

Interim Financial Statements of

PHOENIX COAL INC.

For the three and nine months ended September 30, 2009 and 2008
(Unaudited – Prepared by Management)

Management’s Comments on Unaudited Interim Consolidated Financial Statements

The accompanying unaudited interim consolidated financial statements of Phoenix Coal Inc. for the three and nine months ended September 30, 2009 and 2008 have been prepared by management and approved by the Board of Directors of the Company. These statements have not been reviewed by the Company’s external auditors.

PHOENIX COAL INC.
CONSOLIDATED BALANCE SHEETS
(Expressed in U.S. Dollars)

	Note	September 30, 2009 <i>(unaudited)</i>	December 31, 2008
ASSETS			
Current Assets			
Cash and cash equivalents.....	7	\$ 14,964,507	\$ 40,525,609
Short-term investments	7	2,473,656	100,707
Trade accounts receivable	7	6,349,834	2,843,134
Amounts due from sale of surface mining operations.....	2, 7	793,464	—
Coal inventories		—	452,558
Prepaid expenses and other current assets.....		257,998	470,506
Restricted cash, cash equivalents and certificates of deposit	2, 7, 8	7,642,667	—
Total current assets		<u>32,482,126</u>	<u>44,392,514</u>
Property, Plant and Equipment, net	2, 4	1,026,139	46,037,904
Restricted Cash, Cash Equivalents and Certificates of Deposit	2, 7, 8	6,777,991	11,638,921
Mining Rights, Mine Development Costs and Mineral Reserves, net of accumulated amortization of \$nil as at September 30, 2009 and \$3,888,082 as at December 31, 2008.....	2, 3	43,891,078	52,582,655
Amounts Due from Sale of Surface Mining Operations	2, 7	500,000	—
Other Assets		643,161	492,520
		<u>\$ 85,320,495</u>	<u>\$ 155,144,514</u>
LIABILITIES AND SHAREHOLDERS' EQUITY			
Current Liabilities			
Trade accounts payable and accrued liabilities		\$ 9,036,503	\$ 6,470,390
Vendor financing.....	3	3,000,000	—
Current portion of long-term debt	6	—	6,532,045
Current portion of asset retirement obligations	5	1,259,800	1,958,000
Total current liabilities		<u>13,296,303</u>	<u>14,960,435</u>
Asset Retirement Obligations, less current portion	2, 5	502,000	2,366,000
Long-term Debt, less current portion	2, 6	—	14,641,745
Other Long-term Liabilities		402,857	482,743
Shareholders' Equity			
Share capital		171,817,981	171,817,981
Stock options and warrants	9	19,209,566	16,625,724
Accumulated deficit		(119,908,212)	(65,750,114)
		<u>71,119,335</u>	<u>122,693,591</u>
		<u>\$ 85,320,495</u>	<u>\$ 155,144,514</u>

See accompanying notes to consolidated financial statements

PHOENIX COAL INC.

CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS
(Expressed in U.S. Dollars)
(Unaudited)

For the Three and Nine Months Ended September 30, 2009 and 2008

	<u>Note</u>	<u>Three Months Ended</u>		<u>Nine Months Ended</u>	
		<u>September 30,</u> <u>2009</u>	<u>September 30,</u> <u>2008</u>	<u>September 30,</u> <u>2009</u>	<u>September 30,</u> <u>2008</u>
Revenue		\$ 23,201,496	\$ 18,094,088	\$ 58,493,767	\$ 57,915,648
Cost and Expenses					
Cost of sales		22,767,738	17,919,115	54,531,148	56,603,982
Selling expenses		1,843,778	1,757,567	5,851,821	5,902,502
General and administrative expenses	9	2,574,881	2,540,540	8,177,464	7,952,829
Depreciation and amortization		—	2,220,777	3,731,492	5,327,953
Loss (adjustment to previously estimated loss) on sale of surface mining operations	2	(2,677,848)	—	36,242,152	—
Sales contract termination cost.....	10	—	—	3,000,000	—
		<u>24,508,549</u>	<u>24,437,999</u>	<u>111,534,077</u>	<u>75,787,266</u>
Loss from operations		(1,307,053)	(6,343,911)	(53,040,310)	(17,871,618)
Other Income (Expense)					
Interest expense, including accretion		(431,104)	(306,805)	(1,215,729)	(5,431,774)
Interest income		20,687	324,203	119,165	350,924
Foreign currency gain		—	—	—	129,130
Other, net.....		937	(337,382)	(5,143)	(552,534)
		<u>(409,480)</u>	<u>(319,984)</u>	<u>(1,101,707)</u>	<u>(5,504,254)</u>
Loss before income taxes		(1,716,533)	(6,663,895)	(54,142,017)	(23,375,872)
Income taxes (benefit)		6,000	—	16,081	(879)
Net loss and comprehensive loss		<u>\$ (1,722,533)</u>	<u>\$ (6,663,895)</u>	<u>\$ (54,158,098)</u>	<u>\$ (23,374,993)</u>
Basic and diluted loss per share		\$(0.01)	\$(0.04)	\$(0.36)	\$(0.30)
Weighted average number of common shares outstanding		150,045,552	150,012,904	150,045,552	76,851,456

See accompanying notes to consolidated financial statements

PHOENIX COAL INC.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
(Expressed in U.S. Dollars)
(Unaudited)

For the Nine Months Ended September 30, 2009 and Year Ended December 31, 2008

	Note	Common Shares (unlimited authorized)		Stock Options and	Accumulated	Total
		Shares	Dollars	Warrants	Deficit	
December 31, 2007		37,701,440	\$ 22,426,771	\$ 1,458,884	\$ (33,109,913)	\$ (9,224,258)
Share capital contribution - common						
shares issued in payment of loan fees		408,163	510,204	—	—	510,204
Issuance of common shares to settle debt		8,668,000	10,276,682	—	—	10,276,682
Conversion of preferred shares, including						
accrued dividends, to common shares		39,386,270	48,922,722	—	—	48,922,722
Value of additional shares issued in						
payment of debt		—	808,258	—	(808,258)	—
Share-based compensation - options	9	—	—	260,000	—	260,000
Balances – pre merger, pre share issue, and prior to recording loss for the year		86,163,873	82,944,637	1,718,884	(33,918,171)	50,745,350
Marimba Capital Corp. equity balances						
pre-merger		2,320,000	347,514	48,120	(88,255)	307,379
Marimba Capital shares consolidated on the basis of 1 share for every 2.35						
shares outstanding		(1,332,769)	—	—	—	—
Reverse takeover adjustment		—	(88,255)	—	88,255	—
Reverse takeover costs incurred		—	—	—	(408,000)	(408,000)
Issuance of common shares		62,857,160	97,784,678	—	—	97,784,678
Issuance of warrants	9	—	(8,077,145)	8,077,145	—	—
Issuance of broker options	9	—	(1,106,286)	1,106,286	—	—
Share-based compensation - options	9	—	—	5,675,289	—	5,675,289
Options and warrants exercised	9	37,288	12,838	—	—	12,838
Net loss		—	—	—	(31,423,943)	(31,423,943)
December 31, 2008		150,045,552	171,817,981	16,625,724	(65,750,114)	122,693,591
Share-based compensation – options	9	—	—	2,583,842	—	2,583,842
Net loss		—	—	—	(54,158,098)	(54,158,098)
September 30, 2009		150,045,552	\$ 171,817,981	\$ 19,209,566	\$ (119,908,212)	\$ 71,119,335

See accompanying notes to consolidated financial statements

PHOENIX COAL INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Expressed in U.S. Dollars)
(Unaudited)
For the Three and Nine Months Ended September 30

	Note	Three Months Ended		Nine Months Ended	
		September 30, 2009	September 30, 2008	September 30, 2009	September 30, 2008
Cash Flow From Operating Activities					
Net loss		\$ (1,722,533)	\$ (6,663,895)	\$ (54,158,098)	\$ (23,374,993)
Adjustments to reconcile net loss to net cash used in operating activities:					
Depreciation and amortization		—	2,220,777	3,731,492	7,645,481
(Gain) loss on sale of property and equipment		(941)	337,083	790	551,140
Loss (adjustment to previously estimated loss) on sale of surface mining operations	2	(2,677,848)	—	36,242,152	—
Interest rate swap		—	(209,536)	—	(224,696)
Foreign currency gain		—	—	—	(129,130)
Share-based compensation	9	718,842	640,000	2,583,842	2,931,277
Asset retirement obligations	5	(576,270)	(372,717)	(644,219)	(278,151)
Dividends accrued on preferred shares		—	—	—	1,467,165
Changes in non-cash operating assets and liabilities:					
Accounts receivable		(3,061,120)	339,346	(3,506,700)	636,904
Inventories		625,485	(134,719)	200,202	677,841
Prepaid expenses and other current assets		454,505	376	(121,975)	203,864
Trade accounts payable and accrued liabilities		849,770	(3,686,048)	2,622,914	(1,370,140)
Net cash used in operating activities		(5,390,110)	(7,529,333)	(13,049,600)	(11,263,438)
Cash Flow From Investing Activities					
Restricted cash, cash equivalents, and certificates of deposit	2, 8	396,639	(8,679,893)	(981,321)	(8,593,468)
Proceeds from (payments for) investments		605,219	(36,981,408)	(1,873,365)	(36,828,308)
(Payments) reimbursement for other assets, principally mine development		(928,206)	453,997	(2,648,899)	(589,562)
Proceeds from sale of property and equipment		200,000	210,000	210,000	613,300
Proceeds from sale of surface mining operations, net of expenses of sale	2	4,013,783	—	4,013,783	—
Reimbursements (payments) for property and equipment	4	504,831	(1,786,079)	(1,346,610)	(2,000,591)
Net assets acquired in merger, prior to public offering		—	—	—	307,379
Acquisitions		—	(3,000,420)	—	(28,000,420)
Acquisition of mining rights	3	—	—	(3,307,259)	—
Net cash provided by (used in) investing activities		4,792,266	(49,783,803)	(5,933,671)	(75,091,670)
Cash Flow From Financing Activities					
Principal payments on debt	6	(41,872)	(99,259)	(209,024)	(500,243)
Proceeds from debt		—	—	—	4,891,890
Payments on equipment financing	6	(2,057,227)	(2,791,515)	(6,288,921)	(4,813,746)
Reverse takeover costs incurred		—	—	—	(408,000)
Decrease in other long-term liabilities		(33,330)	(190,523)	(79,886)	(221,177)
Net proceeds from capital contributions		—	12,838	—	97,797,516
Net cash (used in) provided by financing activities		(2,132,429)	(3,068,459)	(6,577,831)	96,746,240
Net (Decrease) Increase in Cash and Cash Equivalents		(2,730,273)	(60,381,595)	(25,561,102)	10,391,132
Cash and Cash Equivalents, Beginning of Period		17,694,780	71,154,101	40,525,609	381,374
Cash and Cash Equivalents, End of Period		\$ 14,964,507	\$ 10,772,506	\$ 14,964,507	\$ 10,772,506
Supplemental Disclosure:					
Interest paid		\$ 481,104	\$ 603,851	\$ 1,250,729	\$ 1,849,003
Non-Cash Investing and Financing Activities:					
Amounts due and escrowed from sale of surface mining operations	2	\$ 3,593,464	\$ —	\$ 3,593,464	\$ —
Vendor financing for equipment purchases		\$ 808,324	\$ 7,763,713	\$ 6,629,614	\$ 14,852,350
Vendor provided financing for acquisition of mining rights	3	\$ —	\$ —	\$ 3,000,000	\$ —
Asset retirement obligations assumed by purchaser of surface mining operations	2	\$ 2,764,276	\$ —	\$ 2,764,276	\$ —
Debt related to equipment assumed by purchaser of surface mining operations	2	\$ 21,305,458	\$ —	\$ 21,305,458	\$ —

See accompanying notes to consolidated financial statements

PHOENIX COAL INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Three and Nine Months Ended September 30, 2009 and 2008
(Unaudited)

NOTE 1 — NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations: On September 30, 2009, the Company sold substantially all of its surface mining operations (as described in note 2) and is currently engaged in the development of primarily underground coal reserves in Western Kentucky. The Company's mining activities are currently limited to one reportable business segment, which is the Illinois Basin. On June 27, 2008, Phoenix Coal Corporation ("Phoenix") completed a reverse takeover ("RTO") of Phoenix Coal Inc. (the "Company"), formerly Marimba Capital Corp. ("MCC"), which was previously listed on the TSX Venture Exchange. MCC was incorporated under the Business Corporations Act (Alberta) on February 8, 2007 and was classified as a Capital Pool Company as defined in the TSX Venture Exchange Policy 2.4 and, accordingly, had no assets other than cash and no commercial operations. MCC changed its name to Phoenix Coal Inc. on June 25, 2008. Phoenix, a U.S. company headquartered in Madisonville, Kentucky with a satellite office in Louisville, Kentucky, was formed in July 2004 as a Delaware C corporation and was originally named Dynamic Separations, Inc. ("DSI"). Where the context requires, in respect to transactions prior to the RTO, the "Company" also refers to Phoenix.

Principles of Consolidation: Pursuant to the RTO transaction, these consolidated financial statements reflect the assets, liabilities and results of operations of Phoenix prior to the RTO and the consolidated assets, liabilities and results of operations of the Company and Phoenix subsequent to the RTO. The consolidated financial statements are issued under the name of the legal parent (the Company), but are deemed to be a continuation of the legal subsidiary (Phoenix). The consolidated financial statements include Phoenix Coal Inc. and its subsidiaries, all of which are wholly-owned.

Basis of Presentation: The accompanying interim consolidated financial statements of the Company have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP") for interim financial statements and accordingly do not include all disclosures required for annual financial statements. All monetary references expressed in these notes are references to United States dollars, except occasional references to Canadian dollar amounts, where the dollar amount is preceded by Cdn ("Cdn\$").

With the exception of new accounting pronouncements discussed in this note, these interim consolidated financial statements follow the same significant accounting policies and methods of application as the Company's audited annual consolidated financial statements for the year ended December 31, 2008 (the "Annual Financial Statements"). The interim consolidated financial statements should be read in conjunction with the Annual Financial Statements.

In the opinion of management, all adjustments (including normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for these interim periods are not necessarily indicative of the results that may be expected for the full fiscal year ending December 31, 2009.

Sale of Surface Mining Operations: As further described in note 2, on September 30, 2009, the Company sold substantially all of its surface mining operations. At June 30, 2009, pursuant to Canadian Institute of Chartered Accountants' ("CICA") Section 3475, Disposal of Long-Lived Assets and Discontinued Operations, and Emerging Issues Committee ("EIC") Abstract No. 161, Discontinued Operations, the Company had classified these surface mining assets and liabilities related to this sale, as assets and liabilities held for sale. As the Company will not have substantial continuing operations after September 30, 2009, discontinued operations accounting has not been applied in these consolidated financial statements. Additionally, due to the classification of the property and equipment, mine development and mining rights as assets held for sale at June 30, 2009, no depreciation and amortization expense was recorded on these assets during the three months ended September 30, 2009.

New Accounting Policies:

Goodwill and Intangible Assets: The CICA has issued a new standard, CICA Section 3064, Goodwill and Intangible assets, which establishes revised standards for recognition, measurement, presentation and disclosure of goodwill and intangible assets and is effective January 1, 2009. Concurrent with the introduction of this standard, the CICA withdrew EIC-27, Revenues and Expenses during the pre-operating period. This standard has had no material impact on the Company's consolidated financial statements.

Financial Instruments: The EIC has issued EIC-173, Credit Risk and the Fair Value of Financial Assets and Financial Liabilities, which clarifies the application of credit risk when determining the fair value of financial assets and liabilities.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Three and Nine Months Ended September 30, 2009 and 2008 (Unaudited)

EIC-173 is effective for interim and annual financial statements for periods ending on or after January 20, 2009. This standard has had no material impact on the Company's consolidated financial statements.

Mining Exploration Costs: The EIC has issued EIC-174, Mining Exploration Costs, which discusses the circumstances under which exploration costs may be capitalized. Additionally, EIC-174 clarifies the timing for testing capitalized exploration costs for impairment. EIC-174 is effective for interim and annual financial statements issued after March 27, 2009. This standard has had no material impact on the Company's consolidated financial statements.

Future Accounting Changes:

International Financial Reporting Standards ("IFRS"): In 2006, the Canadian Accounting Standards Board ("AcSB") published a new strategic plan that will significantly affect financial reporting requirements for Canadian companies. In February 2008, the AcSB announced that Canadian GAAP for publicly accountable enterprises will be converged with IFRS effective in calendar year 2011. The Company will adopt IFRS for the fiscal year beginning January 1, 2011, with restatement for comparative purposes of amounts reported by the Company for the fiscal year beginning January 1, 2010.

The Company is in the planning and evaluation phase of the conversion, which includes the identification and analytical review of potential differences between GAAP and existing IFRS as at September 30, 2009, as well as proposed IFRS which may be in effect in 2011. Detailed review of these differences has been performed in several financial statement areas, including property and equipment, asset retirement obligations and share-based compensation. Employees responsible for financial reporting have completed IFRS training. Quantification of GAAP and IFRS differences has not yet been determined as the Company finalizes its policy choices and elections.

Reclassifications: Certain of the 2008 figures have been reclassified to conform to the 2009 financial statement presentation.

NOTE 2 — SALE OF SURFACE MINING OPERATIONS

On September 30, 2009, the Company sold substantially all of its operating assets and operations associated with its surface coal mining operations in Western Kentucky, including coal and supplies inventories, coal reserves and related prepaid royalties, mining property, plant and equipment, mining rights, coal purchase contracts and coal sales contracts. All of the Company's revenues were derived from these operations.

The consideration received under the terms of the agreement ("Acquisition Agreement") for the surface mining operations included cash, assumption by the purchaser of all debt associated with the equipment being sold and the assumption of certain asset retirement obligations. Reclamation liabilities related to surface mining operations whose reserves had been depleted as at September 30, 2009 were not included in the sale. The Company can potentially receive an additional \$500,000 of cash consideration if, by June 30, 2010, it satisfies certain post-closing obligations ("2010 Fee"). The Company will recognize the 2010 Fee when it is received. In addition, upon completion of the regulatory transfer of the acquired mining permits, the purchaser will replace the Company's letters of credit for assumed reclamation obligations, which will release the restrictions on approximately \$5.6 million of restricted cash and certificates of deposit.

With respect to the cash consideration, \$4.6 million was received by the Company on closing, and \$2.3 million was placed in escrow. The Company will receive from the purchaser an additional \$1.5 million during the 2009 fourth quarter ("2009 Fee") as a result of satisfying certain post-closing obligations, and thus has recorded the 2009 Fee in the consolidated financial statements as at September 30, 2009. Of the \$1.5 million, \$500,000 will be placed in escrow when received. The 2009 Fee will be offset by approximately \$207,000 for the amount of the working capital adjustment that is due the purchaser pursuant to the Acquisition Agreement. Additionally, if earned by the Company, the 2010 Fee will also be placed in escrow. Subject to the indemnification provisions of the Acquisition Agreement, the escrowed funds will be released to the Company with one third of the escrowed balance released March 31, 2010, one half of the remaining escrowed balance released September 30, 2010, and the balance of the escrowed funds released March 31, 2011.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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(Unaudited)**

Consideration received from the sale and the related loss on sales is as follows:

Proceeds from sale:

Cash consideration received on closing	\$ 4,573,199
Cash placed in escrow on closing	2,300,000
Amounts due from purchaser for 2009 Fee, net of working capital adjustments.....	1,293,464
Asset retirement obligations assumed by the purchaser	2,764,276
Debt related to equipment assumed by the purchaser	21,305,458
	<u>32,236,397</u>

Net book value of assets sold and expenses of sale:

Working capital components including coal and supplies inventories and prepaid royalties	718,641
Property and equipment	49,953,795
Mine development, mining rights and mineral reserves	17,246,697
Expenses of sale.....	559,416
	<u>68,478,549</u>

Loss on sale of surface mining operations	36,242,152
Write down of assets held for sale previously recognized in the three months ended June 30, 2009	<u>38,920,000</u>

Adjustment to previously estimated loss on sale of surface mining operations in the three months ended September 30, 2009.....	<u>\$ 2,677,848</u>
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Total cash proceeds received or to be received from the sale have been recorded in the consolidated balance sheet at September 30, 2009 as follows:

Cash and cash equivalents	\$ 4,573,199
Amounts due from sale of surface mining operations – current	793,464
Amounts due from sale of surface mining operations – long-term.....	500,000
Restricted cash, cash equivalents, and certificates of deposit – current.....	1,866,667
Restricted cash, cash equivalents, and certificates of deposit – long-term	433,333
Total.....	<u>\$ 8,166,663</u>

The above loss is a preliminary estimate and may differ from the final loss calculation upon finalization of working capital and other post-closing adjustments that will occur after September 30, 2009.

NOTE 3 — MINING RIGHTS, MINE DEVELOPMENT COSTS AND MINERAL RESERVES

Petersburg Coal Sublease

In March 2009, the Company entered into a sublease agreement with Petersburg Coal, LLC (“Petersburg”) to sublease mineral reserves which are contiguous to its Gryphon Mining Complex, formerly known as the Pratt Mine. Under the terms of the sublease, the Company paid \$3,000,000 at closing, assumed \$192,178 in liabilities, and will pay an additional \$3,000,000 upon satisfactory completion of certain contingencies, including receipt of all required permits from Petersburg. The Company also incurred transaction costs related to the sublease of \$115,081, bringing the total cost of the sublease to \$6,307,259.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**Three and Nine Months Ended September 30, 2009 and 2008
(Unaudited)**

A mineral reserve and mineral resource evaluation prepared in accordance with National Instrument 43-101 (“NI 43-101”) of the Gryphon Mining Complex was prepared as at April 1, 2009 by an independent geological and engineering consulting firm. Based on the report, at the Gryphon Mining Complex the Company controls 68.4 million tons of proven and probable coal mineral reserves, 3.7 million tons of underground measured and indicated coal resources, and 0.2 million tons of inferred coal resources.

The costs of the sublease were allocated to the following identifiable assets:

Prepaid royalties	\$ 172,413
Mining rights	6,134,846
	<u>\$ 6,307,259</u>

Mining Rights, Mine Development Costs and Mineral Reserves

Mining rights, mine development costs and mineral reserves consist of the following:

	<u>September 30, 2009</u>	<u>December 31, 2008</u>
Mining rights and mineral reserves related to underground coal reserves.....	\$41,916,440	\$ 35,781,594
Mining rights and mineral reserves related to surface coal reserves.....	—	15,119,914
Mine development costs related to underground coal reserves.....	1,974,638	1,152,035
Mine development costs related to surface coal reserves	—	529,112
	<u>\$ 43,891,078</u>	<u>\$ 52,582,655</u>

NOTE 4 — PROPERTY, PLANT AND EQUIPMENT, NET

Property, plant and equipment consist of the following:

	<u>September 30, 2009</u>			<u>December 31, 2008</u>
	<u>Cost</u>	<u>Accumulated Depreciation</u>	<u>Net Book Value</u>	<u>Net Book Value</u>
Land.....	\$ 917,574	\$ —	\$ 917,574	\$ 1,474,574
Building and improvements	—	—	—	17,726
Preparation plant	—	—	—	2,737,352
Mining equipment	—	—	—	40,128,200
Loading and marine transport equipment.....	—	—	—	1,434,792
Office equipment.....	150,869	42,304	108,565	212,278
Vehicles.....	—	—	—	32,982
	<u>\$ 1,068,443</u>	<u>\$ 42,304</u>	<u>\$ 1,026,139</u>	<u>\$46,037,904</u>

As described in note 2, the Company sold substantially all of its surface mining operations and assets on September 30, 2009.

NOTE 5 — ASSET RETIREMENT OBLIGATIONS

The Company estimates its ARO liabilities for final reclamation and mine closure based upon detailed engineering calculations of the amount and timing of the future cash spending for a third party to perform the required work. Spending estimates are escalated for inflation and then discounted at the credit-adjusted risk-free rate. The Company records an ARO asset associated with the discounted liability for final reclamation and mine closure. The obligation and corresponding asset are recognized in the period in which the liability is incurred. The ARO asset is amortized on the units-of-production method and the ARO liability is accreted to the projected spending date. As changes in estimates occur (such as mine plan revisions, changes in estimated costs or changes in timing of the performance of reclamation activities), the revisions to the obligation and asset are recognized at the appropriate credit-adjusted risk-free rate. The Company also recognizes an obligation for

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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contemporaneous reclamation liabilities incurred as a result of surface mining. Contemporaneous reclamation consists primarily of grading, topsoil replacement, and revegetation of backfilled pit areas.

A progression of the asset retirement obligations recorded on the consolidated balance sheet is as follows:

Total asset retirement obligations as at December 31, 2007.....	\$ 3,757,353
Liabilities acquired	1,131,000
Liabilities incurred.....	166,083
Accretion	189,132
Liabilities settled.....	<u>(919,568)</u>
Total asset retirement obligations as at December 31, 2008.....	4,324,000
Liabilities incurred.....	846,295
Accretion	188,719
Liabilities settled.....	(832,938)
Liabilities assumed by purchaser of surface mining operations	<u>(2,764,276)</u>
Total asset retirement obligations as at September 30, 2009	1,761,800
Less current portion	<u>1,259,800</u>
	<u>\$ 502,000</u>

NOTE 6 — DEBT

Long-term debt consists of the following:

	<u>September 30, 2009</u>	<u>December 31, 2008</u>
Bank notes payable, interest at 5.50% to 8.90%. Payments were made in monthly installments. The loans were collateralized by various pieces of equipment and were scheduled to mature April 2010.....	\$ —	\$ 105,109
Equipment notes payable, interest at 5.25% to 8.75%. Payments were made in monthly installments. The loans were collateralized by related assets and had maturity dates from August 2010 to March 2013.	—	21,068,681
Total long-term debt	<u>—</u>	<u>21,173,790</u>
Less current portion	—	6,532,045
	<u>\$ —</u>	<u>\$ 14,641,745</u>

Long-term debt was assumed by the purchaser under the terms of the Acquisition Agreement as described in note 2.

NOTE 7 — FINANCIAL INSTRUMENTS AND FINANCIAL RISK FACTORS

The Company has exposure to credit risk, liquidity risk, interest rate risk, and foreign currency risk. The Company's risk management objective is to protect earnings and cash flow and, ultimately, shareholder value. Risk management strategies, as discussed below, are designed and implemented to ensure the Company's risks and the related exposure are consistent with its business objectives and risk tolerance.

Credit Risk: Credit risk is the risk of a financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligation.

The Company had invested approximately \$28,100,000 of its cash and cash equivalents (including restricted cash and investments) and short-term investments in a U.S. financial institution, which as at September 30, 2009, carried Standard and Poor's investment ratings on their deposits of A-2 to BBB+. The Company has not experienced any losses on its deposits with this financial institution.

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The Company is also subject to credit risk from its trade accounts receivable and amounts due from the sale of its surface mining operations. While economic factors can affect credit risk, the Company manages risk by providing credit terms on a case by case basis. Customers are primarily investment grade companies and quasi-governmental agencies. As a result, the Company has not experienced any instances of non-payment. The amounts due from the sale of its surface mining operations are payable by a privately-owned coal company with over thirty-five years of mining history. Of the total amount due of \$1,500,000, \$1,000,000 was received in October 2009.

The Company also invests in short-term investments issued by the United States government, such as Treasury bills and Treasury notes. Historically, these types of investments have been AAA rated, so the Company does not anticipate any risk related to default on these investments by the issuer.

As at September 30, 2009, the total fair value of assets subject to credit risk, including cash and cash equivalents (including restricted cash and investments), short-term investments, trade accounts receivable, and amounts due from the sale of surface mining operations approximates their carrying value of \$39,502,644.

Liquidity Risk: Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they come due. The Company manages its liquidity by ensuring that there is sufficient capital to meet short and long-term business requirements, after taking into account cash flows from operations and the Company's holdings of cash, cash equivalents and short-term investments. The Company also strives to maintain sufficient financial liquidity at all times in order to participate in investment opportunities as they arise, as well as to withstand sudden adverse changes in economic circumstances.

Management forecasts cash flows for its current and subsequent fiscal years to predict future financing requirements. Future requirements are met through a combination of credit commitments and access to capital markets. As at September 30, 2009, the Company had \$17.4 million of cash, cash equivalents, and short-term investments.

Interest Rate Risk: Interest rate risk is the risk borne by an interest-bearing asset or liability as a result of fluctuations in interest rates. Financial assets and financial liabilities with variable interest rates expose the Company to cash flow interest rate risk. The Company's most significant interest rate risk arises from its short-term investments and cash equivalents. However, the maturity on these instruments is generally less than ninety days, thereby mitigating the exposure to the impact of changing interest rates.

Currency Risk: The Company's functional currency is the U.S. dollar and the Company's sales are denominated in U.S. dollars. As the Company operates in an international environment, some of the Company's financial instruments and transactions are denominated in currencies other than the U.S. dollar. The results of the Company's operations are subject to currency transaction risk and currency translation risk. As at September 30, 2009, the Company had no material financial instruments that were denominated in non U.S. currencies.

NOTE 8 — COMMITMENTS AND CONTINGENT LIABILITIES

In the normal course of business, the Company makes various commitments and incurs certain contingent liabilities including liabilities related to asset retirement obligations and financial obligations in connection with mining permits that are not reflected in the accompanying consolidated balance sheet. The Company does not anticipate any material losses as a result of these transactions. In accordance with Kentucky state law, the Company is required to post reclamation bonds to assure that reclamation work is completed. Outstanding reclamation bonds related to Company owned reclamation operations totaled approximately \$6.2 million as at September 30, 2009 and approximately \$11.0 million as at December 31, 2008. In addition, at September 30, 2009, the Company had approximately \$5.6 million of additional reclamation bonds outstanding related to its previously owned surface mining operations that are in the process of being replaced by the purchaser under the terms of the Acquisition Agreement. These bonds are secured by letters of credit, cash or certificates of deposit issued by a bank equal to the amount of the outstanding reclamation bonds. The letters of credit are collateralized by cash. The restricted cash and certificates of deposit collateralizing the reclamation bonds on the consolidated balance sheet totaled \$11,970,658 and \$11,638,921 as at September 30, 2009 and December 31, 2008, respectively.

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The Company leases certain office space under an operating lease running through 2009. Future non-cancelable minimum lease commitments under this lease as at September 30, 2009, payable in 2009, totaled \$57,299.

A significant amount of the Company's surface and underground coal reserves are controlled through leasing arrangements and non-cancellable royalty lease agreements under which future minimum lease payments are due.

The Company had future commitments to purchase fuel, coal, and pay fees for the delivery of certain coal reserves to a third party. These commitments were assumed by the purchaser under the terms of the Acquisition Agreement.

NOTE 9 — STOCK INCENTIVE PLAN AND WARRANTS

2007 Stock Option Plan of MCC

MCC adopted an incentive stock option plan in May 2007 (the "2007 Plan") which provides that the board of directors of the Company may from time to time, in its discretion, and in accordance with TSX requirements, grant to directors, officers, employees and technical consultants to the Company, non-transferable options to purchase common shares, provided that the number of common shares reserved for issuance will not exceed 10% of the issued and outstanding common shares. Such options will be exercisable for a period of up to 5 years from the date of grant. Vesting terms will be determined at the time of grant by the board of directors.

In 2007, upon closing of an initial public offering, MCC granted to its directors and officers options to acquire 150,000 shares at a price of Cdn\$0.25 per share, exercisable for a period of five years from August 28, 2007.

The 2007 Plan remains in force and options issued prior to the RTO will continue to be governed by the 2007 Plan; however due to the approval of the 2008 Plan (defined below), no further options will be issued pursuant to the 2007 Plan.

2008 Stock Option Plan of the Company

In connection with completion of the RTO, the Company adopted a new stock option plan (the "2008 Plan") on May 20, 2008, which was effective upon the closing of the RTO.

The 2008 Plan is designed to advance the interests of the Company by encouraging employees, officers, directors and consultants to have equity participation in the Company through the acquisition of common shares. The current intention is to use the 2008 Plan for option grants to employees, officers, directors and consultants of the Company. Options granted under the 2008 Plan may be "incentive stock options" or "non-qualified stock options". The 2008 Plan was approved by the shareholders of the Company in June 2008 and 13,500,000 common shares are reserved for issuance under the 2008 Plan.

The exercise price per common share is not to be less than the market price of the common shares at the time of the grant. The exercise period for each stock option is not to be more than ten years (five years in the case of an incentive stock option granted to a person who owns more than 10% of the issued and outstanding common shares). Options may be granted subject to vesting requirements.

Unless terminated earlier by the board of directors, the 2008 Plan will remain in effect until all options granted under the 2008 Plan have been exercised or forfeited, or have expired. However, no new options may be granted under the 2008 Plan more than 10 years from the date the Plan was originally adopted by the board of directors.

Phoenix had a stock incentive plan authorized by its board of directors in 2004 (the "2004 Plan") to grant options to its employees (including officers), directors and consultants. Pursuant to the 2004 Plan, Phoenix could issue "non-statutory options" and "incentive stock options" to purchase common shares of Phoenix as well as "stock purchase rights".

Stock options granted under the 2004 Plan were generally subject to vesting provisions of 25% at the end-of-year one from the date of grant and then evenly over the following 48 months. The options were granted at a price equal to 100% of the fair value of the Company's common shares on the date of grant and have a ten-year term.

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Upon completion of the RTO, each Phoenix stock option was cancelled and extinguished and the holder received a replacement option of the Company to purchase that number of common shares of the Company equal to the number of shares of Phoenix common shares issuable under the Phoenix option with no change in the exercise price of such options due to the nature of the exchange rate between United States dollars and Canadian dollars. These replacement options are governed by the terms of the 2008 Plan.

Under the terms of the 2008 Plan, and as approved by the board of directors, the sale of the surface mining assets and associated liabilities described in note 2 caused all options outstanding under the 2008 Plan to become fully vested and all unrecognized compensation expense was charged to the consolidated statement of operations on September 30, 2009.

Information regarding stock option activity under the Plans follows:

2007 MCC Plan and 2008 Company Plan

	<u>2009 Activity</u>	
	<u>Number of Options</u>	<u>Weighted Average Exercise Price</u>
Options Denominated in Canadian Dollars		
Balance, December 31, 2008	4,410,830	Cdn\$0.83
Granted	6,500,000	Cdn 0.30
Voluntarily surrendered and cancelled	(900,000)	Cdn 1.75
Cancelled	(25,000)	Cdn 1.75
Cancelled and replaced	(337,000)	Cdn 1.75
Replacement options, including 208,000 previously issued in U.S. dollars	545,000	Cdn 0.30
Forfeited.....	<u>(535,000)</u>	Cdn 1.75
Options outstanding as at September 30, 2009	<u>9,658,830</u>	<u>Cdn\$0.27</u>
Options exercisable as at September 30, 2009.....	<u>9,658,830</u>	<u>Cdn\$0.27</u>
Options Denominated in U.S. Dollars (2004 Plan Options Replaced with 2008 Plan Options)		
Balance, December 31, 2008	5,311,000	\$0.98
Voluntarily surrendered and cancelled	(3,300,000)	1.25
Cancelled and replaced (in Canadian dollars).....	(208,000)	1.25
Forfeited.....	<u>(403,000)</u>	0.96
Options outstanding as at September 30, 2009	<u>1,400,000</u>	<u>\$0.32</u>
Options exercisable as at September 30, 2009.....	<u>1,400,000</u>	<u>\$0.32</u>

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	<u>2008 Activity</u>	
	<u>Number of Options</u>	<u>Weighted Average Exercise Price</u>
Options Denominated in Canadian Dollars		
Balance, December 31, 2007	150,000	Cdn\$0.25
Consolidated at 1:2.35, pursuant to RTO.....	(86,170)	
Balance after consolidation.....	63,830	Cdn 0.59
Granted	9,397,000	Cdn 1.32
Voluntarily surrendered and cancelled	(5,050,000)	Cdn 1.75
Options outstanding as at December 31, 2008.....	<u>4,410,830</u>	<u>Cdn\$0.83</u>
Options exercisable as at December 31, 2008	<u>1,498,340</u>	<u>Cdn\$0.82</u>
Options Denominated in U.S. Dollars (2004 Plan Options Replaced with 2008 Plan Options)		
Balance, December 31, 2007	6,749,000	\$0.87
Granted	1,000	1.25
Exercised	(25,438)	0.25
Forfeited.....	(1,413,562)	0.43
Options outstanding as at December 31, 2008.....	<u>5,311,000</u>	<u>\$0.98</u>
Options exercisable as at December 31, 2008	<u>2,986,495</u>	<u>\$0.89</u>

Compensation cost of stock option grants is recognized straight-line over the options' vesting periods. Compensation expense related to stock options for the nine months ended September 30, 2009 and 2008 was \$2,583,842 and \$2,931,277, respectively. In March 2009, certain officers of the Company voluntarily surrendered, and the board of directors concurrently cancelled, 4,200,000 options that had been previously issued to them, of which 2,075,849 were fully vested at the surrender date. The voluntary surrender was not accompanied by a concurrent grant of a replacement award or other consideration to these officers. This surrender caused an acceleration of the related compensation costs under CICA Handbook Section 3870.

Additionally, in March 2009, the board of directors cancelled and replaced 545,000 stock options that had been previously issued to various production and administrative personnel. These options had originally been granted in 2007 and 2008, with vesting periods ranging from 3 years to 5 years, and exercise prices ranging from \$1.25 to Cdn\$1.75. The replacement options have an exercise price of Cdn\$0.30.

The options' fair value was determined using the Black-Scholes option-pricing model. Expected volatilities are based on comparable company historical share price movement and other factors. The cost relating to the stock-based compensation plans is included in general and administrative expenses in the accompanying consolidated statements of operations.

PHOENIX COAL INC.

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As at September 30, 2009, the following stock options were outstanding:

<u>Number of Options</u>	<u>Exercise Price</u>	<u>Expiration Date</u>
585,000	\$0.25	April 2015
465,000	0.25	December 2015
335,000	0.50	May 2016
15,000	1.25	March 2017
63,830	Cdn 0.59	August 2012
2,550,000	Cdn 0.18	November 2018
6,345,000	Cdn 0.30	March 2019
<u>700,000</u>	Cdn 0.30	May 2019
<u>11,058,830</u>		

Phoenix Warrants

As part of the fee structure related to Phoenix's preferred share offering in August 2007, the underwriter received warrants to purchase 1,780,000 shares of the preferred shares of Phoenix at \$1.25 per share. The warrants expire 24 months following the date Phoenix consummates an initial public offering of its common shares. The warrants' total value of \$462,800 was determined using the Black-Scholes option pricing model. Assumptions used in the model were a risk free interest rate of 4.76%, dividend yield of 6.50%, and expected volatility of .40. The value of the warrants was charged to share capital. On June 27, 2008, under the terms of a broker agreement, the warrants were converted to warrants to purchase common shares of the Company at \$1.25 per common share and expire in June 2010.

Company Warrants

Under the terms of the 2008 public offering (the "Offering"), 31,428,580 warrants were issued to the purchasers of the common shares offered. The warrants entitle the holder to purchase one common share for each warrant held at a price of Cdn\$2.25 per share. The warrants expire in June 2010. The warrants total value of \$8,077,145 was determined by the underwriter of the Offering. The value of the warrants was charged to share capital.

Information regarding the warrant activity follows:

	<u>Number of Warrants</u>	<u>Weighted Average Exercise Price</u>
Phoenix Warrants		
Balance, December 31, 2007	—	\$ —
Converted preferred warrants to common warrants.....	1,780,000	1.25
Warrants outstanding and exercisable as at September 30, 2009 and December 31, 2008	<u>1,780,000</u>	<u>\$1.25</u>
Warrants Denominated in Canadian Dollars		
Company Warrants		
Balance, December 31, 2007	100,000	Cdn\$0.25
Consolidated at 1:2.35, pursuant to RTO.....	(57,447)	
Balance after consolidation.....	42,553	Cdn 0.59
Exercised	(11,850)	Cdn 0.59
Warrants issued with new common shares	31,428,580	Cdn 2.25
Warrants outstanding and exercisable as at December 31, 2008	31,459,283	Cdn 2.25
Warrants expired.....	(30,703)	Cdn 0.59
Warrants outstanding and exercisable as at September 30, 2009	<u>31,428,580</u>	<u>Cdn\$2.25</u>

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As at September 30, 2009 the following warrants were outstanding:

<u>Number of Warrants</u>	<u>Exercise Price</u>	<u>Expiration Date</u>
1,780,000	\$1.25	June 2010
<u>31,428,580</u>	Cdn 2.25	June 2010
<u>33,208,580</u>		

Total cash received from options and warrants exercised during the nine months ended September 30, 2009 and the year ended December 31, 2008 totaled \$nil and \$12,838, respectively.

Broker Options

Under the terms of the Offering, the agents received Brokers' Options entitling the agents to purchase in the aggregate 2,514,286 Brokers' Units. Each Broker Unit entitles the agent to purchase one common share for Cdn\$1.75 per share and one half warrant entitling the agent to purchase one additional common share for each full warrant at Cdn\$2.25 per share. The Brokers Options expire in June 2010 and are all exercisable at September 30, 2009. The options total value of \$1,106,286 was determined using the Black-Scholes option pricing model. Assumptions used in the model were a risk free interest rate of 3.99%, no dividend yield, and expected volatility of .40. The value of the options was charged to share capital as a cost of the Offering.

NOTE 10 — SALES CONTRACT TERMINATION

On March 3, 2009, the Company entered into a mutual release and settlement agreement with one of its customers to terminate a coal supply agreement for delivery of coal in 2009 and 2010 (the "2009/2010 Supply Agreement"). In consideration for terminating the 2009/2010 Supply Agreement, the Company paid the customer \$3,000,000 in cash. The payment relieved the Company of the obligation to deliver approximately 970,000 tons of coal, 470,000 in 2009 and 500,000 in 2010. In addition, the Company agreed to make up in 2009 approximately 170,000 tons of shipments that were not delivered in 2008 under a separate coal supply agreement dated January 1, 2008 (the "2008 Supply Agreement"). In return for fulfilling the 2008 Supply Agreement, the customer agreed to change the guaranteed monthly average BTU specification from 11,500 to 11,200. The \$3,000,000 payment has been charged to the consolidated statement of operations. Under the terms of the Acquisition Agreement, this coal supply agreement was transferred to the purchaser.

NOTE 11 — RELATED PARTY TRANSACTIONS

The Company enters into transactions with shareholders and/or affiliated entities that have some level of common ownership with the Company. A summary of the related party transactions and balances follows for the nine months ended September 30, 2009 and 2008:

	<u>Nine Months Ended September</u>	
	<u>2009</u>	<u>2008</u>
Expenses:		
Consulting fees.....	\$ —	\$ 156,000
Rent and miscellaneous.....	—	32,925
Accounts receivable	—	—
Accounts payable	—	—

The above expense amounts were paid to MHI Energy Partners, LLC, which amounts were applied towards, among other things, salaries, overhead and benefits for individuals who provided services. These transactions are also in the normal course of business, and are recorded at the consideration established and agreed to by the related parties. David Wiley and Timothy Fogarty were managing directors of MHI Energy Partners, LLC. David Wiley is currently an officer and director of the Company and Phoenix, and Tim Fogarty resigned as a director of Phoenix in September 2008. During the second quarter of 2008, the Company discontinued these payments to MHI.