and Production Contract.

In addition to consents described above in respect of the Kazakh Contracts, the purchase and sale of oil and gas properties and oil and gas businesses in Kazakhstan is subject to approval of the Ministry of Energy and Mineral Resources of Kazakhstan ("MEMR") and the Kazakhstan government's waiver of its priority right to purchase the alienated oil and gas assets and businesses. Business acquisitions may also be subject to review by the Committee for Protection of Competition of the Ministry of Industry and Trade (the "**Antimonopoly Committee**") under Kazakhstan antimonopoly legislation and may be subject to findings of non-compliance with other regulatory authorities. Although the Company is of the view that it has obtained the required consents of the MEMR and the necessary Kazakhstan government's waiver in respect of its acquisitions to date, the Company is not in a position to verify its compliance with the antimonopoly legislation, if required. Failure to obtain the Antimonopoly Committee's approval does not make the transaction invalid, although Kazakhstan's antimonopoly legislation gives the Antimonopoly Committee authority to intervene in cases of activities considered to be monopolistic, including the right to file a claim in a court to invalidate prior acquisitions if the transactions violated the antimonopoly legislation. Prior and future acquisitions and divestitures by the Company may be subject to review and possible invalidation by a court if considered to be contrary to antimonopoly legislation.

The interest of the Company's subsidiaries in the Bokhtar Area in Tajikistan is represented by the PSC which grants Kulob Petroleum Limited exploration and production rights over a defined area. The PSC is subject to certain conditions, including minimum expenditure and work programme commitments and as it is the first contract of its type in Tajikistan there are inherent risks associated with its ultimate implementation, despite that fact that disputes under the PSC are arbitrated under Swedish Law. There is also a risk that the PSC may not be renewed after its initial 25 year term.

Conflicts of Interest

Certain of the directors of the Company may have associations with other oil and gas companies or with other industry participants with whom the Company does business. The directors of the Company are required by applicable corporate law to act honestly and in good faith with a view to the Company's best interests and to disclose any interest which they may have in any project or opportunity to the Company. However, their interests in the other companies may affect their judgment and cause such directors to act in a manner that is not necessarily in the best interests of the Company.

Risks Related to the Republics of Kazakhstan and Tajikistan

Political, Economic, Legal and Fiscal Instability

Kazakhstan and Tajikistan are former constituent republics of the Soviet Union. At the time of their respective independence in 1991, each became a member of the CIS. Because Kazakhstan and Tajikistan have a relatively short history of political stability as independent nations and have experienced significant change in adapting to a market oriented economy, there is significant potential for social, political, economic, legal and fiscal instability. These risks include, among other things:

- local currency devaluation;
- civil disturbances;
- exchange controls or availability of hard currency;

- changes in crude oil and natural gas export and transportation regulations;
- changes with respect to taxes, royalty rates, import and export tariffs, and withholding taxes on distributions to foreign investors;
- changes in legislation applicable to oil and gas exploration, development and acquisition activities;
- nationalisation or expropriation of property; and
- interruption or blockage of oil or natural gas exports.

The occurrence of any of these factors could have a material adverse affect on the Company's business, financial condition and results of operations. In addition, adverse economic conditions in Kazakhstan or Tajikistan could have a material adverse affect on the Company's business, financial condition and results of operations.

Further, Kazakhstan and Tajikistan also depend on neighbouring states to access world markets for a number of their exports, including oil and gas. Kazakhstan and Tajikistan are thus dependent upon good relations with its neighbours to ensure their ability to export. Although one of the aims of economic integration within the CIS is to assure continued access to export routes, should access to those routes be materially impaired, this could adversely impact the economies of Kazakhstan and Tajikistan.

Tajikistan has, since its independence from the former Soviet Union, suffered a destructive civil war which not only caused significant damage to the infrastructure and industry of the country, but also led to regional and ethnic rivalries. Although the situation has stabilized since 1997, there is still the potential for instability, particularly with respect to these regional rivalries, and the potential for the emergence of radical Islamist groups. Tajikistan is the poorest country in Central Asia, and this poverty may lead to further civil unrest and potential disruption to the Company's business. Tajikistan's proximity to Afghanistan may lead to further instability dependent on the situation in that country. Certain areas of the country are still military exclusion zones, especially towards the Afghanistan border, and in some areas there may be uncleared landmines, a product of both the civil war and the troubles in Afghanistan.

Like other countries in Central Asia, Kazakhstan and Tajikistan could be affected by military action taken in the region, including in Afghanistan and the effect such military action may have on the world economy and political stability of other countries. In particular, countries in Central Asia, such as Kazakhstan and Tajikistan, whose economies and state budgets rely in part on the export of oil, gas and other commodities, the import of capital equipment and significant foreign investments in infrastructure projects, could be adversely affected by any resulting volatility in oil, gas and other commodity prices and by any sustained fall in them or by the frustration or delay of any infrastructure projects caused by political or economic instability in countries engaged in such projects. In addition, instability in other countries, such as Russia, has affected in the past, and may materially affect in the future, economic conditions in Kazakhstan and Tajikistan.

The transition of Kazakhstan and Tajikistan to market oriented economies marked in the earlier years by political uncertainty and tension, a recessionary economy marked by high inflation and instability of the local currency and rapid, but incomplete, changes in the legal environment. Although reforms designed to establish a free market economy have been adopted, there can be no assurance that such reforms will continue or that such reforms will achieve all or any of their intended aims.

Legal and Regulatory Environment in Kazakhstan

Kazakhstan's foreign investment, petroleum, subsoil use, licensing, corporate, tax, customs, currency, banking and antimonopoly laws and legislation are still developing and uncertain. From time to time, including the present, draft laws on these subjects are prepared by government ministries and some have been submitted to Parliament for approval. Legislation in respect of some or all of these areas could be passed. Currently, the regulatory system contains many inconsistencies and contradictions. Many of the laws are structured to provide substantial administrative discretion in their application and enforcement. In addition, the laws are subject to changing and different interpretations. These factors mean that even the Company's best efforts to comply with applicable law may not always result in compliance. Non-compliance may have consequences disproportionate to the violation. The uncertainties, inconsistencies and contradictions in Kazakh laws and their interpretation and application could have a material adverse affect on the Company's business and results of operations.

The judicial system in Kazakhstan may not be fully independent of outside social, economic and political forces, and court decisions can be difficult to predict. In addition, senior Kazakh government officials may not be fully independent of outside economic forces owing to the underdeveloped regulatory supervision system enabling improper payments to be made without detection. Both Kazakhstan and TAG are signatories to the Extractive Industries Transparency

Initiative promoted by the UK government. This initiative supports improved governance in resource-rich countries through the verification and full publication of company payments and government revenues from oil and gas and which also works to build multi-stakeholder partnerships in developing countries in order to increase the accountability of governments. In addition, the government of Kazakhstan has stated that it believes in continued reform of the corporate governance processes and will ensure discipline and transparency in the corporate sector to promote growth and stability. However, there can be no assurance that the Kazakh government will continue such policy, or that such policy, if continued, will ultimately prove to be successful. Therefore, it is not possible to predict the effect of future legislative developments on the Company's business and prospects.

The Company's exploration and production licences, hydrocarbon contract and other agreements may be susceptible to revision or cancellation, and legal redress may be uncertain, delayed or unavailable. In addition, it is often difficult to determine from governmental records whether statutory and corporate actions have been properly completed by the parties or applicable regulatory agencies. Ensuring the Company's ongoing rights to licences and its hydrocarbon contracts will require a careful monitoring of performance of the terms of the licences and hydrocarbon contracts, and monitoring the evolution under Kazakh laws and licencing practices.

Foreign Exchange Fluctuations in Kazakhstan

To the extent that the Company or its subsidiaries or affiliates hold Tenge positions, there is a risk from foreign exchange fluctuations. Prior to its devaluation on February 4, 2009 the Tenge had been relatively stable for a year or two though between its introduction in 1993 and 2002, the Tenge depreciated significantly against the U.S. dollar, in two cases over a short period of time. The Company cannot assure prospective investors that the Tenge will not experience further depreciation against the U.S. dollar. The Company also cannot assure prospective investors that Tenge will continue to be freely exchangeable into U.S. dollars or that the Company will be able to exchange sufficient amounts of Tenge into U.S. dollars to pay interest to meet its other foreign currency obligations. Although some of its expenses and revenues are in Tenge, the Company's financial statements are reported in U.S. dollars, consistent with the practice in the oil and gas industry. If the exchange rate of the Tenge fluctuates substantially or the rate of inflation materially increases in Kazakhstan in the future, the Company's financial statements may not be indicative of its future performance and may not accurately reflect the U.S. dollar value of its assets or current operations.

Taxation Risks and Issues in Kazakhstan

The taxation system in Kazakhstan is at an early stage of development and the tax risks and problems with respect to its operations and investment in Kazakhstan are significant. Tax legislation is evolving and is subject to different and changing interpretations as well as inconsistent enforcement at both the local and state levels. Laws related to these taxes have not been in force for significant periods in contrast to more developed market economies, therefore, regulations are often unclear or nonexistent. Accordingly, few precedents with regard to issues have been established.

Tax declarations, together with other legal compliance areas (as examples, customs and currency control matters) are subject to review and investigation by a number of authorities, who are enabled by law to impose extremely severe fines, penalties and interest charges. These facts create tax and other risks in Kazakhstan substantially more significant than typically found in countries with more developed tax systems.

All legal entities carrying on activities in Kazakhstan must be registered with the local tax committee. Taxes in Kazakhstan include income tax, value added tax, excise tax, social tax, land tax, property tax, transport tax, as well as required contributions to various funds, duties and fees for licences. In addition, the Company has, through its various operations, been making and expects to continue to make, contributions to various social funds.

Additional payments, such as signing bonuses, commercial discovery bonuses, royalties and excess profit taxes, are required from oil and gas companies and other subsoil users. A signing bonus is a one-time payment for the rights to explore and/or develop and produce resources. A commercial discovery bonus is a one-time payment for each commercial discovery and is payable once a discovery of commercial value is made in a contract territory as well as for any increase in reserves. Excess profit tax is payable pursuant to all subsurface use contracts executed before January 1, 2004, applying sliding scale rates with increasing rates of excess profit tax of up to 30% if the project IRR is greater than 30%. For subsurface use contracts executed after January 1, 2004, excess profit tax is calculated using as the tax base the net income of a subsurface user in excess of 20% of tax deductions. The rates of excess profit tax are established on a sliding scale ranging from 10% to 60%, using the after tax profit as the tax base, and depends on the net income and deductions of a subsurface user.

On January 1, 2004, the Kazakh government adopted changes to the tax regime covering subsoil users. Such changes include: (i) there being no tax stability for contracts, other than production sharing agreements signed after January 1,

2004; (ii) changes to the current procedures for establishing royalties (including those for oil and gas producers); (iii) changes to the current procedures for determining the value of extracted hydrocarbons; (iv) the establishment of a new rent tax for exported crude oil; (v) increased excess profit taxes; and (vi) changes to the tax regime for production sharing agreements. The above changes will generally only impact subsoil users that have entered into hydrocarbon contracts after January 1, 2004, including any new hydrocarbon contracts entered into by the Company.

The uncertainty of application and the evolution of tax laws creates a risk of additional payment of tax by the Company, especially for contracts entered into after January 1, 2004, which could have a material adverse affect on the Company's business, financial condition and results of operations.

Legal and Regulatory Framework in Tajikistan

Tajikistan adopted production sharing legislation in 2008 and the Company's PSC is the first to be adopted under the new regulatory regime. As the legal and regulatory framework for oil and gas is emerging in Tajikistan, it is possible that the terms of such a PSC may be challenged, additional taxes may be imposed, or may be found to conflict with other Tajik laws and regulations. There may also be problems with repatriation of currency from Tajikistan, and in the use of the banking system.

Taxation Risks and Issues in Tajikistan

Although under the PSC all of KPL's tax obligations are covered through the State's share of production, the taxation system in Tajikistan is at an early stage of development and the tax risks and problems with respect to its operations and investment in Tajikistan are significant. Tax legislation is evolving and is subject to different and changing interpretations as well as inconsistent enforcement at both the local and state levels. Laws related to these taxes have not been in force for significant periods in contrast to more developed market economies, therefore, regulations are often unclear or nonexistent. Accordingly, few precedents with regard to issues have been established. Despite the fact that the Company's CEO currently sits on the Consultative Council for the Improvement of the Investment Climate under the President of Tajikistan there can be no guarantee that such involvement can prevent negative changes in the business environment which may affect the Company.

Tax declarations, together with other legal compliance areas are subject to review and investigation by a number of authorities, who are enabled by law to impose extremely severe fines, penalties and interest charges. These facts create tax and other risks in Tajikistan substantially more significant than typically found in countries with more developed tax systems. In addition, amendments to current Tajikistan taxation laws and regulations which alter tax rates and/or capital allowances could have a material adverse impact on the Company.

Taxes in Tajikistan include income tax, value added tax, excise tax, social tax, land tax, property tax, transport tax, as well as fees for licences. Profits are taxed at a rate of 25% of taxable income (calculated as revenue less permitted deductions). VAT at a rate ranging to 20% is imposed on goods produced in Tajikistan and goods imported into Tajikistan. In addition, payments due to state agencies in respect of oil and gas production are determined under the particular terms of production sharing agreements.

Foreign Exchange Fluctuations in Tajikistan

To the extent that the Company or its subsidiaries or affiliates hold positions in the local Tajik currency, the Somoni, there is a risk from foreign exchange fluctuations. The same would apply to sales contracts or purchase / service / employment contracts denominated in Somoni. In the period to December 31, 2008 such issues were not material but may become material as the Company further develops its business in Tajikistan. As for the Kazakhstan Tenge the Company cannot assure prospective investors that the Somoni will not experience depreciation against the U.S. dollar nor that it will continue to be freely exchangeable into U.S. dollars or that the Company will be able to exchange sufficient amounts of Somoni into U.S. dollars to pay interest to meet its other foreign currency obligations. Although some of its expenses and future revenues will be in Somoni, the Company's financial statements are reported in U.S. dollars, consistent with the practice in the oil and gas industry. If the exchange rate of the Somoni fluctuates substantially or the rate of inflation materially increases in Tajikistan in the future, the Company's financial statements may not be indicative of its future performance and may not accurately reflect the U.S. dollar value of its assets or current operations.

Lack of Infrastructure in Tajikistan

Tajikistan depends on neighbouring countries to access world markets, and this could lead to problems bringing in equipment and services to the country, as well as exporting products. There are only limited oil refining facilities in Tajikistan, and as such any crude oil will require export, either to regional refineries or to world markets. There are no

guarantees that this export will be allowed by the surrounding countries, and/or additional taxes or levies imposed, or prices offered being substantially less than world market prices. Similarly the gas infrastructure is poorly developed and maintained in Tajikistan, and although pipelines exist, it is possible that such infrastructure would not be available to the Company on commercially attractive terms, or may be unsuitable. Similarly export of gas to world markets would require access to pipelines and infrastructure in neighbouring countries and such access may not be given, or not be given on commercially attractive terms.

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March 31, 2009

Auditors' Report

To the Shareholders of
Tethys Petroleum Limited

We have audited the consolidated balance sheets of Tethys Petroleum Limited as at December 31, 2008 and 2007 and the consolidated statements of operations and comprehensive loss, changes in stockholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

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

PricewaterhouseCoopers LLP

Chartered Accountants
Calgary, Alberta

PricewaterhouseCoopers refers to the Canadian firm of PricewaterhouseCoopers LLP and the other member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

TETHYS PETROLEUM LIMITED
(formerly known as Tethys Petroleum Investments Limited)

Consolidated Balance Sheet

	Note	As at December 31, 2008	December 31, 2007
		(Expressed in 000's United States dollars)	
ASSETS			
Current Assets			
Cash and cash equivalents		22,200	26,692
Prepayments	**3**	900	351
Accounts Receivable		1,124	219
Inventory		213	-
Other current assets		640	790
Total current assets		25,077	28,052
Non Current Assets			
Prepayments	**3**	1,514	3,062
Restricted Cash	**5**	587	318
Value added tax recoverable	**6**	4,843	2,752
Capital assets	**7**	73,793	37,472
Total non-current assets		80,737	43,604
Total Assets		105,814	71,656
LIABILITIES AND STOCKHOLDERS' EQUITY			
Current Liabilities			
Accounts payable		1,219	1,388
Current portion of long term debt	**8**	853	-
Accrued & other liabilities		1,516	891
Total current liabilities		3,588	2,279
Non Current Liabilities			
Long term debt	**8**	5,096	-
Other non-current liabilities	**9**	523	776
Asset retirement obligation	**10**	433	661
Total non current liabilities		6,052	1,437
Total Liabilities		9,640	3,716
Stockholders' equity	**13**		
Share capital		145,237	99,483
Contributed Surplus	**14**	7,472	3,527
Warrants	**15**	17,717	16,555
Accumulated deficit		(74,252)	(51,625)
Total stockholders' equity		96,174	67,940
Total Liabilities and Stockholders' Equity		105,814	71,656
Commitments and contingencies	**11**		

See accompanying notes to these financial statements

Approved by the board of directorson March 31, 2008

"D Robson" Director

"B Murphy" Director

TETHYS PETROLEUM LIMITED
(formerly known as Tethys Petroleum Investments Limited)

Consolidated Statement of Operations and Comprehensive Loss

	Note	Year ended December 31, 2008	2007
		(Expressed in 000's United States dollars except share data)	
Revenues Net of Royalties			
Oil and gas sales		5,360	194
		5,360	194
Expenses			
Operating		1,334	19
Selling, general and administrative		13,421	9,461
Stock based compensation	**14**	3,945	17,624
Depreciation, depletion and amortization (2007 includes ceiling test write down of $12.8 million)	**7**	6,449	13,057
		25,149	40,161
Operating Loss		(19,789)	(39,967)
Other Income/(Expense):			
Interest, net		754	(1,437)
Foreign exchange (losses)		(3,060)	(96)
Finance charges		(373)	(238)
Other		(159)	(41)
Total Other (Expense)		(2,838)	(1,812)
Loss Before Income Taxes		(22,627)	(41,779)
Income taxes		-	-
Net Loss and Comprehensive Loss for the year		(22,627)	(41,779)
Weighted average number of common shares outstanding	**14**	55,987,525	33,274,413
Basic and diluted loss per share		(0.40)	(1.26)

See accompanying notes to these financial statements

Consolidated Statement of Cash Flows

		Year ended December 31	
		2008	**2007**
		(Expressed in 000's United States dollars)	
Operating activities:			
Net loss for the year		(22,627)	(41,779)
Items not affecting cash			
Stock based compensation		3,945	17,624
Accretion		56	-
Finance costs		-	238
Non-cash interest expense		-	1,916
Depreciation, depletion and amortization		6,449	13,057
Unrealised foreign exchange loss		1,363	-
Net change in non-cash working capital items	**4**	(844)	(305)
Net cash used in operating activities		(11,658)	(9,249)
Investing activities:			
Capital expenditures		(42,343)	(23,001)
Restricted cash		(269)	(113)
Value added tax recoverable		(2,091)	(1,666)
Change in oil & gas suppliers prepayments		1,548	820
Net change in non-cash working capital items		(217)	226
Net cash used in investing activities		(43,372)	(23,734)
Financing activities:			
Proceeds from sale of common stock		50,000	67,337
Share issue costs		(4,246)	(5,169)
Proceeds (Repayment) from long term debt		7,430	(5,000)
Amortisation of debt discount		(1,030)	-
Other non-current liabilities		(253)	744
Net cash provided by financing activities		51,901	57,912
Foreign exchange loss on cash held in foreign currency		(1,363)	-
Net increase/(decrease) in cash and cash equivalents		(4,492)	24,929
Cash and cash equivalents, beginning of year		26,692	1,763
Cash and cash equivalents, end of year		22,200	26,692
Supplemental disclosure of cash and non-cash transactions			
Interest paid		454	375

See accompanying notes to these financial statements

TETHYS PETROLEUM LIMITED
(formerly known as Tethys Petroleum Investments Limited)

Consolidated Statements of Changes in Stockholders' Equity

	Common Stock					
	No of Shares Issued	**Share Capital**	**Contributed Surplus**	**Warrants Reserve**	**Accumulated Deficit**	**Total Stockholders' Equity**
		(Expressed in 000's United States dollars except share data)				
Total December 31, 2006	70,000,000	22,315	-	2,220	(9,846)	14,689
Shares Issued pursuant to Private Placement	34,674,390	17,337	-	-	-	17,337
	104,674,390	39,652	-	2,220	(9,846)	32,026
Share restructure 1:5	20,934,878	39,652	-	2,220	(9,846)	32,026
Issue of shares to acquire 30% of BN Munai	6,000,000	15,000	-	-	-	15,000
Initial Public Offering (IPO)	18,181,818	50,000	-	-	-	50,000
Share Warrants and Options	-	-	3,527	14,335	-	17,862
Finance Costs	-	(5,169)	-	-	-	(5,169)
Net loss in 2007	-	-	-	-	(41,779)	(41,779)
Total December 31, 2007	45,116,696	99,483	3,527	16,555	(51,625)	67,940
Share Warrants and Options	-	-	3,945	1,162	-	5,107
Public offering	21,276,596	50,000	-	-	-	50,000
Share issue costs	-	(4,246)	-	-	-	(4,246)
Net loss in 2008	-	-	-	-	(22,627)	(22,627)
Total December 31, 2008	66,393,292	145,237	7,472	17,717	(74,252)	96,174

See accompanying notes to these financial statements

TETHYS PETROLEUM LIMITED
(formerly known as Tethys Petroleum Investments Limited)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2008

NOTE 1 - NATURE OF OPERATIONS AND GOING CONCERN

Tethys Petroleum Limited (formerly known as Tethys Petroleum Investments Limited) was headquartered in Guernsey, British Isles and incorporated in the Cayman Islands. The Company's domicile was moved from Guernsey, British Isles to the Cayman Islands on July 17, 2008. Tethys Petroleum Limited and its consolidated subsidiaries (collectively "Tethys" or "the Company"), is an oil and gas company operating within the Republic of Kazakhstan and the Republic of Tajikistan. Tethys' principal activity is the acquisition of and development of crude oil and natural gas fields.

Significant Business Risks and Basis of Presentation

Since inception, the Company has incurred significant losses from operations and negative cash flows from operating activities, and has an accumulated deficit at December 31, 2008. Also as described in note 11, the Company has significant short-term and longer term contractual commitments that will necessitate cash outflows. The ability of the Company to successfully carry out its business plan is primarily dependent upon its ability not only to maintain the current level of gas production but also to achieve further production of commercial oil and gas and to control the costs of operating and capital expenditures. While these factors create doubt about the Company's ability to continue as a going concern, management is confident of achieving the Company's short term plans.

The Company completed an Initial Public Offering (IPO) of equity securities on the Toronto Stock Exchange (TSX) on June 27, 2007. The Company subsequently issued additional capital for gross proceeds of US$50,000,000 on June 27, 2008 that generated sufficient funds to secure its future at least in the short term. In the event the Company is unable to generate significant revenues and cash flows from operations it may need to seek further funding from its shareholders or alternative sources. There can be no assurances that management will be successful with these initiatives.

The financial statements have been prepared on the basis that the Company will continue to operate as a going concern, which contemplates the realization of assets and the settlement of liabilities and commitments in the normal course of business. These financial statements do not reflect adjustments in the carrying values of assets and liabilities reported, revenue or expenses and the balance sheet classification used, that would be necessary if the going concern assumption was not appropriate. Such adjustments could be material.

Foreign Operations

Tethys' future operations and earnings will depend upon the results of Tethys' operations in the Republics of Kazakhstan and Tajikistan. There can be no assurance that Tethys will be able to successfully conduct such operations, and a failure to do so would have a material adverse effect on Tethys' financial position, results of operations and cash flows. Also, the success of Tethys' operations will be subject to numerous contingencies, some of which are beyond management control. These contingencies include general and regional economic conditions, prices for crude oil and natural gas, competition and changes in regulation. Since Tethys is dependent on international operations, specifically those in Kazakhstan and Tajikistan, Tethys will be subject to various additional political, economic and other uncertainties. Among other risks, Tethys' operations may be subject to the risks and restrictions on transfer of funds, import and export duties, quotas and embargoes, domestic and international customs and tariffs, and changing taxation policies, foreign exchange restrictions, political conditions and regulations.

Concentration of Credit Risk

Although Tethys' cash and cash equivalents and accounts receivable are exposed to potential credit loss, Tethys does not believe such risk to be significant.

In order to reduce concentration of credit risk associated with cash and cash equivalent balances, the Company has spread its cash investments over three recognized financial institutions with appropriate credit ratings. Although a

significant amount of the deposits at financial institutions are not covered by bank guarantees, the Company does not believe there to be a significant risk of credit loss.

Concentration of credit risk associated with accounts receivable balances is as a result of contracted gas sales to only one customer during the year. The Company does not believe it is dependent upon this customer for sales due to the nature of gas products and the associated market. The Company's sales commenced in December 2007 and the Company has not experienced any credit loss to date. Although a portion of the Accounts receivable balance has been outstanding more than 60 days as at December 31, 2008, the Company has not recorded a provision against the amount as it does not consider the balance to be impaired.

Market Risks

As an independent oil and gas producer, Tethys' revenue, profitability and future rate of growth are substantially dependent upon prevailing prices for oil and gas, which are dependent upon numerous factors beyond Tethys' control, such as economic, political and regulatory developments and competition from other sources of energy. The energy markets have historically been very volatile, and there can be no assurance that oil and gas prices will not be subject to wide fluctuations in the future. A substantial or extended decline in oil and gas prices could have a material adverse effect on Tethys' financial position, results of operations, cash flows and Tethys' access to capital and on the quantities of oil and gas reserves that may be economically produced.

Gas Pipeline

The Company is economically dependent on Bukhara-Urals trunk line. The trunk line carries gas from Central Asia through Kazakhstan and into the Russian export system. If anything adverse should occur to restrict the operation of the trunk line then the sales revenue would cease. The Bukhara-Urals trunk line is owned by Intergas Central Asia which is currently a Kazakh State company and no problems are currently envisaged with respect to exporting the Company's gas through the system. However, there is no guarantee that the trunk line owners will continue to accept the Company's gas, that excessively high transportation charges won't be imposed, or that the trunk line capacity will be available to the Company. Although the Company does not regard this as a significant risk at present, there is a possibility that the Company may encounter these situations in the future. The Uzbekistan economy, and to a lesser extent the Russian economy, are also dependent upon the Bukhara-Urals pipeline and consequently, Management expects that there would be significant efforts to minimize any break in supply.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The Consolidated Financial Statements and notes thereto are prepared in accordance with accounting principles generally accepted in the United States of America (US GAAP). All dollar amounts are expressed in United States (U.S.) dollars. Tethys has adopted U.S. dollars as the reporting and functional currency since its revenue and expenses are closely tied to the U.S. dollar and in order to facilitate a more direct comparison to other international crude oil and natural gas exploration and development companies. All references to US$ and $ are to the Unites States dollar. All tabular amounts are in thousands of United States dollars.

Principles of Consolidation

The Consolidated Financial Statements include the accounts of Tethys and its wholly owned subsidiaries and are presented in accordance with generally accepted accounting principles of the United States of America (US GAAP). All significant intercompany transactions and accounts have been eliminated.

In most respects, the accounting policies applied conform to accounting principles generally accepted in Canada (Canadian GAAP). The differences between US GAAP and Canadian GAAP that apply to the Company are explained in Note 19)

Measurement Uncertainty

The preparation of financial statements in conformity with US GAAP requires Management to make estimates and assumptions, and use judgments regarding the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the Consolidated Financial Statements and the reported amounts of revenues and expenses during the reporting period. Such estimates primarily relate to unsettled transactions and events as of the date of the Consolidated Financial Statements. Accordingly, actual results may differ from those estimates amounts as future confirming events occur.

Amounts recorded for depreciation, depletion and amortisation, asset retirement costs and obligations and amounts used for ceiling test and impairment calculations are based on estimates of natural gas reserves and the costs to be incurred for developing those reserves. By their nature, these estimates of reserves, including estimates of prices, costs and related future cash flows are subject to measurement uncertainty. Refer to note 7 for additional disclosure relating to the measurement uncertainty specific to the Company's full cost ceiling test.

The amount of valuation allowance against deferred taxes is subject to measurement uncertainty. The estimates, assumption and judgments made in relation to the fair value of stock based compensation and warrants and the associated expense recognition is subject to measurement uncertainty. The estimated fair value of financial assets and liabilities, by their very nature, are subject to measurement uncertainty.

Accordingly, the impact of these estimates, assumptions and judgments on the Consolidated Financial Statements in future periods could be material.

Cash and Cash Equivalents

Cash and cash equivalents includes cash in hand, deposits held at call with banks, other short-term highly liquid investments with original maturities of three months or less.

Inventory

Inventory is valued at the lower of cost or net realisable value and on a first in, first out basis.

Fair Value of Financial Instruments

The fair value of cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities approximate their carrying amount due to the short term maturity of the instruments. Long term debt and other non-current liabilities have been recorded at amortized cost using the effective interest rate method.

Property, plant and equipment

Oil and Gas Properties

Tethys accounts for oil and gas properties and interests in accordance with the full cost accounting method. Under the full cost method, all directly attributable acquisition, exploration and development costs associated with oil and gas properties are capitalized on a country by country cost centre basis.

Capitalized costs include the cost of drilling and equipping productive wells, including the estimated costs of dismantling and abandoning these assets, dry hole costs, lease acquisition costs, seismic and other geological and geophysical costs, delay rentals and costs related to such activities. General and administrative costs directly attributable to the exploration and development of oil and gas properties are also capitalised.

Proved oil and gas properties

Costs accumulated within each cost centre are depreciated, depleted and amortized using the unit-of-production method based on estimated proved reserves. Capitalized costs subject to depletion include estimated future costs to be incurred in developing proved reserves. Proceeds from the divestiture of properties are normally deducted from the full cost pool

without recognition of gain or loss unless that deduction would result in a change to the rate of depreciation, depletion and amortization of 20 percent or greater, in which case a gain or loss is recorded. Costs of major development projects and costs of acquiring and evaluating significant unproved properties are excluded, on a cost centre basis, from the costs subject to depletion until it is determined whether or not proved reserves are attributable to the properties, or impairment has occurred. Costs that have been impaired are included in the costs subject to depreciation, depletion and amortization.

An impairment loss is recognized in net earnings when the carrying amount of a cost centre is not recoverable and the carrying amount of the cost centre exceeds the sum of the discounted cash flows from proved reserves. The discounted cash flow calculation assumes constant pricing, discounts the cash-flows at 10% and takes into account the expected future costs to develop proved reserves, estimated operating expenses and income taxes (the "ceiling amount"). If the ceiling amount is less than the carrying amount, an impairment loss is recognized in the amount of such deficiency.

Unproved oil and gas properties

The costs of investments in unproved properties and portions of costs associated with major development projects are excluded from the calculation of depreciation, depletion and amortization until it is determined whether or not proved reserves are attributable to the properties exist, or impairment has occurred.

In cost centres where proved reserves have been established, significant unproved properties are evaluated periodically, but not less than annually, for impairment. If a reduction in value has occurred, these property costs are considered impaired and are transferred to the related full cost pool. Unproved properties whose acquisition costs are not individually significant are aggregated and the portion of such costs estimated to be ultimately non-productive, based on experience is amortized to the full cost pool over an average holding period.

In cost centres where the existence of proved reserves has not yet been determined, leasehold costs, seismic costs and other costs incurred during the exploration phase remain capitalized in unproved property cost centres until proved reserves have been established or until exploration activities cease or impairment occurs. If exploration activities result in the establishment of a proved reserve base, amounts in the unproved property cost centre are reclassified as proved properties and become subject to depreciation, depletion and amortization and the application of the ceiling test. If exploration efforts are unsuccessful in establishing proved reserves, it may be determined that the value of exploratory costs incurred there have been permanently diminished in part or in whole. Therefore, based on the impairment evaluation and future exploration plans, the unproved property cost centres related to the area of interest could be impaired, and accumulated costs charged against earnings.

Oil and gas equipment

Drilling rigs are carried at cost less accumulated depreciation using the unit of production method based on the number of operating days. Management estimates the useful life of the drilling rigs to be 3,650 operating days. Related drilling rig equipment is depreciated on a straight line basis over the estimated useful life of each asset which ranges from 3 to 15 years.

Corporate assets

Office furniture and fixtures, leasehold improvements and information technology are carried at cost less accumulated depreciation, which is calculated on a straight line basis over the estimated useful life of the asset, which ranges from 3 to 5 years.

Expenditures for major renewals and betterments, which extend the original estimated economic useful lives of applicable assets, are capitalized. Expenditures for normal repairs and maintenance are charged to expense as incurred. The cost and related accumulated depreciation of assets sold or retired are removed from the accounts and any gain or loss thereon is reflected in operations.

If the carrying amount of the asset is not viewed as recoverable, the asset is considered impaired and the carrying value of the asset is reduced to the estimated recoverable amount. See "Impairment of Long-Lived Assets" below.

Revenue Recognition

Tethys recognizes revenues when hydrocarbons have been produced and delivered and payment is reasonably assured.

Foreign Currency Translation

The US dollar is the functional currency for Tethys and its subsidiaries' operations. All monetary assets and liabilities denominated in foreign currency are translated into US dollars at the rate of exchange in effect at the balance sheet date and the resulting unrealized translation gains or losses are reflected in operations. Non-monetary assets are translated at historical exchange rates. For the Kazakhstan and Tajikistan entities, revenue and expense items (excluding depreciation and amortization which are translated at the same rates as the related assets) are translated at the average rate of exchange. In all other entities, foreign currency transactions are translated into the functional currency using the exchange rate prevailing at the date of transaction.

Income Taxes

The Company accounts for income taxes under the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the financial statements. The principal temporary differences arise from depreciation on property, plant and equipment, and tax losses carried forward and, in relation to acquisitions, on the differences between the fair values of the net assets acquired and their tax base. Tax rates enacted by the balance sheet date are used to determine the deferred income tax. Deferred tax assets and liabilities are recognized for the expected future tax consequences of events that have been recognized in the financial statements or tax returns. A valuation allowance is provided for deferred tax assets if management consider it is more likely than not that these items will either expire before the Company is able to realize the benefit, or that future deductibility is uncertain.

Impairment of Long Lived Assets

The Company evaluates its long lived assets, other than its oil and gas properties, for impairment using the guidance of Statement of Financial Accounting Standard ("SFAS") 144 *Accounting for the Impairment or Disposal of Long-Lived Assets*. An impairment loss shall be recognized only if the carrying amount of a long-lived asset or asset group is not recoverable and exceeds its fair value. The carrying amount of a long-lived asset or asset group is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset or asset group. An impairment loss is measured as the amount by which the carrying amount of a long-lived asset or asset group exceeds its fair value.

Asset retirement obligations

The fair value of estimated asset retirement obligations is recognised in the Consolidated Balance Sheet when incurred and a reasonable estimate of fair value can be made.

Asset retirement obligations include those legal obligations where the Company will be required to retire tangible long lived assets such as producing and exploratory well sites. The asset retirement cost, equal to the initially estimated fair value of the asset retirement obligation, is capitalised as part of the cost of the related long lived asset. Changes in the estimated obligation resulting from revisions to the estimated timing or amount of undiscounted cash flows are recognised as a change in the asset retirement obligation and the related asset retirement cost.

Amortisation of asset retirement costs are included in depreciation, depletion and amortisation expense in the Consolidated Statement of Operations and Comprehensive Loss. Increases in the asset retirement obligation resulting from the passage of time are recorded as accretion of asset retirement obligation in the Consolidated Statement of Operations and Comprehensive Loss

Actual expenditures incurred are charged against the accumulated obligation.

Recently Adopted Pronouncements

Fair Value Measurements

As of January 1, 2008 Tethys adopted SFAS 157 *Fair Value Measurements.* This statement replaces multiple existing definitions of fair value with a single definition, establishes a consistent framework for measuring fair value and expands financial statement disclosures regarding fair value measurements. This standard applies where other accounting pronouncements require fair value measurements and does not require new fair value measurements. The adoption of this standard did not have a material impact on the Consolidated Financial Statements.

The Fair Value Option for Financial Assets and Financial Liabilities

As of January 1, 2008 Tethys adopted SFAS 159 *The Fair Value Option for Financial Assets and Financial Liabilities*. This statement permits entities to choose to measure financial assets and liabilities, except those that are specifically scoped out of the Statement, at fair value. The election to measure a financial asset or liability at fair value can be made on an instrument-by-instrument basis and is irrevocable. The Company elected not to adopt the fair value option provisions of SFAS 159 for its financial assets and liabilities. Adoption of this standard did not have a material impact on the Company's Consolidated Financial Statements.

Recently Issued Accounting Pronouncements

In December 2007, the FASB issued SFAS 141 (revised 2007) *Business Combinations* (SFAS 141R), which replaces FASB Statement 141. SFAS 141R will change how business acquisitions are accounted for and will impact financial statements both on the acquisition date and in subsequent periods. SFAS 141R requires the acquiring Company to measure almost all assets acquired and liabilities assumed in the acquisition at fair value as of the acquisition date. SFAS 141R is effective for fiscal years beginning on or after December 15, 2008 and should be applied prospectively with the exception of income taxes which should be applied retrospectively for all business combinations. Early adoption is prohibited. As the Company is adopting IFRS as of January 1, 2009, the adoption of SFAS 141 will not be applicable.

In March 2008, the FASB issued SFAS 161 *Disclosures about Derivative Instruments and Hedging Activities*, (SFAS 161), an amendment to SFAS 133 *Accounting for Derivative Instruments and Hedging Activities*. SFAS 161 requires enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under SFAS 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. This Statement would be effective for the Company's interim and annual consolidated financial statements beginning January 1, 2010. This Statement encourages, but does not require, comparative disclosures for earlier periods at initial adoption. As the Company is adopting IFRS as of January 1, 2009, the adoption of SFAS 161 will not be applicable.

FUTURE CHANGES IN ACCOUNTING POLICY

The Accounting Standards Board (AsSB) confirmed in February 2008 that Canadian publicly accountable enterprises will be required to report in accordance with International Financial Reporting Standards (IFRS) for financial reporting periods beginning on and after January 1, 2011. As a foreign issuer, Tethys has elected to early adopt IFRS and will report in accordance with IFRS from January 1, 2009. Tethys will prepare its first financial statements under IFRS for the interim period ended March 31, 2009.

NOTE 3 – PREPAYMENTS

Prepayments consisted of the following:

	As at December 31,	
	2008	2007
Contractors	1,514	3,062
Other prepayments	900	351
Balance	2,414	3,413

Prepaid contractor amounts relate to suppliers who were paid in advance for materials and services relating to both the Akkulka and the Kul-Bas contracts. For the Akkulka contract, the prepayments relate to the drilling of a new well and payments on compressors, pipes and associated construction work that will constitute phase two of the Company's gas production plan. For Kul-Bas the prepayment related primarily to the drilling of a new well. Refer to note 11 for additional information relating to the above contracts and associated commitments.

Other prepayments primarily relate to prepaid insurance and other corporate operating expense items.

NOTE 4 – NET CHANGES IN NON-CASH WORKING CAPITAL

	Year ended December 31,	
	2008	2007
Accounts receivable	(905)	(219)
Inventory	(213)	-
Other current assets	150	(788)
Prepayments	(549)	(20)
Accounts payable	(169)	510
Accruals and other liabilities	625	438
Balance	(1,061)	(79)

Changes in non-cash working capital are categorised below:

	Year ended December 31,	
	2008	2007
Operating activities	(844)	(305)
Investing activities	(217)	226
Balance	(1,061)	(79)

NOTE 5 – RESTRICTED CASH

Restricted cash at December 31, 2008 consisted of bank deposits that have been placed to satisfy local Kazakhstan requirements in respect of asset retirement obligations.

NOTE 6 – VALUE ADDED TAX RECOVERABLE

Non-current VAT recoverable represents VAT on capital expenditures in Kazakhstan that is allowed as an offset against VAT on revenues.

NOTE 7 - CAPITAL ASSETS

Capital assets, net of accumulated depletion, depreciation and amortization ("DD&A") and impairment, include the following at December 31, 2008:

	Cost	Accumulated DD&A & Impairment	Net Capital Assets
Oil and gas properties			
Proved properties	56,939	(19,060)	37,879
Unproved properties	13,934	-	13,934
	70,873	(19,060)	51,813
Plant and equipment			
Oil & gas equipment	16,830	(72)	16,758
Oil and gas equipment under construction	3,210	-	3,210
Vehicles	1,388	(187)	1,201
Office equipment, furniture, fixtures and other	967	(156)	811
	22,395	(415)	21,980
Balance	93,268	(19,475)	73,793

Capital assets, net of accumulated of accumulated depletion, depreciation and amortization ("DD&A") and impairment, include the following at December 31, 2007:

	Cost	Accumulated DD&A & Impairment	Net Capital Assets
Oil and gas properties			
Proved properties	39,727	(12,975)	26,752
Unproved properties	7,749	-	7,749
	47,476	(12,975)	34,501
Plant and equipment			
Oil and gas equipment	178	-	178
Oil and gas equipment under construction	1,879	-	1,879
Vehicles	579	(19)	560
Office equipment, furniture, fixtures and other	386	(32)	354
	3,022	(51)	2,971
Balance	50,498	(13,026)	37,472

Proved properties consist of both the Kyzyloi and Akkulka contracts contained within the Kazakhstan cost centre. Following the establishment of commercially viable reserves, the proved properties have been subject to depreciation, depletion and amortisation on a unit of production basis.

Unproved property assets relate to activities being carried out in relation to properties where there are no proved reserves as at December 31, 2008. Unproved property costs split by country cost centres are as follows: Kazakhstan US$11,322,000, Tajikistan US$2,484,000 and other Central Asian countries US$128,000.

In the year ended December 31, 2008, US$414,600 of directly attributable general and administrative expense was capitalised to capital assets (2007 – US$316,200). Capitalised borrowing costs for the year ended December 31, 2008 was US$712,000 (2007 - US$312,000).

Oil & gas equipment includes the deep drilling rig, Telesto, plus ancillary equipment that was purchased during the year ended December 31, 2008. The Company purchased an additional drilling rig, 'Tykhe', during 2008 and this asset was under construction as at December 31, 2008. Consequently, no depreciation expense was recorded in relation to this asset. Refer to Note 11 for information regarding the associated purchase commitments.

In accordance with US GAAP a ceiling test was performed as at December 31, 2008. Calculation of the full-cost ceiling was based on constant prices and proved reserves discounted at 10%. The proved reserves balance is supported by the third party reserves report prepared by the Company's independent petroleum engineers. The ceiling test assumes natural gas sales prices in US$/Mcf as follows:

	2009	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**
Kyzyloi	0.90	0.90	0.90	0.90	3.80	3.80	-	-	-
Akkulka	3.80	3.80	3.80	3.80	3.80	3.80	3.80	3.80	3.80

The assumed price of US$3.80 per Mcf for future gas sales is supported by the third party reserves report prepared by the Company's independent petroleum engineers, and represents their best estimate of the future price at which such gas will be sold.

As of the date of finalisation of these Consolidated Financial Statements, this price remains the subject of negotiations which have not been finalised. This is a source of measurement uncertainty in the Company's full cost ceiling test calculations since there can be no assurance that this price will be achieved. Using this assumed price of US$3.80 per Mcf, the Company has a ceiling test cushion (i.e. an excess of discounted future cash flows relating to proved reserves over costs subject to depletion) for the Kazakhstan cost centre balance of US$14.6 million. If the actual realised price is lower than US$3.80 per Mcf, then the amount of this ceiling test cushion would be reduced, or potentially eliminated, in which case a ceiling test impairment would be recognised. The ceiling test cushion would be reduced by approximately US$1.8 million for each US$0.10 diminution of the actual realised price below the assumed price of US$3.80 per Mcf.

NOTE 8 – LONG TERM DEBT

	As at December 31,	
	2008	**2007**
Balance, beginning of year	-	3,084
Proceeds from long term debt issued	7,430	-
Current portion of long term debt	(853)	-
Debt discount	(1,163)	-
Amortisation of debt discount	258	1,916
Principal loan repayments	(576)	(5,000)
Balance, end of year	5,096	-

Drilling rig Telesto

On March 19, 2008 the Company completed a financing arrangement for funds of US$5,300,000 to assist with the purchase of a deep drilling rig (Telesto) by means of a 3-year loan with monthly payments of interest and capital and a final balloon payment. The interest payable on the borrowed funds was 12% per annum. In addition, 795,000 warrants to purchase Tethys shares were also issued to the lenders with a term of 3 years and an exercise price of CAD$3.25. The fair value of the warrants issued was calculated using the Black-Scholes option pricing model. For warrants granted in connection with the loan financing agreement, the fair value on grant date was US$1.23 per warrant, using the following assumptions: dividend yield of 0%; expected term of 3.0 years; a risk free interest rate of 1.64%; and an expected volatility of 69%. Fair value of the warrants issued is US$980,394.

The fair value associated with the warrants issued has been recognised as a debt discount and presented as a direct reduction to the face value of the long-term debt. The effective interest rate method has been applied and results in the amortisation of the debt discount over the life of the loan. For the year ended December 31, 2008, US$257,935 was amortised (2007 - $Nil).

Lenders have security over the shares of Tethys Petroleum Inc. which has no other assets except the drilling rig. No corporate guarantees or security are being provided by Tethys. Borrowing costs of US$712,000 were capitalised to the asset (2007 - $Nil).

Based on the borrowing rates currently available to the Company for loans with similar terms and average maturities, the fair value of long term debt relating to the Telesto drilling rig is US$3,632,968 (2007 - US$Nil).

Principal repayments on the loan amount are required to be made as follows:

		US$'000
To December 31,	2009	853
	2010	962
	2011	2,909
Balance		4,724

Drilling rig 'Tykhe'

At December 31, 2008 the Company received funds of US$2,130,000 relating to a financing arrangement to assist with the purchase of a second drilling rig (Tykhe). The term of the loan is 3-years. In the first year, quarterly payments of interest only are required. In years two and three, monthly payments of interest and capital are payable. A balloon payment is due at the end of year three. The interest payable on the borrowed funds is 15% per annum. In addition, 638,298 warrants to purchase Tethys shares were issued to the lenders with a term of 3 years and an exercise price of CAD$1.25. The fair value of the loan was calculated using the Black-Scholes option pricing model. For warrants granted in connection with the loan financing agreement, the fair value on the date of grant was US$0.29 per warrant, using the following assumptions: dividend yield of 0%; expected term of 3.0 years; a risk free interest rate of 1.15%; and an expected volatility of 85%. Fair value of the warrants issued is US$182,234.

The fair value associated with the warrants issued has been recognised as a debt discount and presented as a direct reduction to the face value of the long-term debt. The effective interest rate method has been applied and results in the amortisation of the debt discount over the life of the loan. For the year ended December 31, 2008, no amortisation was incurred as the funds were received on December 31, 2008 (2007 - $Nil).

Investors have been granted security over the shares of AOE Tykhe BV which has no other assets except the drilling rig. A corporate guarantee is being provided by Tethys.

As loan financing terms for the Tykhe drilling rig were concluded in December 2008, the carrying value of the loan approximates its fair value at December 31, 2008.

Principal repayments on the loan amount are required to be made as follows:

		US$'000
To December 31,	2009	-
	2010	493
	2011	1,637
Balance		2,130

NOTE 9 – NON CURRENT LIABILITIES

Other non-current liabilities relates to the accrual of Historic Costs due to the Government of Kazakhstan on the Kyzyloi contract in Kazakhstan. The principal amount outstanding at December 31, 2008 was US$908,098 and this is to be paid in quarterly instalments between January 2009 and March 2014.

The liability is non-interest bearing. The liability is measured at amortised cost using the effective interest rate method. The net present value of liability using an assumed rate of interest of 10% is US$680,000 of which US$157,000 is current, leaving a non-current balance of US$523,000.

Based on the borrowing rates currently available to the Company for loans with similar terms and average maturities, the fair value of non current liability relating to historic costs is US$508,441 (2007 - US$Nil).

NOTE 10 – ASSET RETIREMENT OBLIGATION

The following table presents the reconciliation of the beginning and ending aggregate carrying amount of the obligation associated with the retirement of oil and gas assets:

	As at December 31,	
	2008	**2007**
Asset retirement obligation , Beginning of year	661	451
Liabilities incurred	274	175
Change in estimated future cash flow	(558)	-
Accretion expense	56	35
Asset retirement obligation, End of year	433	661

The total undiscounted amount of estimated cash flows required to settle the obligation is US$645,000 (2007 – US$1,600,000) which has been discounted using a weighted average credit adjusted risk free rate of 10% (2007 – 10%), Most of these obligations are not expected to be settled for several years in the future.

NOTE 11 - COMMITMENTS AND CONTINGENCIES

Kyzyloi Field Licence and Gas Production Contract

The Kyzyloi Field License and Gas Production Contract initially agreed on June 12, 2007. An amendment was granted on November 8, 2007 which extended the terms of the contract to June 13, 2014 with a commitment to spend an additional US$2,687,000 on a minimum work program focused on the development of the contractual territory. At December 31, 2008 the above commitment had been satisfied. The Company has committed to an additional minimum work program for 2009 which requires US$100,000 to be spent in completing work-overs in the contractual territory.

Akkulka Field Exploration Licence and Contract

Tethys Aral Gas ("TAG") a wholly owned subsidiary of the Company is the sole party to the Akkulka Field Exploration License and Contract #265 dated November 17, 1998. The contract initially granted TAG the exploration rights for a period of 5 years, however, the terms of the contracts have been extended to September 17, 2009 through subsequent amendments to the original contract. The latest amendment signed on November 8, 2007 committed the Company to spend an additional US$1,850,000 on a minimum work program focused on the exploration of the contractual territory. The Company is required to meet this commitment by September 17, 2009. The Company has agreed the 2009 minimum work programme with the Government and is committed to spending US$1,170,500 on exploration and development activities in 2009 which will satisfy the remaining commitments.

Furthermore, contingent upon commencement of commercial production on the Akkulka contractual territory, an additional payment in the amount of US$3,500,000 will be due to the Kazakhstan Government as a reimbursement of historical costs previously incurred by the Government in relation to the contractual territory. The amount and procedure of reimbursement will be subject to the terms and conditions to be set out in the production contract, which is yet to be agreed.

Kul-Bas Exploration and Production Contract

Kul-Bas LLP, a wholly owned subsidiary of the Company, owns a 100% interest in "Kul-Bas Exploration and Production Contract" #1897 dated November 11, 2005 (also known as "Greater Akkulka Exploration and Production Contract"), which was concluded for 25 years (first 6 years of exploration and 19 years of production). Under the contract 100% of crude oil produced in the exploration phase is required to be sent to Kazakh refineries. On commencement of commercial production, at least 20% of produced crude oil should be sent to Kazakh refineries. Any associated gas is required to be utilized in accordance with the applicable environmental legislation.The initial minimum work program for the contractual territory resulted in commitment of US$7,700,000. The minimum work program agreed for 2009 is US$706,000 for the acquisition and processing of new seismic. The remaining commitment of US$2,894,000 is required to be satisfied by November 11, 2011.

In addition to the minimum work program commitments, the Kazakhstan Government is to be compensated for the historical costs related to the contractual territory in the amount of US$3,275,780. The Company has previously paid an amount of US$49,137 in relation to this balance. No further payments on this balance are required until commencement of commercial production within the contractual territory. If and when commercial production commences, US$88,666 is due in quarterly installments until the remaining historical costs of US$3,226,643 has been paid in full.

Sales Contract

On January 5, 2006 Tethys' Kazakh subsidiary, TAG, executed a natural gas supply contract with Gaz Impex S.A. ("Gaz Impex") relating to gas sales from TAG's Kyzyloi field in Kazakhstan. In December 2007 this contract was assigned to Kazakhstani Petrochemical Company Kemikal LLP ("KNK").

The contracted price is US$0.90 per thousand cubic feet (Mcf) (US$32 per thousand cubic metres (Mcm)) plus VAT which was 13% in 2008 moving to 12% in 2009. The VAT receipts can be offset against VAT costs incurred on the Kyzyloi project. The Gas Supply Contract has a term until the earlier of December 1, 2012, the contract termination date, or until such time as a cumulative quantity of 850 thousand cubic metres (Mcm) of natural gas is delivered. The contract is based on a take–or–pay principle and covers all gas produced from the Kyzyloi Field Licence and Production Contract area up to termination. As at December 31, 2008, 17.55% of the contract volume had been delivered.

Tajikistan

On June 13, 2008, the Company's wholly owned subsidiary, Kulob Petroleum Limited ("KPL"), signed a Production Sharing Contract ("PSC") with the Government of the Republic of Tajikistan. Under the PSC, KPL will recover 100% of its costs from up to 70% of total production (the maximum allowed under the newly approved production sharing legislation of Tajikistan) and the remaining production (termed "Profit Oil and Gas") will be shared 70% to KPL and 30% to the Government whose share includes all taxes, levies and duties. The terms are fixed over the life of the PSC which is a minimum of 25 years.

Pursuant to the PSC, Tethys has committed to funding a work program designed to provide data for a focused exploration of the Contract Area and which will be carried out in two stages (the "Work Program"). The first phase of the Work Program will include geological studies, reprocessing of existing seismic and other geophysical data, acquisition of seismic and other geophysical data and the commencement of initial rehabilitation activities on the Beshtentyak and Khoja Sartez fields. The minimum spend commitment under Phase 1 of the contract is US$3,000,000. This expenditure must be met within 18 months on the effective date of the contract, which is December 13, 2009. This commitment will be satisfied through a contract agreed on November 14, 2008 relating to a seismic survey work program which commits the company to expenditure of US$4,925,300.

Drilling Rig Telesto

On October 16, 2007, Tethys placed an order for a new 2,000 horsepower (1,470 kN) ZJ70/4500L drilling rig (Telesto) from a Chinese supplier. The rig has a nominal drilling depth of 23,000 feet (7,000 metres). The rig was transported from China to Kazakhstan arriving in September 2008 for use on the Akkulka deep exploration program, and though drilling commenced on December 9, 2008 it stopped soon after because of technical problems. The cost of the rig is US$6,263,000 and at December 31, 2008 the final payment of US$313,150 (5%) remained outstanding but will be made after resolution of the technical problem and completion of a successful operating period.

Drilling Rig Tykhe

On July 25, 2008 Tethys placed an order for a new ZJ30 truck mounted rig (Tykhe) at a cost of US$5,350,000. The Company paid the rig deposit of US$1,605,000 in July 2008 and a stage payment of the same amount in September 2008. The third installment of US$1,872,500 will be due upon delivery in early 2009 and the final payment of US$267,500 will be made after assembly and a successful operating period.

Coiled Tubing Unit

In September 2008, Tethys placed an order for a new Coil Tubing Unit at a cost of US$1,110,000. The Company paid a deposit of US$80,000 in October 2008 with the balance of US$1,030,000 due upon delivery in early 2009.

Operating leases

Operating leases consist primarily of leases for offices. Lease commitments are as follows:

	Total	Less than 1 year	1 – 3 years	4-5 years
Operating leases	847,956	645,852	202,104	-

NOTE 12 – INCOME TAXES

Tethys is domiciled in the Cayman Islands which has no company income tax.

At December 31, 2008 the Company's Kazakhstan based subsidiary Tethys Aral Gas LLP had net operating loss carry forwards ("NOLs") for income tax purposes of approximately US$4,393,500. If the NOLs are not utilized to reduce taxable income in future periods, they will expire in various amounts from 2012 through 2015. The Company has established a valuation allowance for deferred taxes equal to its entire net deferred assets as management currently believes that it is more likely than not that these losses will not be utilized.

Under the Bokhtar PSC in Tajikistan, the State's production share includes all Tajik taxes, levies and duties however no revenue was generated from the Company's Tajikistan operations in 2008.

NOTE 13 –STOCKHOLDERS' EQUITY

The Company is authorised to issue 700,000,000 common shares (2007 - 500,000,000) and 50,000,000 (2007 – nil) preference shares.

On June 27, 2008 Tethys successfully completed a public offering, having placed 21,276,596 shares at a price of US$2.35 (CAD$2.39), raising US$50,000,000 (gross). The ordinary shares are listed on the Toronto Stock Exchange.

At the Annual General Meeting on April 24, 2008 the authorized share capital of the Company was increased by an additional 200,000,000 ordinary shares and 50,000,000 preference shares. The preference shares have the rights as set out in the Memorandum and Articles of Association approved at the AGM on April 24, 2008. Significant terms related to preference shares are summarized below:
may be issued in one or more series;
are entitled to any dividends in priority to the ordinary shares;
confer upon the holders thereof rights in a winding-up in priority to the ordinary shares;
may have such other rights, privileges and conditions (including voting rights) as the Board may determine prior to the first allotment of any series of preference shares, provided that if a series of preference shares has no or limited voting rights it shall be designated as such by the Board.

There are currently no preference shares outstanding.

NOTE 14 - STOCK BASED COMPENSATION

The Company has adopted a stock incentive plan referred to as the "2007 Long Term Stock Incentive Plan" pursuant to which the Company may grant stock options to any director, employee or consultant of the Company, or any subsidiary or Vazon Energy Limited (collectively, "Service Providers"). The purpose of the plan is to secure for the Company and its shareholders the benefits of incentives inherent in share ownership by employees and service providers who, in the judgment of the Board of Directors, will be largely responsible for its future growth and success.

The maximum number of Ordinary Shares reserved for issuance subsequent to the initial Purchase Offer on the Toronto Stock Exchange under the plan equals 10% of the outstanding Ordinary Shares after giving effect to the Treasury Offering. The plan is administered by the Compensation and Nomination Committee of the Board of Directors. Options may be granted pursuant to recommendations of the Compensation and Nomination Committee. The Compensation and Nomination Committee may determine the vesting schedule and term, provided that options may not have a term exceeding ten years. Subject to any resolution passed by the Compensation and Nomination Committee, options will terminate three months after an optionee ceases to be a Service Provider.

The exercise price of options granted under the plan may not be less than the closing price of Ordinary Shares on the principal stock exchange where the Ordinary Shares are listed as of the date of the option grant. The plan contains amendment provisions which allow amendments to the plan by the Board of Directors, without shareholder approval, for amendments of a "housekeeping" nature, changes to vesting or termination provisions, and discontinuance of the plan. The plan also provides that outstanding options will vest immediately on the occurrence of a "change of control" (as defined in the plan). Options granted under the plan are only assignable to certain related entities of an optionee or otherwise with the consent of the Company.

The following table summarizes the stock option activity under the 2007 Long Term Stock Incentive Plan:

	2008			2007		
	Number of options	Weighted average exercise price	Weighted average remaining term	Number of Options	Weighted average exercise price	Weighted average remaining term
Outstanding at December 31, 2007	4,497,000	2.76		-	-	-
Granted	2,274,000	2.51		4,497,000	2.76	-
Forfeited	(96,000)	2.75		-	-	-
Exercised	-	N/A		-		-
Expired	-	N/A		-		-
Outstanding at December 31, 2008	6,675,000	2.67	5.84	4,497,000	2.76	6.57
Exercisable at December 31, 2008	3,692,000	2.71	5.71	1,499,000	2.76	6.57

For options granted during the fiscal year ended December 31, 2008, the weighted average fair value on the date of grant, estimated using the Black-Scholes option pricing model, was $1.5493 per option, using the following weighted average assumptions: dividend yield of 0%; expected term of 4.0 years; a risk free interest rate of 3.32%; and an expected volatility of 73.5%. The options will vest over a period of two years.

For the fiscal year ended December 31, 2008, there was $3.9 million of pre-tax compensation expense for options granted under the 2007 Long Term Stock Incentive Plan. As of December 31, 2008, there was $2.8 million of total unrecognized compensation expense related to unvested stock options granted under the plan. The Company expects to recognize the expense over a weighted-average period of 1.09 years.

NOTE 15 - WARRANTS

2017 warrants

On February 14, 2007, the Company agreed to issue, and on June 8, 2007 the Company issued certain warrants (the "2017 Warrants") to purchase an aggregate of 2,090,000 Ordinary Shares. The 2017 Warrants relate to the January 24, 2007 private placement of Ordinary Shares and the recipients included, among others, a number of members of management of Tethys. The 2017 Warrants are exercisable at US$2.50 through the period ending June 2017.

Performance warrants

The Company has approved the grant to its executive officers of warrants (the "Performance Warrants") to acquire 6,767,504 Ordinary Shares as follows:

Exercise period ending	Exercise price (US$)	Number of ordinary shares
December 25, 2009	4.125	1,353,501
June 25, 2011	5.500	2,255,835
December 25, 2012	6.875	3,158,168

Warrants issued in connection with loan financing

During the fiscal year ended December 31, 2008, there were 1,433,298 warrants issued in connection with loan financing and a total cost of US$1,162,628. Refer to note 8 for further information.

The following table summarizes the warrant activity, including Performance Warrants, for the fiscal year ended December 31, 2008.

	2008			2007		
	Number of Warrants	Weighted Average Exercise Price	Weighted average remainin g term	Number of Warrants	Weighted average exercise price	Weighted average remaining term
Outstanding at December 31, 2007	10,203,658	4.04	-	1,346,154	2.50	-
Granted	1,433,298	2.33	-	8,857,504	5.07	
Forfeited	-	-	-	-		-
Exercised	-	-	-	-		
Expired	-	-	-	-		
Outstanding at December 31, 2008	11,636,956	3.82	3.89	10,203,658	4.04	4.88
Exercisable at December 31, 2008	11,636,956	3.82	3.89	10,203,658	4.04	4.88

As at December 31, 2008 all options and warrants were out of the money.

NOTE 16 - NET LOSS PER COMMON SHARE

Basic net loss per common share is computed by dividing the net loss attributable to common stockholders by the weighted average number of shares of common stock outstanding during the applicable period. Diluted per share information is calculated, including the dilutive effect of stock options which are determined using the treasury stock method. The treasury stock method assumes that the proceeds that would be obtained upon exercise of "in the money" options would be used to purchase common shares at the average market price during the period. No adjustment to diluted earnings per share is made if the result of this calculation is anti-dilutive.

NOTE 17 - RELATED PARTY TRANSACTIONS

Vazon Energy Limited ("Vazon") is a corporation organized under the laws of the Bailiwick of Guernsey, of which Dr. David Robson, Chief Executive Officer, is the sole owner and managing director. Tethys has a management services contract with Vazon that came into effect from June 27, 2007 whereby the services of Dr. Robson and other Vazon employees are provided to the Company. The total cost charged to Tethys for services from Vazon in the fiscal year ended December 31, 2008 was US$1,070,156 (2007 - US$522,237).

Kraken Financial Group (KFG) has a common director with the Company. In 2008, KFG was engaged by the Company to assist in obtaining loan financing in relation to the purchase of both Telesto and Tykhe drilling rigs. As a result of the services provided in connection with the Telesto transaction, KFG received 6% commission of the funds it was responsible for introducing to the Company. This commission is to be taken in the form 81,447 shares, which were yet to be issued at year end. As a result the Company has recognized a liability for US$234,000 (2007 - US$Nil). In relation to similar services provided in connection with the loan financing of the Tykhe drilling rig, KFG received commission of US$21,000 (2007 - US$Nil).

KFG also acted as broker for Tethys in the placement of various insurance policies, including Directors & Officers, for which the combined annual premiums were US$112,615 (2007 - US$112,000).

Oilfield Production Consultants (OPC) Ltd and Oilfield Production Consultants (OPC) USA LLC, both of which have one common director with the company, has charged Tethys a monthly retainer fee for engineering expertise, provided services relating to the optimization of the existing compressors and those to be installed as part of Phase 2 gas production from Akkulka, and has consulted on certain reservoir modelling work on projects in Tajikistan. Total fees in the fiscal year ended December 31, 2008 were US$395,531 (2007- US$Nil).

Transactions with affiliates or other related parties including management of affiliates are to be undertaken on the same basis as third party arms-length transactions and have been recorded at their exchange amounts.

NOTE 18 – SUBSEQUENT EVENTS

On January 13, 2009 1,400,000 Tethys ordinary shares were issued in part settlement of the purchase of a Coil Tubing Unit the Company subsidiary Asia Oilfield Equipment BV.

On January 16, 2009 the Company announced that it had signed a 1-year gas sales contract with OJSC Kulyabgaz to supply gas to the town of Kulob in Southern Tajikistan. The price under the contract is fixed for the period of the contract at 300 Somoni (approximately USD86 per thousand cubic metres ("Mcm") (USD2.44 per thousand cubic feet ("Mcf")) and the initial contract is to supply up to 65,000 cubic metres (2.3 million cubic feet) of gas per day.

On February 27, 2009 the Company announced that its 100% subsidiary, Tethyda Limited, had signed an agreement, under which subject to certain regulatory requirements, corporate approvals and additional conditions, it is to acquire from the British company, Rosehill Energy plc ("Rosehill"), its wholly-owned subsidiary ("the Contractor") which holds Rosehill's entire interest in the Production Enhancement Contract ("PEC") for the North Urtabulak Oil Field in Uzbekistan. The consideration for the purchase of this project is 15,000,000 (fifteen million) ordinary shares of Tethys.

These shares will be restricted for resale for a period of up to one (1) year. The value of the transaction (based on a Tethys share price of US$0.42 calculated as the 5 day volume weighted average ending on February 25, 2009) is approximately US$6.5 million.

NOTE 19 – CANADIAN ACCOUNTING PRINCIPLES AND REPORTING

The Consolidated Financial Statements have been prepared in accordance with accounting principles generally accepted in the United States of America (US GAAP) which in most respects conform to Canadian generally accepted accounting principles (Canadian GAAP). The differences between US GAAP and Canadian GAAP that apply to the Company are explained in this note.

RECONCILIATION OF NET EARNINGS BETWEEN US GAAP AND CANADIAN GAAP

	Year ended December 31,	
	2008	**2007**
Net loss and comprehensive loss after tax for the year under US GAAP	(22,627)	(41,779)
Impairment charge on proved properties	-	12,800
Additional DD&A on proved properties	(1,928)	-
Net loss and comprehensive loss after tax for the year under Canadian GAAP	(24,555)	(28,979)
Basic and diluted loss per share under Canadian GAAP	(0.44)	(0.87)

CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS, COMPREHENSIVE LOSS AND DEFICIT – CANADIAN GAAP

	Year ended December 31,	
	2008	**2007**
Operating Revenue	5,360	194
Expenses		
Operating expenses	1,334	19
Selling, general & administrative expense	13,421	9,461
Stock based compensation	3,945	17,624
Depreciation, depletion & amortization	8,377	257
Other (net)	2,837	1,812
Loss before income tax for the year under Canadian GAAP	(24,555)	(28,979)
Income Tax	-	-
Net Loss and Comprehensive Loss after tax for the year under Canadian GAAP	(24,555)	(28,979)
Deficit – Beginning of the year	(38,825)	(9,846)
Deficit – End of year	(63,380)	(38,825)

CONDENSED CONSOLIDATED BALANCE SHEET

	As at December 31,	
	2008	**2007**
Assets		
Current assets	25,077	28,052
Non current assets	6,944	6,132
Capital assets	84,665	50,272
Total assets	116,686	84,456
Liabilities and stockholders' equity		
Current liabilities	3,588	2,279
Non current liabilities	6,052	1,437
Total stockholders' equity	107,046	80,740
Total liabilities and stockholders' equity	116,686	84,456

Impairment of oil and gas properties under Canadian GAAP

Under Canadian GAAP, an impairment loss is recognised in net earnings when the carrying amount of a cost centre is not recoverable and the carrying amount of the cost centre exceeds its fair value. The carrying amount of the cost centre is not recoverable if the carrying amount exceeds the sum of the undiscounted cash flows from proved reserves. If the sum of the cash flows is less than the carrying amount, the impairment loss is limited to the amount by whichthe carrying amount exceeds the sum of:

(i) the fair value of proved and probable reserves
(ii) the costs of unproved properties that have been subject to a separate impairment test

Due to differences between the accounting treatment permitted under Canadian GAAP and the Company's accounting policy under US GAAP, the Company recorded an impairment charge of US$12,800,000 in the 2007 US GAAP financial statements as US GAAP permits the use of only proved reserves in the calculation of the full cost ceiling. However, as Canadian GAAP permits the use of proved and probable reserves and forecast pricing in calculating the full cost ceiling, no impairment charge was required for either 2008 or 23007. Under the Canadian GAAP ceiling test the forecast prices would have been as follows:

	2009	2010	2011	2012	2013	2014	2015	2016	2017
Natural gas US$/Mcf									
Kyzyloi	0.90	0.90	0.90	0.90	5.43	5.65	-	-	-
Akkulka	3.80	4.16	4.47	4.68	5.43	5.65	5.86	6.07	6.25

19 (A) - RECENTLY ADOPTED STANDARDS – CANADIAN GAAP

On January 1, 2008, the Company adopted the following CICA Handbook Sections

"Inventories", Section 3031. This new standard replaces the previous standard in Section 3030 and requires inventory to be valued on a first in, first out basis or weighted average cost basis, which is consistent with Tethys former accounting policy. The new standard allows the reversal of previous write downs to net realizable value when there is a subsequent increase in value. The adoption of this standard has had no material effect on the Consolidated Financial Statements.

"Capital Disclosures", Section 1535. This new standard requires the Company to disclose its objectives, policies and processes for managing capital. For related disclosure, refer to note 19 (C).

"Financial Instruments – Presentation", Section 3863 and "Financial Instruments – Disclosures", Section 3862. The new disclosure standard increases Tethys' disclosures regarding the nature and extent of the risk associated with financial instruments and how those risks are managed. For the related disclosure, refer to note 19 (D). The new presentation standard carries forward the former presentation requirements.

19 (B) - RECENT ACCOUNTING PRONOUNCEMENTS – CANADIAN GAAP

The Accounting Standards Board (AsSB) confirmed in February 2008 that Canadian publicly accountable enterprises will be required to report in accordance with International Financial Reporting Standards (IFRS) for financial reporting periods beginning on and after January 1, 2011. Tethys has elected to early adopt IFRS and will report in accordance with IFRS from January 1, 2009. Tethys will prepare its first financial statements under IFRS for the interim period ending March 31, 2009.

In February 2008, the CICA issued Section 3064, "Goodwill and Intangible Assets" which will replace Section 3062 and be effective January 1, 2009. This new standard revises the criteria for the recognition, measurement, presentation and disclosure of goodwill and intangible assets. The Company currently has no Goodwill or Intangible Assets. As the Company is adopting IFRS on January 1, 2009, the adoption of CICA 3064 will not be applicable.

19 (C) - CAPITAL DISCLOSURES

The Company's objectives when managing capital is to maintain adequate financial flexibility to preserve its ability to meet financial obligations, both current and long term. The capital structure of the Company is managed and adjusted to reflect changes in economic conditions.

The Company funds its expenditures on commitments from existing cash and cash equivalent balances, primarily received from issuances of shareholders equity. During the year, the Company also entered into long term debt agreements to finance the purchase of two drilling rigs. These loans are not subject to any externally imposed capital requirements.

As the Company is engaged in acquiring properties and exploring for crude oil and natural gas, it does not currently have sufficient revenue generating activities to fund all of the company's commitments. The Company is therefore required to fund a significant portion of its commitments from existing cash and cash equivalent balances or seek additional financing through debt issuances or equity markets (refer note 1).

Financing decisions are made by Management and the Board of Directors based on forecasts of the expected timing and level of capital and operating expenditure required to meet the Company's commitments and development plan. Factors considered when determining whether to issue new debt or to seek equity financing include the amount of financing required, the availability of financial resources, the terms on which the financing is available and in consideration of the balance between shareholder value creation and prudent financial risk management.

Debt levels are monitored by using the non-GAAP financial metric of Net Debt to Capitalization. Net Debt is calculated as the sum of long term debt balances (including the current portion) less the balance of cash and cash equivalents. There was no Net Debt at December 31, 2008 as the cash and cash equivalents significantly exceeded the total of long term loans. The Company had no outstanding loans at December 31, 2007.

19 (D) - FINANCIAL INSTRUMENTS AND RISK DISCLOSURES

Financial Instruments

Financial instruments of the Company consist of cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities and long term debt. The Company's cash and cash equivalents are designated as held-for-trading and are measured at fair value, which approximates carrying value due to the short-term nature of these instruments. Accounts receivable are designated as loans and receivables and recorded at amortized cost, which approximates fair value due to the short term nature of the instrument.

Accounts payable and accrued liabilities are designated as other liabilities and are recorded at amortised cost. The fair value of accounts payable and accrued liabilities approximate their carrying values due to the short term nature of these instruments.

Long term debt is designated as other liabilities and held at amortised cost using the effective interest method of amortisation. The estimated carrying values of long term borrowings have been determined based on market information where available, or by discounting future payments of interest and principle at estimated interest rates expected to be available to the Company at year end. Fair value of long term debt has been disclosed at note 8. Fair value of non-current liabilities has been disclosed in note 9.

Financial risks

The Company is exposed to credit risk, liquidity risk and funding risk. The following is a description of those risks and how the Company manages exposure to them:

Credit Risk
Credit risk is the risk of financial loss to the Company if a customer or counterparty to financial instruments fails to meet its contractual obligations. Credit risk arises from the Company's cash and cash equivalents and accounts receivable balances.

Although Tethys' cash and cash equivalents and accounts receivable are exposed to potential credit loss, Tethys does not believe such risk to be significant.

In order to reduce concentration of credit risk associated with cash and cash equivalent balances, the Company has spread its cash investments over three recognised financial institutions with appropriate credit ratings. The Board of Director's are required to approve financial institutions prior to any significant investments being made. Although a significant amount of the deposits at financial institutions are not covered by bank guarantees, the Company does not believe there to be a significant risk of credit loss.

Concentration of credit risk associated with accounts receivable balances is as a result of contracted gas sales to only one customer during the period. The Company does not believe it is dependent upon this customer for sales due to the nature of gas products and the associated market. Although a portion of the Accounts receivable balance has been outstanding more than 60 days as at December 31, 2008, the Company has not recorded a provision against the amount as it does not consider the balance to be impaired.

Liquidity Risk
Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they fall due. This risk relates to the Company's ability to generate or obtain sufficient cash or cash equivalents to satisfy these financial obligations as they become due. The Company's processes for managing liquidity risk includes preparing and monitoring capital and operating budgets, coordinating and authorizing project expenditures, and ensuring appropriate authorization of contractual agreements. The budget and expenditure levels are reviewed on a regular basis and updated when circumstances indicate change is appropriate. The Company seeks additional financing based on the results of these processes.

The timing of cash outflows relating to financial liabilities and commitments are summarized below:

	Less than 1 year	1 – 3 years	4 – 5 years	Thereafter	Total
Accounts payable and accrued liabilities	2,735	-	-	-	2,735
Long term debt[1]	1,676	6,850	-	-	8,526
Non current liabilities	173	519	216	-	908
Purchase commitments	10,385	-	-	-	10,385
Operating lease commitments	646	201	-	-	847
Total expected cash outflow	15,615	7,570	216	-	23,401

[1]Principal and interest, including current portion

Recent market turbulence has increased liquidity risk faced by the Company. In particular, significant declines in energy prices, decline in the market price for the Company's shares and a potential decline in the ability of the Company to access the capital markets. This increased risk has the potential to impact on the Company's planned exploration and development projects. The Company does not currently have plans to curtail planned projects that commenced in 2008 or that are included in the contractual commitments discussed at note 11. Management and the Board of Directors reviews the Company's cash and cash equivalent balances against the Company's commitments and assesses the timing and need for additional equity or debt financing on a regular basis. As a result, some of the Company's growth plans have been suspended until such time as the position of the markets becomes clearer, particularly in respect to future gas pricing, production revenues and fund raising opportunities that may be available to the Company. The overall focus of the short-term work programs are aimed primarily at development and production enhancement projects which will enhance short to medium term cash flow rather than pure exploration projects.

In Kazakhstan, the Company's current plans are limited to satisfying the 2009 minimum work program for each of the three contracts. In Tajikistan, the Company intends to initiate its exploration work with an extensive seismic survey while carrying out rehabilitation and work-over activities on existing deposits, to construct field reservoir models and consider horizontal and inclined drilling, field pressure support and similar techniques to increase production of oil and gas, and to look at cost effective approaches to deepening existing wells to test exploration targets. For details of the Company's contractual commitments at December 31, 2008 refer to note 11. For additional details in relation to long-term debt liabilities, refer to note 8.

There can be no assurance that debt or equity financing will be available or sufficient to meet the Company's requirements or if debt or equity financing is available, that it will be on terms acceptable to the Company. The inability of the Company to access sufficient capital for its operations could have a material adverse impact on the Company's financial condition, results of operations and prospects.

Market Risks
Market risk is the risk of loss that may arise from changes in market factors such as commodity prices, interest rate and foreign exchange rates. The Company is exposed to interest rate risk to the extent that changes in market interest rates will impact any interest earned on the Company's cash and cash equivalent. The Company is also exposed to foreign exchange risk as it operates in Kazakhstan, Tajikistan and the British Isles.

Commodity Price Risk
Commodity price risk arises from the effect that fluctuations of future commodity process may have on the price received for sales of gas products. The marketability and price of natural gas that is produced and may be discovered by the Company will be affected by numerous factors that are beyond the control of the Company.

Natural gas prices are subject to wide fluctuations, The Company has entered into a fixed price contract for sales of gas from the Kyzyloi field. However, any material decline in natural gas prices could result in a reduction of Tethys' future net production revenues and impact on the commercial viability of the Company's existing and future oil and gas discoveries. It may become uneconomic to produce from some wells as a result of lower prices, which could result in a reduction in the volumes and the value of Tethys' gas reserves. Tethys might also elect not to produce from certain wells at lower prices.

Interest Rate
Interest rate risk is the risk that the value of a financial instrument will be affected by changes in market interest rates. Existing long term debt is agreed at fixed interest rates and consequently has limited exposure to changes in market interest rates.

The Company is exposed to interest rate risk to the extent that significant reductions in market interest rates will result in a decline in the amount of interest earned on the Company's cash and cash equivalent balances. Assuming that the Company maintains the level cash and cash equivalents held at December 31, 2008 for a whole year then a change in interest rates of 1% would increase/decrease the interest earned by an amount of $200,000.

Foreign exchange risk
The Company is exposed to risks resulting from fluctuations in foreign currency exchange rates. A material change in the value of any such foreign currency could result in a material adverse effect on the Company's cash flow and future profits. To the extent revenues and expenditures denominated in or strongly linked to the U.S. dollar are not equivalent; the Company is exposed to exchange rate risk. In addition, a significant portion of expenditures in Kazakhstan and Tajikistan are denominated in local currency, the Tenge and Somoni, respectively. These currencies are difficult to hedge. Due to the small amount of Tenge and Somoni held at December 31, 2008 had the US dollar changed by one percent against the Kazakhstan Tenge or Somoni, with all other variables held constant, the Company's foreign exchange gain or loss would have been negligible.

The Company is not currently using exchange rate derivatives to manage exchange rate risks but is attempting to negotiate exchange rate stabilization conditions in new local Tenge denominated service and supply contracts in Kazakhstan.

The Company holds the majority of its cash and cash equivalents in US dollars. However, the Company maintains deposits in other currencies, mainly British Pounds Sterling ("GBP") and Canadian dollars ("CDN") in order to fund ongoing general and administrative activity and other expenditure incurred in these currencies. In addition, a significant portion of the funds received in the June 2008 equity financing transaction were received in Canadian dollars. In 2008, the Company had a policy of holding Euros to meet anticipated costs of purchasing oil & gas drilling equipment, casing, drill pipe and similar (as these items were priced at that time in Euros) but this practice ceased prior to December 31, 2008.

With regard to the GBP had the US dollar changed by one percent at December 31, 2008, with all other variables held constant, the Company's foreign exchange gain or loss would have been affected by US$23,000. In relation to the Canadian dollar, had the US dollar changed by one percent, the foreign exchange gain or loss would have been affected by US$35,000.

For additional information on Risk Factors please refer to the Company's AIF.

Fair Value of Financial Assets and Liabilities

Financial instruments are measured at fair value on initial recognition of the instrument. Measurement in subsequent periods depends on whether the financial instrument has been classified as 'held for trading', 'available for sale', held to maturity', loans and receivables, or 'other financial liabilities' as defined by the accounting standard.

The Company's cash and cash equivalents are designated as held-for-trading and are measured at fair value. Accounts receivable are designated as loans and receivables and measured at amortized cost using the effective interest rate method.

Accounts payable, accrued liabilities and long term debt are designated as other liabilities and are recorded at amortized cost using the effective interest rate method.. Tethys capitalizes long term debt transaction costs, premiums and discounts. These costs are capitalized within long term debt and amortized using the effective interest rate method. The fair value of obligations under the loans approximate their carrying values as the interest rates applicable to these instruments reflect current market rates.

NOTE 20 – COMPARATIVES

Certain prior periods' amounts have been reclassified to conform to the current period's presentation.