

## CONSOLIDATED BALANCE SHEETS

	June 30 2005	December 31 2004
	(unaudited)	
<b>Assets</b>		
Current assets		
Cash	\$ 7,393,614	\$ 2,701,477
Accounts receivable	331,679	218,249
Inventory	133,475	141,373
Deposits and cash calls paid	32,063	502,522
	<b>7,890,831</b>	<b>3,563,621</b>
Restricted cash (note 4)	100,000	100,000
Petroleum and natural gas properties – net of accumulated depletion and depreciation (note 3)	10,838,594	6,140,058
	<b>18,829,425</b>	<b>9,803,679</b>
<b>Liabilities</b>		
Current liabilities		
Accounts payable and accrued liabilities	1,293,601	572,033
Bank loan (note 4)	194,300	234,500
	<b>1,487,901</b>	<b>806,533</b>
Promissory note payable (note 5)	600,000	600,000
Asset retirement obligation (note 6)	1,890,021	1,848,503
	<b>3,977,922</b>	<b>3,255,036</b>
<b>Shareholders' Equity</b>		
Common shares (note 7)	41,020,693	31,339,389
Contributed surplus (note 7)	232,897	41,952
Deficit	(26,402,087)	(24,832,698)
	<b>14,851,503</b>	<b>6,548,643</b>
<b>Going Concern Matters (note 1)</b>		
	<b>\$ 18,829,425</b>	<b>\$ 9,803,679</b>

See accompanying notes to consolidated financial statements.

Approved by the Board of Directors



Director



Director

## CONSOLIDATED STATEMENTS OF LOSS AND DEFICIT

(unaudited)

	For the three months ended June 30		For the six months ended June 30	
	2005	2004	2005	2004
<b>Revenue</b>				
Petroleum and natural gas, net of royalties	\$ 520,965	\$ 903,601	\$ 964,261	\$ 968,156
	<b>520,965</b>	903,601	<b>964,261</b>	968,156
<b>Expenses</b>				
Operating	329,747	782,538	534,305	949,168
General and administrative	74,239	99,740	311,766	219,322
Restructuring costs	—	286,665	—	286,665
Stock-based compensation (note 7)	115,610	47,199	190,945	94,398
Interest expense	28,171	23,282	45,687	31,067
Interest income	(2,751)	(8,205)	(9,128)	(11,709)
Gain on settlement of obligations	—	(291,959)	—	(291,959)
Depletion and depreciation	344,510	859,314	1,418,557	6,094,628
Accretion on asset retirement obligation (note 6)	41,518	14,842	41,518	29,684
	<b>931,044</b>	1,813,416	<b>2,533,650</b>	7,401,264
<b>Net loss</b>	<b>(410,079)</b>	(909,815)	<b>(1,569,389)</b>	(6,433,108)
Deficit, beginning of period	<b>(25,992,008)</b>	(31,049,494)	<b>(24,832,698)</b>	(25,455,674)
Restatement for changes in accounting policies				
Stock-based compensation	—	—	—	(70,527)
<b>Deficit, end of period</b>	<b>(26,402,087)</b>	(31,959,309)	<b>(26,402,087)</b>	(31,959,309)
<b>Net loss per share</b>				
Basic and diluted	\$ (0.01)	\$ (0.02)	\$ (0.02)	\$ (0.15)

See accompanying notes to consolidated financial statements.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

	For the three months ended June 30		For the six months ended June 30	
	2005	2004	2005	2004
Cash provided by (used in):				
<b>Operating Activities</b>				
Net loss	\$ (410,079)	\$ (909,815)	\$ (1,569,389)	\$ (6,433,108)
Items not affecting cash				
Depletion and depreciation	344,510	859,314	1,418,557	6,094,628
Accretion on asset retirement obligation	41,518	14,8424	1,518	29,684
Stock-based compensation expense	115,610	47,199	190,945	94,398
	91,559	11,540	81,631	(214,398)
Net change in non-cash working capital	662,879	(14,026)	397,233	77,060
	754,438	(2,486)	478,864	(137,338)
<b>Financing Activities</b>				
Issue of common shares	10,985,567	—	10,985,567	745,570
Issue of flow-through shares	—	—	—	2,442,428
Share issue costs	(1,292,795)	4,551	(1,304,263)	(210,288)
Proceeds of promissory note	—	500,000	—	500,000
Repayment of bank loan	(20,100)	(20,100)	(40,200)	(40,200)
	9,672,672	484,451	9,641,104	3,437,510
<b>Investing Activities</b>				
Expenditures on petroleum and natural gas properties	(3,654,055)	(575,143)	(6,117,093)	(6,254,418)
Disposal of petroleum and natural gas properties	—	—	—	—
Net change in non-cash working capital	218,346	(404,053)	689,262	2,487,617
	(3,435,709)	(979,196)	(5,427,831)	(3,766,801)
Increase (Decrease) in cash	6,991,401	(497,231)	4,692,137	(466,629)
Cash, beginning of period	402,213	1,709,213	2,701,477	1,678,611
<b>Cash, end of period</b>	<b>\$ 7,393,614</b>	<b>\$ 1,211,982</b>	<b>\$ 7,393,614</b>	<b>\$ 1,211,982</b>

See accompanying notes to consolidated financial statements.

During the three months ended June 30, 2005, the Company paid \$28,171 (2004 – \$10,782) of cash interest and \$Nil in cash taxes (2004 – \$Nil). During the six months ended June 30, 2005, the Company paid \$45,687 (2004 – \$18,567) of cash interest and \$Nil in cash taxes (2004 – \$Nil).

# SELECTED NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

*For the Six Months ended June 30, 2005 (unaudited)*

The interim consolidated financial statements include the accounts of Questerre Energy Corporation and its subsidiaries (“Questerre” or “the Company”) and have been prepared by management in accordance with Canadian Generally Accepted Accounting Principles. The interim consolidated financial statements are unaudited and have not been subject to review by the Company’s external auditors. The interim financial statements have been prepared following the same accounting policies and methods of computation as the consolidated financial statements for the fiscal year ended December 31, 2004. Certain comparative figures have been reclassified to conform with the presentation adopted in the current year. The disclosure which follows is incremental to the disclosure included with the annual consolidated financial statements. These interim consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto in the Company’s annual report for the year ended December 31, 2004.

## **1 Nature of Operations and Basis of Presentation**

Questerre is primarily involved in the exploration and development of naturally fractured and hydrothermally dolomitized reservoirs. As at June 30, 2005, the Company has five primary projects - the Beaver River Field in British Columbia, the St. Lawrence Lowlands in Quebec, the Parkland and Vulcan areas in Southern Alberta and the Westlock area of Central Alberta. Questerre also holds minority interests in producing, non-operated properties in Alberta. The St. Lawrence Lowlands and Southern Alberta projects remained unproved at June 30, 2005.

The Company’s efforts and resources are directed at developing a portfolio of projects and ultimately realizing the value of these projects. Due to the numerous risks inherent in these projects, there can be no assurance the Company will be successful. While the Company seeks to mitigate risks by securing joint venture partners and developing a stable production base, the Company’s success will, to a large extent, depend on its continued ability to finance the development of existing projects and the acquisition and development of new projects.

These financial statements have been prepared using Canadian generally accepted accounting principles (“GAAP”) and, accordingly, have been prepared using the same principles as those for a going concern. Should the Company be unsuccessful in realizing the value of its current and future projects, it may not be able to realize its assets and discharge its liabilities in the normal course of business.

## **2 Corporate Restructuring**

On April 1, 2004, Questerre Beaver River Inc. (“QBR”), a wholly owned subsidiary of Questerre, was granted an Order by the Court of Queen’s Bench of Alberta providing for creditor protection under the Companies’ Creditors Arrangement Act (“CCAA”). On June 22, 2004, Questerre also applied for and was granted an Order by the Court of Queen’s Bench of Alberta providing for creditor protection under CCAA.

QBR’s financial difficulty was the result of significant problems and cost overruns associated with a re-entry operation undertaken at the Beaver River natural gas field (the “Beaver River Field” or the “Field”) that is located approximately 100 miles northwest of Fort Nelson, British Columbia. QBR holds a 60% working interest and a 100% priority right to cash flow (subject to payouts) in the Field. QBR held a 100% working interest in the operation as a result of joint venture partners choosing to forego participation under penalty. The CCAA filing by Questerre was necessary due to claims advanced or threatened by certain parties that provided goods and services in connection with the re-entry operation and was intended to allow the Company to restructure its affairs while continuing operations on a normalized basis.

On August 9, 2004, the Company filed Plans of Compromise or Arrangement (the “Plans”) under the CCAA for the settlement of all outstanding claims. The Plans were approved by the requisite majority of unsecured creditors at meetings of creditors held on August 31, 2004 and sanctioned by the Court of Queen’s Bench of Alberta on September 9, 2004. Questerre and QBR subsequently emerged from Court protection under the CCAA on October 8, 2004.

Pursuant to the Plans proposed by Questerre and QBR, unsecured creditors received either the lesser of the amount of their claim or \$2,000. Alternatively, unsecured creditors elected to receive a cash dividend of \$0.05 plus one Common Share of Questerre for each dollar of their claims. The Common Shares of Questerre issued under the Plans are subject to a contractual escrow and released in two equal instalments on the fourth and eighth month anniversary of the date the Plans received final Court approval.

In addition to the proposed settlement, Questerre arranged for a liquidity option. Under this liquidity option, unsecured creditors received \$0.05 for each dollar of their claims, and also received an additional \$0.07 for each dollar of their claim in exchange for foregoing each Common Share they would have otherwise received. This resulted in a cash settlement of \$0.12 per dollar of claim outstanding.

The Common Shares that would otherwise have been issued to these unsecured creditors were issued to Terrenex Acquisition Corporation (“Terrenex”), a related party, pursuant to the terms of the Liquidity Option Agreement. In consideration, Terrenex established a fund to finance the liquidity option up to a maximum of \$668,500.

A total of \$0.56 million in cash and 9,623,012 Common Shares were issued on the implementation of these Plans. 6,756,102 Common Shares were issued to Terrenex pursuant to the Liquidity Option Agreement.

### 3 Capital Assets

	June 30 2005	December 31 2004
Petroleum and natural gas properties	46,192,609	\$ 40,075,517
Less: Accumulated depletion and depreciation	(35,354,015)	(33,935,459)
	<b>10,838,594</b>	<b>\$ 6,140,058</b>

The Company incurred a ceiling test writedown of \$1.2 million for the six months ended June 30, 2005 (December 31, 2004 – \$6.4 million). This relates to the Company’s share of drilling costs of an unsuccessful well in the Simonette area of Alberta during the first quarter. This amount is included in the depletion and depreciation provision on the income statement.

At June 30, 2005, petroleum and natural gas properties included \$7.8 million (December 31, 2004 – \$5.7 million) relating to unproved properties which have been excluded from the depletion and depreciation calculation. All costs associated with the Beaver River property, net of estimated salvage values, have been written down and included in depletion expense except \$3.0 million of geological and geophysical costs. These costs primarily relate to the 3-D seismic survey acquired over the Field in 2002. Management does not believe these assets are impaired as the data is a key component of the Company’s plan for future development of the Field.

Questerre does not include costs of \$1.9 million associated with its St. Lawrence Lowlands, Quebec acreage in the calculation of depletion or in costs subject to the ceiling test calculation. The Company also does not include costs of \$2.5 million relating to its exploration projects in the Parkland and Vulcan areas of Southern Alberta and \$0.4 million relating to its exploration project in the Westlock area of Central Alberta as these assets remain unproved at June 30, 2005.

#### 4 Bank Indebtedness

In July 2002, the Company obtained a five-year, \$400,000 term loan with a Canadian bank. Under the terms of the loan, the Company must make monthly payments of \$6,700 principal plus interest until the loan is paid out. The interest rate under the loan is the bank's floating base rate plus 2.0% and the Company may lock in the rate at any time. The loan is secured by the first assignment to the bank of a \$100,000 Guaranteed Investment Certificate and by a General Security Agreement over the assets of the Company and QBR. Financial covenants include maintaining a minimum long term debt to tangible equity ratio of 0.8 to 1.0 and maintaining a working capital ratio of at least 1.0 to 1.0. The Company was not in compliance with these financial covenants in the past and, therefore, the bank loan has been classified as a current liability.

#### 5 Promissory Note

The Company has issued a promissory note for \$0.6 million to Rupert's Crossing, an Investment Corporation ("Rupert's"). Rupert's is a private investment holding company controlled by the President and Chief Executive Officer of Questerre. The promissory note was issued in 2004 on the receipt of \$0.6 million in cash from Rupert's.

The promissory note is due November 14, 2006 and bears interest at 8% per annum, payable monthly. It is secured by a General Security Agreement over the assets of the Company and the hypothecation of the Company's exploration licenses in the St. Lawrence Lowlands in Quebec. Pursuant to the terms of the note, the Company has the right to prepay the entire amount or any portion thereof with 30 days' notice in writing to Rupert's. Rupert's has been granted an option, subject to regulatory approval, to convert the entire amount into Common Shares of the Company at a conversion rate of \$0.30 per Common Share.

#### 6 Asset Retirement Obligation

The total future asset retirement obligation was estimated by management based on Questerre's net ownership interest in all wells and facilities, estimated costs to reclaim and abandon the wells and facilities and the estimated timing of the costs to be incurred in future periods. The Company estimates its total asset retirement obligations to be \$1,908,503, at June 30, 2005. Questerre used a credit adjusted risk free rate of seven per cent and an inflation rate of 2 per cent to calculate the present value of the asset retirement obligation. The following table provides a reconciliation of the Company's total asset retirement obligation:

	June 30 2005	December 31 2004
Balance, beginning of period	1,848,503	\$ 848,134
Increase in estimate of obligation	40,810	909,179
Accretion expense	708	91,190
<b>Balance, end of period</b>	<b>1,890,021</b>	<b>1,848,503</b>

## 7 Share Capital

### a) Authorized

The Company is authorized to issue an unlimited number of Class A common voting shares. The Company is also authorized to issue an unlimited number of Class B common voting shares and an unlimited number of preferred shares, issuable in one or more series. At June 30, 2005, there were no Class B common voting shares or preferred shares outstanding.

### b) Issued and outstanding – Class A common shares

	Number	Amount
<b>Common Shares</b>		
Balance, December 31, 2004	66,751,904	\$ 31,339,389
Issued for cash	33,125,000	10,985,567
Share issue costs related to December 2004 financing		(1,304,263)
<b>Balance, June 30, 2005</b>	<b>99,876,904</b>	<b>41,020,693</b>

### c) Per Share Amounts

The following table summarizes the weighted average Common Shares used in calculating net loss per common share:

	Three Months Ended June 30		Six Months Ended June 30	
	2005	2004	2005	2004
Basic	74,399,871	44,665,892	70,597,014	44,053,299
Diluted	76,190,872	44,665,892	72,484,868	44,059,591

The reconciling item between the basic and diluted average common shares is stock options.

### d) Stock Options

The Company has a stock option plan that provides for the issuance of options to its directors, officers and employees at or above market prices. The stock options granted under the plan vest evenly over a three year period and expire five years from the date of grant.

The following table sets forth a reconciliation of the stock option plan activity for the three months ended June 30, 2005:

	Number of Options	Weighted Avg. Exercise Price
Outstanding, December 31, 2004	3,365,000	\$ 0.16
Granted	3,250,000	\$ 0.42
Cancelled	(170,000)	\$ 0.10
<b>Outstanding, June 30, 2005</b>	<b>6,445,000</b>	<b>\$ 0.30</b>
<b>Exercisable, June 30, 2005</b>	<b>774,583</b>	<b>\$ 0.16</b>

The outstanding options have a range of exercise prices between \$0.10 per share and \$1.00 per Common Share, and a weighted average number of years to expiry of 4.6. The exercisable options have a range of exercise prices between \$0.10 and \$1.00 per Common Share and have a weighted average number of years to expiry of 4.3.

e) *Stock-based Compensation Costs*

The Company accounts for its stock based compensation plan using the fair value method. Under this method, compensation cost attributable to share options granted to employees or directors is measured at fair value at the grant date and expensed over the expected exercise time frame with a corresponding increase to contributed surplus.

The fair value of each option granted is estimated in the date of grant using the Black-Scholes option pricing model with weighted average assumptions for grants as follows:

Risk free interest rate (%)	3.0
Expected life (years)	3.0
Expected volatility (%)	90.0

f) *Contributed Surplus*

The following table sets forth a reconciliation of contributed surplus for the three months ended June 30, 2005:

Balance, December 31, 2004	\$	41,952
Stock based compensation expense		190,945
<b>Balance, June 30, 2005</b>	<b>\$</b>	<b>232,897</b>

## 8 Related Party Transactions

At June 30, 2005, Questerre had amounts owing to Terrenex totaling \$804 (December 31, 2004 — \$1,836). All the directors of Terrenex serve as directors or officers of Questerre.

Questerre incurred fees of \$63,000 for the six months ended June 30, 2005 (2004 - \$63,000) to a company with common directors and officers. The transactions were in the normal course of business paid pursuant to an Office Rental Agreement for the provision of office space, office equipment and support personnel. The agreement may be terminated by either party with six months written notice.

In April 2005, the Company completed a private placement of 3,125,000 Common Shares for gross proceeds of \$1 million. A cash commission of \$0.06 million was paid on closing of the private placement. Terrenex subscribed for 2,815,000 Common Shares and Rupert's subscribed for 312,500 Common Shares.

In May 2005, the Company executed an agreement with Ampac Petroleum Inc., a private exploration and production company, to earn an interest in the Field. Jed Wood, a director of the Company is the sole shareholder and director of Ampac.

In April 2005, the Company executed a purchase and sale agreement with Rupert's to acquire its interest in producing properties and exploration acreage in Central Alberta. The purchase price of \$2.1 million was based on an evaluation of the assets prepared by an independent reservoir engineering firm. The transaction was completed in June 2005.