



# strength shows in our results

Celtic   
Exploration Ltd.

Q3

INTERIM REPORT FOR THE THREE MONTHS AND NINE MONTHS ENDED SEPTEMBER 30, 2007

## HIGHLIGHTS

(\$ thousands, unless otherwise indicated)	Three months ended September 30,			Nine months ended September 30,		
	2007	2006	Change	2007	2006	Change
<b>FINANCIAL</b>						
Revenue, before royalties and financial derivatives	\$ 40,356	\$ 33,919	19%	\$ 105,710	\$ 97,102	9%
Funds from operations	\$ 18,805	\$ 20,812	-10%	\$ 60,095	\$ 59,358	1%
Funds from operations per share						
Basic (\$/share)	\$ 0.50	\$ 0.70	-29%	\$ 1.73	\$ 1.98	-13%
Diluted (\$/share)	\$ 0.50	\$ 0.68	-26%	\$ 1.70	\$ 1.92	-11%
Net earnings	\$ 4,584	\$ 15,850	-71%	\$ 4,691	\$ 28,632	-84%
Earnings per share						
Basic (\$/share)	\$ 0.12	\$ 0.53	-77%	\$ 0.13	\$ 0.95	-86%
Diluted (\$/share)	\$ 0.12	\$ 0.52	-77%	\$ 0.13	\$ 0.92	-86%
Capital expenditures, net of dispositions	\$ 31,637	\$ 47,940	-34%	\$ 154,633	\$ 131,998	17%
Total assets				\$ 479,026	\$ 354,768	35%
Bank debt				\$ 116,100	\$ 79,450	
Working capital deficiency, excluding bank debt				11,927	5,801	
Bank debt, net of working capital				\$ 128,027	\$ 85,251	50%
Shareholders' equity				\$ 277,294	\$ 198,236	40%
Common shares issued and outstanding (thousands)						
Basic				37,529	32,129	17%
Diluted				40,472	34,486	17%
<b>OPERATIONS</b>						
Production						
Oil (bbls/d)	3,102	3,048	2%	3,065	3,282	-7%
Natural gas (mcf/d)	34,871	18,759	86%	26,140	15,421	70%
Combined (BOE/d)	8,914	6,175	44%	7,422	5,852	27%
Production per million shares (BOE/d)	238	197	21%	213	195	9%
Realized sales prices, after financial derivatives						
Oil (\$/bbl)	\$ 69.84	\$ 70.99	-2%	\$ 67.40	\$ 65.49	3%
Natural gas (\$/mcf)	\$ 6.20	\$ 8.31	-25%	\$ 7.97	\$ 9.54	-16%
Operating netbacks (\$/BOE)						
Oil and gas revenue, before hedging	\$ 47.00	\$ 55.46	-15%	\$ 51.06	\$ 55.77	-8%
Increased price from physical fixed price contracts	2.21	4.25		1.12	5.00	
Realized gain (loss) on financial derivatives	(0.66)	0.60		3.73	1.10	
Realized sales price, after hedging	\$ 48.55	\$ 60.31	-19%	\$ 55.91	\$ 61.87	-10%
Royalties	(10.25)	(10.05)	2%	(10.67)	(11.34)	-6%
Production expense	(11.55)	(10.38)	11%	(11.34)	(9.99)	14%
Transportation and selling expense	(0.97)	(0.58)	67%	(0.90)	(0.63)	43%
Operating netback	\$ 25.78	\$ 39.30	-34%	\$ 33.00	\$ 39.91	-17%
Drilling activity						
Total wells	18	19	-5%	57	73	-22%
Working interest wells	12.6	14.4	-13%	48.0	54.4	-12%
Success rate on working interest wells	76%	65%	17%	78%	75%	4%
Undeveloped land						
Gross acres				324,002	312,153	4%
Net acres				245,406	223,107	10%

## MESSAGE TO SHAREHOLDERS

Celtic Exploration Ltd. (“Celtic” or the “Company”) is pleased to report to shareholders the Company’s activities in the third quarter of 2007. During the third quarter, Celtic drilled 18 (12.6 net) wells with an overall success rate of 76%. Production during the quarter averaged a record 8,914 BOE per day, an increase of 44% from the third quarter of 2006. In the third quarter of 2007, Celtic reported funds from operations of \$18.8 million or \$0.50 per share, diluted. Net earnings for the quarter were \$4.6 million or \$0.12 per share, diluted.

Lower natural gas prices have plagued the industry in recent months and natural gas storage levels continue to reach record high levels. In order to mitigate the risk of price volatility during the next 12 months, Celtic has entered into financial derivative contracts whereby the Company has fixed the price, at AECO, on future sales of 25,000 GJ (23,706 mcf) per day from November 1, 2007 to October 31, 2008 at a price of \$7.10 per GJ (\$7.49 per mcf). In addition, the Company has a put option at NYMEX for the November 1, 2007 to December 31, 2007 period on 10,000 mmbtu per day at a price of US\$7.50 per mmbtu. Based on third quarter average natural gas production, these contracts represent 97% of production for the November 1, 2007 to December 31, 2007 period and 68% of production for the January 1, 2008 to October 31, 2008 period.

Celtic’s syndicate of lenders has completed an interim review in October 2007. As a result of the review, the lenders have agreed to increase the Company’s credit facility by \$10.0 million to \$165.0 million. With substantial natural gas forward price contracts in place and an increased borrowing base, Celtic can continue drilling development wells and is well positioned financially to take advantage of strategic acquisitions during this period of commodity price volatility and uncertainty.

In Southern Alberta, Celtic drilled eight coal bed methane (“CBM”) wells with 100% success. The Company’s average working interest in these wells is 32.5%. These wells tested at gross rates between 155 and 215 mcf per day and are expected to come on-stream in the fourth quarter of 2007.

In West Central Alberta, drilling activity was focused on liquids-rich natural gas prospects at Kaybob South and light oil at Swan Hills.

At Swan Hills, the Company drilled a successful light oil well in the Beaverhill Lake formation. This well is now on production. Celtic expects to drill additional wells targeting light oil in this area during the fourth quarter of 2007.

At Kaybob South, Celtic drilled seven wells during the quarter, two of which were horizontal wells on the main block. Four wells are now on production and the remaining three wells are in the process of being completed and tied-in.

At the end of the third quarter, Celtic temporarily shut-in the recently acquired Kaybob South Beaverhill Lake Gas Unit #2, allowing the Company to complete upgrades to the pipeline and related facilities. These upgrades will ensure a more stable production and transportation profile in the future. Facility work has now been completed and production was restored during the third week of October 2007.

At September 30, 2007, Celtic’s net undeveloped land holdings increased by 10% compared to the corresponding period of the previous year, to over 245,000 acres. In addition to the increase in its undeveloped land position, the Company continues to add significantly to its drilling inventory as a result of successful exploration and development activity.

On October 25, 2007, the Government of Alberta released a report entitled *The New Royalty Framework* (“NRF”) whereby Crown royalty rates will change effective January 1, 2009. Included in the NRF is a royalty incentive for deep natural gas wells which Celtic is assuming will apply to qualifying wells, regardless of when they were drilled. The Company has re-run its December 31, 2006 reserves evaluation using the new royalty rates proposed in the NRF and using constant commodity prices based on Celtic’s forecasted commodity prices provided in its 2008 guidance. As a result, royalties in 2009 are expected to be marginally higher; however, royalties over the life of total reserves is expected to be marginally lower.

The royalty incentive for deep natural gas wells would appear to be positive for Celtic’s horizontal drilling plans at Kaybob South. Using the Company’s 2008 budgeted commodity prices as a constant, the net present value of each horizontal well, discounted at 10% before tax, would increase by 3.4% under NRF.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

### Introduction

The Company was incorporated on April 16, 2002 as Desco Exploration Ltd. and completed its initial public offering on June 27, 2002. On September 30, 2002, the Company changed its name to Celtic Exploration Ltd. ("Celtic" or the "Company"). Celtic's head office is based in Calgary, Alberta, Canada. Common shares of the Company are listed and posted for trading on the Toronto Stock Exchange ("TSX") under the symbol "CLT."

The following management's discussion and analysis ("MD&A") should be read in conjunction with the Company's unaudited interim financial statements and related notes for the nine months ended September 30, 2007. This MD&A is effective November 6, 2007. The accompanying financial statements of Celtic 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 Canadian generally accepted accounting principles ("GAAP"). Additional information relating to Celtic can be found on the SEDAR website at [www.sedar.com](http://www.sedar.com).

**Non-GAAP Financial Measurements** This document contains the terms "funds from operations" and "operating netbacks" which do not have a standardized meaning prescribed by Canadian GAAP and therefore may not be comparable with the calculation of similar measures by other companies. Funds from operations and operating netbacks are used by Celtic as key measures of performance. Funds from operations and operating netbacks are not intended to represent operating profits nor should they be viewed as an alternative to cash flow provided by operating activities, net earnings or other measures of financial performance calculated in accordance with GAAP. The reconciliation between net earnings and funds from operations can be found in the statement of cash flows included in the financial statements. Operating netbacks are determined by deducting royalties, production expenses and transportation and selling expenses from oil and gas sales revenue. The Company calculates funds from operations per share using the same method and shares outstanding which are used in the determination of earnings per share.


**Other Measurements** All dollar amounts are referenced in Canadian dollars, except when noted otherwise. Where amounts are expressed on a barrel of oil equivalent ("BOE") basis, natural gas volumes have been converted to oil equivalence at six thousand cubic feet per barrel. The term BOE may be misleading, particularly if used in isolation. A BOE conversion ratio of six thousand cubic feet per barrel is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead. References to oil in this discussion include crude oil and natural gas liquids ("NGLs"). NGLs include condensate, propane, butane and ethane.

**Critical Accounting Estimates** Management is required to make judgments, assumptions and estimates in the application of generally accepted accounting principles that have a significant impact on the financial results of the Company.

Capitalized costs relating to the exploration and development of oil and gas reserves, along with estimated future capital expenditures required in order to develop proved reserves, are depleted and depreciated on a unit-of-production basis using estimated proved reserves.

The carrying value of property, plant and equipment is reviewed at least annually for impairment. Impairment occurs when the carrying value of the assets is not recoverable by the future undiscounted cash flows. The cost recovery ceiling test is based on estimates of proved reserves, production rates, oil and gas prices, future costs and other relevant assumptions. By their nature, these estimates are subject to measurement uncertainty and the impact on the financial statements could be material.

Liability recognition for asset retirement obligations associated with oil and gas well sites and facilities are determined using estimated costs discounted based on the estimated life of the asset. These capitalized costs are amortized on a unit-of-production basis, consistent with depletion and depreciation. Over time, the liability is accreted up to the actual expected cash outlay to perform the abandonment and reclamation.



In order to recognize stock-based compensation expense, the Company estimates the fair value of stock options granted using assumptions related to interest rates, expected life of the option, volatility of the underlying security and expected dividend yields. These assumptions may vary over time.

The determination of the Company's income and other tax liabilities requires interpretation of complex laws and regulations often involving multiple jurisdictions. All tax filings are subject to audit and potential reassessment after the lapse of considerable time. Accordingly, the actual income tax liability may differ significantly from that estimated and recorded on Celtic's financial statements.

**Changes in Accounting Policies and Practices** Effective January 1, 2007, the Company has adopted the following new Canadian Institute of Chartered Accountants ("CICA") Handbook sections:

- (i) Section 1530, *Comprehensive Income*;
- (ii) Section 3251, *Equity*;
- (iii) Section 3855, *Financial Instruments – Recognition and Measurement*; and
- (iv) Section 3865, *Hedges*.


These new accounting standards provide requirements for the recognition and measurement of financial instruments and the use of hedge accounting. The standards have been adopted prospectively and, therefore, the comparative interim financial statements have not been restated. The adoption of these Handbook sections has no impact on opening retained earnings or opening accumulated other comprehensive income.

Also effective January 1, 2007, the Company adopted the revised recommendations of CICA Handbook Section 1506, *Accounting Changes*.

Under the revised standards, voluntary changes in accounting policies are permitted only if they result in financial statements which provide more reliable and relevant information. Accounting policy changes are applied retrospectively unless it is impractical to determine the period or cumulative impact of the change. Corrections of prior period errors are applied retrospectively and changes in accounting estimates are applied prospectively by including these changes in earnings. These standards are effective for all changes in accounting policies, changes in accounting estimates and corrections of prior period errors initiated in periods beginning on or after January 1, 2007.

**Disclosure Controls and Procedures** Disclosure controls and procedures are designed to provide reasonable assurances that all relevant information is gathered and reported to senior management, including the Chief Executive Officer ("CEO") and the Chief Financial Officer ("CFO"), on a timely basis in order that appropriate decisions can be made regarding public disclosure. The CEO and the CFO have evaluated the effectiveness of Celtic's disclosure controls and procedures as defined in Multilateral Instrument 52-109 of the Canadian Securities Administrators and have concluded that such disclosure controls and procedures are effective.

**Internal Controls over Financial Reporting** The CEO and CFO are responsible for designing 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 purposes in accordance with Canadian GAAP. Management, including the CEO and the CFO, has designed Celtic's internal controls over financial reporting as required by Multilateral Instrument 52-109 of the Canadian Securities Administrators.



During the review of the design of internal controls over financial reporting, it was noted that, due to the limited number of staff at Celtic, it is not feasible to achieve complete segregation of incompatible duties. However, other internal controls over financial reporting have been designed which provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements.

Due to its inherent limitations, internal controls over financial reporting may not prevent or detect misstatements. In addition, projections of any evaluation relating to the effectiveness in future periods are subject to the risk that controls may become inadequate as a result of changes in conditions, or that the degree of compliance with policies and procedures may deteriorate.

## **GROWTH STRATEGY**

Celtic growth strategy is dual-pronged. The Company seeks to acquire assets with exploitation potential and, at the same time, implements its full-cycle exploration program. This strategy has proved successful to date as is evidenced by Celtic's rapid growth since commencing active oil and gas operations in September 2002. To complement this strategy, the Company has assembled a team of experienced and qualified personnel and is well positioned financially to act quickly on new opportunities. Celtic believes that its growth strategy will continue to increase funds from operations per share, net asset value per share and production per share.

## **RESULTS OF OPERATIONS**


### **2007 Third Quarter Highlights**

- Drilled 18 (12.6 net working interest) wells during the quarter resulting in one (1.0 net) oil well, six (6.0 net) natural gas wells, eight (2.6 net) coal bed methane wells and three (3.0 net) unsuccessful wells, for an overall success rate, based on net wells drilled, of 76%;
- Increased average daily production by 44% to 8,914 BOE per day, up from 6,175 BOE per day in the three months ended September 30, 2006;
- Reported funds from operations of \$18.8 million (\$0.50 per share, diluted), a decrease of 10% from \$20.8 million (\$0.68 per share, diluted) in the same period of the previous year; and
- Generated an average operating netback of \$25.78 per BOE, down 34% from \$39.30 per BOE in the third quarter of 2006.

**Production** Oil and gas production in the third quarter of 2007 increased 44% to average 8,914 BOE per day compared to 6,175 BOE per day in the third quarter of 2006. Production per million shares outstanding in the third quarter of 2007 averaged 238 BOE per day, up 21% from 197 BOE per day in the same period of 2006.

Celtic's strong growth in production during the third quarter of 2007 came from successful drilling results, primarily at Kaybob South, coupled with the acquisition of additional assets in the same area completed at the end of the second quarter of 2007. The Company expects to generate continued production growth as a result of its substantial development drilling program inventory at Kaybob South.

For the nine months ended September 30, 2007, production averaged 7,422 BOE per day (41% oil and 59% gas), resulting in a 27% increase from 5,852 BOE per day average production for the same period in 2006. Production per million shares outstanding in the first nine months of 2007 averaged 213 BOE per day, up 9% from 195 BOE per day in the same period of 2006.



**Revenue and Royalties** Revenue, before royalties and financial derivatives, for the three months ended September 30, 2007 was \$40.4 million, an increase of 19% compared to \$33.9 million in the same period of the previous year. Royalties in the third quarter of 2007 averaged 20.9% of sales (excluding financial derivatives) compared to 16.8% in the corresponding period of 2006. Revenue for the nine months ended September 30, 2007 was \$105.7 million, an increase of 9% compared to \$97.1 million in the same period of the previous year. Royalties in the first nine months of 2007 averaged 20.5% of sales compared to 18.7% in the corresponding period of 2006.

The combined average product price received for oil and gas sales, before financial derivative contracts, for the quarter ended September 30, 2007 was \$49.21 (\$48.55 after realized financial derivatives) per BOE, a decrease of 18% compared to the third quarter of the previous year. The combined average product price received for oil and gas sales, before financial derivative contracts, for the nine months ended September 30, 2007 was \$52.18 (\$55.91 after realized financial derivatives) per BOE, a decrease of 14% compared to the first nine months of the previous year.

**Expenses** For the three-month period ended September 30, 2007, production expenses were \$9.5 million (\$11.55 per BOE), transportation and selling expense was \$0.8 million (\$0.97 per BOE), general and administrative expenses were \$0.6 million (\$0.76 per BOE), interest expense was \$1.7 million, and depletion, depreciation and amortization expenses were \$17.8 million (\$21.66 per BOE). In the previous year, for the three-month period ended September 30, 2006, production expenses were \$5.9 million (\$10.38 per BOE), transportation and selling expense was \$0.3 million (\$0.58 per BOE), general and administrative expenses were \$0.5 million (\$0.80 per BOE), interest expense was \$1.0 million, and depletion, depreciation and amortization expenses were \$11.4 million (\$20.08 per BOE).


For the nine months ended September 30, 2007, production expenses were \$23.0 million (\$11.34 per BOE), transportation and selling expense was \$1.8 million (\$0.90 per BOE), general and administrative expenses were \$2.2 million (\$1.10 per BOE), interest expense was \$4.5 million, and depletion, depreciation and amortization expenses were \$44.4 million (\$21.91 per BOE). In the previous year, for the nine months ended September 30, 2006, production expenses were \$16.0 million (\$9.99 per BOE), transportation and selling expense was \$1.0 million (\$0.63 per BOE), general and administrative expenses were \$1.5 million (\$0.94 per BOE), interest expense was \$2.7 million, and depletion, depreciation and amortization expenses were \$30.4 million (\$19.00 per BOE).

**Taxes** For the three months ended September 30, 2007, Celtic provided for a provision of future income taxes in the amount of \$1.2 million, compared to a provision of \$2.4 million in the same period of 2006. For the nine-month period ended September 30, 2007, the Company recorded a provision for future income taxes in the amount of \$1.3 million, compared to a provision of \$8.5 million in the nine-month period ended September 30, 2006.

As at September 30, 2007, Celtic had sufficient tax deductions available, allowing the Company to not record any current income tax expense. Estimated unused income tax deductions available as at September 30, 2007 were approximately \$313.0 million.

On October 30, 2007, the Government of Canada announced a proposal to reduce future corporate income taxes. Upon enactment into law, these changes would reduce the Company's future income tax obligations.

**Net Earnings and Funds from Operations** Net earnings for the three months ended September 30, 2007 were \$4.6 million (\$0.12 per share, basic and diluted), a decrease of 71% from \$15.8 million (\$0.53 per share, basic and \$0.52 per share, diluted) in the same period of the previous year. For the nine months ended September 30, 2007, the Company recorded net earnings of \$4.7 million (\$0.13 per share, basic and diluted), compared to \$28.6 million (\$0.95 per share, basic and \$0.92 per share, diluted) recorded for the nine months ended September 30, 2006.



Funds from operations were \$18.8 million (\$0.50 per share, basic and diluted) in the third quarter of 2007, a decrease of 10% compared to \$20.8 million (\$0.70 per share, basic and \$0.68 per share, diluted) in the third quarter of 2006. For the nine months ended September 30, 2007, funds from operations were \$60.1 million (\$1.73 per share, basic and \$1.70 per share, diluted), up 1% from \$59.4 million (\$1.98 per share, basic and \$1.92 per share, diluted) in the same period of 2006.

**Capital Expenditures** Capital expenditures in the third quarter of 2007 were \$31.6 million, down 34% from \$47.9 million spent in the third quarter of 2006. During the nine-month period ended September 30, 2007, capital expenditures, including acquisitions, were \$154.6 million, an increase of 17% compared to the same period of the previous year. Drilling and completion operations accounted for \$74.1 million, equipment and facility expenditures were \$29.0 million, \$5.6 million was spent on land and seismic and \$45.6 million was incurred on property acquisitions. The Company continues to invest in land and seismic in order to build on its inventory of prospects for future drilling.

**Drilling Activity** During the three months ended September 30, 2007, Celtic drilled 18 (12.6 net) wells compared to 19 (14.4 net) wells in the third quarter of the previous year, with an overall success rate of 76% on net wells drilled. The average vertical depth of net wells drilled was 2,076 metres, 30% shallower than the average drilling depth of 2,958 metres in the third quarter of 2006. For the nine months ended September 30, 2007, the Company drilled 57 (48.0 net) wells resulting in five (3.8 net) oil wells, 25 (24.3 net) natural gas wells and nine (7.3 net) unsuccessful wells, resulting in an overall success rate of 79% based on net wells drilled.

## CAPITAL RESOURCES AND LIQUIDITY

**Source of Funds** Investment funding for capital expenditures incurred in the first nine months of 2007 was provided by funds from operations, proceeds from equity offerings, working capital and bank debt.

In February 2007, the Company issued 1.5 million common shares on a flow-through basis by way of private placement, at a price of \$16.65 per share. The equity offering resulted in gross proceeds of \$25.0 million. In June 2007, Celtic issued 3.2 million common shares by way of private placement, at a price of \$14.35 per share, resulting in gross proceeds of \$45.9 million.

The Company has in place a committed term credit facility with Canadian financial institutions. The maximum amount available to be drawn under this facility is currently \$165.0 million, up from \$155.0 million available at June 30, 2007. At September 30, 2007, Celtic had drawn \$116.1 million, leaving sufficient unused credit lines available to fund ongoing capital expenditures. Repayments of principal are not required provided that the borrowings under the facility do not exceed the authorized borrowing amount and the Company is in compliance with all covenants, representations and warranties.

**Working Capital** The capital-intensive nature of Celtic's activities may create a working capital deficiency position during periods with high levels of capital investment. However, during such periods, the Company maintains sufficient unused bank credit lines to satisfy such working capital deficiencies. At September 30, 2007, the working capital deficiency plus outstanding bank debt represented 83% of the Company's maximum authorized bank borrowing credit limit.

**Common Share Information** As at September 30, 2007, there were 37.5 million common shares outstanding. In addition, directors, employees and certain consultants have been granted options to purchase 2.9 million common shares of the Company at an average exercise price of \$10.33 per share. Detailed information regarding the Company's stock options outstanding is contained in the notes to the financial statements. The Company's common shares trade on the Toronto Stock Exchange ("TSX") under the symbol "CLT."

**Contractual Obligations** Celtic has a committed term credit facility with Canadian financial institutions. The authorized borrowing amount under this facility is currently \$165.0 million, of which \$116.1 million was outstanding at September 30, 2007. Interest under this facility is payable monthly. Additional disclosure relating to bank debt is provided in the notes to the financial statements.

From time to time, the Company enters into agreements to transport and market oil and gas production. In addition, the Company has entered into agreements with third parties that provide employees with access to specialized computer software and information including production and reserves data, geological data, accounting systems and land management systems.

As a normal course of business, the Company leases office space, vehicles for field personnel and office equipment such as computers, printers and photocopiers.

**Related-Party Transactions** The Company has retained the law firm of Borden Ladner Gervais LLP to provide Celtic with legal services. William C. Guinan, a director, chairman and corporate secretary of Celtic is a partner of this law firm. The Company expects to continue using the services of this law firm from time to time.

#### SUPPLEMENTAL QUARTERLY INFORMATION

The Company has been successful in providing strong growth in funds from operations and daily average production. The following table summarizes key financial and operating information by quarter:

(\$ thousands, except per unit amounts)	2007 Q3	2007 Q2	2007 Q1	2006 Q4	2006 Q3	2006 Q2	2006 Q1	2005 Q4
Revenue, net of royalties (\$)	36,664	28,077	18,518	33,091	37,758	24,632	27,782	26,647
Funds from operations (\$)	18,805	19,244	22,045	19,183	20,812	18,008	20,538	18,674
Per share – basic (\$/share)	0.50	0.56	0.68	0.60	0.70	0.60	0.71	0.65
Per share – diluted (\$/share)	0.50	0.55	0.67	0.58	0.68	0.59	0.69	0.62
Net earnings (loss) (\$)	4,584	2,957	(2,850)	6,599	15,850	5,481	7,301	7,062
Per share – basic (\$/share)	0.12	0.09	(0.09)	0.21	0.53	0.18	0.25	0.24
Per share – diluted (\$/share)	0.12	0.09	(0.09)	0.20	0.52	0.18	0.24	0.24
Total assets (\$)	479,026	465,151	405,249	373,882	354,768	308,890	288,839	242,113
Bank debt, net of working capital (\$)	128,027	119,367	117,188	98,236	85,251	83,452	85,107	63,426
Production (BOE/d)	8,914	7,013	6,310	6,290	6,175	5,376	6,004	5,094
Production per million shares (BOE/d)	238	213	192	196	197	181	207	176
Realized sales price (\$/BOE)	48.55	55.64	66.81	59.59	60.31	60.69	64.63	65.00
Operating netback (\$/BOE)	25.78	33.72	42.60	35.79	39.30	40.01	40.49	35.37
Netback as a percentage of sales	53%	61%	64%	60%	65%	66%	63%	54%



## **BUSINESS RISKS**

Celtic's exploration and production activities are concentrated in the Western Canadian Sedimentary Basin, where activity is highly competitive and includes a variety of different-sized companies ranging from smaller junior producers, intermediate and senior producers and royalty trust organizations, to the much larger integrated petroleum companies. Celtic is subject to a number of risks which are also common to other organizations involved in the oil and gas industry. Such risks include finding and developing oil and gas reserves at economic costs, estimating amounts of recoverable reserves, production of oil and gas in commercial quantities, marketability of oil and gas produced, fluctuations in commodity prices, financial and liquidity risks and environmental and safety risks.

In order to reduce exploration risk, Celtic employs highly qualified and motivated professional employees who have demonstrated the ability to generate quality proprietary geological and geophysical prospects. To maximize drilling success, Celtic explores in areas that afford multi-zone prospect potential, targeting a range of shallower low- to moderate-risk prospects with some exposure to select deeper high-risk prospects with high-reward opportunities.

Celtic has retained an independent engineering consulting firm that assists the Company in evaluating recoverable amounts of oil and gas reserves. Values of recoverable reserves are based on a number of variable factors and assumptions such as commodity prices, projected production, future production costs and government regulation. Such estimates may vary from actual results.

The Company mitigates its risk related to producing hydrocarbons through the utilization of the most advanced technology and information systems. In addition, Celtic strives to operate the majority of its prospects, thereby maintaining operational control. The Company does rely on its partners in jointly owned properties that Celtic does not operate.

Celtic is exposed to market risk to the extent that the demand for oil and gas produced by the Company exists within Canada and the United States. External factors beyond the Company's control may affect the marketability of oil and gas produced. These factors include commodity prices and variations in the U.S./Canadian currency exchange rate, which in turn respond to economic and political circumstances throughout the world. Oil prices are affected by worldwide supply and demand fundamentals while natural gas prices are affected by North American supply and demand fundamentals. Celtic may periodically use futures and options contracts to hedge its exposure against the potential adverse impact of commodity price volatility.

Exploration for and production of oil and gas is very capital intensive. As a result, the Company relies on equity markets as a source of new capital. In addition, Celtic utilizes bank financing to support ongoing capital investment. Funds from operations also provide Celtic with capital required to grow its business. Equity and debt capital are subject to market conditions and availability may increase or decrease from time to time. Funds from operations also fluctuate with changing commodity prices.

Oil and gas exploration and production can involve environmental risks such as pollution of the environment and destruction of natural habitat, as well as safety risks such as personal injury. The Company conducts its operations with high standards in order to protect the environment and the general public. Celtic maintains current insurance coverage for comprehensive and general liability as well as limited pollution liability. The amount and terms of this insurance are reviewed on an ongoing basis and adjusted as necessary to reflect current corporate requirements, as well as industry standards and government regulations.

## BUSINESS OUTLOOK

**Advisory Regarding Forward-Looking Statements** Certain information with respect to Celtic contained herein, including management's assessment of future plans and operations, contains forward-looking statements. These forward-looking statements are based on assumptions and are subject to numerous risks and uncertainties, certain of which are beyond Celtic's control, including the impact of general economic conditions, industry conditions, volatility of commodity prices, currency exchange rate fluctuations, imprecision of reserve estimates, environmental risks, competition from other explorers, stock market volatility and ability to access sufficient capital. As a result, Celtic's actual results, performance or achievement could differ materially from those expressed in, or implied by, these forward-looking statements and, accordingly, no assurance can be given that any events anticipated by the forward-looking statements will transpire or occur. In addition, the reader is cautioned that historical results are not necessarily indicative of future performance.

**2007 Forecast** Celtic's Board of Directors has approved a capital expenditure budget in the amount of \$186.0 million for 2007. During the nine-month period ended September 30, 2007, the Company had incurred \$154.6 million in capital expenditures. The remaining expenditures in the amount of \$31.4 million to be incurred in the fourth quarter of 2007 will be financed by funds from operations and unused bank credit lines. Celtic's capital expenditure budget for 2007 will see the Company participate at high working interests in the drilling of approximately 70 to 75 wells during the year.

After forecasting risked production discoveries, timing of production on-stream dates resulting from the Company's planned capital expenditures for 2007 and estimated decline rates on existing volumes, Celtic expects production in 2007 to average between 7,800 and 8,000 BOE per day (40% oil and 60% gas). This represents a 31% to 34% increase from average production of 5,963 BOE per day in 2006.


The Company's commodity price assumptions for 2007 are US\$68.75 per barrel for WTI oil, US\$7.00 per mmbtu for NYMEX natural gas and a U.S./Canadian exchange rate of US\$0.9258. These prices compare to 2006 average prices of US\$66.22 per barrel for WTI oil, US\$7.26 per mmbtu for NYMEX natural gas and a U.S./Canadian exchange rate of US\$0.8815.

After giving effect to the aforementioned production and commodity price assumptions and taking into effect commodity risk price management contracts in place (as outlined in detail in the notes to the financial statements), funds from operations for 2007 is forecasted to be approximately \$85.5 million or \$2.39 per share (\$2.34 per share, diluted) and net earnings is forecasted to be approximately \$3.5 million or \$0.10 per share (\$0.10 per share, diluted). Changes in forecasted commodity prices and variances in production estimates can have a significant impact on estimated funds from operations and net earnings. Please refer to the advisory regarding forward-looking statements shown above.

Bank debt, net of working capital, is estimated to reach \$141.0 million by the end of 2007 or 85% of current available credit lines.

**2008 Guidance** Celtic continues to be optimistic about its future prospects. The Company has successfully established a substantial production base that provides a cash flow stream that can be re-invested in Celtic's ongoing exploration and development activity. Celtic is opportunity driven and is confident that it can continue to grow the Company's production base by building on its current inventory of development prospects and by adding new exploration prospects. Celtic will endeavour to maintain a high-quality product stream that on a historical basis receives a superior price with reasonably low production costs. In addition, the Company takes advantage of royalty incentive programs in order to further increase netbacks. Celtic will continue to focus its exploration efforts in areas of multi-zone potential for light gravity crude oil and liquids-rich natural gas.

Celtic's Board of Directors has approved an initial capital expenditure budget in the amount of \$120 million for 2008. This capital spending will be financed by funds from operations and available bank credit lines.



After forecasting risked production discoveries, timing of production on-stream dates resulting from the Company's planned capital expenditures for 2008 and estimated decline rates on existing volumes, Celtic expects production in 2008 to average between 10,500 and 10,700 BOE per day (34% oil and 66% gas).

The Company's commodity price assumptions for 2008 are US\$70.00 per barrel for WTI oil, US\$7.50 per mmbtu for NYMEX natural gas and a U.S./Canadian exchange rate of US\$1.0000. These prices compare to estimated 2007 average prices of US\$68.75 per barrel for WTI oil, US\$7.00 per mmbtu for NYMEX natural gas and a U.S./Canadian exchange rate of US\$0.9258.

After giving effect to the aforementioned production and commodity price assumptions and taking into effect commodity risk price management contracts in place (as outlined in detail in the notes to the financial statements), funds from operations for 2008 is forecasted to be approximately \$102.5 million or \$2.74 per share (\$2.67 per share, diluted) and net earnings is forecasted to be approximately \$9.5 million or \$0.25 per share (\$0.25 per share, diluted). Changes in forecasted commodity prices and variances in production estimates can have a significant impact on estimated funds from operations and net earnings. Please refer to the advisory regarding forward-looking statements shown above.

Bank debt, net of working capital, is estimated to reach \$155.0 million by the end of 2008 or approximately 1.5 times forecasted 2008 funds from operations.

Celtic's capital expenditure budget for 2008 will see the Company participate at high working interests in the drilling of approximately 58 to 62 wells during the year. Celtic continues to pursue property acquisitions that would complement its existing asset base. Depending on actual commodity prices, completion of such acquisitions would be in lieu of drilling operations or over and above the Company's planned capital expenditure budget.

Celtic is excited about the growth prospects being generated in the Company and remains optimistic about the Company's ability to deliver continued per share growth in production, funds from operations and earnings. Given the Company's strong inventory of drilling locations, we look forward to continued growth in 2008 and beyond.

#### **ADDITIONAL INFORMATION**

Additional information relating to Celtic, including the Company's Annual Information Form ("AIF") is filed on SEDAR and can be viewed on their website at [www.sedar.com](http://www.sedar.com). Copies of the AIF can also be obtained by contacting Sadiq H. Lalani, Vice President, Finance and Chief Financial Officer at Celtic Exploration Ltd., Suite 500, 505 Third Street S.W., Calgary, Alberta, Canada, T2P 3E6. Further information relating to the Company is also available on its website at [www.celticex.com](http://www.celticex.com).

On behalf of the Board of Directors,



David J. Wilson  
*President and Chief Executive Officer*

November 6, 2007

## FINANCIAL STATEMENTS

### BALANCE SHEET (Unaudited)

(\$ thousands)	As at September 30, 2007	As at December 31, 2006
<b>ASSETS</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$ 4,080	\$ 824
Accounts receivable	18,937	19,278
Prepaid expenses	647	833
Financial derivative contracts <i>(Note 8)</i>	5,249	13,635
	<b>28,913</b>	<b>34,570</b>
Other assets	1,558	1,713
Property, plant and equipment <i>(Note 2)</i>	448,555	337,599
	<b>\$ 479,026</b>	<b>\$ 373,882</b>
<b>LIABILITIES</b>		
<b>Current liabilities</b>		
Accounts payable and accrued liabilities	\$ 39,259	\$ 26,804
Current portion of future income taxes	1,581	4,202
Bank debt <i>(Note 3)</i>	116,100	101,800
	<b>156,940</b>	<b>132,806</b>
Asset retirement obligation <i>(Note 4)</i>	5,842	4,885
Future income taxes	38,950	36,162
	<b>\$ 201,732</b>	<b>\$ 173,853</b>
<b>SHAREHOLDERS' EQUITY</b>		
Share capital <i>(Note 5)</i>	\$ 199,861	\$ 127,841
Contributed surplus <i>(Note 5)</i>	3,021	2,467
Retained earnings	74,412	69,721
Accumulated other comprehensive income <i>(Note 1b)</i>	-	-
	<b>\$ 277,294</b>	<b>\$ 200,029</b>
	<b>\$ 479,026</b>	<b>\$ 373,882</b>

The accompanying notes form an integral part of these financial statements.

#### ON BEHALF OF THE BOARD OF DIRECTORS:



Director



Director

**STATEMENT OF OPERATIONS**  
(Unaudited)

(\$ thousands, except per share amounts)	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
<b>REVENUE</b>				
Oil and natural gas	\$ 40,356	\$ 33,919	\$ 105,710	\$ 97,102
Royalties	(8,407)	(5,708)	(21,626)	(18,115)
Realized gain (loss) on financial derivatives	(540)	342	7,561	1,751
Unrealized gain (loss) on financial derivatives <i>(Note 8)</i>	5,255	9,205	(8,386)	9,432
	\$ 36,664	\$ 37,758	\$ 83,259	\$ 90,170
<b>EXPENSES</b>				
Production	\$ 9,469	\$ 5,899	\$ 22,971	\$ 15,968
Transportation and selling	799	330	1,819	1,005
Interest	1,715	1,029	4,534	2,718
General and administrative	621	453	2,226	1,494
Stock-based compensation <i>(Note 5d)</i>	406	273	1,095	818
Depletion, depreciation and amortization <i>(Note 2)</i>	17,756	11,407	44,406	30,362
Accretion of asset retirement obligation <i>(Note 4)</i>	72	72	229	433
	\$ 30,838	\$ 19,463	\$ 77,280	\$ 52,798
<b>Earnings before taxes</b>	\$ 5,826	\$ 18,295	\$ 5,979	\$ 37,372
Capital tax	–	30	–	195
Provision for future income taxes	1,242	2,415	1,288	8,545
<b>Net earnings</b>	\$ 4,584	\$ 15,850	\$ 4,691	\$ 28,632
<b>Other comprehensive income, net of tax</b>	–	–	–	–
<b>Comprehensive income</b>	\$ 4,584	\$ 15,850	\$ 4,691	\$ 28,632
<b>Earnings per share</b>				
Basic	\$ 0.12	\$ 0.53	\$ 0.13	\$ 0.95
Diluted <i>(Note 6)</i>	\$ 0.12	\$ 0.52	\$ 0.13	\$ 0.92

The accompanying notes form an integral part of these financial statements.

**STATEMENT OF RETAINED EARNINGS**  
(Unaudited)

(\$ thousands)	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
<b>Retained earnings, beginning of period</b>	<b>\$ 69,828</b>	\$ 47,272	<b>\$ 69,721</b>	\$ 34,490
<b>Net earnings</b>	<b>4,584</b>	15,850	<b>4,691</b>	28,632
<b>Retained earnings, end of period</b>	<b>\$ 74,412</b>	\$ 63,122	<b>\$ 74,412</b>	\$ 63,122

**STATEMENT OF ACCUMULATED OTHER COMPREHENSIVE INCOME**  
(Unaudited)

(\$ thousands)	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
<b>Accumulated other comprehensive income, beginning of period</b>	<b>\$ —</b>	\$ —	<b>\$ —</b>	\$ —
<b>Other comprehensive income, net of tax</b>	<b>—</b>	—	<b>—</b>	—
<b>Accumulated other comprehensive income, end of period</b>	<b>\$ —</b>	\$ —	<b>\$ —</b>	\$ —

The accompanying notes form an integral part of these financial statements.

## STATEMENT OF CASH FLOWS

(Unaudited)

(\$ thousands)	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
<b>OPERATING ACTIVITIES</b>				
Net earnings	\$ 4,584	\$ 15,850	\$ 4,691	\$ 28,632
Items not affecting cash:				
Depletion, depreciation and amortization	17,756	11,407	44,406	30,362
Accretion of asset retirement obligation	72	72	229	433
Stock-based compensation	406	273	1,095	818
Unrealized loss (gain) on financial derivatives	(5,255)	(9,205)	8,386	(9,432)
Future income taxes	1,242	2,415	1,288	8,545
<b>Funds from operations</b>	<b>\$ 18,805</b>	<b>\$ 20,812</b>	<b>\$ 60,095</b>	<b>\$ 59,358</b>
Change in non-cash operating working capital <i>(Note 9)</i>	9,262	11,595	(5,329)	7,885
<b>Cash provided by operating activities</b>	<b>\$ 28,067</b>	<b>\$ 32,407</b>	<b>\$ 54,766</b>	<b>\$ 67,243</b>
<b>FINANCING ACTIVITIES</b>				
Increase (decrease) in bank debt	\$ (9,350)	\$ 7,200	\$ 14,300	\$ 37,750
Issue of common shares, net of costs	346	16,656	70,358	42,207
<b>Cash provided by financing activities</b>	<b>\$ (9,004)</b>	<b>\$ 23,856</b>	<b>\$ 84,658</b>	<b>\$ 79,957</b>
<b>INVESTING ACTIVITIES</b>				
Property, plant and equipment expenditures	\$ (31,817)	\$ (47,915)	\$ (109,002)	\$(141,657)
Property, plant and equipment acquisitions	180	(29)	(45,634)	(448)
Property, plant and equipment dispositions	-	4	3	10,107
Change in other assets	152	(532)	155	(824)
Change in non-cash investing working capital <i>(Note 9)</i>	12,056	(5,474)	18,310	(10,400)
<b>Cash used in investing activities</b>	<b>\$ (19,429)</b>	<b>\$ (53,946)</b>	<b>\$ (136,168)</b>	<b>\$ (143,222)</b>
<b>Net change in cash and cash equivalents</b>	<b>\$ (366)</b>	<b>\$ 2,317</b>	<b>\$ 3,256</b>	<b>\$ 3,978</b>
<b>Cash and cash equivalents, beginning of period</b>	<b>4,446</b>	<b>3,473</b>	<b>824</b>	<b>1,812</b>
<b>Cash and cash equivalents, end of period</b>	<b>\$ 4,080</b>	<b>\$ 5,790</b>	<b>\$ 4,080</b>	<b>\$ 5,790</b>

The accompanying notes form an integral part of these financial statements.

## NOTES TO THE INTERIM FINANCIAL STATEMENTS

For the interim period ended September 30, 2007

(All tabular amounts in thousands, unless otherwise stated) (Unaudited)

### NOTE 1

#### A NATURE OF BUSINESS AND BASIS OF PRESENTATION

Celtic Exploration Ltd. (“Celtic” or the “Company”) was incorporated under the *Business Corporations Act* (Alberta) on April 16, 2002 as Desco Exploration Ltd. The Company changed its name to Celtic Exploration Ltd. on September 30, 2002. Celtic is an oil and natural gas exploration, development and production company based in Calgary, Alberta, Canada. The Company’s operations are focused in Western Canada, primarily in Alberta.

The interim financial statements of the Company have been prepared following the same accounting policies and methods of computation as the financial statements of the Company for the year ended December 31, 2006, with the exception of the changes in accounting policies noted below. The disclosure herein is incremental to that included in the annual financial statements. In this regard, these interim financial statements should be read in conjunction with the financial statements and notes thereto for the year ended December 31, 2006.

These financial statements are stated in Canadian dollars and have been prepared in accordance with Canadian generally accepted accounting principles (“GAAP”). The interim financial statements have not been reviewed by the Company’s external auditors. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the period. Actual results could differ from these estimates.

#### B CHANGES IN ACCOUNTING POLICIES AND PRACTICES

Effective January 1, 2007, the Company has adopted the following new Canadian Institute of Chartered Accountants (“CICA”) Handbook sections:

- (i) Section 1530, *Comprehensive Income*;
- (ii) Section 3251, *Equity*;
- (iii) Section 3855, *Financial Instruments – Recognition and Measurement*; and
- (iv) Section 3865, *Hedges*.

These new accounting standards provide requirements for the recognition and measurement of financial instruments and the use of hedge accounting. The standards have been adopted prospectively and, therefore, the comparative interim financial statements have not been restated. The adoption of these Handbook sections has no impact on opening retained earnings or opening accumulated other comprehensive income.

**Comprehensive income** CICA Handbook Section 1530 establishes standards for reporting and presenting comprehensive income and other comprehensive income. Comprehensive income is defined as the change in equity from transactions and other events from non-owner sources and other comprehensive income comprises revenues, expenses, gains and losses that, in accordance with GAAP, are recognized in comprehensive income but excluded from net earnings.

**Financial instruments and derivatives** CICA Handbook Section 3855 prescribes when a financial asset, financial liability or non-financial derivative is to be recognized on the balance sheet and at what amount, requiring fair value or cost-based measures under different circumstances. All financial instruments must be classified as one of the following five categories: loans and receivables; held-to-maturity investments; held-for-trading instruments; available-for-sale financial assets; or other financial liabilities. All financial instruments, with the exception of loans and receivables, held-to-maturity investments and other financial liabilities are reported on the balance sheet at fair value. Subsequent measurement and changes in fair value will depend on their initial classification. Available-for-sale financial assets are measured at fair value and unrealized gains or losses resulting from changes in fair value are recorded in other comprehensive income until the investment is de-recognized or impaired at which time the amounts would be recorded in earnings.

All derivative instruments, including embedded derivatives, are recorded on the balance sheet at fair value unless they qualify for the normal sale and purchase exception. All changes in fair value are included in earnings unless cash flow hedge or net investment accounting is used, in which case changes in fair value are recorded in other comprehensive income, to the extent the hedge is effective, and in earnings, to the extent it is ineffective.

**Hedge accounting** CICA Handbook Section 3865 establishes standards for when and how hedge accounting may be applied. Hedge accounting continues to be optional. At inception of the hedge, the Company must formally document the designation of the hedge, the risk management objectives, the hedging relationships between the hedged items and the hedging items and the methods for testing the effectiveness of the hedge. The Company assesses, both at inception of the hedge and on an ongoing basis, whether the derivatives designated as hedges are highly effective in off-setting changes in fair values or cash flows of hedged items.

For cash flow hedges that have been terminated or cease to be effective, prospective gains or losses on the derivative are recognized in earnings. Any gain or loss that has been included in accumulated other comprehensive income at the time the hedge is discontinued continues to be deferred in accumulated other comprehensive income until the original hedged transaction is recognized in earnings. If the likelihood of the original hedged transaction occurring is no longer probable, the entire gain or loss in accumulated other comprehensive income related to this transaction is immediately reclassified to earnings.

#### **ACCOUNTING CHANGES**

Effective January 1, 2007, the Company adopted the revised recommendations of CICA Handbook Section 1506, *Accounting Changes*. Under the revised standards, voluntary changes in accounting policies are permitted only if they result in financial statements which provide more reliable and relevant information. Accounting policy changes are applied retrospectively unless it is impractical to determine the period or cumulative impact of the change. Corrections of prior period errors are applied retrospectively and changes in accounting estimates are applied prospectively by including these changes in earnings. These standards are effective for all changes in accounting policies, changes in accounting estimates and corrections of prior period errors initiated in periods beginning on or after January 1, 2007.

#### **NOTE 2 PROPERTY, PLANT AND EQUIPMENT**

At September 30, 2007	Cost	Accumulated depletion, depreciation and amortization	Net book value
Oil and gas properties, plant and equipment	\$ 588,766	\$ 144,142	\$ 444,624
Asset retirement obligation costs	5,609	2,326	3,283
Head office assets	1,103	455	648
	<b>\$ 595,478</b>	<b>\$ 146,923</b>	<b>\$ 448,555</b>

At December 31, 2006	Cost	Accumulated depletion, depreciation and amortization	Net book value
Oil and gas properties, plant and equipment	\$ 434,385	\$ 100,199	\$ 334,186
Asset retirement obligation costs	4,879	1,974	2,905
Head office assets	852	344	508
	<b>\$ 440,116</b>	<b>\$ 102,517</b>	<b>\$ 337,599</b>

At September 30, 2007, oil and gas properties with a cost of \$34.4 million (December 31, 2006 – \$32.8 million) relating to unproved properties have been excluded from the depletion and depreciation calculation. Future capital costs required to develop proved reserves in the amount of \$4.0 million (2006 – \$30.9 million) are included in the depletion and depreciation calculation. During the nine months ended September 30, 2007, the Company capitalized \$0.4 million (2006 – \$0.4 million) with respect to employee salaries directly relating to exploration and development activities.

**NOTE 3 BANK DEBT**

	September 30, 2007	December 31, 2006
Bank loan	\$ 26,100	\$ 51,800
Bankers' acceptances	90,000	50,000
	<b>\$ 116,100</b>	<b>\$ 101,800</b>

Celtic has a committed term credit facility with Canadian financial institutions. Subsequent to September 30, 2007, the authorized borrowing amount under this facility was increased to \$165.0 million (previously \$155.0 million). Interest is payable monthly for borrowings through direct advances. Interest rates fluctuate based on a pricing grid and range from bank prime to bank prime plus 1.5%, depending upon the Company's then current debt to cash flow ratio of between less than one and a half times to greater than or equal to three times. At September 30, 2007, interest was payable at bank prime. Under the credit facility, borrowings through the use of bankers' acceptances are also available. The Company has a fixed rate bankers' acceptance in the amount of \$90.0 million maturing on October 22, 2007 at an aggregate interest rate of 5.7%. Security is provided for by a floating charge debenture over all assets in the amount of \$250.0 million, general assignment of book debts and a fixed charge on the Company's major producing petroleum and natural gas properties.

Repayments of principal are not required provided that the borrowings under the facility do not exceed the authorized borrowing amount and the Company is in compliance with all covenants, representations and warranties. The maturity date for the credit facility is May 3, 2008, at which time the banks will complete their annual review. The banks may conduct an interim review prior to May 3, 2008.

**NOTE 4 ASSET RETIREMENT OBLIGATION**

The following table provides a reconciliation of the carrying amount of the obligation associated with the retirement of oil and gas properties:

	September 30, 2007	December 31, 2006
Asset retirement obligation, beginning of period	\$ 4,885	\$ 4,294
Liabilities incurred, net of liabilities disposed	728	736
Liabilities settled	–	(646)
Revisions to estimated liabilities	–	(25)
Accretion expense	229	526
Asset retirement obligation, end of period	<b>\$ 5,842</b>	<b>\$ 4,885</b>

The key assumptions, on which the carrying amount of the asset retirement obligations is based, include a credit-adjusted risk-free rate of 8.75% and an inflation rate of 2.75%. The total undiscounted amount of the estimated cash flows required to settle the obligations is \$23.7 million (December 31, 2006 – \$20.7 million). The inflated value of estimated cash flows required to settle the obligations at a future period at the time the asset is retired is \$52.3 million (December 31, 2006 – \$43.6 million). The expected timing of payment of the cash flows required to settle the obligations ranges from 5 years to 51 years.

#### **NOTE 5 SHARE CAPITAL**

##### **A Authorized**

Unlimited number of common shares.

Unlimited number of preferred shares.

##### **B Issued**

The following table summarizes the changes in common shares outstanding for the period ended September 30, 2007:

	Common shares	Amount
Balance, December 31, 2006	32,180	\$ 127,841
Issued for cash on exercise of stock options	649	2,953
Amount relating to exercised options previously recorded as contributed surplus	–	541
Issued for cash through flow-through private placement	1,500	24,975
Issued for cash through private placement	3,200	45,920
Share issue costs, after future income taxes	–	(2,369)
<b>Balance, September 30, 2007</b>	<b>37,529</b>	<b>\$ 199,861</b>

##### **C Flow-through shares**

On February 27, 2007, Celtic issued 1.5 million common shares on a flow-through basis at an issue price of \$16.65 per share for gross proceeds of \$25.0 million. At September 30, 2007, the Company had an estimated \$16.8 million remaining obligation to incur Canadian Exploration Expenditures (“CEE”), which must be completed by December 31, 2008.

##### **D Stock options**

The following table summarizes the changes in stock options outstanding during the nine-month period ended September 30, 2007:

	Number of options	Average exercise price
Balance, December 31, 2006	2,630	\$ 8.02
Granted	1,020	12.76
Exercised	(649)	4.55
Forfeited	(57)	12.81
<b>Balance, September 30, 2007</b>	<b>2,942</b>	<b>\$ 10.33</b>

The Company uses the fair-value method to record stock-based compensation expense with respect to stock options granted. The fair value of each option granted is estimated on the date of grant using the Black-Scholes option pricing model with weighted average assumptions for grants as follows:

Nine months ended September 30	2007	2006
Risk-free interest rate	4.50%	4.25%
Expected life (years)	3.0	3.0
Expected volatility	20%	20%
Expected dividend yield	–	–
Fair value of options granted during the year (\$/share)	2.54	2.47

The following table summarizes information regarding stock options outstanding at September 30, 2007:

Range of exercise prices per share	Number of options outstanding	Weighted average remaining term in years	Weighted average exercise price per share for options outstanding	Number of options exercisable	Weighted average exercise price per share for options exercisable
\$ 2.01 – \$ 4.00	127	0.1	\$ 3.14	127	\$ 3.14
\$ 4.01 – \$ 6.00	478	1.0	5.63	478	5.63
\$ 6.01 – \$ 8.00	302	1.9	7.67	302	7.67
\$ 8.01 – \$ 10.00	28	2.1	8.65	18	8.65
\$ 10.01 – \$ 12.00	466	2.8	11.22	232	11.08
\$ 12.01 – \$ 14.00	1,491	4.4	12.60	84	12.44
\$ 14.01 – \$ 16.00	50	4.7	14.70	–	–
<b>Total</b>	<b>2,942</b>	<b>3.1</b>	<b>\$ 10.33</b>	<b>1,241</b>	<b>\$ 7.40</b>

#### **NOTE 6 EARNINGS PER SHARE**

The Company uses the treasury stock method to determine the dilutive effect of stock options and other dilutive instruments. Under this method, only “in-the-money” dilutive instruments impact the calculations in computing diluted earnings per share.

In computing diluted earnings per share, 0.4 million (2006 – 0.9 million) shares were added to the 34.8 million (2006 – 30.1 million) weighted average number of common shares outstanding during the nine-month period for the dilutive effect of stock options.

**NOTE 7 COMMITMENTS**

The Company is committed to future payments under the following agreements:

	October to December 2007	2008	2009	2010	2011	Total
Operating lease – office	\$ 140	\$ 558	\$ 558	\$ 559	\$ 186	\$ 2,001
Firm transportation agreements	164	456	172	–	–	792
Exploration and development	–	16,803	–	–	–	16,803
	\$ 304	\$ 17,817	\$ 730	\$ 559	\$ 186	\$ 19,596

Rental leases relating to office space expire on April 30, 2011. Exploration and development commitments relate to the Company's obligation pursuant to a flow-through share issue (see Note 5c).

**NOTE 8 FINANCIAL INSTRUMENTS****A Fair values of financial assets and liabilities**

Financial instruments of the Company consist mainly of receivables, payables, bank debt and financial derivative contracts, all of which are included in these financial statements. At September 30, 2007, the classification of financial instruments and the carrying amounts reported on the balance sheet and their estimated fair values are as follows:

Classification	Carrying amount	Fair value
Loans and receivables (accounts receivable)	\$ 18,937	\$ 18,937
Held-to-maturity investments	–	–
Held-for-trading instruments (financial derivative contracts)	5,249	5,249
Available-for-sale financial assets	–	–
Other financial liabilities (accounts payable and bank debt)	(155,359)	(155,359)
Total	\$ (131,173)	\$ (131,173)

**B Credit risk**

The majority of the Company's accounts receivable is in respect of oil and gas operations. Celtic generally extends unsecured credit to these third parties, and therefore, the collection of accounts receivable may be affected by changes in economic or other conditions and may accordingly impact the Company's overall credit risk. Celtic has not experienced any material credit loss in the collection of receivables in 2007.

**C Interest rate risk**

The Company is exposed to fluctuations in interest rates on its bank debt. Interest rate risk is mitigated through short-term fixed rate borrowings using bankers' acceptances.

**D Foreign exchange rate risk**

The Company is exposed to the risk of changes in the U.S./Canadian dollar exchange rate on sales of commodities that are denominated in U.S. dollars or directly influenced by U.S. dollar benchmark prices.

## **E Commodity price risk management**

The following is a summary of oil sales price derivative contracts in effect as at September 30, 2007, that have fixed future sales prices (fixed oil prices are based on the West Texas Intermediate ["WTI"] Index):

Daily quantity	Remaining term of contract	Fixed price per bbl
1,000 bbls/d (costless collar)	October 1 to December 31, 2007	US\$65.00 (floor) US\$85.00 (cap)
500 bbls/d (costless collar)	October 1 to December 31, 2007	US\$70.00 (floor) US\$85.00 (cap)
500 bbls/d	October 1 to December 31, 2007	US\$70.00
500 bbls/d	January 1 to December 31, 2008	US\$70.00

The fair value of the above oil contracts, mark-to-market at September 30, 2007, is an unrealized loss of \$1.9 million.

The following is a summary of natural gas sales price derivative contracts in effect as at September 30, 2007, that have fixed future sales prices (fixed natural gas prices are based on the New York Mercantile Exchange ["NYMEX"] Index):

Daily quantity	Remaining term of contract	Fixed price per mmbtu (NYMEX)
10,000 mmbtu/d (costless collar)	November 1 to December 31, 2007	US\$7.50 (floor) US\$12.40 (cap)

The following is a summary of natural gas sales price derivative contracts in effect as at September 30, 2007, that have fixed future sales prices (fixed natural gas prices are based on the AECO Index):

Daily quantity	Remaining term of contract	Fixed price per GJ (AECO)
25,000 GJ/d	November 1, 2007 to October 31, 2008	\$ 7.10

The fair value of the above natural gas contracts, mark-to-market at September 30, 2007, is an unrealized gain of \$7.1 million.

In addition to financial derivative instruments, the Company may, from time to time, enter into physical fixed-price sales contracts in order to manage its exposure to fluctuations in commodity prices and foreign currency exchange rates. The following is a summary of natural gas physical fixed-price sales contracts in effect as at September 30, 2007, that have fixed future sales prices (fixed natural gas prices are based on the AECO Index):

Daily quantity	Remaining term of contract	Fixed price per GJ (AECO)
2,000 GJ/d	October 1 to October 31, 2007	\$ 7.59
2,000 GJ/d	October 1 to October 31, 2007	\$ 7.40
4,000 GJ/d	October 1 to October 31, 2007	\$ 7.20

**NOTE 9 SUPPLEMENTAL CASH FLOW INFORMATION**

Changes in non-cash working capital, excluding bank debt:

Nine months ended September 30	2007	2006
Accounts receivable	\$ 341	\$ 1,280
Prepaid expenses	186	(307)
Accounts payable and accruals	12,454	(9,608)
<b>Change in non-cash working capital</b>	<b>\$ 12,981</b>	<b>\$ (8,635)</b>
Relating to:		
Operating activities	\$ (5,329)	\$ (3,709)
Investing activities	18,310	(4,926)
<b>Change in non-cash working capital</b>	<b>\$ 12,981</b>	<b>\$ (8,635)</b>

During the reporting period, the Company made the following cash outlays in respect of interest expense and capital taxes:

Nine months ended September 30	2007	2006
Interest	\$ 4,723	\$ 3,811
Capital tax	\$ –	\$ 195

## CORPORATE INFORMATION

### BOARD OF DIRECTORS

Robert J. Dales<sup>2,3,4</sup>

*President, Valhalla Ventures Inc.*

William C. Guinan<sup>1,5</sup>

*Partner, Borden Ladner Gervais LLP*

Eldon A. McIntyre<sup>2,3,4</sup>

*President, Jarrod Oils Ltd.*

Neil G. Sinclair<sup>2,4,5</sup>

*President, Sinson Investments Ltd.*

David J. Wilson<sup>3,5</sup>

*President & Chief Executive Officer,  
Celtic Exploration Ltd.*

### OFFICERS

David J. Wilson

*President & Chief Executive Officer*

Sadiq H. Lalani

*Vice President,  
Finance & Chief Financial Officer*

Michael R. Shea

*Vice President, Land*

David C. Morgenstern

*Vice President, Exploration*

Alan G. Franks

*Vice President, Operations*

<sup>1</sup> *Chairman of the Board*

<sup>2</sup> *Member of the Audit Committee*

<sup>3</sup> *Member of the Reserves Committee*

<sup>4</sup> *Member of the Compensation Committee*

<sup>5</sup> *Member of the Disclosure Committee*

### HEAD OFFICE

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Calgary, Alberta  
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### LEGAL COUNSEL

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Calgary, Alberta  
T2P 4H2

### BANKERS

National Bank of Canada  
Suite 2700, 530 Eighth Avenue S.W.  
Calgary, Alberta  
T2P 3S8

### AUDITORS

PricewaterhouseCoopers LLP  
Suite 3100  
111 Fifth Avenue S.W.  
Calgary, Alberta  
T2P 5L3

### EVALUATION ENGINEERS

Sproule Associates Limited  
Suite 900  
140 Fourth Avenue S.W.  
Calgary, Alberta  
T2P 3N3

### STOCK EXCHANGE LISTING

Toronto Stock Exchange  
Trading symbol "CLT"

### ABBREVIATIONS

bbls	barrels
mbbls	thousand barrels
bbls/d	barrels per day
BOE	barrels of oil equivalent
mBOE	thousand barrels of oil equivalent
BOE/d	barrels of oil equivalent per day
mcf	thousand cubic feet
mmcf	million cubic feet
bcf	billion cubic feet
mmcf/d	million cubic feet per day
mmbtu	million British Thermal Units
GJ	gigajoules
AECO-C	Alberta Energy Company "C" Meter Station of the Nova Pipeline System
API	American Petroleum Institute
ARTC	Alberta Royalty Tax Credit
CICA	Canadian Institute of Chartered Accountants
BIT	before income taxes
WTI	West Texas Intermediate

### CONVERSION OF UNITS

Imperial = Metric
1 acre = 0.4 hectares
2.5 acres = 1 hectare
1 bbl = 0.159 cubic metres
6.29 bbls = 1 cubic metre
1 foot = 0.3048 metres
3.281 feet = 1 metre
1 mcf = 28.2 cubic metres
0.035 mcf = 1 cubic metre
1 mile = 1.61 kilometres
0.62 miles = 1 kilometre
1 mmbtu = 1.054 GJ
0.949 mmbtu = 1 GJ
Natural gas is equated to oil on the basis of 6 mcf = 1 BOE.