

PHOENIX COAL INC.

Management's Discussion and Analysis

For the years ended December 31, 2008 and 2007

Phoenix Coal Inc.
Management's Discussion and Analysis
Years Ended December 31, 2008 and 2007

The following discussion of the results of operations, financial condition and cash flows of Phoenix Coal Inc. (the "Company") prepared as at March 18, 2009 should be read in conjunction with the Company's 2007 and 2008 audited financial statements and the notes thereto. These financial statements, which were prepared in accordance with generally accepted accounting principles in Canada, are available at www.sedar.com. All amounts disclosed are in United States dollars unless otherwise stated.

This Management Discussion and Analysis contains "forward-looking statements" which may include, but are not limited to, statements with respect to the future financial or operating performance of the Company and its projects, the future price of coal, the estimation of mineral resources, the timing and amount of estimated future production, costs of production, capital, operating and exploration expenditures, costs and timing of the development of new deposits, costs and timing of future exploration, requirements for additional capital, government regulation of mining operations, environmental risks, reclamation expenses, title disputes or claims, limitations of insurance coverage and the timing and possible outcome of regulatory matters. Often, but not always, forward-looking statements can be identified by the use of words such as "plans," "expects," "is expected," "budget," "scheduled," "estimates," "forecasts," "intends," "anticipates," or "believes" or variations (including negative variations) of such words and phrases, or statements that certain actions, events or results "may," "could," "would," "might" or "will" be taken, occur or be achieved. Forward-looking statements are based on the reasonable assumptions, estimates, analysis and opinions of management made in light of its experience and perception of trends, current conditions and expected developments, as well as other factors that management believes to be relevant and reasonable at the date that such statements are made. Forward-looking statements involve known and unknown risks, uncertainties, assumptions and other factors that may cause the actual results, performance or achievements of the Company to be materially different from any future results, performance or achievements expressed or implied by the forward-looking statements. Such factors include, but are not limited to, the factors discussed in the section entitled "Risk Factors" in the prospectus of the Company available on SEDAR at www.sedar.com. Although the Company has attempted to identify important factors that could cause actual actions, events or results to differ materially from those described in forward-looking statements, there may be other factors that cause actions, events or results to differ from those anticipated, estimated or intended. Forward-looking statements contained herein are made as at the date of this management discussion and analysis. There can be no assurance that forward-looking statements will prove to be accurate, as actual results and future events could differ materially from those anticipated in such statements. Accordingly, readers should not place undue reliance on forward-looking statements. The Company does not undertake to update any forward-looking statements except as required by applicable securities laws.

Overview

The Company is headquartered in Madisonville, Kentucky and is engaged in the exploration, production, acquisition and sale of coal from the Illinois Basin. The primary customers of the Company are electric utilities and consumers of industrial fuel. The current mining operations and near-term development projects of the Company are located in Western Kentucky, an area that comprises a part of the Illinois Basin. As at December 31, 2008, the Company operated three surface mines – Briar Hill, Jessup and Beech Creek/Beech Creek South ("Beech Creek").

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Highlights for 2008

During the year ended December 31, 2008:

- 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. Where the context requires, in respect to transactions prior to the RTO, the "Company" also refers to Phoenix.
- Concurrent with the RTO, the Company raised \$97,784,678, net of issuance costs, in a prospectus offering of 62,857,160 subscription receipts priced at Cdn\$1.75. In connection with the RTO, each subscription receipt was exchanged for one unit, with each unit consisting of one common share and one half common share purchase warrant exercisable until June 25, 2010 at Cdn\$2.25.
- On July 29, 2008, the Company's subsidiary, PACT Resources LLC, received the required permitting from the Kentucky Department of Natural Resources ("KDNR") and the U.S. Army Corps of Engineers ("COE") for the Pratt mine to be able to put it into production.
- At the end of July 2008, the Company closed the acquisitions of C&R Coal Inc. ("C&R") and Renfro Equipment, Inc. ("Renfro").
- On September 26, 2008, an environmental activist group protested the COE's pending issuance of a permit pursuant to Section 404 of the Clean Water Act ("404 Permit") for the Company's KO Mine ("KO"). Two other 404 Permits for the Company's Radio Hill and Winn North reserves were expected to be delayed as well. Consequently, on October 6, 2008, the Company declared *force majeure* to all of its customers. As at December 31, 2008, all requisite permits for KO, Radio Hill and Winn North had not been received and, thus, the *force majeure* declaration had not been lifted.
- The Company estimates that it lost approximately 825,000 tons of production due to the delay in the issuance of these permits related to the KO, Radio Hill and Winn North mines. In addition, Covol Fuels No. 2, LLC ("Covol"), a party from whom the Company has an agreement to purchase coal, fell short of its 2008 coal delivery obligation by approximately 125,000 tons. Because of these issues, the Company accumulated a shortfall in coal shipments to its customers of approximately 1.0 million tons.
- During the month of December and subsequent thereto, the Company received the required permitting from the KDNR and the COE for its Winn North and Radio Hill reserves. To date, the Company has received two out of the three required permits for KO. The state mining permit from the KDNR has been issued conditionally, pending the outcome of a phase one archaeological study. When the phase one study is complete the condition will be lifted; however, the conditional permit allows for initial development of KO. The 404 Permit, which was originally protested in September 2008, is still outstanding on this property.
- During the month of December and subsequent thereto, the Company was able to renegotiate two of its coal supply agreements and come to proposed terms on a third agreement, resulting in changes in quality specifications, deferment of volume and extinguishment of future obligations.
- During the fourth quarter of 2008, the Company produced approximately 527,000 tons of saleable coal and purchased nearly 18,000 tons of clean coal. For the full 2008 year, the Company produced approximately 1,932,000 tons of saleable coal and purchased approximately 323,000 tons of saleable coal.

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- Coal sales totaled approximately 568,000 tons for the fourth quarter 2008 and approximately 2,303,000 tons for the full 2008 year.
- Revenue for the three months and year ended December 31, 2008 was approximately \$18,809,000 and \$76,724,000, respectively, for an average revenue per ton of coal sold of \$33.11 and \$33.31, respectively.
- Cost of sales for the three months and year ended December 31, 2008 was approximately \$15,278,000 and \$71,882,000, respectively, for an average cost per ton of coal sold of \$26.90 and \$31.21, respectively.
- For the fourth quarter of 2008 and full year 2008, net loss was approximately \$8,049,000 and \$31,424,000, respectively.
- Capital expenditures for 2008 were \$21,708,544, which included \$18,025,434 of new equipment that was financed through term loans.
- At December 31, 2008, the Company had approximately \$40,626,000 in cash, cash equivalents and short-term investments.

RTO

In May, 2008, MCC and Phoenix entered into a definitive merger agreement with respect to the RTO. The RTO was completed on June 27, 2008. Prior to the completion of the RTO, MCC effected a reverse split of its outstanding common shares on the basis of one new share for each 2.35 shares outstanding. Pursuant to the RTO, the Company issued one common share for each outstanding common share of Phoenix. In addition, warrants and options to purchase Phoenix common shares outstanding immediately prior to the RTO were replaced with warrants and options to purchase an equivalent number of common shares of the Company, on economically equivalent terms and conditions.

Summary of Quarterly Results

(figures in thousands except per unit data)	Q4 '08	Q3 '08	Q2 '08	Q1 '08	Q4 '07	Q3 '07	Q2 '07	Q1 '07
Saleable coal production	527	431	472	502	547	584	495	475
Purchased coal ¹	18	109	170	27	-	-	9	43
Tons sold	568	529	646	560	539	562	521	499
Average revenue per ton	\$33.11	\$34.20	\$33.00	\$33.03	\$31.19	\$31.62	\$31.67	\$32.24
Average cost of sales per ton ...	\$26.90	\$33.87	\$32.80	\$31.23	\$34.40	\$27.21	\$29.27	\$26.21
Revenue	\$18,809	\$18,094	\$21,326	\$18,495	\$16,830	\$17,764	\$16,495	\$16,095
Cost of sales	15,278	17,919	21,200	17,485	18,562	15,287	15,242	13,084
Selling expenses	2,286	1,757	2,074	2,071	2,175	2,229	1,842	1,613
General and administrative	5,593	2,541	3,813	1,599	3,118	1,206	1,583	1,155
Depreciation and amortization ..	3,084	2,221	2,043	1,064	1,023	837	712	571
Asset impairment write down ...	-	-	-	-	2,873	-	-	-
Loss from operations	(\$7,432)	(\$6,344)	(\$7,804)	(\$3,724)	(\$10,921)	(\$1,795)	(\$2,884)	(\$328)
Other expense, net	578	320	2,893	2,292	4,859	3,875	431	828
Income taxes	38	-	(1)	-	76	(7)	1	-
Net loss for the year	(\$8,048)	(\$6,664)	(\$10,696)	(\$6,016)	(\$15,856)	(\$5,663)	(\$3,316)	(\$1,156)
Basic and diluted net loss per share	(\$0.05)	(\$0.04)	(\$0.25)	(\$0.16)	(\$0.43)	(\$0.15)	(\$0.09)	(\$0.03)

¹ The Company purchased coal from Covol Engineered Fuels ("Covol") and C&R – Beech Creek, a mine which it managed from September 2007 through July 2008 before Phoenix acquired C&R.

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The Company's 2008 production and purchased coal were severely impacted by the COE protest and Covol's inability to meet its commitments. For 2008, the Company had planned to produce coal from several reserves that included already permitted areas (Briar Hill, Graham #5, Back in Black and Stony Point) and pending permit areas (Radio Hill, Winn North and KO). It also planned to purchase coal from Covol and C&R until C&R was acquired by the Company, as described further below. Together, the already permitted areas, pending permit areas and purchased coal were the expected sources of coal for the Company's sales commitments for 2008.

For 2008, the Company expected to receive the necessary permits to continue mining its Back in Black reserve (Winn North permit area) and open two new reserves – KO and Radio Hill during the latter half of the year. Because the Company had not received these permits earlier in the year, it had to increase production at its existing mine sites, which accelerated the rate of depletion of the already permitted reserves. However, production was still limited due to pit sizes and logistics. Consequently, the Company was running less efficient mining operations and still could not meet total customer commitments. The Company estimates that it lost approximately 825,000 tons of production in 2008 due to the delay in the issuance of these permits. In addition, Covol delivered nearly 100,000 tons of coal during 2008, but fell well short of its obligation to ship approximately 225,000 tons. Consequently, the shortfall in tonnage had an impact on the Company's ability to meet its own customer commitments by approximately 125,000 tons. Because of these issues, as at December 31, 2008, the Company had accumulated a shortfall in coal shipments to its customers of approximately 1.0 million tons.

Production

During 2007, the Company operated six surface mines and two coal fines recovery sites, of which three surface mines were in operation the entire year — Briar Hill, Back-in-Black and Graham #5. The Company depleted the reserves at the Rockcrusher surface mine, shuttered Crittenden County and idled its fines recovery operation at Rockcrusher before selling it on November 30, 2007. In May, 2007, the Company put into production the Stony Point surface mine and restarted the seasonal fines recovery operation at Providence I. In addition, the Company expanded its operations at Graham #5 during the summer of 2007. After entering into a management services agreement with C&R Coal Inc. in September 2007, the Company permitted the Beech Creek South mine in the first quarter 2008 and purchased the coal produced from that property.

During 2008, the Company operated the Briar Hill, Graham #5, Stony Point, Back in Black, Beech Creek and Jessup mines. The Stony Point mine effectively depleted at the end of February 2008, only producing approximately 24,500 tons from March through July 2008 while completing a required face-up project for the lessor of the property. As at the beginning of June 2008, the Company had mined through its Back in Black mine permit area, and production at Back in Black was idled until the Company receives the requisite permits for the adjacent property, all of which had not been issued as at December 31, 2008. The equipment and manpower had been moved to Beech Creek to maintain similar Company-wide production levels. At the end of July 2008, the Company closed the acquisitions of C&R and Renfro, which added the Beech Creek and Jessup mines to the Company's owned portfolio.

The third 2008 quarter results were negatively impacted by a two-week vacation shutdown taken in August. Typically, vacation is scheduled for the end of June and the beginning of July, thus spreading the effect over the second and third quarters, not just one quarter. Fourth quarter production was negatively affected by depletion at Graham #5, which depleted in December, and Beech Creek which experienced declining production as it neared the end of its reserve life. These production losses were somewhat offset by Jessup, which produced nearly 43,000 tons in the fourth quarter 2008 as opposed to approximately 19,000 tons in the third quarter 2008. The following table summarizes the quarterly production results for 2008.

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	<u>Q1 '08</u>	<u>Q2 '08</u>	<u>Q3 '08</u>	<u>Q4 '08</u>	<u>FY '08</u>
Briar Hill	238,136	236,586	182,438	256,188	913,348
Graham #5	146,297	154,986	108,251	83,614	493,148
Back in Black	62,032	65,605	0	0	127,637
Stony Point	55,957	14,564	9,971	0	80,492
Jessup	0	0	18,742	42,495	61,237
Beech Creek	<u>0</u>	<u>0</u>	<u>111,465</u>	<u>145,053</u>	<u>256,518</u>
Total production	502,422	471,741	430,867	527,350	1,932,380

Purchased Coal

Prior to the acquisition of C&R at the end of July 2008, the Company managed the Beech Creek property on behalf of C&R and purchased the production from the mine. During the first quarter 2008, the Company developed the mine area for the Beech Creek South permit, which had limited production at the outset. However, after developing a longer, more efficient pit length and acquiring new equipment, the second quarter production improved to where the Company could purchase over 140,000 tons from C&R. Although total production from Beech Creek reached approximately 191,000 tons in the third quarter 2008, the declining trend in purchased coal from the second quarter to the third quarter is due to the acquisition and accounting for the tonnage from August and September as production and no longer as purchased coal.

Since the first quarter 2008, the Company had been purchasing coal fines from Covol, whose production trended upward through the third quarter. Covol's coal fines production increased from approximately 7,500 tons and 29,000 tons in the first and second quarter 2008, respectively, to approximately 44,200 tons in the third quarter 2008. Covol's slow start in the first quarter (its first full quarter of operation after acquiring the Rock Crusher preparation plant and slurry reserves from the Company at the end of November 2007) was due to inclement weather, start-up issues and downtime related to capital improvements. The Company only purchased approximately 18,000 tons of coal fines in the fourth quarter because Covol was not able to meet quality specifications. By the end of 2008, Covol had finished construction on its new preparation plant and modifications on the Rock Crusher plant that Phoenix sold to it in November 2007. As a result of the additional capacity and processing improvements, the Company expects Covol to significantly improve production and produce a more consistent product that meets contract specifications.

The following table summarizes the quarterly production and purchased coal for 2008, illustrating the transition of Beech Creek from purchased coal to owned production.

	<u>Q1 '08</u>	<u>Q2 '08</u>	<u>Q3 '08</u>	<u>Q4 '08</u>	<u>FY '08</u>
Company production (excl. Beech Creek)	502,422	471,741	319,402	382,297	1,675,862
Beech Creek (Owned)	<u>0</u>	<u>0</u>	<u>111,465</u>	<u>145,053</u>	<u>256,518</u>
Sub-total Company production	502,422	471,741	430,867	527,350	1,932,380
C&R - Beech Creek (purchased coal)	19,142	140,496	64,803	0	224,441
Covol (purchased coal)	<u>7,508</u>	<u>29,269</u>	<u>44,190</u>	<u>17,558</u>	<u>98,525</u>
Sub-total purchased coal	26,650	169,765	108,993	17,558	322,966
Total sources of production	529,072	641,506	539,860	544,908	2,255,346

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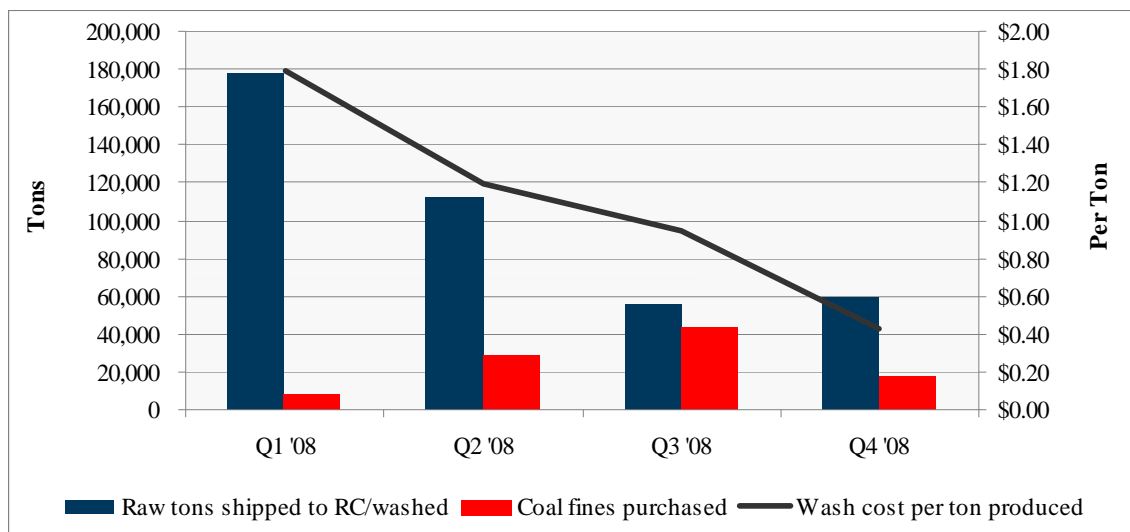
Revenue

From 2007 to 2008, average revenue per ton sold increased 5.2% from \$31.67 to \$33.31. During the second quarter of 2007, the Company restructured one of its coal sales contracts so that the utility paid for the trucking cost. The effect of the restructuring was to reduce the average revenue per ton sold and average cost of coal sales per ton produced for 2007 by approximately \$1.00. Revenue per ton sold growth in 2008 was due to contractual price increases on existing contracts and servicing new contracts with higher negotiated sales prices. The incremental revenue per ton sold realized in the third quarter 2008, compared to the second quarter of 2008, was due to additional transportation and loading fees paid to the Company to ship coal to customers from alternate dock facilities during the Green River lock maintenance shutdown, which occurred in August and September.

Cost of sales

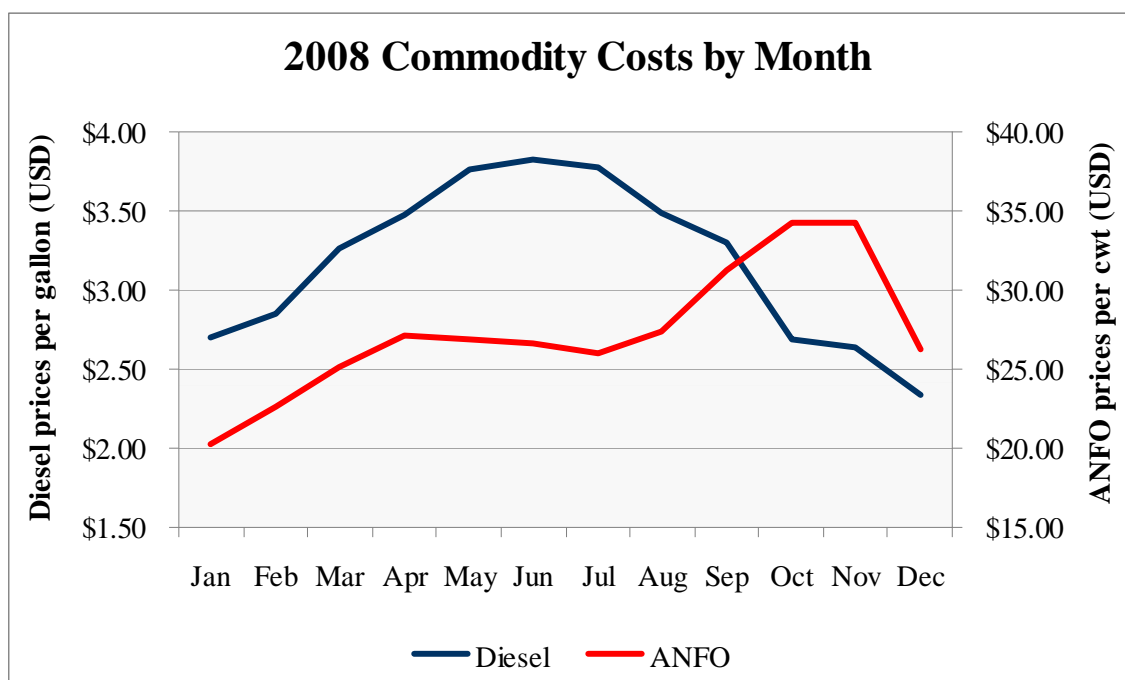
The trend in cost of sales has primarily been impacted by maintenance costs, coal preparation costs and commodity costs. Throughout 2006 and 2007, the Company struggled with older equipment that required more maintenance than normal, thus lowering availability and driving up costs. Since the beginning of the fourth quarter 2007, the Company has spent approximately \$31,100,000 on new production equipment, which has increased productivity and lowered maintenance costs in 2008.

Over a similar period from 2007 through the first quarter 2008, the Company could not produce or purchase enough coal fines to use as a blending feedstock with the Company's raw coal. Consequently, the Company was forced to wash more raw coal to meet contract specifications, thus increasing wash costs and shipping fees. As discussed above, Covol produced nearly 100,000 tons of coal fines in 2008 (mostly in the second and third quarters), enabling the Company to purchase more coal fines for blending and reducing its need to wash coal. As a result, coal washing costs, on a per ton produced basis, consistently decreased quarter over quarter in 2008. During the fourth quarter 2008, raw tons washed increased slightly and coal fines purchased decreased as compared to the third quarter. However, the Company had put in service its own preparation plant at the Briar Hill mine in the fourth quarter. This significantly reduced the aggregate amount of washing costs and transportation related costs relative to the costs incurred for washing coal at Covol's Rock Crusher preparation plant during the previous part of 2008. The following graph depicts the relationship between the number of raw tons washed, the amount of coal fines purchased from Covol and the overall washing cost per ton produced.



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Rising commodity costs had a significant impact on the Company's diesel fuel and explosives costs through the first three quarters of 2008. After the severe sell-off in commodities during the latter part of 2008, diesel fuel cost per gallon and ammonium nitrate fuel oil ("ANFO") cost per hundred-weight trended downward by year-end, as depicted in the following graph² (ANFO is a key raw material used in the Company's explosives).



As a result of the decline in diesel fuel and ANFO prices, the Company experienced a sharp drop during the fourth quarter of 2008 in these costs on a per ton produced basis. From its peak in the second quarter, the Company was able to realize a savings of nearly \$5.00 per ton produced. The following table summarizes the trend in diesel and ANFO/Explosives costs during 2008.

	<u>Cost per ton produced</u>				
	<u>Q1 '08</u>	<u>Q2 '08</u>	<u>Q3 '08</u>	<u>Q4 '08</u>	<u>FY '08</u>
Diesel fuel	\$7.86	\$9.10	\$8.38	\$5.10	\$7.53
ANFO/Explosives	<u>2.78</u>	<u>3.16</u>	<u>2.92</u>	<u>2.43</u>	<u>2.81</u>
Total	\$10.64	\$12.26	\$11.30	\$7.53	\$10.34

In the ordinary course of business, for 2009, the Company has entered into contracts to purchase diesel fuel from local suppliers for physical delivery at specified prices. As at, and subsequent to, December 31, 2008, the Company had executed purchase contracts for a total of 2,688,000 gallons to be delivered in 2009 at a total cost of \$5,871,096, or a weighted average price of \$2.18 per gallon, compared

² Prices represent invoiced prices to the Company.

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to \$3.38 in 2008. This represents approximately 60% of the Company's expected diesel fuel usage for 2009.

Selling, general and administrative expenses

During 2008, selling expenses, which include coal taxes and royalties, ranged from approximately 10% to 12% of coal sales. The Company does not pay coal taxes or royalties on purchased coal so selling expenses declined as a percentage of coal sales to approximately 10% during the second and third quarters of 2008 when purchased coal was at its highest for the year. During the third quarter, the Company started paying a \$0.60 per ton sold overriding royalty to the owners of C&R as part of the acquisition agreement. For the fourth quarter of 2008, selling expenses reached 12.2% of coal sales as approximately 97% of sales was sourced from the Company's production and it was the first full quarter for paying the overriding royalty to C&R. After Beech Creek depletes, the Company will not have to pay the \$0.60 per ton sold overriding royalty for the remainder of 2009.

General and administrative expenses ("G&A") have risen as the Company has hired more employees to fill various roles at the middle and senior management levels. The spike in G&A in the fourth quarter 2007 and the second quarter 2008 was because of a non-cash stock-based compensation charge related to options issuances of \$1,448,859 and \$2,151,277, respectively. During the fourth quarter of 2008, the Company cancelled certain stock options that the Board of Directors and two senior executives voluntarily surrendered. This action accelerated the non-cash stock option expense related to these options and increased compensation expense by approximately \$2,250,000 for the fourth quarter of 2008.

Fourth quarter 2008 adjustments

In addition to the non-cash stock-based expense incurred as a consequence of the cancellation of stock options as described above, the Company had other year-end adjustments and one-time charges mostly related to asset retirement obligation and legal/accounting items. Annually, the Company performs a reclamation study assessing its outstanding reclamation obligations. Based on this study, the Company reduced its asset retirement obligation in the fourth quarter of 2008 by \$500,000. The Company also negotiated discounts on some older accounts payable invoices from its Crittenden County Coal subsidiary, generating a \$110,000 reduction in cost of sales for the quarter. Lastly, the Company incurred net charges of approximately \$49,000 for one-time legal and accounting items.

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<i>(figures in thousands except unit data)</i>		<u>As at</u> <u>December 31, 2008</u>	<u>As at</u> <u>December 31, 2007</u>
Balance sheet	Total assets	\$155,145	\$72,781
	Short-term financing	0	13,321
	Preferred shares	0	45,635
	Asset retirement obligation	4,324	3,757
	Long-term debt	21,174	9,687
	Shareholders' equity	122,694	(9,224)
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Income statement	Revenue	\$76,724	\$67,184
	Cost of sales	71,882	62,175
	Selling expenses	8,189	7,860
	G&A	13,545	7,061
	Depreciation and amortization	8,412	3,143
	Asset write down	<u>0</u>	<u>2,873</u>
	Operating loss	(\$25,304)	(\$15,928)
	Other expense, net	6,082	9,993
	Income taxes	<u>38</u>	<u>70</u>
	Net loss for year	(\$31,424)	(\$25,991)
	Basic and diluted net loss per share	(\$0.33)	(\$0.70)
Statistics	Saleable coal production	1,932	2,101
	Purchased coal	323	52
	Coal sales	2,303	2,121

Results of Operations

Production

For the fourth quarter and year ended December 31, 2008, the Company produced approximately 527,000 tons and 1,932,000 tons, respectively. The year over year decrease of 3.7% and 8.0%, respectively, is primarily attributable to depletion, delay in permit issuance, and Beech Creek's production prior to August 2008 being accounted for as purchased coal during the management of C&R Coal. The following table summarizes the production (in tons) from the Company's owned mines during the fourth quarter and year ended December 31, 2008 versus the prior year.

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	<u>Q4 2008</u>	<u>Q4 2007</u>	<u>Variance</u>	<u>% Variance</u>	<u>YTD 12/31 2008</u>	<u>YTD 12/31 2007</u>	<u>Variance</u>	<u>% Variance</u>
Briar Hill	256,188	235,971	20,217	8.6%	913,347	946,923	(33,576)	(3.5%)
Graham #5	83,614	167,010	(83,396)	(49.9%)	493,149	592,778	(99,629)	(16.8%)
Back in Black	-	48,763	(48,763)	(100.0%)	127,637	210,678	(83,041)	(39.4%)
Stony Point	-	86,104	(86,104)	(100.0%)	80,492	171,593	(91,101)	(53.1%)
Jessup	42,495	-	42,495	0.0%	61,237	-	61,237	0.0%
Beech Creek/Ebenezer	145,053	-	145,053	0.0%	256,518	-	256,518	0.0%
Sub-total	<u>527,350</u>	<u>537,848</u>	<u>(10,498)</u>	<u>(2.0%)</u>	<u>1,932,380</u>	<u>1,921,972</u>	<u>10,408</u>	<u>0.5%</u>
Other mines	-	9,557	(9,557)	(100.0%)	-	179,091	(179,091)	(100.0%)
Total	<u>527,350</u>	<u>547,405</u>	<u>(20,055)</u>	<u>(3.7%)</u>	<u>1,932,380</u>	<u>2,101,063</u>	<u>(168,683)</u>	<u>(8.0%)</u>

Briar Hill remained the largest contributor to total production with 256,188 tons and 913,347 tons for the fourth quarter and year ended December 31, 2008, respectively. Briar Hill continued the trend of washing less coal with only 48,000 tons sent to the preparation plant in the fourth quarter. However, for 2008, Briar Hill washed approximately 382,000 raw tons of coal (approximately 73% of that in the first two quarters of 2008), which impacted its annual output and contributed to the 3.5% decline in year over year saleable production.

As discussed above, Graham #5 depleted in December 2008 and had become less efficient as the pit length shortened and the mining ratio increased. Therefore, Graham #5 only produced approximately 83,600 tons in the fourth quarter 2008, approximately half the amount for the similar period in 2007. Through July 2008, the mine was producing at an annual run rate of approximately 600,000 tons, similar to the prior year. However, as Graham #5 approached depletion in the second half of the year, the Company was only able to produce approximately 138,000 tons in the last five months resulting in approximately 100,000 less tons for all of 2008 as compared to the full year 2007.

In 2008, the Company managed the Beech Creek mine on behalf of C&R for the first seven months of the year and then owned it for the remainder of the year. During the year, the Company produced a total of approximately 529,000 tons of coal from Beech Creek. From that production, the Company purchased 224,442 tons to service its sales contracts before acquiring C&R at the end of July 2008. After the end of July 2008, under its ownership, the Company produced nearly 257,000 tons, as illustrated in the table above. The remaining amount of tons, approximately 48,000, represents the tons that were shipped on C&R's coal sales contract while the Company managed the property, plus the tons in inventory on the date the Company acquired C&R.

The remaining mines, Back in Black, Stony Point and Jessup, contributed approximately 269,000 tons during 2008. The Back in Black mine was idled in early June due to a delay in permit issuance and had not returned to production as at December 31, 2008. Stony Point mined some residual coal while it continued its reclamation efforts. Jessup, purchased at the end of July 2008, produced approximately 61,000 tons of coal as it ramped up from approximately 19,000 in the third quarter of 2008 to approximately 42,000 in the fourth quarter of 2008.

Purchased Coal

In addition to the purchased coal from C&R, as described above, the Company purchased nearly 100,000 tons of coal fines from Covol during 2008. The following table summarizes the purchased coal during the fourth quarter and year ended December 31, 2008 versus the prior year.

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	<u>Q4</u> <u>2008</u>	<u>Q4</u> <u>2007</u>	<u>Variance</u>	<u>YTD 12/31</u> <u>2008</u>	<u>YTD 12/31</u> <u>2007</u>	<u>Variance</u>
Covol	17,558	0	17,558	98,524	0	98,524
C&R Coal	0	0	0	224,442	0	224,442
Total	17,558	0	17,558	322,966	0	322,966
Other mines	0	0	0	0	52,420	(52,420)
Total	17,558	0	17,558	322,966	52,420	270,546

Revenue

The Company primarily derives its revenue from coal sales to electric utility companies. For the full 2008 year, the Company's revenue increased by 14.2% to \$76,724,270 from \$67,184,104 in the prior year. Sales volume was up 8.6% and revenue per ton sold grew 5.2%, year over year, from \$31.67 to \$33.31. The increase over 2007 was primarily due to contractual price increases from existing sales contracts and new sales contracts with better pricing terms. Specifically, for the third quarter 2008, the Company was paid additional compensation from certain customers for extra transportation costs incurred by the Company to transport coal to and load coal at dock facilities on the Ohio River during the Green River shutdown in August and September.

The Company's legacy contracts were entered into before the rise in coal prices and cost of inputs during the first nine months of 2008. Since the Company was not hedged for diesel fuel or explosives, costs rose dramatically while revenues remained fixed, thus negatively impacting the Company's profitability for the year. As the contracts are fulfilled and assuming current coal prices continue to prevail, the Company expects significant increases in revenue and resultant improved operating performances as it enters into new contracts at current market prices.

Cost of Sales

Cost of sales consists of all mining related expenses, preparation costs, transportation costs and purchased coal before depreciation and amortization. On a cost per ton produced basis, diesel fuel and explosives had the largest negative impact on operating costs during 2008 as compared to 2007. Diesel fuel cost was \$7.53 per ton produced in 2008 compared to \$5.36 per ton in 2007, a \$2.17 increase or 40.4% year over year. Explosives were up 12.4%, or \$0.31 per ton produced, from \$2.50 per ton produced in 2007 to \$2.81 per ton in 2008. The \$2.48 per ton increase in commodity costs was offset by a \$1.22 per ton produced savings from maintenance costs. The Company's \$31,100,000 investment in new equipment since the beginning of the fourth quarter of 2007 played a significant role in decreasing maintenance costs and improving productivity. For 2008, maintenance parts and supplies expense was \$8,947,992 versus \$12,288,196 in 2007, or \$4.63 per ton produced compared to \$5.85 per ton produced.

Overall, the Company's cost of sales increased by 15.6% to \$71,881,533 in 2008 from \$62,175,073 in 2007. Comparing the same periods on a cost per ton sold basis, cost of sales was \$31.21 versus \$29.31 for an increase of 6.5%. The 8.6% year over year increase in sales volume also contributed to higher total cost of sales. Trucking, a variable cost, increased 31.5% from \$5,184,533 in 2007 to \$6,817,771 in 2008. Purchased coal, another variable cost, accounted for approximately 14% of the cost of sales in 2008. For the 2008 year, purchased coal was \$9,899,922 versus \$1,614,430 for the same period in 2007. The Company's cost per ton purchased for 2008 and 2007 was \$30.65 and \$30.80, respectively.

Selling, General and Administrative ("SG&A") Expenses

SG&A expenses primarily consist of royalty payments to surface and mineral owners, sales commissions, federal excise tax, severance tax, federal reclamation fee and corporate overhead costs in the Company's Madisonville and Louisville offices. For 2008, the Company's SG&A expenses were

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\$21,734,357 versus \$14,920,851 in 2007. The Company's selling costs (royalties and coal taxes described above) are variable with respect to coal sales and were 10.8% of coal sales during 2008.

G&A costs for 2008 were \$13,545,412 compared to \$7,061,280 in 2007. The primary variance is a non-cash charge to employee stock-based compensation, which was \$5,935,289 in 2008 versus \$1,448,859 in 2007. On June 27, 2008, the board of directors granted 6,847,000 employee stock options, of which one-third vested on the grant date. Then, on November 3, 2008, the board of directors and two senior executives voluntarily surrendered 5,050,000 options that had been issued to them in June 2008, accelerating the amortization of the expense related to those options to the current year. On a cash basis, for 2008 and 2007, G&A costs were \$7,610,123 and \$5,612,420, respectively, or \$3.30 per ton sold and \$2.65 per ton sold, respectively. This cost increase is primarily attributable to the addition of corporate staff to support field operations, sales and corporate development.

Depreciation and Amortization

Depreciation and amortization expenses in 2008 were \$8,412,073 versus \$3,143,365 in 2007. Depreciation expense for 2008 increased \$1,712,108 primarily because of the approximately \$31,100,000 invested in mining equipment since September 30, 2007. Mining rights and mine development amortization expense increased year over year by \$3,591,916 mainly due to the amortization of mining rights in 2008 as explained more fully in Note A to the Company's 2008 audited financial statements.

Interest Expense/Foreign Currency Adjustment

Interest expense is comprised of (1) interest on the Company's revolving line of credit, equipment financing, and short-term bridge financing and (2) non-cash costs which include accrued dividends on the preferred shares, accretion of the preferred share offering costs, accretion of loan costs on the short-term bridge financing, and mark to market on the interest rate swap. Total interest expense for 2008 was \$5,767,496, of which non-cash costs, as described above, totaled \$3,784,695.

The foreign currency gain of \$129,130 for 2008 was related to mark to market adjustments for the short-term bridge financing which was denominated in Canadian dollars. This financing was converted to common share equity in June 2008.

As at December 31, 2008, the Company no longer had a revolving line of credit, short-term bridge financing or preferred shares. The revolving line of credit matured in July 2008, and the short-term bridge financing and preferred shares converted to common equity as part of the RTO.

Interest Income

For 2008, interest income was \$570,378 compared to \$106,692 in the prior year. The increase of \$463,686 in interest income from 2007 to 2008 resulted from the increase in cash and short-term investments in 2008 due to the prospectus offering.

Other Expense

For 2008, the Company had a loss on the sale of assets in the amount of \$1,012,780 versus a loss of \$1,810,137 for 2007. During these periods in 2008 and 2007, the Company disposed of non-core property and equipment.

Liquidity and Capital Resources

As at December 31, 2008, the Company had \$40,626,316 in cash, cash equivalents and short-term investments, compared to \$534,474 at December 31, 2007. The Company also had restricted cash, cash

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equivalents and certificates of deposit as collateral for letters of credit for reclamation bonding in the amount of \$11,638,921 at December 31, 2008 versus \$2,312,500 at December 31, 2007. As at December 31, 2008, the Company's current assets exceeded its current liabilities by \$29,432,079.

The Company's primary sources of cash include sales of coal production to customers, sales of non-core assets and financing transactions. The Company's primary uses of cash include cash costs of coal production, capital expenditures, costs for development projects, debt service costs and costs related to reclamation obligations. The Company's ability to continue to grow its business is dependent on its ability to continue to generate cash from its primary sources in excess of its primary uses.

Operating Activities

Cash used by operating activities during 2008 was \$13,994,621. The Company's operating loss in 2008 was the primary reason for the use of cash. In addition, the Company spent approximately \$1,157,000 on reclamation obligations and the pay-off of an interest rate swap. Accounts receivable and inventory decreased as production declined by year-end while accounts payable and accrued liabilities used approximately \$3,900,000 in cash to reduce the aging to acceptable levels with the Company's suppliers after the prospectus offering in July, 2008.

Investing Activities

Investing activities resulted in a net cash decrease of \$40,372,882 for 2008. The Company's investing activities primarily related to the final payment in the amount of \$25,000,000 for the acquisition of Pact Resources LLC ("PACT"), the increase of restricted cash in the amount of approximately \$8,800,000 to fully collateralize all outstanding reclamation bonds and the purchase of property and equipment not financed through term loans in the amount of approximately \$3,700,000. The Company also spent approximately \$2,900,000 on the acquisitions of C&R and Renfro as well as approximately \$950,000 on mine development and mining rights.

Capital expenditures for 2008 were \$21,708,544, which included \$18,025,434 of new equipment that was financed through term loans. The remaining \$3,683,110 was primarily spent on the construction of a preparation plant at the Briar Hill mine, which was operational beginning in October 2008, a track hoe and the acquisition of surface property for the PACT development project.

As at December 31, 2008, the Company had spent \$28,318,815 related to its capital expenditure program to recapitalize its surface mining equipment fleet. After the delivery of three trucks and one loader, expected in the first quarter of 2009, totaling approximately \$5,100,000 of purchase commitments this program will be finished. The Company has commitments from the financing arms of the equipment manufacturers to provide debt financing for the entire purchase amount less a down payment, which is estimated to be approximately \$765,000. The interest rates are expected to range from 8.50% to 8.75% and terms of 36 to 48 months. The notes will be collateralized by the equipment purchased.

Financing Activities

Financing activities generated net cash of \$94,511,738 for 2008. Net proceeds from the prospectus offering generated cash of \$97,784,678 after agents' fees, other out-of-pocket expenses and converting the proceeds from Canadian to US dollars. The Company also generated net proceeds of \$4,891,890 from a loan from a finance company after conversion from Canadian to US dollars. Equipment financing and long-term debt principal payments totaled \$7,544,616.

As at December 31, 2008, the Company's long-term debt consisted of financing related to equipment purchases. It also had non-cancelable equipment lease obligations that will expire in 2009. The following table summarizes the contractual lease, principal and interest payments through maturity (excluding the \$5,100,000 of purchase commitments expected to be delivered in 2009).

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	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>
Notes payable	\$7,714,042	\$7,267,849	\$6,048,502	\$2,439,738
Operating leases	<u>338,160</u>	<u>0</u>	<u>0</u>	<u>0</u>
Total	\$8,052,202	\$7,267,849	\$6,048,502	\$2,439,738

Coal Sales Contract Revisions

During December 2008 and subsequent thereto, the Company was able to renegotiate certain coal sales contracts with two customers and come to proposed terms with a third customer. Generally, the negotiations resulted in changes in quality specifications, deferment of volume commitments to later years and the extinguishment of certain obligations. The three customers required a guaranteed monthly average delivery of 11,500-BTU coal, the highest BTU requirement for any of the Company's contracts. Two of the customers agreed to lower this specification to 11,200-BTU. As a result, the percentage of contract commitments that required 11,500-BTU coal over the life of the Company's total portfolio of commitments reduced from 66% to 50% and the weighted average BTU requirement dropped by approximately 60 BTUs from 11,320 to 11,260. In addition, one of the customers agreed to increase the maximum allowable sulfur dioxide ("SO₂") requirement. The change in BTU and SO₂ will help improve the Company's unit operating costs as it will reduce washing expenses, logistics related costs and the loss factor on washed coal.

In addition to the change in quality specifications, the Company was successful in deferring or extinguishing volume commitments with two of its customers. For 2009, the Company's coal sales commitments have reduced by approximately 700,000 tons from these two customers. One customer has agreed in principle to defer approximately 600,000 tons of 2008 and 2009 commitments to 2010 and 2011, and add approximately 200,000 tons at over \$50 per ton. With another customer, the Company entered into a mutual release and settlement agreement where the Company agreed to make up in 2009 approximately 170,000 tons of shipments that were not delivered in 2008. Additionally, the customer agreed to cancel nearly 1.0 million tons of commitments for 2009 and 2010 in exchange for a \$3,000,000 cash payment.

Consequently, as at December 31, 2008, the Company had coal sales contract commitments of nearly 6.7 million tons at a weighted average price of \$34.92 that extended through 2011. The Company initially had approximately 3.3 million tons of commitments for 2008, but was only able to fulfill 2.3 million tons in 2008 primarily due to permitting delays, resulting in a 1.0 million ton shortfall (the "Shortfall"). The Company has deferred or extinguished approximately 40% of the Shortfall and has been working with its customers to reschedule delivery of the remainder over the next few years. The Company believes that the customers associated with the remaining Shortfall will be agreeable to deferring volume. As at the filing of the MD&A, the Company's coal sales commitments before adjustments for BTU or transportation (if applicable in the contract) were the following:

	<u>2008 shortfall</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>Total</u>
Commitments (tons)	619,661	2,470,845	2,440,727	1,150,000	6,681,233
Avg. sales price	\$32.23	\$34.24	\$36.06	\$35.41	\$34.92
% of 11,500 BTU contracts	37%	54%	57%	35%	50%

Outlook

The Company's outlook regarding production, sales, operating costs and capital expenditures are based on running seven surface mining fleets at its Muhlenberg County operations and purchasing coal from Covol (the "2009 Coal Sources"). It does not take into account future acquisitions or development projects outside of the planned 2009 Coal Sources. The outlook could change at any point during 2009 due to, among other items, unforeseen production problems, equipment malfunction, permitting delays,

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geologic issues, inadequate transportation outlets and less than expected output from Covol (the "Negative Impacts").

The primary 2009 Coal Sources include Radio Hill, Back in Black, KO and Jessup. During the month of December and subsequent to December, 2008, the Company received the required permitting from the KDNR and the COE for its Winn North and Radio Hill reserves. The Company expects to receive the 404 Permit for KO and have the provisional status removed from its state mining permit to begin mining in 2009. Beech Creek and Briar Hill are also expected to contribute production but are anticipated to deplete during the first and second quarters 2009, respectively. The Company will also purchase coal from Covol. In total, the Company expects to have approximately 2,700,000 to 2,900,000 tons of coal available for sale from the 2009 Coal Sources.

The Company expects its total cash operating costs per ton sold to decline in 2009 to between \$32 and \$33. Lower commodity and maintenance costs and higher productivity from its recapitalized equipment fleet will be the key drivers. However, the Company will have exposure to the commodity markets, particularly those related to diesel fuel and ANFO. If those commodity costs should exceed the Company's expectations, it will adversely affect its unit costs. Similarly, the Negative Impacts discussed above could unfavorably influence productivity, resulting in higher than expected costs on a per ton basis.

As previously discussed, the Company has approximately \$5.1 million in purchase commitments for 2009 related to the capital expenditure program that began in the fourth quarter 2007. In addition to these remaining items, the Company plans to spend approximately \$2.5 million for maintenance capital expenditures for the operations included in the 2009 Coal Sources.

Acquisitions

In July 2008, the Company's subsidiary, R&L Winn Inc. ("R&L Winn"), purchased all of the outstanding common shares of C&R Coal Inc. ("C&R") for cash consideration of \$2,051,000. In addition, under the terms of the agreement, R&L Winn will pay the former owners a royalty of \$0.60 per ton for each ton of coal sold from the C&R mines. The current mining area, Beech Creek and Beech Creek South, contained approximately 450,000 reserve tons (697,000 reserve tons as at December 31, 2007 pursuant to the Company's National Instrument 43-101 revised technical report less coal mined in the first seven months of 2008) as at July 31, 2008. R&L Winn also acquired other leases in the transaction from C&R and R&G Leasing, LLC, a company that is affiliated with C&R through common ownership. Based on exploration completed to date by the Company, management estimates the leases contain approximately 1,500,000 tons of coal. The potential quantity is conceptual in nature as there has been insufficient exploration to define a mineral resource and it is uncertain that further exploration will result in the delineation of a mineral resource.

In July 2008, the Company purchased all of the outstanding common shares of Renfro Equipment, Inc. ("Renfro") for total cash consideration of \$1,129,000. Additionally, the Company incurred \$18,000 of closing costs. The purchase included all assets and liabilities of Renfro, except certain equipment and associated debt specifically excluded from the purchase. Based on exploration completed to date by the Company, management estimates Renfro controls approximately 1,000,000 tons of coal reserves and 465,000 resource tons via lease. The potential quantity is conceptual in nature as there has been insufficient exploration to define a mineral resource and it is uncertain that further exploration will result in the delineation of a mineral resource. Additionally, if by the second anniversary of the closing date, the Company acquires at least 1,500,000 reserve tons as defined by National Instrument 43-101 due to the direct efforts of the sellers (the "Additional Reserves"), the Company will pay the sellers \$1,000,000 for the first 1.5 million tons of reserves, plus \$0.50 per ton for each reserve ton in excess of 1.5 million. The share purchase agreement defines a specific territory from which the Additional Reserves can be acquired. The acquisition of the Additional Reserves is on terms and conditions acceptable to the Company in its sole, reasonable discretion.

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In June 2008, the Company and the former owners of PACT entered into an agreement to clarify and amend certain terms of their Buy-out Agreement dated March 31, 2008 ("Buy-out Agreement"), pursuant to which the Company was required to pay the former owners of PACT \$25 million ("Buy-out Payment") within three days of MCC's receipt of the proceeds of the public offering. On June 27, the Company completed the RTO and subsequently paid \$25 million to the former owners of PACT on June 30, 2008.

In January 2007, the Company acquired 100% of the membership interest in Charolais Coal Sales, LLC and other assets ("Charolais Assets") from the Charolais Corporation, Charolais No. 1, LLC, Charolais Coal Resources, LLC, Mark Energy, Inc., Mark One, Inc., and Donald Bowles, (collectively, "Charolais Group"), for consideration of \$21,735,000 (plus the assumption of asset retirement obligation estimated as at December 31, 2007, at \$495,967), of which \$12,003,000 was paid in cash, \$543,300 was paid by issuing 434,640 common shares of the Company and the remaining \$9,188,700 was satisfied by the issuance of a seller's note. The Charolais Assets included active surface mining operations (the Graham #5 mine) and Greenfield surface reserves with permits, coal and surface leases, land, a workforce, surface mining equipment, a preparation plant and the Island Dock facility on the Green River.

Prospectus Offering

Concurrent with the RTO in June 2008, the Company raised \$97,784,678, net of issuance costs, in a prospectus offering of 62,857,160 subscription receipts priced at Cdn\$1.75 for gross proceeds of Cdn\$110,000,030 (the "Offering"). The subscription receipts were converted into units in connection with the RTO, with each unit consisting of one common share and one half common share purchase warrant exercisable until June 25, 2010 at Cdn\$2.25.

Pursuant to an agreement among MCC, Phoenix and the Offering agents, the agents received a cash commission equal to 6% of the gross proceeds of the Offering plus compensation options equal to 4% of the Subscription Receipts sold pursuant to the Offering.

A summary of the gross proceeds received and Offering costs incurred is as follows:

Gross proceeds (Cdn\$110,000,030 converted to U.S. dollars at a conversion rate of 0.99007 U.S. to Cdn).....	\$108,908,500
Agents' fees.....	(6,534,510)
Other out-of-pocket costs	<u>(4,589,312)</u>
Net proceeds.....	<u>\$97,784,678</u>

In addition to the Offering costs, the Company incurred an estimated \$408,000 in costs related to the RTO, which have been treated as a capital transaction and charged to accumulated deficit.

Outstanding Share Data

At March 18, 2009, the Company had 150,045,552 common shares issued and outstanding. In addition, there were 9,721,830 stock options, 33,239,283 warrants and 2,514,286 brokers options (which entitle the holder to purchase one common share and one half of one warrant) outstanding at March 18, 2009. If all options, warrants, and brokers' options (including the subsequent exercise of the warrants purchased) were exercised and issued, it would bring the fully diluted issued common shares to a total of 196,778,094, and would generate cash of approximately \$73,000,000.

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Subsequent Events

On January 8, 2009, the Company announced that it received a 404 Permit granted by the COE. With the 404 Permit, the Company secured all of the necessary permits to begin mining on the Radio Hill section of the Briar Hill surface mine ("Radio Hill") in Muhlenberg County, Kentucky. During December 2008, Phoenix had obtained a permit required under Section 401 of the Clean Water Act ("401 Permit") and a state mining permit granted by the KDNR for Radio Hill.

On March 4, 2009, the Company announced that it received a 404 Permit for its Winn North property, which is part of the Back in Black mine. With the 404 Permit, the Company secured all of the necessary permits to begin mining on Winn North in Muhlenberg County, Kentucky. During December 2008, Phoenix had obtained a 401 Permit and a state mining permit granted by the KDNR for Winn North. In addition, the Company announced it received two out of the three required permits for KO. The state mining permit from the KDNR had been issued conditionally, pending the outcome of a phase one archaeological study. When the phase one study is complete the condition will be lifted; however, the conditional permit allows for initial development of KO. The 404 Permit, which was originally protested in September 2008, is still outstanding on this property.

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 will be charged to the consolidated statement of operations in 2009.

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 2008 and 2007:

	<u>Dec. 31, 2008</u>	<u>Dec. 31, 2007</u>
Expenses:		
Consulting fees	\$156,000	\$610,000
Rent and miscellaneous	32,925	65,377
Accounts receivable.....	—	16,858
Accounts payable	—	6,670

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.

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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 Company's 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 totaled approximately \$11 million at December 31, 2008 and approximately \$9 million at December 31, 2007. These bonds are secured by letters of credit or certificates of deposit issued by a bank equal to the amount of the outstanding reclamation bonds. At December 31, 2008, the letters of credit are collateralized by the restricted cash and certificates of deposit on the consolidated balance sheet of \$11,638,921. At December 31, 2007, the letters of credit were collateralized by general business assets of the Company and the restricted cash and certificates of deposit on the consolidated balance sheet of \$2,312,500. In July 2008, the Company agreed to increase its restricted cash collateral securing its letters of credit with its bank to 100% of the reclamation bonds outstanding. As a result, the letters of credit are only collateralized by the restricted cash balance, and the general business assets of the Company were released.

The Company leases certain office space and mining equipment over long-term operating leases running through 2009. Future minimum lease commitments under non-cancelable operating leases as at December 31, 2008, payable in 2009, totaled \$567,355.

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

Business Environment and Risks

The Company's operations are subject to the risks normally inherent in the operation and development of coal properties. There is no assurance of developing economic coal reserves in commercial quantities. Operational risks include weather, geologic anomalies, competition, potential transportation interruptions, a complex regulatory regime and environmental and safety concerns. Financial and liquidity risks include commodity price fluctuations, interest rates, and the costs of goods and services. The Company uses a variety of means to help minimize its business risks.

The Company's risk exposures and the impact on the Company's financial instruments are summarized below:

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 invests its cash and cash equivalents and short-term investments in a U.S. financial institution, which at December 31, 2008, carried Standard and Poor's investment ratings on their deposits of A to A-1. At December 31, 2008 approximately \$39,700,000 of the cash and cash equivalents balance was invested in a money market fund managed by this financial institution. In January 2009, the Company reduced this money market balance to approximately \$8,000,000, an amount that is guaranteed until April 30, 2009 by the U.S. Treasury Department under the Temporary Guarantee Program for Money Market Funds. The Company has not experienced any losses on its deposits with this financial institution.

The Company is also subject to credit risk from its trade accounts receivable. 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. Subsequent to December 31, 2008, the Company has collected all of its trade accounts receivable at December 31, 2008.

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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.

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. At December 31, 2008, the Company had \$40.6 million of cash, cash equivalents, and short-term investments, significantly exceeding its short-term liabilities of \$15.0 million.

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 investments in marketable securities 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.

The Company's long-term debt consists of only fixed rate notes. The Company previously maintained a credit facility which bore variable interest rate based on LIBOR. This facility was retired on July 7, 2008.

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. At December 31, 2008, the Company had no material financial instruments that were denominated in non U.S. currencies.

Critical Accounting Estimates

The Company's consolidated financial statements are prepared in accordance with generally accepted accounting principles in Canada and, in preparing these statements, management must make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. The estimates and assumptions are believed to be reasonable under the circumstances and are based on historical experience and current conditions. The use of other assumptions could result in different estimates, and actual results may vary from results based on these estimates. As events occur and additional information is obtained, these estimates may be subject to change. Estimates are deemed critical when the Company's financial condition or results of operations could be materially impacted by a change in estimate. The Company's significant accounting policies are discussed in note A of the Company's December 2008, consolidated financial statements. The following is a discussion of the critical accounting estimates used to determine the financial results of the Company.

Mining Rights, Mineral Reserves and Mine Development

Mining rights, mineral properties and development assets include expenditures to acquire and develop mineral reserves, as well as development costs incurred to develop new reserves in advance of production. Depletion of producing properties, and amortization of mining rights and development costs,

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are based on units of production over the estimated proven and probable reserves of the respective coal properties.

The determination of coal reserves requires a number of assumptions and estimates, including geological sampling and modeling as well as estimates of future coal prices and future production costs. Estimates of the reserves may change based on additional information obtained subsequent to the assessment date. This may include data obtained from exploration drilling, significant changes in the price of coal and changes in estimates of the cost of production. A change in the estimate of reserves could result in a change in the rate of depletion, development amortization, or impairment of the reserves, resulting in a write down.

Mining rights and mine development are tested for impairment when events or changes in circumstances indicate that their carrying amount may not be recoverable. This impairment testing is based on estimated future undiscounted cash flows to be realized from the Company's mining operations. These future cash flows are developed using assumptions that reflect the long-term operating plans given management's best estimate of future economic conditions, such as revenues, production costs, and reserve estimates. A change in these factors could result in a modification of the impairment calculation.

Future Income Taxes

The Company is subject to Canadian tax and U.S. federal income tax as well as income tax of multiple state jurisdictions. The tax years 2005 through 2008 remain open to examination for Canadian, U.S. federal income tax and various state income tax matters.

The expense for income taxes includes federal and state income taxes currently payable and those deferred or prepaid because of temporary differences between the financial statement and the tax basis of assets and liabilities. As a result of losses from operations, the Company has recorded a valuation allowance against its future tax assets as it does not believe it is more likely than not these assets will be realized. Should these tax assets be realized, the valuation allowance would be reduced accordingly.

Asset Retirement Obligations

The Company's asset retirement obligations ("ARO") primarily consists of estimates related to reclaiming surface land and support facilities at its mining operations in accordance with federal and state reclamation laws as defined by each mining permit. The ARO, calculated using estimates of the timing and amount of third party cash flows required for reclamation, is discounted to its present value using the Company's credit adjusted risk-free rate, and the corresponding amount is recognized by increasing the carrying amount of mining related assets. The carrying amount is amortized over the life of the proven and probable coal reserves. The liability amount is increased each reporting period due to the passage of time and the amount of accretion is charged to expense. Any change in the timing or amount of the cash flows subsequent to initial recognition results in a change in the asset and liability, which then impacts amortization and accretion charges. A progression of the asset retirement obligation recorded on the consolidated balance sheet is as follows:

	<u>2008</u>	<u>2007</u>
Balance at beginning of year	\$3,757,353	\$1,536,948
Liabilities acquired	1,131,000	821,000
Liabilities incurred	166,083	1,339,052
Accretion	189,132	60,353
Liabilities settled	(919,568)	---
Total asset retirement obligations.....	<u>\$4,324,000</u>	<u>\$3,757,353</u>

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Stock-Based Compensation

Compensation cost attributable to all share options granted is measured at fair-value at the grant date using the Black-Scholes model and expensed over the vesting period with a corresponding increase to stock options and warrants in shareholders' equity. In determining the fair value, the Company makes estimates for expected volatility of the shares as well as an estimated discount rate. Changes to these estimates could result in the fair-value of the stock-based compensation to be less than or greater than the amount recorded.

Initial Adoption and Changes in Accounting Policies

All accounting policies adopted by the Company are in accordance with Canadian generally accepted accounting principles ("GAAP"). There were no significant changes in accounting policies during the 2007 fiscal year. The following financial reporting standards were applicable to the Company in 2008.

Business Combinations: Canadian Institute of Chartered Accountants' ("CICA") Handbook Section 1581 establishes standards for the recognition, measurement and disclosure of business combinations including criteria for the recognition of intangible assets of the acquired enterprise apart from goodwill. Initially, in all of the Company's previous acquisitions, including the acquisition of Pact Resources LLC ("Pact"), a development-stage enterprise, as described in note D in the consolidated financial statements, the amount of the purchase price in excess of the fair value of identifiable tangible assets was allocated in its entirety to goodwill. The Company has determined that in each of these acquisitions, the excess should have been allocated to mining rights. Consequently, on the June 30, 2008 and subsequent balance sheets, the Company has reclassified \$32,393,227, previously shown as goodwill at December 31, 2007, to Mining Rights and Mine Development Costs. Other than this reclassification, the change in the purchase allocation in the Pact and other acquisitions has had no material impact on the reported financial position or results of operations of any prior or current period. Mining rights are being amortized on a units-of-production basis.

Capital Disclosures: Effective January 1, 2008 the Company adopted CICA Handbook Section 1535, Capital Disclosures. Handbook Section 1535 specifies the disclosure of (i) an entity's objectives, policies and processes for managing capital; (ii) quantitative data about what the entity regards as capital; (iii) whether the entity has complied with any capital requirements; and (iv) if it has not complied, the consequences of such noncompliance. The Company has included disclosures recommended by the new Handbook section in note B to its December 31, 2008 consolidated financial statements.

Financial Instruments - Disclosures and Presentation: Effective January 1, 2008 the Company also adopted the following new CICA Handbook Sections: Section 3862, Financial Instruments Disclosures, and Section 3863, Financial Instruments Presentation. Sections 3862 and 3863 consist of a comprehensive series of disclosure requirements and presentation rules applicable to financial instruments. Section 3862 revises and enhances the disclosure requirements set out in Section 3861, Financial Instruments Disclosure and Presentation, and Section 3863 carries forward unchanged the presentation requirements of Section 3861. Section 3862, Financial Instruments Disclosures, requires the Company to provide disclosures in its financial statements that enable users to evaluate the significance of financial instruments for the Company's financial position and performance, the nature and extent of the risks arising from financial instruments to which the Company is exposed during the year and at the balance sheet date, and how the Company manages those risks. The Company has included disclosures recommended by the new Handbook section in note H to its December 31, 2008 consolidated financial statements.

Amendments to Section 1400 - General Standards of Financial Statement Presentation: The CICA amended Handbook Section 1400, Going Concern, to include additional requirements to assess and disclose an entity's ability to continue as a going concern. The Company has determined that these amendments had no material impact on the Company's consolidated financial statements.

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Inventories: Effective January 1, 2008, the Company adopted new accounting recommendations from the CICA, Handbook Section 3031, "Inventories", which supersedes the previously issued standard on inventory. The new standard introduces significant changes to the measurement and disclosure of inventory. The measurement changes include: the elimination of LIFO, the requirement to measure inventories at the lower of cost and net realizable value method, for inventories that are not ordinarily interchangeable and goods or services produced for specific purposes, the requirement for an entity to use a consistent cost formula for inventory of a similar nature and use, and the reversal of previous write downs to net realizable value when there is a subsequent increase in the value of inventories. Disclosures of inventories have also been enhanced. Inventory policies, carrying amounts, amounts recognized as an expense, write downs and the reversals of write downs are required to be disclosed. This standard has had no material impact on the Company's December 31, 2008 consolidated financial statements.

Future Accounting Changes

Goodwill and Intangible Assets: The CICA has issued a new standard which may affect the financial disclosures and results of operations of the Company for interim and annual periods beginning January 1, 2009. Section 3064, Goodwill and intangible assets, establishes revised standards for recognition, measurement, presentation and disclosure of goodwill and intangible assets. Concurrent with the introduction of this standard, the CICA withdrew EIC-27, Revenues and Expenses during the pre-operating period.

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 currently in the planning phase of the conversion, which includes identifying potential differences between GAAP and existing IFRS at December 31, 2008, as well as proposed IFRS which may be in effect in 2011. The Company is utilizing both internal and external resources to identify and ultimately quantify these differences and the impact that they will have on accounting policies, information technology and data systems, internal control over financial reporting, disclosure controls and procedures, financial reporting and business activities. Employees responsible for financial reporting will attend IFRS training and begin IFRS accounting policy development in 2009.

Disclosure Controls and Procedures

Disclosure controls and procedures have been designed to ensure that information required to be disclosed by the Company is accumulated and communicated to the Company's management as appropriate to allow timely decisions regarding required disclosure. For the fiscal year ended December 31, 2008, an evaluation was commissioned by the Company under the supervision of the CEO and CFO and with the participation of management of the effectiveness of the Company's disclosure controls and procedures as defined under the rules adopted by the Canadian securities regulatory authorities. Based on this evaluation, the Company's CEO and CFO have concluded as at December 31, 2008, that the Company's disclosure controls and procedures provide reasonable assurance that material information related to the Company is made known to them for disclosure in these financial statements. It should be noted that while the Company's CEO and CFO believe that the Company's disclosure controls and procedures provide a reasonable level of assurance that they are effective, they do not expect that the disclosure controls and procedures or internal controls over financial reporting will prevent all errors and fraud. A control system, no matter how well conceived or operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met.

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Internal Controls over Financial Reporting

Internal controls over financial reporting are designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external reporting purposes in accordance with generally accepted accounting principles in Canada. Management is responsible for establishing and maintaining adequate internal controls over financial reporting appropriate to the nature and size of the business to provide reasonable assurance regarding the reliability of financial reporting for the Company. However, any system of internal control over financial reporting has inherent limitations and can provide only reasonable assurance with respect to financial statement preparation and presentation.

The Company uses the COSO control framework. For the fiscal year ended December 31, 2008, an evaluation was commissioned by the Company under the supervision of the CEO and CFO and with the participation of management of the effectiveness of the Company's internal control over financial reporting. Based on this evaluation, the CEO and CFO have concluded that the design and operation of the Company's internal controls over financial reporting were effective as at December 31, 2008. Management is continually monitoring and revising its control procedures and processes. Due to the size of its finance staff, there is not complete segregation of duties in the Company. However, for more complex areas of accounting and accounting estimates, the CFO and Controller review each other's work.

There were no changes to the Company's internal controls over financial reporting that occurred during the year ended December 31, 2008 that materially affected, or are reasonably likely to affect, the Company's internal controls over financial reporting.

Financial Instruments

In 2006, the Company entered into an interest rate swap transaction whereby the interest payments on an original notional dollar amount of \$7,000,000 converted to a fixed rate of 8.10% compared to a variable rate of LIBOR re-measured on a quarterly basis. The notional amount decreased over the life of the swap agreement, which was due to expire in December 2011. The notional amount of the agreement was \$5,483,333 at December 31, 2007. Under the agreement, the Company paid or received the net interest amount monthly, with the monthly settlements included in interest expense.

In 2006, management designated the interest rate swap agreement as a cash flow hedging instrument and determined the agreement met the requirements for hedge accounting under GAAP. In August, 2007, the debt to which this swap was related was retired. As a result, the amount previously recorded in other comprehensive income was charged to interest expense in October 2007 and any future changes to the fair value of the swap either increased or decreased interest expense as the contract no longer qualified as an accounting hedge.

On July 15, 2008, the Company paid \$237,200 to terminate the swap. The fair value of the derivative was \$224,696 at December 31, 2007, and was included in accrued liabilities on the consolidated balance sheet on that date.