

## management's discussion and analysis of financial condition and results of operations

The following Management Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") was prepared at, and is dated, March 27, 2006. This MD&A is provided by Management of Questerre Energy Corporation ("Questerre" or the "Company") to review 2005 activities and results as compared to the previous year and should be read in conjunction with the audited consolidated financial statements for the years ended December 31, 2005 and 2004. Additional information relating to Questerre, including Questerre's Annual Information Form is available on SEDAR at [www.sedar.com](http://www.sedar.com).

Questerre was incorporated in October 1971. The Company initially operated as an oil and gas exploration and production company with minority interests in several producing properties in Western Canada. In November 2000, a new management team was assembled and the Company changed its focus to pursuing what Management believes will be large-scale exploration and development projects. Management intends to leverage its specialized knowledge of naturally fractured and hydrothermally dolomitized reservoirs to develop these projects.

To mitigate the risks associated with these projects, the Company seeks industry partners to jointly participate in their development. The Company further seeks to temper risk through the development of a portfolio of conventional, lower risk projects in Alberta. It is expected the Alberta projects will provide near-term cash flow and growth.

As at March 24, 2006, the Company has two projects it believes hold the potential to create significant shareholder value – the Beaver River Field in British Columbia (the "Field") and the St. Lawrence Lowlands in Quebec. The lower risk Alberta project under development include assets in the areas of Westlock, Hector, Vulcan, Parkland and Drumheller.

The Company's Common Shares are listed on the Toronto Stock Exchange and Oslo Stock Exchange under the symbol QEC.

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.

### HIGHLIGHTS

- Proven and probable reserves on a NPV-10% basis increased from \$3.9 million at December 31, 2004 to \$22.1 million at December 31, 2005 on a constant dollar basis
- Proved, probable and possible reserves on a NPV-10% basis increased from \$174.8 million at December 31, 2004 to \$225.6 million at December 31, 2005 on a constant dollar basis
- Questerre participated in the drilling of 17 (5.93 net) wells in 2005 resulting in 14 gas wells, 1 oil well and 2 dry holes for an 88% success rate
- Questerre expanded its land holdings from 740,000 (603,000 net) acres in 2004 to 1,076,000 (770,000 net) acres in 2005
- The Company completed an initial public offering in Oslo, Norway and listed its Common Shares on the Oslo Stock Exchange, increasing average daily trading volumes from 70,940 shares in 2004 to 1,960,929 shares in 2005.

## SELECTED ANNUAL INFORMATION

Item	For Year Ended		
	December 31, 2005	December 31, 2004	December 31, 2003
Total Revenues	\$ 1,734,477	\$ 1,636,096	\$ 2,788,701
Expenses	(4,740,039)	(2,768,162)	19,513,827
Net Income (Loss)			
Total	(3,005,562)	693,503	(16,725,126)
Per Share	(0.03)	0.02	(0.54)
Per Share (Diluted)	(0.03)	0.02	(0.54)
Total Assets	26,192,763	9,803,679	8,240,837
Total Capital Expenditures	10,307,805	7,475,182	13,287,416
Working Capital (Deficiency)	9,802,130	2,857,088	(4,457,846)
Total Long Term Debt	–	600,000	–
Total Liabilities	4,022,876	3,255,036	8,388,171
Shareholders' Equity	22,169,887	6,548,643	(147,334)
Cash Dividend per Share	0.00	0.00	0.00

## QUARTERLY FINANCIAL INFORMATION

Period ended December 31, 2005	Q1	Q2	Q3	Q4	Total
Production revenue, net of royalties	\$ 461,249	\$ 520,965	\$ 282,696	\$ 469,567	\$ 1,734,477
Net income (loss)	(1,159,310)	(410,079)	(548,764)	(887,409)	(3,005,562)
Per share – basic	(0.02)	(0.01)	(0.01)	(0.01)	(0.03)
Per share – diluted	(0.02)	(0.01)	(0.01)	(0.01)	(0.03)
Period ended December 31, 2004	Q1	Q2	Q3	Q4	Total
Production revenue, net of royalties	\$ 64,555	\$ 903,601	\$ 286,365	\$ 381,575	\$ 1,636,096
Net loss	(5,523,293)	(909,815)	6,698,361	428,250	693,503
Per share – basic	(0.13)	(0.02)	0.15	0.01	0.02
Per share – diluted	(0.13)	(0.02)	0.15	0.01	0.02

## OPERATIONAL INFORMATION

	2005	2004
Production (boe per day)	<b>110</b>	138
Average Sales price (\$/mcf)	<b>\$ 8.28</b>	\$ 6.25
Land Holdings (acres)		
Undeveloped		
Gross	<b>1,059,403</b>	731,743
Net	<b>764,080</b>	600,674
Developed		
Gross	<b>16,414</b>	8,254
Net	<b>6,127</b>	2,387
Reserves (mboe)		
Proved	<b>506</b>	-
Probable	<b>402</b>	382
Possible	<b>9,094</b>	14,163
Total	<b>10,002</b>	14,545
NPV 10% Based on constant pricing		
Proved	<b>\$ 13,014,000</b>	\$ (134,000)
Probable	<b>\$ 9,129,000</b>	\$ 4,044,000
Possible	<b>\$ 203,411,000</b>	\$ 170,864,000
Total	<b>\$ 225,554,000</b>	\$ 174,774,000

## 2005 ACTIVITIES

### *Beaver River Field*

#### Farm-in agreement with Ampac Petroleum

In May 2005, Questerre Beaver River Inc. ("QBR"), a wholly owned subsidiary of the Company, entered into a definitive farmout agreement for the development of the Field with Ampac Petroleum Inc. ("Ampac"). Ampac is a private exploration and production company controlled by a director of Questerre. Ampac subsequently farmed out this agreement to Transeuro Energy Corp., an emerging international oil and gas company.

The development will target both the shallow Mattson and the deeper Nahanni formations. The first phase of the farmout involves the re-entry and re-completion of four existing wells for the Mattson. The agreement also includes two optional wells – one for a new 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 Mattson formation in the four re-entry wells. By drilling the first option well, Ampac will earn 50% of the remaining rights in the Mattson formation. Ampac will earn a 50% interest in the Nahanni formation and the facilities and infrastructure at the Field by drilling the second option well.

In February 2006, Transeuro acquired a copy of the 3-D seismic survey over the Field from QBR. In the event that Transeuro does not proceed with the Nahanni option well, it will pay QBR \$750,000 for the seismic survey.

#### 2005 Work Program

The first phase of this development commenced in September 2005 and operations on three of the four wells were finalized by March 2006.

The first well, A-2, was successfully re-entered, completed and stimulated. The well tested at 2 mmcf per day and was tied-in to the local gathering system in the first quarter of 2006. The re-entry of the second well, B-2, confirmed the integrity of the casing to the deeper Nahanni formation. This well will be preserved as a re-entry candidate for the Nahanni instead of the shallower Mattson. QBR has accepted the work completed on the B-2 well as satisfying the minimum work requirements for this well.

The third well, A-6, was fracture stimulated during the first quarter of 2006. The well initially flowed natural gas, but after the fracture stimulation it flowed at lower rates, which was unexpected. It is currently shut-in for an extended pressure buildup to support a detailed evaluation of the data and determine why the stimulation resulted in lower flow rates. Operations on the fourth well are scheduled for this summer. To this end, the Company has granted its partner an extension until June 15, 2006 to complete the initial work program.

It is anticipated that the seismic data recently acquired from QBR will assist in the joint evaluation of additional drilling locations for the Mattson as well as the deeper Nahanni formation.

#### Fire Incident

In June 2005, a fire broke out in the workshop at the Field. Operations staff contained the fire following QBR's emergency response procedures and no injuries were sustained. For the second half of 2005, operations at the Field have focused on the reconstruction of the workshop and staff quarters. QBR has submitted its insurance claim and expects this will be settled in early 2006.

### *St. Lawrence Lowlands*

#### Farm-in agreement with Talisman Energy

In early October 2005, Questerre executed a definitive agreement with Talisman Energy Canada for its existing 711,000 acres in the St. Lawrence Lowlands.

In early 2006, at its sole cost, Talisman commenced a 2-D seismic program over two Questerre prospects. Based on the results of the program Talisman has the right to drill up to four wells to earn on all the acreage.

Questerre and its partners may retain a 25% working interest in the acreage and receive a 5% gross overriding royalty from Talisman. The Company and its partners will be responsible for 15% of the drilling costs with Talisman funding the remainder of the drilling and all land, geological and geophysical costs.

#### Farm-in agreement with Gastem Inc.

The Company expanded its land holdings in Quebec through a farm-in agreement with Gastem Inc., a junior exploration and production company. Pursuant to this agreement, Questerre will earn a 50% interest in over 311,000 acres held by Gastem by funding a prescribed work program. In January 2006, Questerre acquired a 10% interest in Gastem by subscribing, on a private placement basis, for 1.46 million units of Gastem at \$0.10 per unit. Each unit consists of 1 common share and one unit. Each unit entitles the holder to acquire one additional common share of Gastem at \$0.10 per share for two years.

### *Vulcan*

Questerre participated in a new Mannville pool discovery in the Vulcan area of Southern Alberta. Questerre has a 50% interest in this discovery.

Three wells including the discovery well were drilled into the pool in 2005. The discovery well tested at 332 boe per day and the second well tested at a constrained rate of 740 boe per day. The third well did not encounter any commercial hydrocarbons in the target formation.

Based on test results and re-processing of the 3-D seismic survey, Questerre and its partner identified up to eight additional gas locations and ten additional oil locations for this pool in 2006. To date, three locations were drilled in the first quarter of 2006 and all have encountered commercial hydrocarbons.

In conjunction with Questerre, the operator is developing a reservoir simulation study to support its development plan for the pool. It is expected this plan will be submitted to the Alberta Energy and Utilities Board ("EUB") during the second quarter. Subject to EUB approval, the operator anticipates commercial production will begin early in the third quarter of 2006.

Questerre and its partner are also evaluating secondary shallower targets on these lands, including the Horseshoe Canyon coal bed methane ("CBM") horizon. A minimum of four locations has been identified for these targets on the Vulcan acreage. Two wells have been drilled during the first quarter of 2006 with completion and testing expected in the third quarter of this year.

### *Westlock, Hector and Drumheller*

#### Purchase and Sale Agreement with Rupert's Crossing

The Company entered into an agreement with Rupert's Crossing, an Investment Corporation ("Rupert's") to acquire Rupert's interest in certain producing properties and acreage in the Westlock and Hector areas of Central Alberta. Rupert's is a private investment holding company controlled by the President and Chief Executive Officer of Questerre.

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

During 2005, the Company expanded its landholdings in the area through participation at Crown land sales. The Company participated in the drilling of three gross wells (1.6 net) resulting in two gas wells and one oil well.

In Drumheller, Questerre participated for a 20% interest in an 8 well development program with EOG Resources Canada, Inc., a US based independent. The program yielded eight gas wells. Subject to receipt of regulatory approval and tie-in, these wells are scheduled to be on production by July 2006.

Current production from these areas is approximately 160 boe per day with an additional 50 boe per day of production behind pipe.

### *Other Areas*

#### Parkland

Questerre participated in the completion and stimulation of a well in the Parkland area of Alberta in early 2005. The well was targeting natural gas in multiple horizons. Based on an analysis of the test results, it appears that the original completion and stimulation was not optimized for the target formations. The Company proposes to recomplete and stimulate the well during the first quarter of 2006.

#### Simonette

The Company participated in the drilling of a well in the Simonette area of Alberta during the first quarter of 2005 with Cabot Petroleum Canada Corporation. The well was testing a Swan Hills reef play adjacent to two fields that produced in excess of 15 million barrels each from the Swan Hills formation. The well did not encounter reservoir in the Swan Hills formation and was subsequently abandoned. Questerre farmed out a 26.7% interest (20% after payout) in this well to Devon Canada and retained a 23.3% interest (30% after payout) in this well.

### *Drilling Activities*

In 2005, Questerre participated in the drilling of 17 gross wells (5.93 net wells) resulting in 14 gas wells, 1 oil well and 2 dry holes for an 88% success rate.

## *Corporate*

### Listing on Oslo Stock Exchange

Questerre completed a \$10 million public offering and listed its Common Shares for trading on the Oslo Stock Exchange in Norway during the second quarter of 2005. 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.

### Equity Offerings

Including the initial public offering in Norway, the Company completed a total of three placements for gross proceeds of \$19.19 million through the issuance of 43,112,690 Common Shares.

## **PRODUCTION**

The Company's production in 2005 was primarily natural gas from its interests in non-operated producing properties in Alberta and the Beaver River Field (the "Field").

Production for the year ended December 31, 2005 averaged 110 boe per day as compared to 138 boe per day for the year ended December 31, 2004. The 20% decline in production is attributable to the lower production from the Field in 2005 offset by increased production from its properties in Alberta.

Field production averaged 39 boe per day in 2005 as compared to 113 boe per day in 2004. The sole producing well at the Field, the A-5 well, was shut-in at the beginning of the third quarter due to a downhole obstruction. A workover of this well is planned for 2006.

The Company has recently tied-in the A-2 well at the Field. QBR will have a 50% interest in this well.

The acquisition of producing properties in Central Alberta effective April 2005 and subsequent drilling increased production from Alberta from 25 boe per day in 2004 to 72 boe per day in 2005. The Company has identified several additional drilling locations on these new lands and plan to participate in the drilling of four wells in this area in 2006.

Based on the drilling success in early 2006, the Company believes it has 1,000 boe per day of natural gas production behind pipe in Vulcan. Subject to the results from the 2006 winter drilling program in Vulcan, the Company plans to participate in up to five additional gas wells and ten potential oil wells in 2006.

## **2005 FINANCIAL RESULTS**

### *Revenue*

Questerre reported petroleum and natural gas revenues of \$2.10 million in 2005 (2004 - \$1.94 million). 2005 revenues include \$0.57 million (2004: \$1.53 million) in natural gas sales from the Field and \$1.53 million (2004: \$0.41 million) from its interests in producing properties in Central and Southern Alberta. Questerre's realized natural gas prices increased by 32% to \$8.28 per mcf in 2005 from \$6.25 per mcf in 2004. These higher prices offset the decrease in production and accounted for the 8% increase in gross revenue over the year.

### *Royalties*

Questerre recorded royalty expense of \$0.36 million for the year ended December 31, 2005 (2004 –\$0.31 million).

Crown and overriding royalties in 2005 include a recovery of Crown royalties of \$0.14 million accrued on Field production in 2004. The recovery reflects the Company's qualification during the year for a \$0.75 million royalty credit for the A-5 well. The Company did not record Crown royalties on production from the Field in 2005 and offsets them against this royalty credit. To date, the Company has utilized \$0.23 million of this credit.

Excluding the royalty credit, crown and overriding royalties on production from Alberta were \$0.51 million (2004 – \$0.1 million). The significant increase can be attributed to higher production from Alberta in 2005 as compared to the previous year. On a percentage basis, the royalty rate increased by 17% to 33% in 2005 from 28% in 2004.

### *Operating Costs*

Total operating expenses for the year ended December 31, 2005 decreased substantially to \$0.71 million from \$1.72 million in 2004. The majority of the decrease is due to the lower operating expenditures at the Field in 2005.

The Company recorded minimal operating expenses for the Beaver River Field during the second half of 2005. With the A-5 well shut-in in July, operations at the Field were directed towards the reconstruction of the operators' quarters and workshop after the fire in June 2005. The Company expects to be reimbursed for these specific expenses under its insurance policy.

### *General & Administrative Expenses*

General and administrative expenses of \$1.03 million in 2005 reflect the increased corporate activity securing farm-in partners for the Company's projects and the development of a portfolio of assets in Alberta. Overhead capitalization of \$0.42 million associated with this increased capital expenditures in Alberta offset a significant portion of 2005 expenses.

(\$ thousands)	2005	2004
General & administrative expenses	\$ 1,450	\$ 1,010
Bad debt expense	–	139
Overhead recoveries	(416)	(411)
General & administrative expenses, net	\$ 1,034	\$ 738

### *Other Income and Expenses*

Questerre incurred restructuring charges of \$80,500 in 2005 representing the issuance of Common Shares in connection with the corporate restructuring completed in 2004. During the year ended December 31, 2004, Questerre recorded restructuring expenses of \$0.43 million representing professional services associated with the Company's filings under the CCAA.

Questerre recorded a gain of \$7.63 million in 2004 representing the net forgiveness of outstanding amounts owing by the Company to its unsecured trade creditors. \$7.30 million related to amounts settled under the Plans. See Note 3 to the audited consolidated financial statements.

### *Stock Based Compensation*

Stock based compensation expense for the year ended December 31, 2005 totaled \$0.70 million as compared to a credit of \$0.03 million in 2004. The higher expense in 2005 can be attributed to the issuance of 6.02 million options at a weighted average price of \$0.58 per Common Share. The fair value of these options using the Black-Scholes option-pricing model is \$0.34 per option. By comparison, the Company issued a total of 3.68 million options at a weighted average price of \$0.27 per Common Share in 2004. The fair value of these options was \$0.13 per option.

### *Interest Expense*

Interest expense of \$0.07 million in 2005 was unchanged from 2004. In both years, this comprised of interest payable on the term bank loan and the promissory note to Rupert's. See Related Party Transactions. The expense in 2005 was offset by interest earned of \$0.04 million during the year (2004 – \$0.03 million).

### *Depletion, Depreciation and Site Restoration*

Questerre recognized \$2.07 million in depletion and depreciation in 2005 compared to \$7.4 million in 2004. Included in 2005 depletion is a \$1.31 writedown to reflect the costs of an unsuccessful well in the Simonette area of Alberta.

Included in 2004 depletion is a \$7.0 million ceiling test write-down and depletion charge recorded by the Company on its Field petroleum and natural gas assets. The write-down reflected the majority of the costs incurred to finish the drilling, completion and tie-in of the A-5 re-entry in 2004. Depletion for 2004 also includes \$0.2 million relating to the Company's costs of an unsuccessful well in the Gaspe Peninsula, Quebec.

Questerre does not include costs of \$1.81 million associated with its St. Lawrence Lowlands acreage in Quebec in the calculation of depletion or in costs subject to the ceiling test calculation. The Company also does not include costs of \$1.37 million related to its exploration project in the Parkland area in Alberta in its calculation of depletion or in costs subject to the ceiling test calculation. The projects in Parkland and in Quebec remain unproved at December 31, 2005.

The Company's estimated undiscounted asset retirement cost for the Beaver River Field at December 31, 2005 was \$1.78 million, unchanged from 2004. Questerre acquired four wells and participated in the drilling of 17 wells in 2005, resulting in an increased asset retirement obligation of \$0.27 million. Questerre estimates its total undiscounted asset retirement obligations to be \$2.38 million at December 31, 2005.

### *Taxes*

Consistent with prior years, Questerre had sufficient tax pool deductions to offset taxable income in 2005 resulting in no income taxes payable for the current year. In addition, the Company's tax assets continue to significantly exceed tax liabilities. No tax asset is recognized at December 31, 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 \$3.01 million (\$0.03 per share) in 2005 compared to net income of \$0.07 million (\$0.02/share) in 2004. The net loss for the year is due primarily to the depletion expense that includes a writedown of the unsuccessful well in the Simonette area of Alberta. The net income in 2004 is primarily due to the gain on settlement of all outstanding obligations and the recovery due to future tax on flow-through shares offset by higher depletion.

## liquidity and capital resources

### CAPITAL EXPENDITURES

Questerre incurred capital expenditures of \$10.31 million in 2005 compared to \$7.48 million in 2004.

The vast majority of these expenditures relate to the development of its portfolio of assets in Central and Southern Alberta

- \$4.20 million was incurred developing the new pool discovery in Vulcan, including \$0.37 million on land acquisition and \$0.47 million on seismic data acquisition, processing and interpretation
- \$3.50 million was spent on acquired lands in the Hector and Westlock areas and includes \$2.1 million for the acquisition of production properties from Rupert's
- Participation in the Simonette well totaled \$1.23 million with the balance spent in Drumheller and in Parkland

The majority of capital spending in 2004 at the Field related to the drilling, completion and tie-in of the A-5 re-entry. In Quebec, approximately \$0.2 million was spent on the drilling of the Miguasha #1 well with the remainder incurred in the St. Lawrence Lowlands. In Alberta, Questerre incurred approximately \$0.8 million in drilling costs in the Parkland area with the remainder spent on land acquisition in the Vulcan and Simonette areas.

(\$ thousands)	2005	2004
Capital Expenditures		
Beaver River Field, British Columbia	\$ 227	\$ 6,271
St. Lawrence Lowlands, Quebec	21	287
Alberta Properties	10,060	917
Total	\$ 10,308	\$ 7,475

### WORKING CAPITAL POSITION

Questerre reported a working capital surplus of \$9.80 million at December 31, 2005 compared to a working capital surplus of \$2.86 million as of December 31, 2004. The improved working capital position primarily reflects the equity placements completed by the Company in 2005.

The Company's current assets at December 31, 2005 primarily consist of cash of \$9.30 million, accounts receivable of \$1.53 million and field inventory of \$0.09 million. \$1.0 million of the receivables represent amounts due under the insurance claim for the Field. The Company expects this claim will be settled early in 2006.

Questerre's current liabilities consist of trade payables of \$1.60 million and \$0.15 million representing the term bank loan that has been classified as a current liability.

A significant portion of the Company's working capital will finance its projected capital expenditures of approximately \$5.24 million for the first quarter of 2006. Approximately three quarters of these expenditures relate to the development of the new pool in Vulcan. To augment its working capital position, the Company completed a \$7.2 million placement in early February. The Company anticipates these funds will finance potential acquisitions and farm-in opportunities.

Subject to commercial production commencing from Vulcan, Questerre believes that future capital expenditures will continue to be financed by existing working capital, cash flow and equity placements.

## **SHARE CAPITAL**

The Company is authorized to issue an unlimited number of Class A common voting shares (the "Common Share"), an unlimited number of Class B common voting shares and an unlimited number of preferred shares, issuable in one or more series.

In April 2005, the Company completed a private placement of 3,125,000 Common Shares at \$0.32 per Common Share for gross proceeds of \$1.0 million.

In June 2005, the Company completed an offering of 30,000,000 Common Shares at \$0.33 per Common Share for gross proceeds of \$10 million. Concurrent with this offering, the Company listed its Common Shares for trading on the Oslo Stock Exchange.

In September 2005, Questerre completed a private placement of 9,987,690 Common Shares at \$0.82 per Common Shares for gross proceeds of \$8.19 million.

A total of 3,125,000 Common Shares were issued in November 2005 in connection with the corporate restructuring transactions completed in 2004. (See "Related Party Transactions")

At December 31, 2005, there were no Class B common voting shares or preferred shares outstanding, a total of 113,014,594 Common Shares outstanding and 9,205,000 stock options outstanding.

## **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 annual commitment under this agreement is \$126,000 for 2006.

The Company is responsible for principal payments on its bank loan in the amount of \$80,400 in 2006 and \$73,700 in 2007.

## **OFF-BALANCE SHEET ARRANGEMENTS**

Questerre has no off-balance sheet arrangements.

## **RELATED PARTY TRANSACTIONS**

Questerre incurred fees of \$126,000 for the years ended December 31, 2005 and 2004 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 3,000,000 Common Shares at \$0.32 per Common Share. Terrenex Acquisition Corporation ("Terrenex") subscribed for 2,812,500 Common Shares and Rupert's subscribed for 312,500 Common Shares. Terrenex currently holds approximately 9% of the issued and outstanding share capital of Questerre. All of the Directors of Terrenex serve as directors or officers of Questerre.

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. Rupert's is a private investment holding company controlled by the President and Chief Executive Officer of Questerre. See "Purchase and Sale Agreement with Rupert's Crossing."

In May 2005, QBR entered into a farm-in agreement with Ampac Petroleum (“Ampac”), a private exploration and production company for the development of the Field. A director of the Company is the sole shareholder and director of Ampac. See “Farm-in agreement with Ampac Petroleum.”

In November 2005, the Company issued a total of 3,150,000 Common Shares as follows

- 2,000,000 Common Shares were issued on the conversion of the \$0.6 million promissory note due to Rupert’s at a conversion rate of \$0.30 per Common Share. See Note 6 to the Audited Consolidated Financial Statements.
- 300,000 Common Shares were issued to Terrenex pursuant to the Liquidity Option Agreement. See Note 3 to the Audited Consolidated Financial Statements.
- 850,000 Common Shares were issued to employees of the Company and QBR pursuant to the Employee Retention Plan established in May 2004. No additional shares are to be issued pursuant to this retention plan.

## **FINANCIAL INSTRUMENTS**

The Company’s financial instruments included in the balance sheet are comprised of accounts receivable, accounts payable, accrued liabilities, marketable securities and the bank loan. The fair value of financial instruments classified as current assets approximate their carrying amounts due to the short-term maturity of these instruments. The fair value of bank loan approximates its carrying amount as the interest rate approximates market.

Excluding the amounts due under the insurance claim, the remainders of the Company’s accounts receivable are for revenue due on production from the Company’s interest in non-operated properties in Alberta. The Company is exposed to credit risks normal for the oil and gas industry.

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

### **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 reservoir engineering firm. 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.

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 Company has recorded a \$1.78 million obligation on the Field and \$0.49 million on its assets in Southern and Central Alberta.

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.

## **risk management**

Companies engaged in the petroleum and natural gas industry face a variety of risks. For Questerre, these include risks associated with exploration and development drilling as well as production operations, commodity prices, exchange rate and interest rate fluctuations. Unforeseen significant changes in such areas as markets, prices, royalties, interest rates and government regulations could have an impact on the Company's future operating results and/or financial condition. While management realizes that all the risks may not be controllable, they can be monitored and managed.

A significant risk for Questerre as a junior exploration company is access to capital. The Company attempts to secure both equity and debt financing on terms it believes are attractive in current markets. Management also endeavors to seek farm-in participants to participate in the development of its projects on favorable terms. However, there can be no assurance that the Company will be able to secure sufficient capital if required or that such capital will be available on terms satisfactory to the Company.

The Company has issued and will continue to issue flow through shares to investors. The Company uses its best efforts to ensure that qualifying expenditures of CEE are incurred in order to meet its flow through obligations. However, in the event that the Company incurs qualifying expenditures of CDE or has CEE expenditures reclassified under audit by the Canada Revenue Agency, the Corporation may be required to liquidate certain of its assets in order to meet the indemnity obligations under the flow through share subscription agreements.

Exploration and development drilling risks are managed through the use of geological and geophysical interpretation technology, employing technical professionals and working in areas where those individuals have experience. For its non-operated properties, the Company strives to develop a good working relationship with the operator monitors the operational activity on the property. The Company also carries appropriate insurance coverage for risks associated with its operations.

Although Questerre has no formal hedging policy, the Company may use financial instruments to reduce corporate risk in certain situations. Questerre currently has no hedges or other financial instruments in place.

Interest rates on long-term debt float with the Bank of Canada rate. The Company does not have any US\$ denominated debt. If strong indications arise that interest rates would be increasing significantly, steps would be taken where possible to fix the rate for a period of time.

Potential risks to the environment are inherent in some of the business activities of the Company. Questerre intends to conduct its operations in a manner consistent with environmental regulations as stipulated in provincial and federal legislation. Facilities are modern and are well maintained complying with environmental and safety regulations. The Company also mitigates the potential financial exposure of environmental risks by maintaining adequate insurance.

## **control environment**

Based on their evaluation as of December 31, 2005, the Company's President and the Chief Financial Officer concluded, pursuant to Canadian Multilateral Instrument 52-109 Part 2.1, that the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in its annual filings is recorded, processed, summarized and reported within the time periods that meet the regulatory requirements. In addition, as of December 31, 2005, there were no changes in the Company's internal controls over financial reporting that occurred during 2005 that have materially affected, or are reasonably likely to materially affect its internal controls over financial reporting. The Company will continue to periodically evaluate its disclosure controls and procedures and internal controls over financial reporting and will make any modifications from time to time as deemed necessary.