

August 15, 2004



Management Discussion and Analysis

The following discussion and analysis by management of the 2nd Quarter 2004 financial condition and financial results for InterOil Corporation should be read in conjunction with the unaudited Consolidated Financial Statements for the six months ended June 30, 2004 in this Interim Report and the audited Consolidated Financial Statements and Management Discussion and Analysis for the year ended December 31, 2003. The financial statements and the financial information herein have been prepared in accordance with generally accepted accounting principles in Canada and are presented in United States dollars.

Forward Looking Statements

All statements, other than statements of historical facts, included in this release, including without limitation, statements regarding our drilling plans, business strategy, plans and objectives of management for future operations and those statements preceded by, followed by or that otherwise include the words “believe”, “expects”, “anticipates”, “intends”, “estimates” or similar expressions or variations on such expressions are forward-looking statements. The Company can give no assurances that such forward-looking statements will prove to be correct. Risks and uncertainties include, but are not limited to, the existence of underground deposits of commercial quantities of oil and gas; fluctuations in prices for oil and gas production; curtailments or delays in development due to mechanical, operating, marketing or other problems; capital expenditures that are either significantly higher or lower than anticipated because the actual cost of identified projects varied from original estimates; and from the number of exploration and development opportunities being greater or fewer than currently anticipated. InterOil currently has no reserves as defined in Canadian National Instrument 51-101 Standards of Disclosure for Oil and Gas Activities (“NI 51-101”). All information contained herein regarding resources are references to undiscovered resources under NI 51-101, whether stated or not. See the Company’s filings with the Canadian securities regulators for additional risks and information about the Company’s business.

Upstream Activities

InterOil announced on June 29, 2004 that it would suspend drilling operations pending the acquisition of additional drilling equipment with greater depth capabilities. Seismic surveys will be carried out as part of the forward exploration program

The Moose-2 well, located in Petroleum Prospecting License (“PPL”) 238, was drilled to appraise the extent of the limestone reservoir that had oil shows in the Moose-1 well and to explore the Late Cretaceous Pale and Subu Sandstones primary target. InterOil’s June 29, 2004 announcement stated that as long as limited progress was being made in the Moose -2 well it would continue drilling. On August 10, 2004 InterOil suspended drilling operations in Moose – 2 due to the limited progress utilizing the existing hard rock coring equipment. The well has been drilled to a depth of 1,520 (4,987 feet). Live oil was confirmed in Moose – 2 in the limestone reservoir and methane has been recovered in the lower shale section in mud returns.

InterOil drilled the Sterling Mustang-1 exploration well to target the Late Cretaceous Pale and Subu Sandstones (primary) and the Eocene “Mendi” Limestone with fracture porosity as a (secondary) target. On June 29, 2004 InterOil suspended drilling operations at the Sterling Mustang -1 due to the depth limitations of the existing rig. The well was drilled to a depth of 2,958 meters (9,705 feet) which exceeded the original target depth of 2,200 meters (7,218 feet). The well encountered

sandstone and possible limestone drilling breaks in sections above the secondary target with associated background and trip gas in the drilling mud to surface increasing in quantity from 6% to 29%. The gas samples also reflected a shift in composition to heavier gas (c1-methane to c5-pentane) as the well was drilled deeper. The heavier composition is based on the recovery of I-Pentane and N-Pentane from samples returned to surface and recorded by Baker Hughes INTEQ, while down-hole formation pressures were read up to 3,800 PSI.

These gas shows and the oil and gas shows in Moose are being treated as indications only of the presence of hydrocarbons to be tested by further drilling.

Drill site locations have been identified on other structures located in PPL 238 and preparations of the drill sites have been completed. Additional drilling rig equipment is being sourced that will provide deeper drilling capability to ensure exploration targets are thoroughly tested.

In the current six month period, oil and gas costs capitalized on Petroleum Retention License's 4 and 5 in the amount of approximately US\$1.5 million have been expensed to comply with accounting policy. The justification for the adjustment was due to the non-existence of commercial gas contracts and no immediate development plans for these licenses.

[Midstream Activities](#)

First refined product sales from InterOil's refinery occurred on August 10, 2004

As at June 29, 2004 the refinery construction had progressed in excess of 99 percent complete. First oil in to the refinery occurred on June 30, 2004 with the Crude Distillation Unit placed into service on July 5, 2004. The commissioning activities are well advanced as evidenced by the introduction of hydrocarbons into the refining process, and the first sale of refined product to the PNG domestic market occurred on August 10, 2004. The refined products have been independently certified as meeting contractual specifications and InterOil expects to continue generating product for sale during the remainder of the commissioning period. During this period the refinery reached throughput levels as high as 32,500 barrels per day (the refinery name plate capacity). Sustained full production is not expected to be reached until commissioning activities have concluded. The Catalytic Reformer will be placed into service late-August 2004, followed by the system wide performance and reliability testing. The commissioning and testing period is anticipated to extend into the fourth quarter 2004.

The refinery has accepted three crude cargos (approximately 770,000 barrels) containing feedstock of PNG sourced Kutubu Blend crude. The third crude oil shipment arrived on July 15, 2004 and will subsequently be followed by regular shipments as the refinery moves through the commissioning and testing stages and towards full production.

[Downstream Activities](#)

Acquisition of BP Papua New Guinea (now InterOil Products Limited)

On April 29, 2004 InterOil announced that, after receiving all necessary PNG Government approvals and completing all other required conditions, its wholly owned subsidiary, S.P.I. Distribution Limited, finalized the acquisition of BP Papua New Guinea Limited. The date of transfer of shares was April 28, 2004. The company has been renamed InterOil Products Limited. The final purchase price at the date of transfer was US\$12.2 million for assets and inventory of which a down payment of US\$1 million was paid at transfer date, with the balance of funds payable twelve months from the effective date (March 1, 2004). Included in the purchase are the 2003

retained profits of approximately US\$4.2 million (Kina 13.5 million), retained profits for the first two months of 2004 of approximately US\$0.7 million (Kina 2.2 million) of which US\$0.50 million (Kina 1.5 million) was paid in April 2004. These amounts will be repaid to BP, no later than twelve months after the effective date, from proceeds obtained in collecting the closing accounts receivable balance.

BP had been operating in PNG for over 30 years. The acquisition of BP Papua New Guinea Limited and the establishment of InterOil Products Limited (IPL) has afforded InterOil with direct participation in PNG's downstream petroleum distribution market. The asset portfolio comprises terminals, depots, retail and commercial sites. InterOil is now involved in the complete value chain from refining operations to the end consumer, which includes shipping, bulk terminaling and distribution and marketing operations nationwide. The BP brand is in the process of being replaced by the new InterOil brand. The majority of IPL's 160 employees are PNG nationals. The main centers of employment are in the National Capital of Port Moresby, the center of commercial activity around the city of Lae, and regional centers of Madang, Rabaul and Mt Hagen.

InterOil assumption of the BP business will be assisted by the secondment of existing BP management under a Services Agreement with BP Australia, to provide for an efficient transfer over the following year.

InterOil Corporation Consolidated Results Summary

In the current period, the InterOil Downstream Business Segment finalized the acquisition of BP Papua New Guinea on April 2004 which generated operational revenue in the amount of \$12.6 million in the months of May and June 2004, while net revenue from March and April 2004 will be credited to offset the purchase price. The Midstream Business Segment continues to be in the construction and pre-operating stage of development of the refinery in Papua New Guinea and therefore has not undertaken any operating activities to date. There was a net loss of \$4,167,205 in the first six months of 2004 compared to a net loss of \$518,019 for the same period in 2003 which difference was attributable to P.I.E. Corporation, a related party, waiving prior years' management fees totaling \$840,000 in the first quarter 2003, and the six months of 2004 not recognizing an adjustment of this nature. In addition, \$1,478,534 of the oil and gas properties capitalized in prior periods were written down and expensed in the first six months of 2004 compared to –nil- for the same period in 2003 in accordance with the new accounting policy as explained in the upstream section above. Legal and professional fees were \$829,054 in the first six months of 2004 compared with \$302,355 for the same period in 2003. The higher costs were associated with expenses related to the equity capital raisings completed in the prior year that matured subsequent to December 31, 2003, and various legal expenses related to new stock exchange listings in the current year. The increase in administrative and general expenses in the six months ended in 2004 as compared to the same period in 2003 is primarily related to both the inclusion of IPL expenses for May and June 2004 which were \$675,277 (nil in 2003) and the inclusion of the fair value of stock options as compensation expense in the six months of 2004 (nil in 2003) in the amount of \$626,084. The foreign exchange loss was minimal for the first six months of 2004 due to the Papua New Guinea Kina exchange rate to the US Dollar at June 30, 2004 being similar to the rates at December 31, 2003.

Quarters Ended	30-Jun-04	31-Mar-04	31-Dec-03	30-Sep-03	30-Jun-03	31-Mar-03	30-Dec-02	30-Sep-02
Total Revenue	12,690,533	155,596	203,964	13,349	27,717	14,250	(4,373)	92,922
Net Income (Loss) before discontinued operations	(2,522,279)	(1,644,927)	(1,489,036)	(1,510,516)	(689,090)	171,073	(228,404)	(1,148,882)

and extraordinary items								
Net Income (Loss) per share	(0.10)	(0.07)	(0.06)	(0.06)	(0.03)	0.01	(0.01)	(0.06)
Diluted Income (Loss) per share	(0.10)	(0.07)	(0.06)	(0.06)	(0.03)	0.01	(0.01)	(0.06)
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Diluted Income (Loss) per share	(0.10)	(0.07)	(0.06)	(0.06)	(0.03)	0.01	(0.01)	(0.06)

Total assets increased to \$317,486,703 at June 30, 2004 compared to \$260,339,851 at December 31, 2003. The predominant portion of the assets is the capital expenditures related to the Midstream refinery development, construction costs and commissioning along with the Upstream capitalization of oil and gas exploration expenditures. In June 2004 the refinery procured crude feedstock which value is recorded as inventory at the lower of cost, on a first-in, first-out basis, or net realizable value which is \$23.5 million (nil at June 2003) at June 30, 2004. A total of \$13.7 million of refinery development and construction costs were capitalized in the six month period in 2004 compared to \$37.0 million capitalized in the same period in 2003. The level of project capitalized costs will be lower as the refinery construction nears completion. InterOil follows the successful efforts method of accounting for expenditures related to oil and gas exploration and development activities, which are capitalized and carried forward where they are expected to be recouped through successful development, or by sale, or where exploration and evaluation activities have not reached a stage to allow reasonable assessment regarding the existence of economical reserves. The company capitalized \$15.7 million of drilling and exploration costs in the first six months of 2004. In addition to the Midstream and Upstream assets, the Downstream acquisition of BP Papua New Guinea added approximately \$26.0 million in assets to the InterOil Consolidated Balance sheet at the date of the acquisition. These assets include a trade receivable balance of \$7.1 million.

The accounts payable and current liabilities increased significantly as at June 30, 2004 when compared to June 30, 2003. The two contributing factors to the increase are the payable related to the procurement of crude feedstock for the refinery in the amount of approximately \$23.5 million at June 30, 2004 (nil at June 2003), and the inclusion of IPL's payables and liabilities of approximately \$11.0 million at June 30, 2004 (nil at June 2003). The deferred acquisition cost of approximately \$11.9 million at June 30, 2004 is associated with the acquisition of BP Papua New Guinea on March 1, 2004 which is summarized above in Midstream activities.

InterOil's long-term debt consists of amounts drawn under the US\$85 million Project Financing Facility obtained in June 2001 from the Overseas Private Investment Corporation ("OPIC"), an agency of the US Government, to support the development of the refinery, and the indirect participation interests in the company's Phase One Exploration Program. OPIC is the primary lender of capital to the refinery project. The total amount available under the facility is fully drawn down at June 30, 2004. The principal repayments of US\$4.5 million were to commence on June 30, 2004, but the terms of the facility were amended in accordance with the current project schedule and now the semi-annual principal payments will commence on June 30, 2005. The interest rate is equal to the US treasury cost applicable to each promissory note established at time of disbursement plus 3.0% per annum prior to the refinery completion and 3.5% per annum on and

after refinery completion. In 2003, two separate indirect participation interests totaling US\$19.8 million were granted to independent investors, PNG Energy Investors LLC (PNGEI) and PNG Drilling Ventures Limited (PNGDV), each of which may elect to convert their interests into a working interest in the drilling program, debt or InterOil common shares. The Indirect Participation Interest decreased by \$7,650,000 at June 30, 2004 when compared to the account balance at March 31, 2004. The reason for this decrease was due to PNGEI converting their entire interest into InterOil common shares on May 17, 2004.

Liquidity and Capital Resources

InterOil ended the June 30, 2004 quarter with approximately US\$21.3 million in cash and temporary investments compared to approximately US\$34.0 million in cash at December 31, 2003.

OPIC remains the primary lender of capital to the refinery project. To provide funding for InterOil's ongoing exploration and production activities in PNG and general corporate purposes capital was raised through three private placements in 2003. In addition to the private placements, capital was raised from indirect participation interests in InterOil's Phase One Exploration Program, of which the balance of \$3.2 million was received in the first quarter of 2004. During the period cash was spent on refinery construction, development costs, oil and gas exploration expenses, distributing refined product in PNG and administrative and general costs.

The capital budget of the refinery project is currently:

	US\$ (millions)
Capital Costs	\$197.4
Finance Costs	\$8.0
Funded Debt Service Reserve Account	\$9.0
Total	\$ 214.4

Of the \$214.4 million capital budget, approximately \$206 million in equipment and development costs have been paid as of June 30, 2004. The project costs, crude procurement and associated revenues generated from product sales during the commissioning of the refinery will be included in the capital costs of the project.

In March 2004 InterOil obtained final credit approval to structure and arrange, on an exclusive basis, a US\$60 million revolving crude oil procurement facility with BNP Paribas (Singapore) to finance the crude feedstock for the refinery. In June 2004 there were two Documentary Letters of Credit issued under the facility to BP Singapore in support of the refinery crude procurement in the amount of approximately \$26.0 million. Upon expiry of these letters, the credit facility enables the company to roll open amounts into short-tem loans.

Share Capital

The authorized share capital of the company consists of an unlimited number of common shares with no par value. The issued and outstanding shares of InterOil, and reconciled to June 30, 2004, are set out below:

	Number of Shares	\$
Balance, 31 December 2002	20,585,943	\$94,120,609
Shares issued for Cash	3,817,500	\$61,060,640

Shares issued for Debt	31,240	\$316,359
Shares issued on exercise of Options	381,278	\$1,951,592
Balance, 31 December 2003	24,815,961	\$157,449,200
Shares issued for Cash	Nil	Nil
Shares issued for Debt	688,140	7,425,500
Shares issued on exercise of Options	15,500	90,125
Balance, 30 June 2004	25,519,601	\$164,964,825

Changes in Accounting Policies

Stock-based compensation - Prior to January 1, 2004, the Company applied the fair value based method of accounting prescribed by CICA Handbook Section 3870, Stock-based Compensation and Other Stock-based Payments, only to employee stock appreciation rights, and applied the settlement method of accounting to employee stock options. Under the settlement method, any consideration paid by employees on the exercise of stock options or purchase of stock is credited to share capital and no compensation expense was recognized.

The CICA Accounting Standards Board has amended CICA Handbook Section 3870, Stock-based Compensation and Other Stock-based Payments, to require entities to account for employee stock options using the fair value based method, beginning January 1, 2004. Under the fair value based method, compensation expense is measured at fair value at the date of grant and is expensed over the award's vesting period. In accordance with one of the transitional options permitted under amended Section 3870, the Company has retroactively applied the fair value based method to all employee stock options granted on or after January 1, 2002, without restatement to prior periods. The effect of retroactively adopting the fair value based method, without restatement, is to increase the opening accumulated deficit by \$737,650, increase additional paid up capital by \$645,216 and increase share capital by \$92,434.

Inventory valuation - Crude oil and refined petroleum products are valued at the lower of cost, on a first-in, first-out basis, or net realizable value. Cost consists of raw material, labor, direct overheads and transportation.

Foreign currency - For subsidiaries considered to be self-sustaining foreign operations, all assets and liabilities denominated in foreign currency are translated to United States dollars at exchange rates in effect at the balance date and all revenue and expense items are translated at the rates of exchange in effect at the time of the transactions. Foreign exchange gains or losses are reported as a separate component of shareholders' equity.

For subsidiaries considered to be an integrated foreign operation, monetary items denominated in foreign currency are translated to United States dollars at exchange rates in effect at balance date and non-monetary items are translated at rates of exchange in effect when the assets were acquired or obligations incurred. Revenue and expense items are translated at the rates of exchange in effect at the time of the transactions. Foreign exchange gains or losses are included in income.

Deferred financing costs - Deferred financing costs represent the unamortized cost of fees incurred to secure long-term borrowings. Amortization is provided on a straight-line basis, over the term of the related debt and is included in administrative and general expenses for the period.

Receivables - The collectability of debts is assessed at reporting date and specific provision is made for any doubtful accounts.

Risks and Uncertainties

Please refer to the 2003 Annual Report for detailed information as the economic and industry factors are substantially unchanged.

Outlook

The refinery commissioning activities are well advanced and are expected to continue into the fourth quarter of 2004. The sale of refined products in PNG will continue and export sales will commence during this commissioning and testing phase.

Drilling activities will recommence upon the acquisition of additional drilling equipment during the fourth quarter of this year. Seismic surveys will be carried out in support of the drilling program.

The transition of the acquired BP Papua New Guinea Limited business, renamed InterOil Products Limited, into the InterOil Group will occur throughout the remainder of the year.

Additional information, including is available on the InterOil website at: www.interoil.com and on SEDAR at: www.sedar.com.