



2004 QUARTERLY REPORT

QUESTERRE ENERGY CORPORATION

Second Quarter  
Six Months Ended June 30, 2004

## President's Message

The impact of the poor results of the A-5 re-entry was a major setback for our Company. During the second quarter of this year we refocused our short-term objectives in response to this situation. I am able to report that we have made some significant progress to improve our financial position and realize the potential of our projects.

On April 1, 2004, our wholly-owned subsidiary, Questerre Beaver River Inc. ("QBR"), applied for and was granted protection from proceedings by creditors under the Companies' Creditors Arrangement Act ("CCAA") to allow for an orderly restructuring of its affairs. On June 22, 2004, Questerre Energy Corporation ("QEC") joined QBR under CCAA protection to facilitate the filing of concurrent plans of arrangement to settle all claims filed in connection with the A-5 re-entry.

Based on extensive discussions with our major creditors early in the third quarter, we found that there were insufficient resources to develop plans of arrangement satisfactory to them. Accordingly, we secured additional financing and improved our identical plans of arrangement for their consideration. These plans consist of cash and equity in the form of escrowed common shares of QEC. The cash component exceeds the maximum value of our assets and is designed to exceed the value of creditors' rights. The equity component gives creditors a meaningful interest in our existing and future projects while preserving a capital structure that facilitates the financing necessary for these projects. For those creditors that wish to maximize their immediate cash recovery under these plans, we have arranged for a liquidity option. Under this liquidity option, Terrenex Acquisition Corporation, a founding shareholder of Questerre, has agreed to purchase these common shares at current prices.

These plans were distributed to our creditors in early August and will be ratified at meetings of unsecured creditors to be held on August 31, 2004. The plans must be approved by creditors representing two-thirds in dollar value and one-half in number of the total creditors voting at each meeting. Each plan is conditional upon both plans being approved by the respective creditors, the receipt of requisite regulatory approvals and other conditions precedent set forth in the plans.

We believe these plans of arrangement provide the best opportunity for all stakeholders to realize a return on their investment in the Company. Based on a successful creditor vote, we believe we have good prospects to finance the development of our projects in the medium to long-term.

In the short-term, we have been successful in financing our exploration project in the St. Lawrence Lowlands in Quebec. Through two farmout agreements we have minimized our capital exposure while retaining a substantial equity interest in this project. Pursuant to these farmout agreements, our farm-in partners – Gastem Inc., Hydro-Quebec, and Jed Wood, a director of the Company – will collectively earn a 60% interest in the Sainte Sophie #1 well and 2,000 surrounding hectares by funding 90% of the costs. These farm-in partners will have the option to drill additional wells on the same terms for six months from the completion of this initial well. As a result of these agreements, Questerre will hold a 32.50% interest in this well and will be responsible for funding 6.25% of the costs.

With funding for our share of this well in place, the Sainte Sophie #1 well was originally scheduled to spud by July 31, 2004. Gastem Inc. recently advised us that the spud date has been postponed to the fourth quarter of 2004. This will allow Gastem to evaluate other cost effective rig options, including utilizing an alternative rig, and, complete an equity financing to primarily fund its share of any cost overruns on the well. In the interim, we have commenced a review of the offset wells and seismic data over the Becancour prospect to verify our drilling prognosis for the Sainte Sophie #1 well.

We also commenced a review of the geophysical data at the Beaver River Field during the quarter. To this end, we engaged a new geophysicist and contracted a new seismic processing company to reprocess the 3-D seismic data over the field. This reprocessing is required to correct velocity anomalies and more accurately image the Nahanni reservoir. We recently began the second stage of this reprocessing – the pre-stack time migration to improve imaging of the deeper horizons and extensive faulting. Utilizing the information from this pre-stack time migration, we will proceed with the final stage, a post-stack depth migration in the fourth quarter.

The initial results of this seismic reprocessing are consistent with our theory of undrilled compartments at the Beaver River Field. We anticipate picking a drilling location for a new compartment well early this winter.

Recent developments in the Liard and Appalachian Basins would appear to validate our exploration concepts for the Beaver River Field and the St. Lawrence Lowlands. A significant partner in the Kotaneelee Field, located 30 km northeast of the Beaver River Field, announced plans to participate in a \$20 million development well to be spud during the third quarter. At the Liard Field, the development well 2M-25 was completed in July and plans are underway for a production test during the third quarter. It is anticipated that a new development plan will be established for the field once the new operator, Paramount Resources Ltd., has completed its review of the technical data.

In the Appalachian Basin, Talisman Energy continues to meet its milestones for the Trenton-Black River play. In June, it reported that production now exceeds 100 mmcf/d and the area generates about 18% of Talisman's operating cash flow from North American gas operations. The company also reported that, through a recent US\$65 million acquisition, it has effectively doubled its landholdings in Appalachia from 433,000 net acres to 803,500 net acres. Questerre by comparison holds 605,000 net acres of land in the St. Lawrence Lowlands prospective for the analogous Trenton-Black River play.

Notwithstanding these developments and the progress made, we remain focused on the substantial work needed to realize the potential of our assets. With the support of our creditors and shareholders we are confident of our ability to do this in the future.



Michael Binnion  
*President and Chief Executive Officer*



## Management's Discussion and Analysis

The following discussion and analysis was prepared by management at August 11, 2004 and offers management's assessment of Questerre's historical financial and operating results. This interim discussion and analysis should be read in conjunction with the unaudited interim consolidated financial statements of the Company for the six months ended June 30, 2004, and the MD&A and audited financial statements for the year ended December 31, 2003 together with the notes related thereto. The reader should be aware that historical results are not necessarily indicative of future performance. This discussion may contain forward-looking statements that involve risks and uncertainties. Such information, though considered reasonable by Questerre at the time of preparation, may prove to be incorrect and actual results may differ materially from those anticipated in the statements made and the variances may be significant.

When calculating unit costs, natural gas is converted to a barrel of oil equivalent using a conversion ratio of six thousand cubic feet equal to one barrel (6:1 ratio).

### CREDITOR PROTECTION

Questerre Beaver River Inc. ("QBR"), a wholly owned subsidiary of Questerre Energy Corporation encountered a financial crisis in April of 2004 as a result of significant problems associated with the drilling of a re-entry well ("A-5 well") in the Beaver River Field (the "Field"). The drilling operation commenced in August 2003 and was completed in March 2004 with the tie-in of the well. The objective of the re-entry was to access "attic gas" which, based upon extensive seismic work, QBR believed to exist above the highest producing well in the Beaver River Field. The A-5 re-entry well did not encounter any attic gas and is currently producing from a previously drained section of an existing compartment at approximately 750 Mcf/day of gas with 700 cubic meters/day of formation water.

The unsuccessful results of the A-5 well were compounded by significant operational delays and cost overruns. Questerre engaged an experienced drilling consultant to plan and manage the drilling of the well. The cost estimate prepared by this consultant was \$5.3 million based on a multi-well program and \$6.5 million based on a single well program. The total project costs, including completion, testing and tie-in, were closer to \$19 million, or almost three times the original cost estimate. Despite raising a total of \$11.5 million cash net of financing and administration costs, over \$9 million remains unpaid to unsecured creditors. Accordingly, on April 1, 2004, QBR applied for and was granted an Initial Order by the Court of Queen's Bench of Alberta providing for creditor protection under the *Companies' Creditors Arrangement Act* ("CCAA").

Subsequent to QBR filing for protection under CCAA, several parties who provided goods and services in respect of the A-5 well filed statements of claim against Questerre Energy Corporation ("QEC") with respect to those goods and services. Several other parties indicated that they intended to advance similar claims, either jointly against QEC or as an alternative to a settlement with QBR. Although QEC disputed liability for the vast majority of the claims advanced by parties who worked on the A-5 well, and in some cases both QEC and QBR disputed the amounts claimed, QEC believed that the cost of defending the actions could exceed its available cash resources. As well, the existence of these claims and the possibility of further potential claims against QEC seriously restricted QEC's ability to raise capital in the public markets.

On June 22, 2004, QEC was added as a petitioner in QBR's CCAA proceedings and was granted protection under the CCAA.

The filings under CCAA are intended to allow the Company to restructure its affairs while continuing operations on a normalized basis. The Court Orders prohibit creditors from taking action against the Company and prevents QBR from paying most claims which arose before April 1, 2004 and QEC from paying most claims which arose before June 22, 2004.

## PLAN OF ARRANGEMENT AND RESTRUCTURING

On August 9, 2004, the Company filed Plans of Compromise or Arrangement for QEC and QBR ("the Plans" or "Plans of Arrangement") under the CCAA. Pursuant to the Plans proposed by QEC and QBR, unsecured creditors will receive either the lesser of the amount of their claim or \$2,000. Alternatively, unsecured creditors can elect instead to receive a cash dividend of \$0.05 plus one Common Share of QEC for each dollar of their claims. The Common Shares of QEC will be subject to a contractual escrow and released in two equal installments on the four and eight month anniversary of the date the plan receives final Court approval.

In addition to the proposed settlement, QEC has arranged for a liquidity option for interested creditors. Under this liquidity option, unsecured creditors will still receive \$0.05 for each dollar of their claim, and will also receive an additional \$0.07 for each dollar of their claim in exchange for forgoing each Common Share of Questerre they would have otherwise received. This would result 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 will be issued to Terrenex Acquisition Corporation ("Terrenex") pursuant to the terms of a Liquidity Option Agreement. Under the Liquidity Option Agreement, Terrenex will establish a fund to finance the liquidity option up to a maximum of \$668,500, representing the maximum number of Common Shares of QEC to be issued under the plans of arrangement multiplied by \$0.07. In consideration for providing this liquidity option, Terrenex will receive 300,000 Common Shares of QEC. It will also be issued Common Shares of QEC that, but for the election of the unsecured creditors to participate in the liquidity option, would have been issued to the creditors of QBR and QEC. These Common Shares that would be issued to Terrenex, will be subject to the same hold obligations were they issued to the creditors of QBR and QEC.

The Plans will be voted on at meetings of the respective unsecured creditors to be held on August 31, 2004 at the offices of the Monitor, Ernst & Young Inc. Each Plan is conditional upon both Plans being approved by creditors representing at least two-thirds in dollar value and one-half in number of the total creditors voting at each meeting. The Plans are also conditional upon the receipt of requisite regulatory approvals and other conditions precedent set forth in the Plans.

There is no assurance that the Company will be able to obtain creditor acceptance of its proposed restructuring under CCAA. If the restructuring can not be completed, Questerre may not be able to realize its assets and discharge its liabilities in the normal course of business. If the going concern basis is not appropriate for either QEC or QBR, adjustments may be necessary in the carrying amounts and/or classification of assets, liabilities, revenues and expenses in the consolidated financial statements. The Company's future outlook and plans of operation will be determined by the outcome of the restructuring of QBR and QEC under the CCAA.

## SECOND QUARTER 2004 FINANCIAL RESULTS

### PRODUCTION

Production from the Company's Beaver River Field averaged 1,482 Mcf/day for the three months ended June 30, 2004 (2003 – 603 Mcf/day) and 745 Mcf/day for the first six months of 2004 (2003 – 560 Mcf/day). All production for the first six months of 2004 was attributed to the new A-5 well brought on production at the beginning of the second quarter. Field production in the first half of 2003 included two producing wells, both of which were shut-in after the second quarter of 2003 due to water disposal constraints and to facilitate the drilling of the new A-5 well. Consistent with the first six months of 2003, the Company's production from minor Alberta properties in the six months ended June 30, 2004 was approximately 25 BOE/day in natural gas and associated natural gas liquids.

### REVENUE

Questerre reported petroleum and natural gas revenue of \$1.0 million in the second quarter of 2004 compared to \$0.6 million for the second quarter of 2003 primarily due to higher production. Despite increased production in the second quarter of 2004, year to date revenues in 2004 decreased to \$1.1 million compared to \$1.2 million for the first six months of 2003 due to the shut-in of production at the Field through the entire first quarter of 2004.

### ROYALTIES

Questerre recorded royalty expense of \$110,000 for the first six months of 2004 compared to \$219,000 for the first six months of 2003. Royalty expense in 2004 included crown, freehold and overriding royalties on the Company's minor Alberta properties as well as gross overriding royalties on its Beaver River Field production. In 2003, royalty expense also included an accrual for crown royalties attributable to the Beaver River Field. No crown royalty expense for the Field was recorded in 2004.

Crown royalties for the Beaver River Field were governed by a royalty agreement which provided for the deferral of all royalties until the earlier of June 30, 2004 and cumulative production of 13 Bcf from the project. Repayment of deferred royalties is contingent on both the success of the experimental project for which the deferral was granted and on monthly production exceeding volumes established by the Crown. In December 2003, Questerre reported a royalty recovery which included the reversal of 2003 and prior years' royalty expense recognized under the royalty agreement. Based on the limited production and disappointing results to date, the Company adjusted the liability for crown royalties to Nil at December 31, 2003 on the basis that the conditions for repayment no longer existed. On the same basis, the Company did not accrue crown royalties on its Beaver River Field production in the six months ended June 30, 2004.

### OPERATING COSTS

Increased production from the Beaver River Field resulted in total operating expenses of \$783,000 for the second quarter of 2004 (2003 – \$377,000) and \$949,000 for the six months ended June 30, 2004 (2003 – \$739,000). Although the Field was not producing for the first three months of 2004, due to the remote location, there continued to be fixed costs associated with maintaining field operations.

## GENERAL AND ADMINISTRATIVE EXPENSES

Questerre reported general and administrative ("G&A") expenses of \$100,000 in the second quarter of 2004 compared to \$154,000 for the second quarter of 2003. Net G&A expenses of \$219,000 for the first six months of 2004 (2003 – \$341,000) included \$150,000 of bad debt expense recorded against amounts receivable from partners on the Beaver River Field. Overhead recoveries of \$371,000 associated with the increased capital expenditures in the first six months of 2004 offset a substantial portion of 2004 G&A expenses.

	Six Months Ended June 30,	
(\$ thousands)	2004	2003
General & administrative expenses	\$ 440	\$ 390
Bad debt expense	150	–
Overhead recoveries	(371)	(49)
General & administrative expenses, net	\$ 219	\$ 341

## OTHER INCOME AND EXPENSES

During the second quarter of 2004, Questerre recorded restructuring costs of \$287,000 representing professional services associated with the Company's filings and restructuring under the CCAA.

Questerre recorded a gain of \$292,000 in the second quarter of 2004 on the forgiveness by a significant creditor of outstanding amounts owing by the Company for services provided on the A-5 drilling operation.

## STOCK BASED COMPENSATION

Effective January 1, 2004 the Company adopted the new accounting standard for stock based compensation resulting in stock based compensation expense of \$47,200 in the second quarter of 2004 and \$94,400 for the first six months of 2004. The new accounting standard was applied retroactively without restatement of prior periods, therefore no corresponding expense was recorded in 2003.

## INTEREST EXPENSE

In June 2004, Questerre borrowed \$0.5 million from a private investment holding company controlled by the Company's President. Interest expense of \$23,000 for the second quarter of 2004 (2003 – \$8,000) reflects interest on this new borrowing as well as interest charged by vendors on outstanding invoices and accounts associated with the A-5 well re-entry. On a year to date basis, interest expense also increased from \$26,000 for the first six months of 2003 to \$31,000 for the first six months of 2004.

## DEPLETION, DEPRECIATION AND ACCRETION

Questerre recognized \$0.9 million in depletion and depreciation for the second quarter of 2004 (2003 – \$0.2 million) and \$6.1 million in depletion and depreciation for the first six months of 2004 (2003 – \$0.3 million). Included in 2004 depletion is a \$5.2 million "ceiling test" write-down recorded by the Company on its Beaver River petroleum and natural gas assets. The write-down reflected the majority of costs incurred during the first quarter of 2004 to finish the drilling, completion and tie-in of the new A-5 well. The write-down amount was calculated in accordance with the new accounting guideline utilizing an internal estimate of reserves and cash flows. Management's reserve estimates were based on the results from the production test of the new A-5 well. As of June 30, 2004, all costs associated with the Beaver River Field, net of estimated salvage values, have been written down and included in depletion except \$2.8 million of geological and geophysical costs.

Questerre excludes \$1.8 million of costs associated with its St. Lawrence Lowlands, Quebec prospect in the calculation of depletion or in costs subject to the ceiling test calculation. The Quebec property remains undeveloped at June 30, 2004.

In the second quarter of 2004, the Company undertook a detailed review of its asset retirement obligations as part of the Court Monitor's determination of liquidation value under the CCAA. The result of this analysis was an increase in the Company's estimated undiscounted asset retirement cost for its Beaver River Field from \$0.9 million to \$1.8 million. The \$0.9 million increase in estimate was added to the asset retirement obligation and also capitalized as part of the carrying amount of the related asset. Based on the current financial position of QBR, the full asset retirement obligation related to the Beaver River Field has been estimated as a current year liability. Accretion of asset retirement obligations for the first six months of 2004 was \$29,700 compared to \$27,700 for the same period in 2003. Questerre did not acquire any new properties in 2003 or 2004 which would result in additional asset retirement obligations.

#### TAXES

Consistent with the prior year, Questerre had sufficient tax pool deductions to offset taxable income in the second quarter of 2004 resulting in no current income taxes payable for the quarter. In addition, the Company's tax assets significantly exceed tax liabilities. No tax asset is recognized at June 30, 2004, as there is no certainty that the Company will be able to realize the value of the tax assets in the future. Tax assets could be significantly reduced by settlement with outstanding creditors as proposed under the CCAA Plan of Arrangement.

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#### NET LOSS

Questerre recorded a net loss of \$6.4 million (\$0.15/share) for the six months ended June 30, 2004 compared to \$0.5 million (\$0.02/share) for the first half of 2003. The net loss for the first six months of 2004 was impacted by higher operating costs, restructuring costs and higher depletion including a \$5.2 million ceiling test write-down on the Beaver River Field. The write-down reflected the majority of costs incurred during the first quarter of 2004 to finish the drilling, completion and tie-in of the new A-5 well.

### LIQUIDITY AND CAPITAL RESOURCES

#### CAPITAL EXPENDITURES

Questerre incurred capital expenditures of \$6.3 million in the first six months of 2004 compared to \$0.34 million in 2003. Substantially all of the 2004 capital spending related to drilling, completion and tie-in of the Beaver River A-5 well, an operation that commenced in August 2003 with \$13.1 million spent on the Beaver River Field in 2003.

(\$ thousands)	Six Months Ended June 30,	
	2004	2003
Capital Expenditures		
Beaver River Field, BC	6,198	(50)
St. Lawrence Lowlands, Quebec	55	815
Minor Properties, Alberta	1	68
Total	6,254	833

### **WORKING CAPITAL DEFICIENCY**

Questerre reported a working capital deficiency of \$8.0 million at June 30, 2004, which includes a \$500,000 promissory note payable on November 14, 2004 and outstanding bank debt of \$274,700. The Company is not in compliance with the bank's financial covenants and, therefore, the bank loan has been classified as a current liability.

Questerre's current assets at June 30, 2004 include accounts receivable of \$0.2 million compared to \$0.6 million at December 31, 2003. GST refunds received in the first quarter of 2004 accounted for the decrease in accounts receivable. Inventory decreased from \$0.7 million at December 31, 2003 to \$0.1 million at June 30, 2004. The December 31, 2003 balance included \$0.5 million in drilling mud, all of which was utilized or returned for credit in the first half of 2004. Deposits and cash calls of \$798,700 at June 30, 2004 includes \$680,000 paid in trust to the operator for the drilling of the first well on the Company's Quebec property. In addition, \$118,700 is recorded as deposits for retainers paid to counsel and the Court Monitor for services required in the Company's CCAA proceedings.

Questerre's trade payables of \$9.6 million primarily relate to capital expenditures and significant cost overruns associated with the Beaver River A-5 well to June 30, 2004. Total costs of the well were approximately \$19 million, with \$6.2 million incurred in the first six months of 2004. A portion of the 2004 costs were financed by a flow-through share offering which raised gross proceeds of \$2.4 million; however the remainder of the costs increased the working capital deficiency. These conditions ultimately led to QBR's declaration of insolvency and application for court protection on April 1, 2004 followed by Questerre Energy Corporation's application for court protection on June 22, 2004.

### **PROMISSORY NOTE PAYABLE**

In June 2004, the Company obtained \$0.5 million in cash on the issue of a \$0.5 million promissory note 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 is due on November 14, 2004 with interest calculated at 12% per annum, payable monthly. The promissory note is secured by a General Security Agreement over the assets of the Company and the hypothecation of the Company's exploration licenses in Quebec. The financing arrangement was necessary to allow the Company to proceed with participation in on-going projects and, specifically to fund a cash call for drilling the first well on the Company's Quebec property.

In August 2004, Rupert's advanced an additional \$100,000 which was placed in trust with the Company's legal counsel. If the Plans are approved, these funds will be advanced on the same terms and conditions as the original advance of \$0.5 million. The funds will be used to finance a portion of the cash component of the Company's proposed Plans of Arrangement.

### **SHARE CAPITAL**

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.

On February 13, 2004, the Company completed a private placement for 642,860 common shares and 1,878,791 flow-through common shares for gross proceeds of \$3.16 million. Proceeds from the flow-through offering were primarily used to finance the completion and tie-in of the A-5 well at Beaver River.

At June 30, 2004, there were no Class B common voting shares or preferred shares outstanding and there were a total of 44,665,892 Common Shares outstanding and 8,200,261 common share warrants outstanding.

### CONTRACTUAL OBLIGATIONS

The following table summarizes the Company's contractual obligations, which require payments to be made over the next four years.

	Payments due by period				
	Remainder of 2004	2005	2006	2007	Total
Bank debt	\$ 40,200	\$ 80,400	\$ 80,400	\$ 73,700	\$ 274,700
Office rental agreement	\$ 63,000	-	-	-	-

Questerre is party to an Office Rental Agreement with a related party for the provision of offices, office equipment and support personnel. The agreement may be terminated by either party with six month's written notice.

### CRITICAL ACCOUNTING ESTIMATES

Management is required to make judgments, assumptions and estimates in the application of generally accepted accounting principles that have a significant impact on the financial results of the Company. A comprehensive discussion of the Company's significant accounting policies is contained in the notes to the audited consolidated financial statements at December 31, 2003 and the notes to the unaudited interim financial statements at June 30, 2004. The following discussion outlines the accounting estimates that are critical to determining Questerre's financial results.

### GOING CONCERN

Questerre's 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. There is no assurance that the company will be able to obtain creditor acceptance on its restructuring under CCAA. If the restructuring cannot be completed, Questerre may not be able to realize its assets and discharge its liabilities in the normal course of business. If the going concern basis is not appropriate for either or both of QEC and QBR, adjustments may be necessary in the carrying amounts and/or classification of assets, liabilities, revenues and expenses in these financial statements.

### FULL COST ACCOUNTING

Questerre follows the Canadian Institute of Chartered Accountants' ("CICA") guideline on full cost accounting to account for its oil and natural gas properties. Under this method, all costs associated with the acquisition of, exploration for and development of natural gas and crude oil reserves are capitalized and costs associated with production are expensed. The capitalized costs are depreciated, depleted and amortized using the unit-of-production method based on estimated proved reserves. Reserve estimates can have a significant impact on earnings, as they are a key component in the calculation of depreciation, depletion and amortization ("DD&A"). A downward revision in a reserve estimate could result in a higher DD&A charge to earnings. In addition, if net capitalized costs are determined to be in excess of the calculated ceiling, which is based largely on reserve estimates, the excess must be written off as an expense charged against earnings.

Certain costs related to unproved properties and major development projects may be excluded from costs subject to depletion until proved reserves have been determined or their value is impaired. These properties are reviewed quarterly to determine if proved reserves should be assigned or if impairment has occurred. If reserves can be assigned, the cost of the properties would be included in the depletion calculation. If impairment has occurred, any write-down would be included in depletion and depreciation expense for the period.

#### **OIL AND GAS RESERVES**

Questerre's proved oil and gas reserves are evaluated and reported on by an independent petroleum engineering consultant. The estimation of reserves is a subjective process. Forecasts are based on engineering data, projected future rates of production, estimated commodity price forecasts and the timing of future expenditures, all of which are subject to a number of uncertainties and various interpretations. These estimates are the basis for the determination of the fair market value and the estimated net revenue stream of these reserves. The Company expects that its estimate of reserves will change to reflect updated information. Reserve estimates can be revised upward or downward based on the results of future drilling, testing, production levels and economics of recovery based on cash flow forecasts. Reserve estimates can have a significant impact on net earnings, as they are a key component in the calculation of depletion and depreciation. A revision to the reserve estimate could result in a higher or lower DD&A charge to net earnings. Downward revisions to reserve estimates could also result in a write-down of oil and natural gas property, plant and equipment under the ceiling test.

#### **ASSET RETIREMENT OBLIGATION**

The Company recognizes asset retirement obligations in the period in which they are incurred if a reasonable estimate of fair value can be determined. The liability is recorded at fair value and is adjusted to its present value in subsequent periods and the amount of the accretion is charged to earnings in the period. The associated asset retirement costs are capitalized as part of the carrying amount of the related asset. The capitalized amount is depleted on a unit of production basis in accordance with the Company's depletion policies.

Revisions to the estimated timing of cash flows or to the original estimated undiscounted cost also result in an increase or decrease to the asset retirement obligation. In the second quarter of 2004, the Company increased its estimated undiscounted asset retirement cost for its Beaver River Field from \$0.9 million to \$1.8 million. The \$0.9 million increase was added to the asset retirement obligation and also capitalized as part of the carrying amount of the related asset.

Actual costs incurred upon settlement of the obligation are charged against the liability to the extent the liability is recorded. Any difference between actual costs incurred upon settlement of the asset retirement obligation and the recorded liability is recognized as a gain or loss in the Company's earnings in the period in which settlement occurs.

Determination of the original undiscounted retirement obligations and timing of these obligations are based on internal estimates using current costs and technology in accordance with existing legislation and industry practice. These estimates are subject to change over time and, as such, may impact the charge against income for asset retirement obligations.

## CHANGES IN ACCOUNTING POLICIES

The following new and amended standards were implemented by the Company in 2004 with the following impact on the 2003 financial statements where retroactive restatement was required.

### STOCK BASED COMPENSATION

In January 2004, the Company adopted the amended CICA Handbook Section 3870 "Stock-based Compensation and Other Stock-based Payments". This change in accounting policy has been applied retroactively without restatement of prior periods presented.

Under this amended standard, the Company must account for compensation expense based on the fair value of rights granted under its stock-based compensation plan. 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. Upon exercise of the stock options, consideration paid by the unit holder together with the amount previously recognized in contributed surplus is recorded as an increase to share capital.

As a result of adopting this change in accounting policy, the consolidated financial statements at January 1, 2004 were changed as follows: contributed surplus increased by \$70,527 and the opening deficit was increased by \$70,527. Net loss for 2004 included stock-based compensation expense of \$47,199 for the three months and \$94,398 for the six months ended June 30, 2004.

### ASSET RETIREMENT OBLIGATIONS

In January 2004, the Company adopted CICA Handbook Section 3110 "Asset Retirement Obligations". This change in accounting policy has been applied retroactively with restatement of prior periods presented.

Utilizing the new accounting policy, the Company recognizes asset retirement obligations in the period in which they are incurred if a reasonable estimate of fair value can be determined. The liability is recorded at fair value and is adjusted to its present value in subsequent periods as accretion expense is recorded. The associated asset retirement costs are capitalized as part of the carrying amount of the related asset. The capitalized amount is depleted on a unit of production basis in accordance with the Company's depletion policies. Revisions to the estimated timing of cash flows or to the original estimated undiscounted cost would also result in an increase or decrease to the asset retirement obligation. Actual costs incurred upon settlement of the obligation are charged against the liability to the extent the liability is recorded. Any difference between actual costs incurred upon settlement of the asset retirement obligation and the recorded liability is recognized as a gain or loss in the Company's earnings in the period in which settlement occurs.

As a result of adopting this change in accounting policy, the previously reported amounts for 2003 have been restated due to the retroactive application of this new standard. Net loss for the six months ended June 30, 2003 decreased by \$13,857. The asset retirement obligation at December 31, 2003 decreased by \$30,699 to \$848,134, property, plant and equipment increased by \$20,599, net of accumulated depletion. Opening 2003 accumulated deficit increased by \$408,202 to reflect the cumulative impact of accretion and depletion expense, less the previously recorded cumulative site restoration provision. Net loss for 2004 included accretion expense of \$14,842 for the three months and \$29,684 for the six months ended June 30, 2004. There was no impact on the Company's cash flow as a result of adopting this new policy.

## FULL COST ACCOUNTING GUIDELINE

In January 2004, the Company prospectively adopted the new Accounting Guideline 16 "Oil and Gas Accounting – Full Cost" issued by the Canadian Institute of Chartered Accountants ("CICA").

Consistent with the former guideline, the net carrying cost of the Company's petroleum and natural gas properties is limited to an estimated net recoverable amount ("ceiling test"). Under the new guideline, the ceiling test calculation is a two step process. First, the Company determines whether a write-down is required by comparing the carrying value of the properties to the undiscounted cash flow of its proved reserves (based on management's best estimate of future prices) plus the lower of cost and market value for unproved properties. If there is an impairment calculated under the first step, the carrying value of properties is written down to the discounted value of the proved plus probable reserves (based on management's best estimate of future prices) plus the lower of cost and market of unproved properties.

The Company recorded a \$5.2 million ceiling test write-down for the six months ended June 30, 2004 related to the Beaver River Field. This amount was calculated in accordance with the new accounting guideline utilizing an internal estimate of reserves and cash flows. The write-down is included in the depletion and depreciation provision on the income statement for the six months ended June 30, 2004.

## ADDITIONAL INFORMATION

Additional information relating to Questerre, including the Company's Annual Information Form can be obtained on SEDAR at [www.sedar.com](http://www.sedar.com) or on the Company's website at [www.questerre.com](http://www.questerre.com).

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## NOTICE TO READER

The accompanying unaudited interim consolidated financial statements of Questerre Energy Corporation for the six months ended June 30, 2004 have been prepared by management and approved by the Audit Committee and the Board of Directors of the Corporation. These statements have not been reviewed by the Corporation's external auditors.



Michael Binnion  
*President and Chief Executive Officer*



Jackie Cugnet, CA  
*Chief Financial Officer*

Calgary, Canada  
August 11, 2004

# Questerre Energy Corporation

## Consolidated Balance Sheets

	June 30, 2004	December 31, 2003
	<i>(unaudited)</i>	<i>(as restated – note 2)</i>
<b>Assets</b>		
Current assets		
Cash	\$ 1,211,982	\$ 1,678,611
Accounts receivable	177,017	623,544
Inventory	113,484	680,036
Deposits and cash calls paid	798,700	–
	<b>2,301,183</b>	2,982,191
Restricted cash (note 4)	100,000	100,000
Petroleum and natural gas properties – net of accumulated depletion and depreciation (note 3)	6,227,615	5,158,646
	<b>\$ 8,628,798</b>	<b>\$ 8,240,837</b>
<b>Liabilities</b>		
Current liabilities		
Accounts payable and accrued liabilities	\$ 9,575,435	\$ 7,225,137
Bank loan (note 4)	274,700	314,900
Promissory note payable (note 5)	500,000	–
	<b>10,350,135</b>	7,540,037
Asset retirement obligation (note 2,6)	1,786,997	848,134
	<b>12,137,132</b>	8,388,171
<b>Shareholders' Equity</b>		
Common shares (note 7)	28,286,050	25,308,340
Contributed surplus (note 7)	164,925	–
Deficit	(31,959,309)	(25,455,674)
	<b>(3,508,334)</b>	(147,334)
<b>Going Concern Matters</b> (note 1)		
<b>Subsequent Events</b> (note 10)	<b>\$ 8,628,798</b>	<b>\$ 8,240,837</b>

See accompanying notes to consolidated financial statements.

Approved by the Board of Directors



Director



Director

## Questerre Energy Corporation Consolidated Statements of Loss and Deficit

(unaudited)

	For the Three Months Ended June 30		For the Six Months Ended June 30	
	2004	2003	2004	2003
	<i>(as restated – note 2)</i>		<i>(as restated – note 2)</i>	
<b>Revenue</b>				
Petroleum and natural gas, net of royalties	\$ 903,601	\$ 490,265	\$ 968,156	\$ 981,631
Interest income	8,205	1,503	11,709	6,739
	<b>911,806</b>	491,768	<b>979,865</b>	988,370
<b>Expenses</b>				
Operating	782,538	377,418	949,168	739,249
General and administrative	99,740	154,237	219,322	341,346
Restructuring costs	286,665	–	286,665	–
Stock-based compensation (note 2)	47,199	–	94,398	–
Interest expense	23,282	7,996	31,067	25,608
Gain on settlement of obligations	(291,959)	–	(291,959)	–
Depletion and depreciation	859,314	178,058	6,094,628	348,748
Accretion on asset retirement obligation (note 2.6)	14,842	13,872	29,684	27,744
	<b>1,821,621</b>	731,581	<b>7,412,973</b>	1,482,695
<b>Net loss</b>	<b>(909,815)</b>	(239,813)	<b>(6,433,108)</b>	(494,325)
Deficit, beginning of period	(31,049,494)	(8,985,061)	(25,455,674)	(8,322,347)
Restatement for changes in accounting policies				
Stock-based compensation (note 2)	–	–	(70,527)	–
Asset retirement obligation (note 2)	–	–	–	(408,202)
<b>Deficit, end of period</b>	<b>\$ (31,959,309)</b>	\$ (9,224,874)	<b>\$ (31,959,309)</b>	\$ (9,224,874)
<b>Net loss per share</b>				
Basic and diluted	\$ (0.02)	\$ (0.01)	\$ (0.15)	\$ (0.02)

See accompanying notes to consolidated financial statements.

# Questerre Energy Corporation

## Consolidated Statements of Cash Flows

(unaudited)

	For the Three Months Ended June 30		For the Six Months Ended June 30	
	2004	2003	2004	2003
		<i>(as restated – note 2)</i>		<i>(as restated – note 2)</i>
<b>Cash provided by (used in):</b>				
<b>Operating Activities</b>				
Net loss	\$ (909,815)	\$ (239,813)	\$ (6,433,108)	\$ (494,325)
Items not affecting cash				
Depletion and depreciation	859,314	178,058	6,094,628	348,748
Accretion on asset retirement obligation	14,842	13,872	29,684	27,744
Stock-based compensation expense	47,199	–	94,398	–
	11,540	(47,883)	(214,398)	(117,833)
Deferral of crown royalties	–	62,716	–	138,062
Net change in non-cash working capital	(14,026)	32,119	77,060	255,473
	(2,486)	46,952	(137,338)	275,702
<b>Financing Activities</b>				
Issue of common shares	–	–	745,570	–
Issue of flow-through shares	–	–	2,442,428	–
Share issue costs	4,551	(73,613)	(210,288)	(73,613)
Proceeds of promissory note	500,000	–	500,000	–
Repayment of bank loan	(20,100)	(13,400)	(40,200)	(33,500)
	484,451	(87,013)	3,437,510	(107,113)
<b>Investing Activities</b>				
Expenditures on petroleum and natural gas properties	(575,143)	(184,795)	(6,254,418)	(343,263)
Disposal of petroleum and natural gas properties	–	–	–	259,100
Net change in non-cash working capital	(404,053)	132,960	2,487,617	(169,372)
	(979,196)	(51,835)	(3,766,801)	(253,535)
Decrease in cash	(497,231)	(91,896)	(466,629)	(84,946)
Cash, beginning of period	1,709,213	561,954	1,678,611	555,004
<b>Cash, end of period</b>	<b>\$ 1,211,982</b>	<b>\$ 470,058</b>	<b>\$ 1,211,982</b>	<b>\$ 470,058</b>

See accompanying notes to consolidated financial statements.

During the three months ended June 30, 2004, the Company paid \$10,782 (2003 – \$7,996) of cash interest and \$Nil in cash taxes (2003 – \$Nil). During the six months ended June 30, 2004, the Company paid \$18,567 (2003 – \$25,608) of cash interest and \$Nil in cash taxes (2003 – \$Nil).

# Questerre Energy Corporation

## Selected Notes to Consolidated Financial Statements

For the Six Months Ended June 30, 2004 (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 auditors. The interim consolidated 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, 2003, except as noted below. 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, 2003.

### 1. GOING CONCERN – CREDITOR PROTECTION

On April 1, 2004, Questerre Beaver River Inc. ("QBR"), a wholly owned subsidiary of Questerre was granted an Initial 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 Energy Corporation ("QEC") also applied for and was granted an Order by the Court of Queen's Bench of Alberta providing for creditor protection under CCAA. The Orders have been amended to provide for a general stay period that expires on September 9, 2004. The Orders may be further amended by the Court throughout the CCAA proceedings based on motions from QEC, QBR, their creditors and other interested parties.

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") which 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 Beaver River Field. QBR held a 100% working interest in the operation as a result of joint venture partners choosing to forego participation under penalty. The filing by QEC was necessary due to claims advanced or threatened by certain parties that provided goods and services in connection with the re-entry operation.

The filing under CCAA is intended to allow the Company to restructure its affairs while continuing operations on a normalized basis. The Orders prohibits creditors from taking action against QBR and QEC and prevents QBR from paying most claims which arose before April 1, 2004 and QEC from paying most claims which arose before June 22, 2004. On August 9, 2004, the Company filed Plans of Compromise or Arrangement for QEC and QBR ("the Plans") under the CCAA. (see note 10).

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. There is no assurance that the company will be able to obtain creditor acceptance of its proposed restructuring under CCAA. If the restructuring can not be completed, Questerre may not be able to realize its assets and discharge its liabilities in the normal course of business. If the going concern basis is not appropriate for either QEC or QBR, adjustments may be necessary in the carrying amounts and/or classification of assets, liabilities, revenues and expenses in these financial statements.

# Questerre Energy Corporation

## Selected Notes to Consolidated Financial Statements

For the Six Months Ended June 30, 2004 (unaudited)

### 2. CHANGE IN ACCOUNTING POLICIES

#### *a) Full cost accounting guideline*

In January 2004, the Company prospectively adopted the new Accounting Guideline 16 "Oil and Gas Accounting – Full Cost" issued by the Canadian Institute of Chartered Accountants ("CICA").

Consistent with the former guideline, the net carrying cost of the Company's petroleum and natural gas properties is limited to an estimated net recoverable amount ("ceiling test"). Under the new guideline, the ceiling test calculation is a two step process. First, the Company determines whether a write-down is required by comparing the carrying value of the properties to the undiscounted cash flow of its proved reserves (based on management's best estimate of future prices) plus the lower of cost and market value for unproved properties. If there is an impairment calculated under the first step, the carrying value of properties is written down to the discounted value of the proved plus probable reserves (based on management's best estimate of future prices) plus the lower of cost and market of unproved properties.

The Company recorded a \$5.2 million ceiling test writedown for the six months ended June 30, 2004 related to the Beaver River Field (see note 1). This amount was calculated in accordance with the new accounting guideline utilizing an internal estimate of reserves and cash flows. The writedown is included in the depletion and depreciation provision on the income statement.

#### *b) Asset retirement obligation*

In January 2004, the Company adopted CICA Handbook Section 3110 "Asset Retirement Obligations". This change in accounting policy has been applied retroactively with restatement of prior periods presented.

Utilizing the new accounting policy, the Company recognizes asset retirement obligations in the period in which they are incurred if a reasonable estimate of fair value can be determined. The liability is recorded at fair value and is adjusted to its present value in subsequent periods as accretion expense is recorded. The associated asset retirement costs are capitalized as part of the carrying amount of the related asset. The capitalized amount is depleted on a unit of production basis in accordance with the Company's depletion policies. Revisions to the estimated timing of cash flows or to the original estimated undiscounted cost would also result in an increase or decrease to the asset retirement obligation. Actual costs incurred upon settlement of the obligation are charged against the liability to the extent the liability is recorded. Any difference between actual costs incurred upon settlement of the asset retirement obligation and the recorded liability is recognized as a gain or loss in the Company's earnings in the period in which settlement occurs.

The previously reported amounts for 2003 have been restated due to the retroactive application of this new standard. Net loss for the six months ended June 30, 2003 decreased by \$13,857. The asset retirement obligation at December 31, 2003 decreased by \$30,699 to \$848,134, property, plant and equipment increased by \$20,599, net of accumulated depletion. Opening 2003 accumulated deficit increased by \$408,202 to reflect the cumulative impact of accretion and depletion expense, less the previously recorded cumulative site restoration provision. Net loss for 2004 included accretion expense of \$14,842 for the three months and \$29,684 for the six months ended June 30, 2004. There was no impact on the Company's cash flow as a result of adopting this new policy.

#### *c) Stock based compensation plan*

In January 2004, the Company adopted the amended CICA Handbook Section 3870 "Stock-based Compensation and Other Stock-based Payments". This change in accounting policy has been applied retroactively without restatement of prior periods presented.

# Questerre Energy Corporation

## Selected Notes to Consolidated Financial Statements

For the Six Months Ended June 30, 2004 (unaudited)

Under this amended standard, the Company must account for compensation expense based on the fair value of rights granted under its stock-based compensation plan (see note 7(e)). 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. Upon exercise of the stock options, consideration paid by the unit holder together with the amount previously recognized in contributed surplus is recorded as an increase to share capital.

As a result of adopting this change in accounting policy, the consolidated financial statements at January 1, 2004 were changed as follows: contributed surplus increased by \$70,527 and the opening deficit was increased by \$70,527. Net loss for 2004 included stock-based compensation expense of \$47,199 for the three months and \$94,398 for the six months ended June 30, 2004

### 3. CAPITAL ASSETS

	June 30, 2004	December 31, 2003
		<i>(as restated – note 2)</i>
Petroleum and natural gas properties	\$ 39,815,680	\$ 32,652,083
Less: Accumulated depletion and depreciation	(33,588,065)	(27,493,437)
	<b>\$ 6,227,615</b>	<b>\$ 5,158,646</b>

During the six months ended June 30, 2004, the company capitalized administrative overhead charges of \$323,238 (year ended December 31, 2003 – \$594,911) relating to exploration and development activities.

The company incurred a ceiling test writedown of \$5.2 million for the six months ended June 30, 2004 (December 31, 2003 – \$16.7 million) related to the Beaver River Project (see note 1). This amount is included in the depletion and depreciation provision on the income statement.

At June 30, 2004, petroleum and natural gas properties included \$4.6 million (December 31, 2003 – \$4.3 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 except \$2.8 million of geological and geophysical costs. Questerre does not include costs of \$1.8 million associated with its St. Lawrence Lowlands, Quebec exploration acreage in the calculation of depletion or in costs subject to the ceiling test calculation. The Quebec property remains undeveloped at June 30, 2004.

### 4. BANK LOAN

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 its subsidiary, Questerre Beaver River Inc. 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 is not in compliance with the financial covenants and, therefore, the bank loan has been classified as a current liability.

# Questerre Energy Corporation

## Selected Notes to Consolidated Financial Statements

For the Six Months Ended June 30, 2004 (unaudited)

### 5. PROMISSORY NOTE PAYABLE

In June 2004, the Company obtained \$0.5 million on the issue of a \$0.5 million promissory note 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 is due on November 14, 2004 with interest calculated at 12% per annum, payable monthly. The promissory note is secured by a General Security Agreement over the assets of the Company and the hypothecation of the Company's exploration licenses in Quebec.

### 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 the net present value of its total asset retirement obligations to be \$1,786,997 at June 30, 2004 based on a total future liability of \$1,848,500. Based on the current financial position of its subsidiary, QBR (note 1), the liability related to the Beaver River Project has been included as a current year liability. 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, 2004	December 31, 2003
		<i>(as restated – note 2)</i>
Balance, beginning of period	\$ 848,134	\$ 353,548
Adoption of asset retirement obligation	–	439,098
Increase in estimate of obligation	909,179	
Accretion expense	29,684	55,488
<b>Balance, end of period</b>	<b>\$ 1,786,997</b>	<b>\$ 848,134</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, 2004, there were no Class B common voting shares or preferred shares outstanding.

#### b) Issued and outstanding

Class A common shares and common share warrants

	Number	Amount
<b>Common Shares</b>		
Balance, December 31, 2003	42,112,246	\$ 25,279,580
Issued for cash	642,860	713,575
Flow through shares issued for cash	1,878,791	2,442,428
Issued for cash on exercise of warrants	31,995	32,155
Share issue costs	–	(210,288)
<b>Balance, June 30, 2004</b>	<b>44,665,892</b>	<b>\$ 28,257,450</b>

# Questerre Energy Corporation

## Selected Notes to Consolidated Financial Statements

For the Six Months Ended June 30, 2004 (unaudited)

	Number	Amount
<b>Warrants</b>		
Balance, December 31, 2003	8,232,256	\$ 28,760
Exercised for common shares	(31,995)	(160)
<b>Balance, June 30, 2004</b>	<b>8,200,261</b>	<b>\$ 28,600</b>
<b>Total Common Share Capital</b>		<b>\$ 28,286,050</b>

The future tax liability associated with the renunciation of tax expenditures under the flow through shares was offset by existing losses and tax deductions not previously recognized.

### c) Per share Amounts

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

	For the Three Months Ended June 30		For the Six Months Ended June 30	
	2004	2003	2004	2003
Basic	44,665,892	26,835,000	44,053,299	26,835,000
Diluted	44,665,892	26,835,000	44,059,591	26,835,000

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 six months ended June 30, 2004:

	Number of Options	Weighted Avg Exercise Price
Outstanding, December 31, 2003	3,643,500	\$ 1.28
Granted	313,000	1.41
<b>Outstanding, June 30, 2004</b>	<b>3,956,500</b>	<b>\$ 1.29</b>
<b>Exercisable, June 30, 2004</b>	<b>2,734,417</b>	<b>\$ 1.28</b>

The outstanding options have a range of exercise prices between \$0.38 per share and \$1.50 per share, and a weighted average number of years to expiry of 2.7. The exercisable options have a range of exercise prices between \$1.00 and \$1.50 per share and have a weighted average number of years to expiry of 2.1.

### 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.

# Questerre Energy Corporation

## Selected Notes to Consolidated Financial Statements

For the Six Months Ended June 30, 2004 (unaudited)

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 (%)	60.0

### f) Contributed surplus

The following table sets forth a reconciliation of contributed surplus for the six months ended June 30, 2004:

Balance, December 31, 2003	\$	-
Adoption of stock based compensation (note 2)		70,527
Stock based compensation expense		94,398
<b>Balance, June 30, 2004</b>	<b>\$</b>	<b>164,925</b>

## 8. FUTURE INCOME TAXES

The provision for income taxes in the financial statements differs from the result, which would have been obtained in applying the combined federal and provincial tax rate to the Company's earnings before income taxes. The difference results from the following items:

	Six Months Ended June 30,	
	2004	2003
Loss before income taxes	\$ (6,433,108)	\$ (494,325)
Combined federal and provincial tax rate	35.16%	42.24%
Computed "expected" income tax expense	(2,261,881)	(208,803)
Increase (decrease) in income taxes resulting from:		
Non-deductible crown charges and recoveries	6,694	70,700
Unrecognized tax benefit of accounting losses	2,255,187	138,103
	\$ -	\$ -

The components of the Company's future income tax liability are as follows:

	June 30, 2004	December 31, 2003
Future income tax assets:		
Property, plant and equipment	\$ 5,643,259	\$ 5,325,981
Asset retirement obligation	476,907	234,489
Share issue expenses	293,051	293,051
Non-capital loss carryforwards (expire 2007 - 2011)	1,768,265	1,199,865
Valuation adjustment	(8,181,482)	(6,707,186)
	-	346,200
Future income tax liabilities:		
Flow through share renouncements to be incurred	-	(346,200)
	-	(346,200)
Net future income tax liability	\$ -	\$ -

# Questerre Energy Corporation

## Selected Notes to Consolidated Financial Statements

For the Six Months Ended June 30, 2004 (unaudited)

### 9. RELATED PARTY TRANSACTIONS

At June 30, 2004, Questerre had amounts owing to Terrenex Acquisition Corporation ("Terrenex") totalling \$2,824 (December 31, 2003 – \$1,237). Three directors of Terrenex are also directors of Questerre.

Questerre incurred fees of \$63,000 for the six months ended June 30, 2004 (2003 – \$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 June 2004, Questerre entered into a farmout agreement with a director of the Company. The farmout agreement covers the Company's exploration acreage in Quebec utilizing the same terms and conditions of a farmout agreement with independent arm's length parties.

In June 2004, the Company completed a financing arrangement whereby Questerre issued a \$0.5 million promissory note 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.

### 10. SUBSEQUENT EVENTS

On August 9, 2004, the Company filed Plans of Compromise or Arrangement for QEC and QBR ("the Plans") under the CCAA. Pursuant to the Plans proposed by QEC and QBR, unsecured creditors will receive either the lesser of the amount of their claim or \$2,000. Alternatively, unsecured creditors can elect instead to receive a cash dividend of \$0.05 plus one Common Share of QEC for each dollar of their claims. The Common Shares of QEC will be subject to a contractual escrow and released in two equal installments on the four and eight month anniversary of the date the Plan receives final Court approval. In addition to the proposed settlement, QEC arranged for a liquidity option. Under this liquidity option, unsecured creditors will still receive \$0.05 for each dollar of their claim, and will also receive an additional \$0.07 for each dollar of their claim in exchange for forgoing each Common Share of QEC they would have otherwise received. This would result 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 will be issued to Terrenex pursuant to the terms of a Liquidity Option Agreement. Under the Liquidity Option Agreement, Terrenex will establish a fund to finance the liquidity option up to a maximum of \$668,500, representing the maximum number of Common Shares of QEC to be issued under the plans of arrangement multiplied by \$0.07. In consideration for providing this liquidity option, Terrenex will receive 300,000 Common Shares of QEC. It will also be issued Common Shares of QEC that, but for the election of the unsecured creditors to participate in the liquidity option, would have been issued to the creditors of QBR and QEC. These Common Shares that would be issued to Terrenex, will be subject to the same hold obligations were they issued to the creditors of QBR and QEC. The Plans will be voted on at meetings of the respective unsecured creditors to be held on August 31, 2004 at the offices of the Monitor, Ernst & Young Inc. Each Plan is conditional upon both Plans being approved by creditors representing at least two-thirds in dollar value and one-half in number of the creditors voting at each meeting. The Plans are also conditional upon the receipt of requisite regulatory approvals and other conditions precedent set forth in the Plans.

In August 2004, Questerre amended its \$0.5 million financing agreement with Rupert's (see note 5) when Rupert's advanced an additional \$100,000 which was placed in trust with the Company's legal counsel. If these Plans are approved, these funds will be advanced to the Company on the same terms and conditions as the original advance of \$0.5 million. The funds will be used to finance a portion of the cash component of the Company's proposed Plans of Arrangement.

## Corporate Information

### DIRECTORS

Les Beddoes, Jr.

Michael Binnion

Russ Hammond

Tom Landry, Jr.

David Mallory

Peder Paus

Jed Wood

### OFFICERS

Michael Binnion  
President and Chief  
Executive Officer

John Brodylo  
VP Exploration

Jackie Cugnet  
Chief Financial Officer

Gordon Love  
VP Engineering

Maria Rees  
Corporate Secretary  
and Controller

### BANKERS

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### LEGAL COUNSEL

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### AUDITORS

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### INDEPENDENT

#### RESERVOIR ENGINEERS

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#### STOCK INFORMATION

Toronto Stock Exchange  
Common Shares: QEC  
Warrants: QEC.WT

