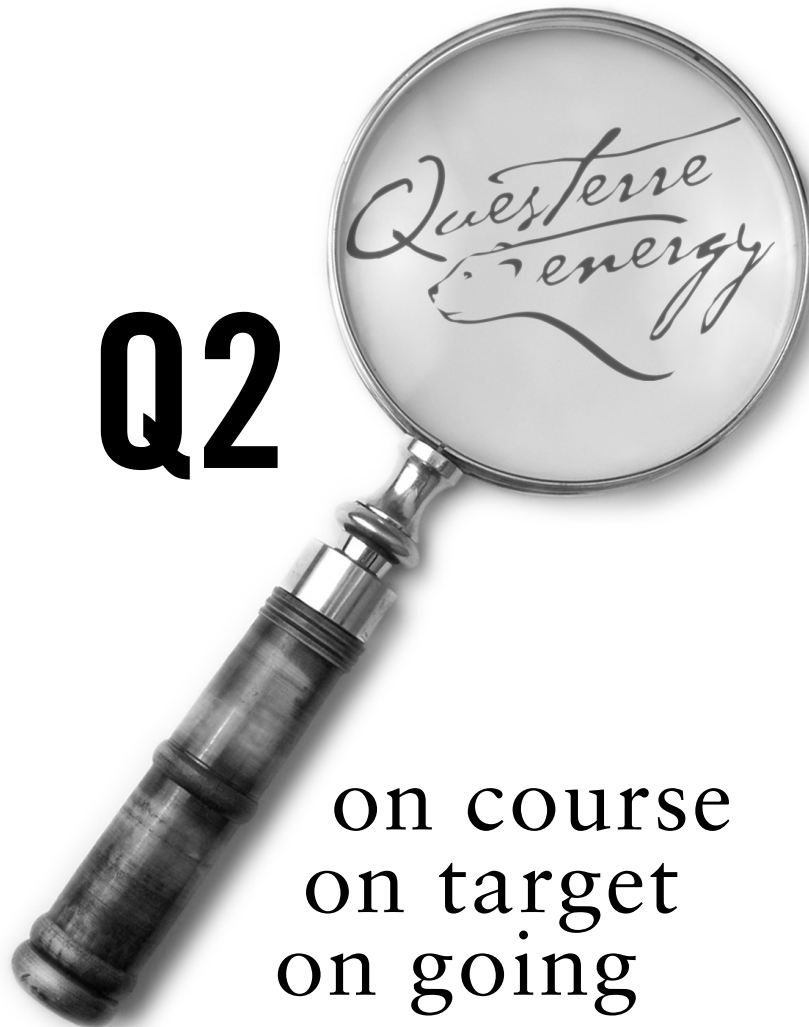


QUESTERRE ENERGY CORPORATION

**Q2**



on course  
on target  
on going

2005 QUARTERLY REPORT

## PRESIDENT'S MESSAGE

I am pleased to report on the promising results from our business plan during the second quarter of 2005.

Our strategy to expand our portfolio of conventional oil and gas assets yielded a 50% interest in a new Mannville pool discovery in the Vulcan area of Southern Alberta this year. The discovery well initially tested at 177 boe per day of oil and gas. On a long-term test, the well averaged 332 boe per day over three days of testing. It is currently shut-in and will resume production testing once a gas pipeline is constructed.

Based on these test results, we successfully acquired 5,120 acres of land prospective for this discovery in conjunction with our partner. This increases our holdings in the area to 8,320 acres. Utilizing a reprocessed 3-D seismic survey, eight follow-up locations have been identified on this land. Current plans include three more wells and the construction of a multi-well battery prior to year-end. Our partner has successfully contracted a rig for this program and the first well is scheduled for mid-August.

We also expanded our portfolio of oil and gas assets in Alberta through an acquisition of producing properties and exploration acreage in the Westlock and Hector areas of Central Alberta. The acquisition added approximately 50 boe per day of production and 8,320 acres of land (2,432 acres net). Building on these assets, we grew our land position by purchasing an additional 1,280 acres and participating in the drilling of two wells. The wells tested at a combined rate of 258 boe per day (95 boe per day net) and will be placed on production by the end of the third quarter. Final rates will depend on plant capacity. We see further potential in this area and anticipate that three additional wells will be drilled here during the third quarter of this year.

Over the quarter, we participated in three wells (1.4 net) and cased all of them as gas producers for a 100% success rate. Activity was less than expected due to an unusually wet spring and flooding conditions in June.

Our strategy of selective partnerships to develop our high-impact projects also met with success.

A definitive agreement with Ampac Petroleum Inc., a private exploration and production company, to farm-in to the Beaver River Field was concluded during the quarter. The work program includes four re-entries targeting the shallow Mattson sands and two option wells – one for a previously undefined Mattson sand and one for a new compartment in the deeper Nahanni formation.

While the Mattson lacks the extensive production history of the deeper Nahanni we believe it holds considerable potential. By correlating bright spots on the seismic with gas shows and tests, we have been able to map 6-10 sands that volumetrically could host up to 100 Bcf in potential recoverable gas. Original test rates ranged from 80 boe per day to 2,000 boe per day. We strongly believe that new completion and stimulation techniques could significantly improve these results.

Towards the end of the quarter we were advised that our farm-in partner intends to transfer its rights under the agreement to Transeuro Energy Corp, a junior E&P company listed on the TSX Venture Exchange. Transeuro in turn has recently contracted High Arctic Energy Services LLC, a global oilfield service provider specializing in underbalanced drilling and completion, to manage its exploration and development projects including the program at the Field. High Arctic proposes to mobilize equipment in August and commence operations in early September.

Our partners, Gastem Inc. and Hydro-Quebec, did not spud the St. Sophie #1 well in the St. Lawrence Lowlands by July 2005 and the farm-in agreement has expired. We continue to evaluate exploration options with other potential farm-in candidates.

Another noteworthy achievement during the quarter was our listing on the Oslo Stock Exchange in Norway and the completion of a C\$10 million offering. The listing on this captive resource-focused market has dramatically improved liquidity in our common shares – our average daily trading volume in Norway has been over 1.6 million shares. The new listing has also improved liquidity on the TSE which has seen a daily volumes increase by over 10%.



Michael Binnion  
*President and Chief Executive Officer*



## MANAGEMENT'S DISCUSSION AND ANALYSIS

The following Management Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") was prepared at, and is dated, August 12, 2005. This MD&A is provided by Management of Questerre Energy Corporation ("Questerre" or the "Company") to review second quarter 2005 activities and results as compared to the previous period. This MD&A should be read in conjunction with the unaudited interim consolidated financial statements for the six months ended June 30, 2005 and the audited consolidated financial statements for the year ended December 31, 2004.

This MD&A contains forward-looking statements. Forward-looking statements are based on current expectations that involve a number of risks and uncertainties which could cause events or results to differ materially from those reflected in the MD&A. Forward-looking statements are based on the estimates and opinions of Questerre's management at the time the statements were made. Questerre assumes no obligation to update forward-looking statements should circumstances or management's estimates change.

Barrel of oil equivalent ("boe") amounts may be misleading, particularly if used in isolation. A boe conversion ratio has been calculated using a conversion rate of six thousand cubic feet of natural gas to one barrel and is based on an energy equivalent conversion method application at the burner tip and does not necessarily represent an economic value equivalent at the wellhead.

### **Vulcan Discovery**

Questerre participated in a new Mannville pool discovery in the Vulcan area of Southern Alberta. The well initially tested 177 boe per day and was placed on a long term production test early in the third quarter. The well averaged 332 boe per day over three days of testing in July. It is currently shut in and will resume production in September once a gas pipeline is constructed. Additional facilities under construction include a multi-well battery.

Based on the initial test results and re-processing of a 3-D seismic survey, Questerre and its partner expanded their holdings prospective for this discovery to 8,320 acres during the quarter. Eight potential follow-up locations have been identified on this acreage. A drilling rig has been contracted through break-up for an initial three-well program with the first well scheduled to spud during the third quarter. Future wells will be based on the results from this initial program and the long-term production test results.

### **Acquisition of Producing Properties in Central Alberta**

The Company entered into an agreement with Rupert's Crossing, an Investment Corporation ("Rupert's") to acquire its interest in certain producing properties and acreage in Central Alberta. Rupert's is a private investment holding company controlled by the President and Chief Executive Officer of Questerre. The acquisition included five producing wells and 8,320 acres (2,432 acres net). Current production from these wells is approximately 50 boe per day.

The purchase price for this acquisition of \$2.1 million was based on an evaluation of these assets prepared by an independent reservoir engineering firm. The acquisition closed during the second quarter with an effective date of April 1, 2005.

## **Farm-out Agreement for Beaver River Field**

During the quarter, the Company entered into a definitive farm-out agreement for the development of the Beaver River Field in British Columbia (the “Field”) with Ampac Petroleum Inc. (“Ampac”). Ampac is a private exploration and production company controlled by Jed Wood, a director of Questerre.

The agreement will target both the shallow Mattson and the deeper Nahanni formations. The first phase of the farmout will involve the re-entry and re-completion of four existing wells for the Mattson. The farmout agreement also includes two optional wells - one for a previously unidentified Mattson sand and the second to target a new compartment in the Nahanni.

Ampac will fund and operate the initial phase to earn a 50% interest in the four re-entry wells. By drilling the first option well, Ampac will earn 50% of the remaining rights in the Mattson. Ampac will earn a 50% interest in the Nahanni by drilling the second option well. The Company expects the first phase will commence in September.

## **Listing on Oslo Stock Exchange**

Questerre completed a C\$10 million public offering and listed its Common Shares for trading on the Oslo Stock Exchange in Norway during the second quarter. A total of 30,000,000 Common Shares were issued at \$0.33 per Common Share under the offering primarily to retail and institutional investors in Norway.

DnB NOR Markets and Pareto Securities ASA acted as the Company’s advisors in connection with the offering. The advisors received a cash commission of 7% of the gross proceeds.

## **Drilling Activities**

The Company participated in three wells in Alberta during the second quarter of 2005. All three wells (1.4 net wells) were cased as gas producers and will be tied-in during the third quarter. Stabilized production will ultimately depend on facility constraints. Activity was less than expected due to an unusually wet spring and flooding conditions in June.

## **SECOND QUARTER 2005 FINANCIAL RESULTS**

### **Production**

The Company’s existing production is primarily natural gas from the Beaver River Field (the “Field”) and its properties in Central Alberta.

Production averaged 148 boe per day for the three months ended June 30, 2005 (2004: 272 boe per day) and 123 boe per day for the first six months of 2005 (2004: 149 boe per day). The A-5 well at the Field accounted for just over 50% of this daily production. The remaining is attributable to the Company’s interest in producing properties in Central Alberta.

The decrease in comparison to the same period in 2004 can be attributed to the decline in production from the A-5 well. Production from this well averaged 247 boe per day over the second quarter in 2004 as compared to 76 boe per day in 2005.

## Revenue

For the first six months of 2005, Questerre reported petroleum and natural gas revenue of \$0.97 million compared to \$1.08 million for the same period in 2004. The 10% decrease is due to the lower revenue from the A-5 well substantially offset by revenue from the recently acquired properties in Central Alberta. Furthermore, higher realized prices compensated for lower production volumes in 2005.

## Royalties

The Company recorded royalty expense of \$0.15 million for the period ending June 30, 2005 (2004: \$0.11 million). The royalty expense in 2005 was offset by a recovery of Crown royalties of \$0.14 million accrued on Field production in 2004. The recovery reflected the Company's qualification during the first quarter for a royalty credit in the amount of \$0.75 million for the A-5 re-entry. To date the Company has utilized \$0.23 million of this credit.

Crown and gross overriding royalties on production from the Company's properties in Alberta decreased marginally as a percentage of gross revenue to 25% in 2005 from 26% in 2004.

## Operating Costs

Operating expenses decreased to \$0.33 million for the second quarter of 2005 (2004: \$0.78 million) and \$0.53 million for the first half of 2005 (2004: \$0.95 million).

Excluding the operating expenses for the Company's properties in Alberta that average 11% of gross revenue in both years, operating costs for the Field were 47% lower in first six months of 2005 as compared to 2004. The decrease can be attributed to the lower gas processing and transmission fees for the Field and the delay of facility turnaround until the third quarter of year.

## General and Administrative Expenses

In 2005, general and administrative expenses for the three months ending June 30 were \$0.07 million (2004: \$0.10 million) and \$0.31 million for the six months ended June 30. (2004: \$0.22 million). The higher costs in the current year relate to the increased activity in Central and Southern Alberta.

<i>(\$ thousands)</i>	2005	2004
General & administrative expenses	656	\$ 440
Bad debt expense	–	150
Overhead recoveries	(344)	(371)
General & administrative expenses, net	312	\$ 219

## Stock Based Compensation

Effective January 1, 2004 the Company adopted a new accounting standard for stock based compensation. This resulted in stock based compensation expense of \$0.12 million in the second quarter of 2005 (2004: \$0.05 million) and \$0.19 million for the first six months of 2005 (2004: \$0.09 million).

## **Interest Expense**

Interest expense on the Company's promissory note and bank debt totaled \$0.03 million for the second quarter of 2005 (2004: \$0.02 million). The increase in the principal amount of the promissory note from \$0.5 million in 2004 to \$0.6 million in 2005 accounts for the difference. On a year to date basis, interest expense increased from \$0.31 million for 2004 to \$0.46 million for 2005.

## **Depletion and Depreciation**

Questerre recognized \$0.34 million in depletion and depreciation in the second quarter of 2005 (2004: 0.86 million) and \$1.42 million for the first two quarters of the year (2004: \$6.1 million).

Included in 2005 depletion is \$1.2 million, representing the Company's share of drilling costs of an unsuccessful well in the Simonette area of Alberta. 2004 depletion includes a \$5.18 million ceiling test write-down recorded by the Company on its Field 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 A-5 re-entry.

Questerre does not include costs associated with its assets in the St. Lawrence Lowlands of Quebec nor the costs associated with its exploration projects in the Parkland, Vulcan and Westlock areas of Alberta in the calculation of depletion or in costs subject to the ceiling test calculation. These properties remained undeveloped at June 30, 2005.

## **Taxes**

Consistent with the prior year, Questerre had sufficient tax pool deductions to offset taxable income in the second quarter of 2005 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, 2005, as there is no certainty that the Company will be able to realize the value of the tax assets in the future.

## **Net Loss and Cash Flow**

Questerre recorded a net loss of \$1.57 million (\$0.02/share) in the first six months of 2005 compared to \$6.4 million (\$0.15/share) for the corresponding period in 2004. The loss reflected the writedown of costs of \$1.2 million associated with the unsuccessful well at Simonette, Alberta.

## **LIQUIDITY AND CAPITAL RESOURCES**

### **Capital Expenditures**

Questerre incurred capital expenditures of \$6.1 million in the first six months of 2005 compared to \$6.3 million in 2004. The expenditures in 2005 related to the costs of drilling and completion of wells in the Parkland, Vulcan and Simonette areas of Alberta and the acquisition in Central Alberta.

Substantially all of the capital spending in 2004 related to drilling, completion and tie-in of the A-5 re-entry at the Field.

(\$thousands)	Six Months Ended March 31,	
	2005	2004
Capital Expenditures		
Beaver River Project, BC	146	6,198
St. Lawrence Lowlands, Quebec	8	55
Alberta Properties	5,963	1
Total	6,117	6,254

## Working Capital

Questerre reported a working capital surplus of \$6.5 million at June 30, 2005. Current assets at June 30, 2005 consisted primarily of \$7.39 million in cash and deposits and \$0.33 million in receivables. The receivables primarily represent natural gas revenue from the Field and the Company's non-operated Alberta properties.

Questerre's current liabilities consisted of trade payables of \$1.29 million and \$0.19 million representing the term bank loan that has been classified as a current liability.

The Company does not anticipate it will need to raise additional equity capital to fund further planned drilling in Southern and Central Alberta for the remainder of this year.

## 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.

At June 30, 2005, there were no Class B common voting shares or preferred shares outstanding and there were a total of 99,876,904 Common Shares outstanding and 6,445,000 stock options outstanding. An additional 2,000,000 Common Shares have been reserved for the conversion of the \$0.6 million promissory note.

The Company completed two equity placements during the second quarter. In April 2005, the Company completed a placement of 3,215,000 Common Shares at \$0.32 per Common Share for gross proceeds of \$1 million. In June 2005, the Company completed a placement of 30,000,000 Common Shares at \$0.33 per Common Share for gross proceeds of \$10 million. A cash commission of 7% of the gross proceeds was paid on this placement.

## Contractual Obligations

Questerre is party to an Office Rental Agreement with a related party for the provision of offices, office equipment and support personnel. Either party may terminate the agreement with six months written notice. Questerre's commitment under this agreement for the remainder of 2005 is \$69,000.

The Company is responsible for principal payments on its bank loan in the amount of \$40,200 for the remainder of 2005, \$80,400 in 2006 and \$73,700 in 2007. The Company has a \$100,000 restricted cash deposit against these obligations.

## Off-Balance Sheet Arrangements

Questerre has no off-balance sheet arrangements.

## **Related Party Transactions**

The Company entered into an agreement with Rupert's to acquire its interest in certain producing properties and acreage in Central Alberta. See "Acquisition of producing properties in Central Alberta".

The Company entered into a definitive farmout agreement for the development of the Beaver River Field with Ampac. See "Farm-out agreement for Beaver River Field".

## **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, 2004. The following discussion outlines the accounting estimates that are critical to determining Questerre's financial results.

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. 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.

### **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. The Company's estimated undiscounted asset retirement cost for the Field and its assets in Central Alberta is \$1.9 million.

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.

### **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, 2005 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*



David Mallory  
*Interim Chief Financial Officer*

## 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.

## 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  
  
David Mallory  
Interim Chief  
Financial Officer  
  
Maria Rees  
Corporate Secretary  
and Controller

### Bankers

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### Stock Information

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Oslo Stock Exchange  
Common Shares: QEC



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