



A CHALLENGING YEAR... A PROMISING FUTURE

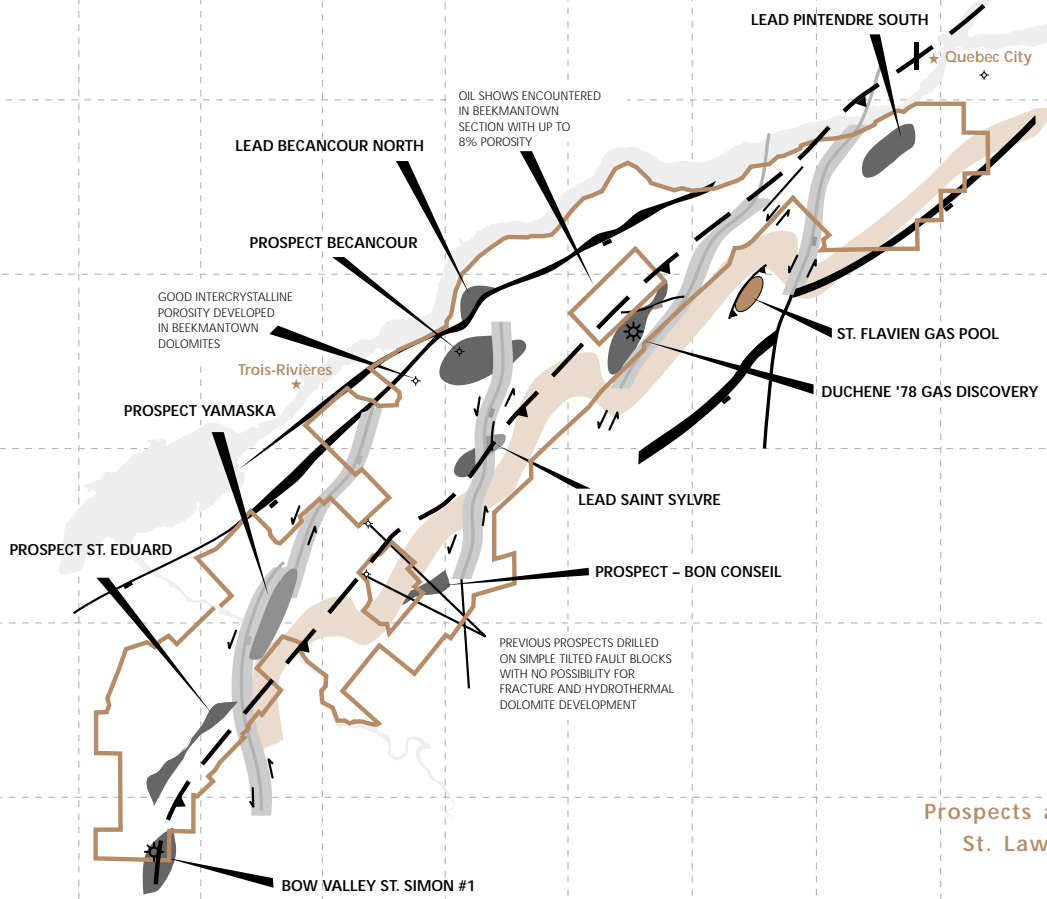
QUESTERRE ENERGY CORPORATION  
2003 Annual Report

#### CORPORATE PROFILE

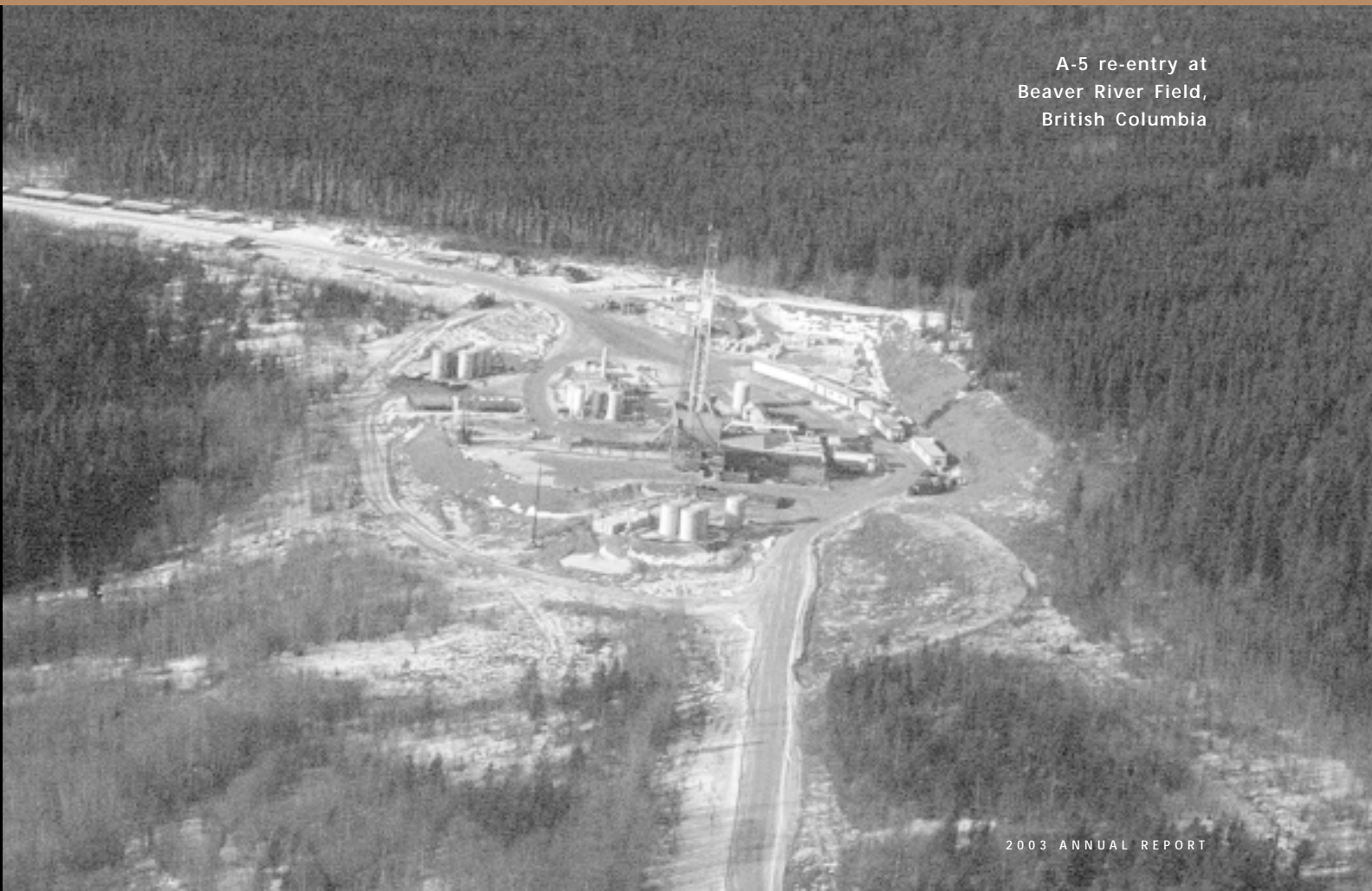
Questerre Energy Corporation is a Calgary-based independent exploration and production company. The Company focuses on scalable high-risk high-reward natural gas projects in Canada. Questerre's current projects are a gas field redevelopment project in British Columbia complemented by an exploration play in Quebec. Questerre's common shares and warrants are listed on the Toronto Stock Exchange under the symbols QEC and QEC.WT respectively.

#### ANNUAL GENERAL MEETING

The annual general and special meeting of shareholders of Questerre Energy Corporation will be held at 3:00 PM on June 23, 2004 in the Lakeview Room, Westin Hotel, 320 4th Avenue SW, Calgary, Alberta. All shareholders are encouraged to attend. Those unable to attend are encouraged to complete and mail their form of proxy.



Prospects and leads in the St. Lawrence Lowlands, Quebec



A-5 re-entry at Beaver River Field, British Columbia

## President's Message

2003 was a challenge for Questerre.

Our objectives for the year were two-fold:

- Test our new exploration concept in the St. Lawrence Lowlands
- Re-establish commercial production from the Beaver River Field

We made significant progress with our exploration acreage in the St. Lawrence Lowlands. In May 2003 we concluded an agreement with Gastem Inc., a Montreal-based junior to develop this acreage. Sainte Sophie #1 will be the first well in a proposed multi-well exploration program targeting the prolific Trenton-Black River formation. This well is scheduled to spud June after spring breakup.

Talisman Energy's success with this play in New York State has no doubt lent credence to our ideas in the Lowlands. While the structures pursued by Talisman are less complex structurally, they are also smaller than our prospects in the Lowlands. Average pool sizes in New York State are estimated at 10 Bcf. By comparison, our first prospect, Becancour, on an unrisksed basis could host up to 650 Bcf in potential reserves.

We were unable to achieve our objective at the Beaver River Field this year. The attic gas well, A-5, that would re-establish commercial production from the field fell short of our expectations. The well did not encounter any up-dip structure and production was less than 1/10 of what we expected. More importantly, the financial impact of this well has setback the spud of a new compartment well by at least a year.

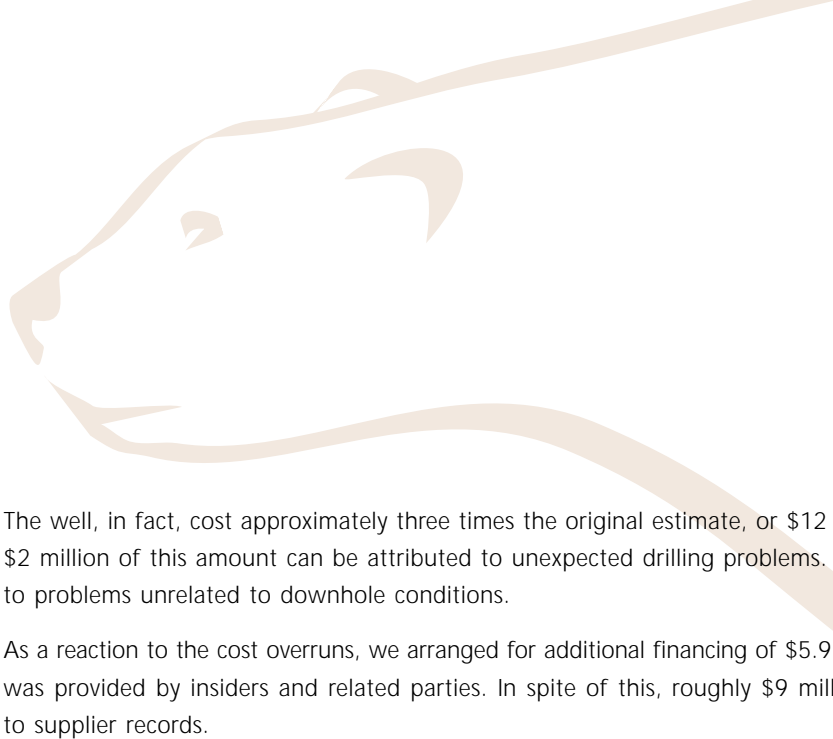
One of the lessons we learned from this well is the vital importance of in-house drilling personnel to oversee operations of this magnitude. For the A-5 re-entry, we engaged and relied exclusively on well-regarded industry experts and suppliers to manage the drilling of this well. Unfortunately, the results were less than our expectations. We have since appointed Gordon Love, P. Eng., as our VP Engineering to address this issue. Mr. Love is a seasoned engineer with over 23 years' experience in the industry.

The up-dip structure targeted by the A-5 re-entry was the result of over two years' technical work including the processing and interpretation of our 3-D seismic survey. This processing included an industry leading geophysical company checking for anisotropic effects and velocity anomalies.

The check for velocity anomalies was flawed. It did not detect a velocity problem that existed in the upper zones. This was responsible for creating the appearance of up-dip structure – the well actually encountered the reservoir structure 130 meters lower and 300 meters east from that predicted by the seismic survey. We are currently investigating what recourse we might have as a result of this problem.

Our strategy to use cash flow from the attic gas well to drill a new compartment well was well-founded technically. However, it was inherently risky as it relied on outside experts and we did not have the financial resources to drill a second well in the event of failure.

Exacerbating this problem were the cost overruns of the well. Our contracted drilling expert estimated that the re-entry would cost \$5.3 million based on a multi-well program and \$6.5 million based on a single well program. Management believed that with a \$7.4 million initial public offering coupled with access to additional financing, it could proceed with this well even if it cost double the original cost estimate.



The well, in fact, cost approximately three times the original estimate, or \$12 million over the estimated amount. \$2 million of this amount can be attributed to unexpected drilling problems. Most of the balance is attributable to problems unrelated to downhole conditions.

As a reaction to the cost overruns, we arranged for additional financing of \$5.9 million. Of this amount \$3.9 million was provided by insiders and related parties. In spite of this, roughly \$9 million remains outstanding according to supplier records.

We propose to settle our creditors claims. As part of our offer, we anticipate issuing between 9 and 10 million restricted common shares. To effect this offer, we have sought court protection for our subsidiary, that holds our interest in the Beaver River Field, under the CCAA.

Needless to say the A-5 well has once again cast doubt on the potential of the Beaver River Field. The announcement that our subsidiary, Questerre Beaver River Inc., has filed for protection under CCAA while it restructures its affairs appears to have further dimmed our prospects.

We continue to believe the upside of both our projects remains untested.

Notwithstanding the results of the A-5 re-entry, the well did not test a fundamental premise of the field's potential – whether separate compartments exist in the field. A preliminary review of the updated seismic data continues to substantiate our theory of compartments. We are encouraged that our independent reservoir engineers have assigned possible reserves of 120 Bcf to these undrilled compartments.

Our exploration play in Quebec holds the possibility to discover a new sub-basin in one of the largest natural gas markets in North America. A successful well will lead to several follow-on locations within our acreage.

For 2004, we have established the following objectives:

- Complete the restructuring of our subsidiary, Questerre Beaver River Inc.;
- Complete a \$1-\$3 million equity financing to fund our exploration program in the St. Lawrence Lowlands; and
- Complete the processing of the 3-D seismic survey and secure financing to drill a well for a new compartment at the Beaver River Field.

The dedication and commitment of our employees has been irreplaceable during this challenge. I look forward to reporting more positive progress in 2004 to reward the perseverance of our shareholders and employees.

Michael Binnion  
*President and Chief Executive Officer*

## Current Projects

### ST. LAWRENCE LOWLANDS, QUEBEC

The St. Lawrence Lowlands lie south of the St. Lawrence River in Quebec, between Montreal and Quebec City. The exploration potential of this acreage is underpinned by proximity to the natural gas markets in the northeastern United States and excellent fiscal terms.

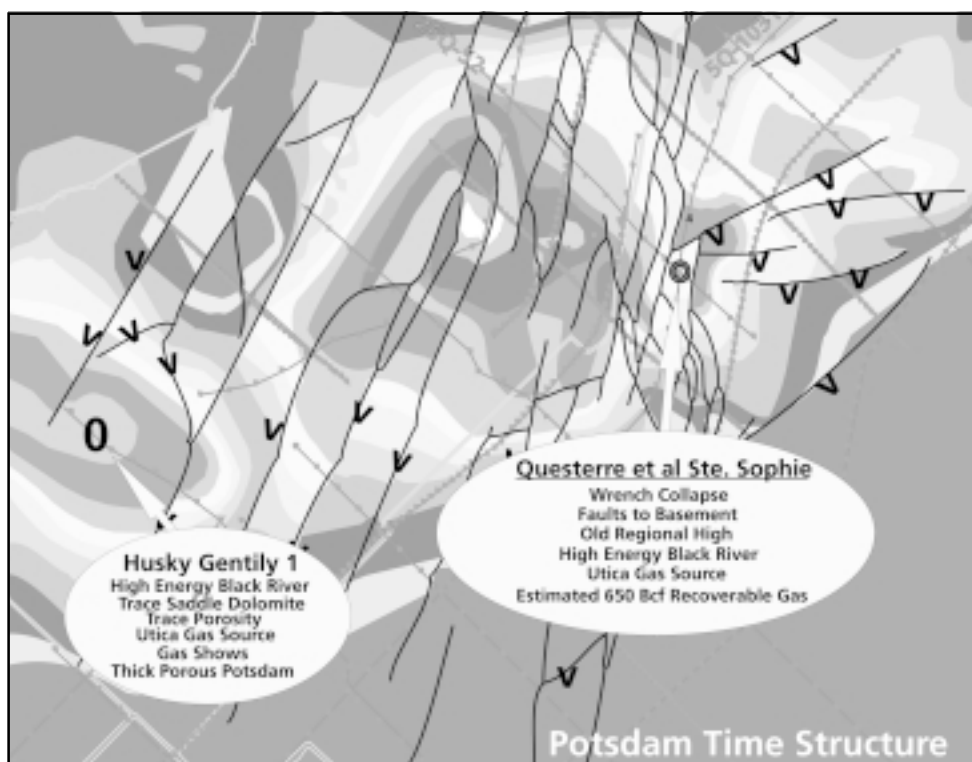
Key Questerre personnel have been active in natural gas exploration in the Lowlands since the 1980s. While these early efforts did not encounter any commercial quantities of gas, they confirmed the existence of a deep gas source. Recognizing the significant wrench faulting in this basin and its vital role in creating hydrothermal dolomite (HTD) reservoirs, we acquired an interest in the Lowlands in 2001.

A detailed regional geological and geophysical study was subsequently completed to validate our original ideas. The study documented the development and existence of HTD in the Lowlands – in outcrop, well bores and in the St. Flavian Field, a HTD reservoir that currently serves as a gas storage facility. South of the Lowlands in the Appalachian Basin in the United States, several significant HTD reservoir discoveries, most recently by Talisman Energy, appear to provide further endorsement of our ideas.

We have reprocessed and re-interpreted over 3,000 km of 2-D seismic data and identified several drillable prospects and leads on our acreage for this HTD play, known regionally as the Trenton-Black River. Our first prospect, Becancour, covers approximately 12 square miles and is estimated to host up to 650 Bcf in recoverable reserves.

The Becancour prospect will be tested by the Sainte Sophie #1 well, our first well in the Lowlands. This is scheduled to spud in June following spring breakup. Under the terms of our agreement with Gastem Inc., they will earn a 50% interest in the well and 1,000 hectares of surrounding land by funding 75% of the well costs. Gastem has an exclusive rolling option to drill additional wells on the same terms for a period of six months from the testing of the initial well.

#### Becancour Prospect



## BEAVER RIVER FIELD, BRITISH COLUMBIA

Discovered in 1961, the Beaver River Field is a natural gas field with an estimated 1.4 Tcf of original gas in place ("OGIP"). Recovery rates for the Field were initially estimated at 90% of OGIP; however, the Field recovered only 12%, or 178 Bcf due to unexpected water influx. Despite numerous efforts to reactivate the Field, commercial production has been unsustainable, fueling the industry perception that the Field has watered out.

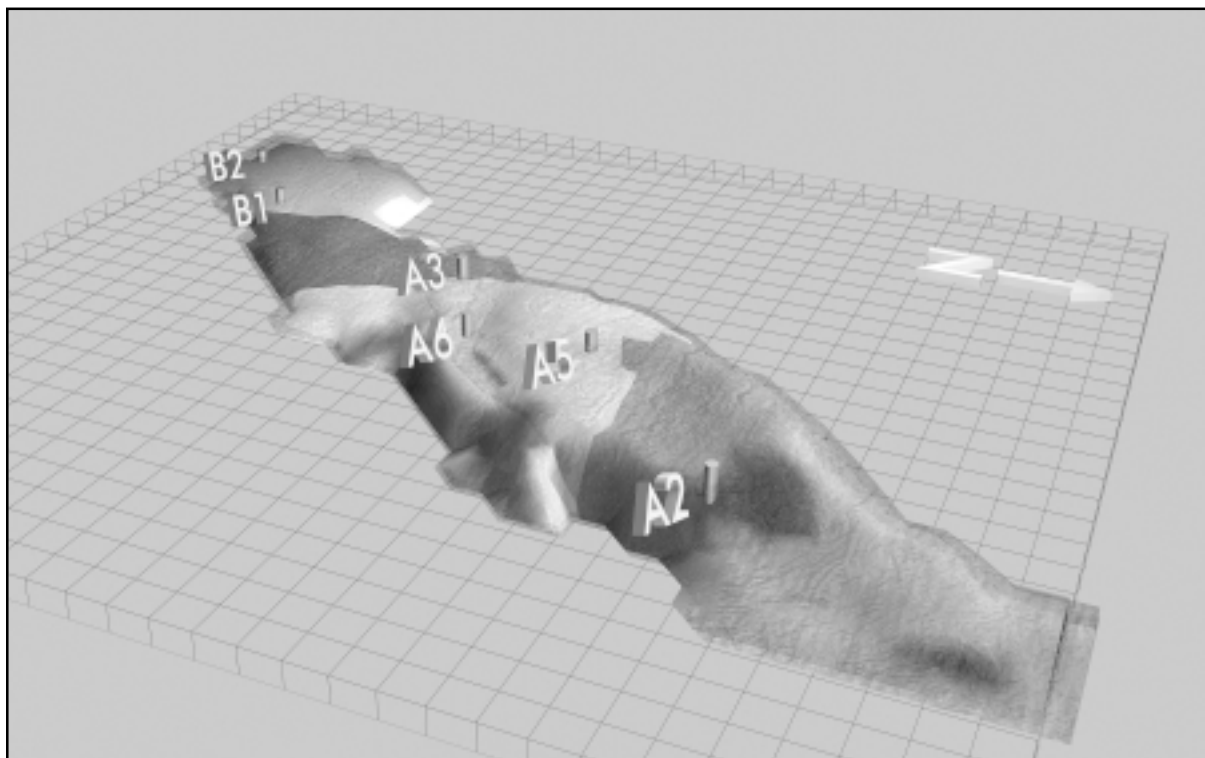
Similar active water drive reservoirs typically experience recovery rates between 20-50% of the OGIP. This indicates remaining recoverable reserves for the Beaver River Field could range between 120 Bcf and 540 Bcf, with individual wells averaging daily production of 35-50 million cubic feet. Questerre believed it could tap this potential and acquired a controlling interest in the Field in 2001.

Our interpretation of the Beaver River Field is based on the theory of compartmentalization and coning – the majority of the recoverable reserves are trapped in undrilled fault blocks or compartments within the field and the remainder behind water cones in existing compartments.

This theory is founded on comprehensive technical work that includes hydrodynamic pressure studies, material balance analysis, pressure transient analysis and gas isotope analysis. It was corroborated by a 3-D seismic survey acquired over the Field in 2002. A review by our independent reservoir engineers, confirms our field interpretation and they have assigned possible reserves of 120 Bcf to these undrilled compartments.

In light of the results from the A-5 well, we plan to re-process our 3-D seismic survey to rectify processing anomalies and better image the reservoir. We anticipate picking a location for a new compartment well later this year. The timing of this well will be subject to our ability to finance either through an equity placement or farm-in partner.

### Beaver River Field Schematic



### A-5 RE-ENTRY

The objective of the A-5 re-entry was to generate sufficient cash flow to spud a new compartment well at Beaver River. The target, clearly defined on the 3-D seismic survey, was 130 m of relatively low risk reservoir structure up-dip from the highest producing well in the field. Possible reserves were 10 Bcf with production estimated at 10-25 mmcf/d. A horizontal leg would be drilled to minimize pressure drawdown and maximize recovery.

Unfortunately the well did not encounter any up-dip structure and intersected

the reservoir at the same subsea level as the old well. An assessment of the seismic data has revealed that improper processing of the seismic survey by a well-renowned geophysical company created a false up-dip structure. The well is currently producing from a previously drained section of an existing compartment.

The financial impact of the unsuccessful well was aggravated by the cost overruns. The A-5 re-entry, budgeted at \$6.5 million, including completion, testing and tie-in costs, is now expected to cost over \$18 million. Problems unrelated to downhole conditions account for a majority of the cost overruns. Notwithstanding, actual drilling took 41 days at an approximate cost of \$3.3 million.

### RESTRUCTURING OF QUESTERRE BEAVER RIVER INC.

Questerre's interest in the Beaver River Field is held by its wholly owned subsidiary, Questerre Beaver River Inc. ("QBR")

As a result of the cost overruns associated with the A-5 re-entry, trade creditors are presently owed approximately \$9.0 million by QBR. On the recommendation of the Special Committee of the Board of Directors of Questerre, to facilitate an orderly restructuring of the financial affairs of QBR, QBR has applied for and was granted protection from proceedings by creditors under the Companies Creditors Arrangement Act ("CCAA") by an Order of the Court of Queen's Bench of Alberta issued on April 1, 2004 under the CCAA. The protection provided under the CCAA will expire on June 30, 2004, unless further extended by a Court Order. Ernst & Young Inc. has been appointed as an officer of the Court of Queen's Bench of Alberta to monitor the business and affairs of QBR while it remains under CCAA protection.

QBR intends to formulate a plan of arrangement for the consideration of its creditors and other stakeholders in the near future. QBR anticipates that the future plan of arrangement will be accepted by the creditors, allowing for the continued development of the Beaver River Field.



Drilling Operations at the A-5 Location

## Management's Discussion and Analysis

The following discussion of financial condition and results of operations was prepared by Management at April 30, 2004 and should be read in conjunction with the Consolidated Financial Statements and the Notes thereto. It offers Management's analysis of Questerre's financial and operating results and provides estimates, where possible, of Questerre's future financial and operating performance based on information currently available. Actual results may vary from estimates 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).

### **TORONTO STOCK EXCHANGE LISTING AND INITIAL PUBLIC OFFERING**

In July 2003, Questerre successfully completed its Initial Public Offering ("IPO") and began trading on the Toronto Stock Exchange. The IPO financing raised gross proceeds of \$7.4 million with 4.14 million flow-through shares, 3.26 million common shares, and 5.34 million common share warrants.

Proceeds from the financing were utilized to drill a new A-5 well on the Company's Beaver River field through the re-entry of the existing A-5 wellbore. The new A-5 well location, supported by seismic, targeted reservoir structure up-dip from the highest producing well in the field.

### **BEAVER RIVER FIELD DRILLING OPERATION**

A significant focus of Questerre's operations in 2003 was the drilling of the new A-5 well at the Beaver River Field. The operation commenced in August 2003 and encountered significant operational delays and cost overruns. The well was completed subsequent to year-end and encountered the reservoir at a sub-sea depth below the original target as identified by seismic. The well was tied-in to existing production facilities in March 2004 and brought on-stream for an extended production test at an initial rate of 3,000 mcf/day.

### **CREDITOR PROTECTION – QUESTERRE BEAVER RIVER INC.**

The substantial cost overruns encountered on the A-5 drilling operations led to serious financial difficulties for Questerre's wholly owned subsidiary, Questerre Beaver River Inc. ("QBR"). 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"). The filing under CCAA is intended to allow QBR to restructure its affairs while continuing operations on a normalized basis. The Court Order prohibits creditors from taking action against QBR and prevents QBR from paying most claims which arose before April 1, 2004. QBR is working to put together a plan of arrangement between QBR and its creditors and other stakeholders.

Statements of claim have been filed by various parties against the Company and its subsidiary, QBR. All of the claims relate to the provision of services and materials for the drilling of the Beaver River well. The amounts claimed have been fully provided for as part of accounts payable at December 31, 2003. The outcome of the lawsuits is dependent, in part, on the CCAA process and is unknown at this time.

The Company's future outlook and plans of operation for QBR and the Beaver River project will be determined by the outcome of the restructuring of QBR under CCAA. If the restructuring cannot be completed, the Company may not be able to realize its assets and discharge its liabilities in the normal course of business.

## **PRODUCTION**

Raw gas production from the Beaver River Field for the first six months of 2003 averaged 692 mcf/day compared to 1,600 mmcf/day of production for the ten months that the field was on production in 2002. The Company had no production from the Beaver River field at the end of 2003 as both producing wells were shut-in. In July 2003, the A-5 was shut-in to drill the new well and in October 2003, the second producing well was shut-in due to pipeline pressures and water disposal constraints. Consistent with 2002, the Company's production from minor Alberta properties in 2003 was approximately 25 boe/day in natural gas and associated natural gas liquids.

## **2003 FINANCIAL RESULTS**

### **REVENUE**

Questerre reported petroleum and natural gas revenues of \$1.5 million in 2003 (2002 – \$2.34 million). 2003 revenues included \$1.1 million (2002 – \$2.0 million) in natural gas sales and priority right to cash flow from Beaver River and \$0.4 million (2002 – \$0.34 million) from non-operated minority interests in Alberta properties. Questerre's realized natural gas prices increased 60% to \$6.79/mcf in 2003 from \$4.25/mcf in 2002. Increases in revenue associated with improved natural gas prices were offset by decreased production in 2003.

### **ROYALTIES**

Crown royalties for the Beaver River property are governed by a royalty agreement which provides 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. Questerre's reported royalty recovery in 2003 included the reversal of prior years' royalty expense recognized under the royalty agreement. Based on the limited production and disappointing results to date, the Company has adjusted the liability from \$1.4 million at December 31, 2002 to Nil at December 31, 2003 on the basis that the conditions for repayment do not exist. The impact on 2003 was a recovery of deferred crown royalties in the amount of \$1.4 million.

### **OPERATING COSTS**

Total operating expenses decreased 22% from \$1.46 million in 2002 to \$1.14 million in 2003, consistent with decreased production. There is a significant amount of fixed costs associated with operating the Beaver River property; however, gas processing and transportation fees are directly proportionate to production and are based on interruptible service rates for production processed at the Duke Fort Nelson plant. Marketing fees in 2002 and 2003 were charged at 5% of gross revenue pursuant to an existing marketing contract. This contract was terminated in 2003 and a daily spot price contract was negotiated for 2004 with substantially reduced marketing fees.

## GENERAL AND ADMINISTRATIVE EXPENSES

General and administrative expenses of \$1.0 million in 2003 included \$650,000 of bad debt expense recorded against amounts receivable from partners on the Beaver River project. Excluding bad debt expense, net general and administrative expenses decreased by 28% compared to 2002 primarily as a result of increased overhead recoveries associated with an increased capital expenditure program in 2003.

<i>(\$ thousands)</i>		<b>2003</b>		2002
General & administrative expenses	\$	<b>1,023</b>	\$	1,000
Bad debt expense		<b>650</b>		-
Overhead recoveries		<b>(671)</b>		(513)
General & administrative expenses, net	\$	<b>1,002</b>	\$	487

## INTEREST ON LONG-TERM DEBT

Interest on bank debt totaled \$65,000 for 2003 compared to \$23,000 in 2002. Questerre obtained its \$400,000 term loan in July 2002 and, as such, the Company only incurred interest expense for five months in 2002 compared to twelve months in 2003.

## DEPLETION, DEPRECIATION AND SITE RESTORATION

Questerre recognized \$17.3 million in depletion and depreciation in 2003 compared to \$5.3 million in 2002. Included in 2003 is a \$16.7 million "ceiling test" write-down recorded by the Company on its Beaver River petroleum and natural gas assets. Based on the reserve evaluation, the Company had no proved or probable reserves associated with its Beaver River property at December 31, 2003. All costs associated with the Beaver River property, excluding geological and geophysical costs of \$2.6 million were written down and included in depletion for the year.

Questerre does not include costs associated with its St. Lawrence Lowlands acreage in Quebec in the calculation of depletion or in costs subject to the ceiling test calculation. The Quebec property remains undeveloped at December 31, 2003.

The Company's estimated future site restoration and abandonment costs at December 31, 2003 were \$898,000 (2002 - \$898,000). The annual provision for site restoration is calculated on a unit of production basis using proved reserves. Questerre has recorded the full amount of the estimated liability for site restoration and abandonment associated with the Beaver River property at December 31, 2003 on the basis that there are no proved reserves associated with the property at the date. The annual provision for future site restoration recorded in 2003 was \$525,300 (2002 - \$109,200).

## TAXES

Consistent with prior years, Questerre had sufficient tax pool deductions to offset taxable income in 2003 resulting in no income taxes payable for the current year. In addition, the Company's tax assets significantly exceed tax liabilities. No tax asset is recognized at December 31, 2003 as there is no certainty that the Company will be able to realize the value of the tax assets in the future.

Questerre does not expect to pay income taxes in 2004 based on the Company's estimated tax pools in excess of \$19 million at December 31, 2003.

## NET LOSS AND CASH FLOW

Questerre recorded a net loss of \$17.2 million (\$0.56/share) in 2003 compared to \$5.6 million (\$0.21/share) in 2002. The current year net loss included a \$16.7 million ceiling test write-down on the Beaver River property (\$3.7 million write-down in 2002).

## LIQUIDITY AND CAPITAL RESOURCES

### CAPITAL EXPENDITURES

Questerre incurred capital expenditures of \$14.0 million in 2003 compared to \$4.5 million in 2002. The majority of 2003 capital spending (\$13.1 million) related to the Beaver River project primarily the drilling of the A-5 well.

Capital expenditures on the Company's Quebec property were largely directed to the acquisition of gas exploration licenses. In May 2003, the Company issued 750,000 common shares at a deemed price of \$1.00/share, to Terrenex Acquisition Corporation on the termination of a Farmout agreement covering the St. Lawrence Lowlands licenses. Subsequent to terminating the agreement, Questerre successfully obtained the gas exploration licenses previously covered by the Farmout agreement.

### CAPITAL EXPENDITURES

<i>(\$ thousands)</i>	2003	2002
Beaver River Project, BC	13,090	3,969
St. Lawrence Lowlands, Quebec	876	526
Minor Alberta Properties	72	–
Total	14,038	4,495

### WORKING CAPITAL DEFICIENCY

Questerre reported a working capital deficiency of \$4.6 million at December 31, 2003, which includes outstanding bank debt of \$314,900. Financial covenants associated with the bank loan 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's current assets at December 31, 2003 include accounts receivable of \$0.6 million, the majority of which relates to outstanding GST refunds. Inventory of \$0.7 million at December 31, 2003 (2002 – \$0.1 million) includes \$0.5 million in drilling mud, all of which was utilized or returned for credit in the first quarter of 2004.

Questerre's trade payables of \$7.2 million primarily related to capital expenditures and significant cost overruns associated with the Beaver River A-5 well to December 31, 2003. The Company intended to satisfy trade payables and rectify the working capital deficiency through additional financing or alternatively, from future cash flow from the A-5 well early in 2004. However, cost overruns continued to escalate on the drilling, completion and tie in operations throughout 2004 and well production capability was significantly less than anticipated.

The substantial cost overruns encountered on the A-5 drilling operations led to serious financial difficulties for Questerre's wholly owned subsidiary, Questerre Beaver River Inc. ("QBR"). 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"). QBR is working to put together a plan of arrangement between QBR and its creditors and other stakeholders.

At December 31, 2003, QBR had a continuing capital expenditure commitment to complete the drilling of the Beaver River well. The total costs of the well are currently estimated at over \$18 million, with \$5.7 million incurred in 2004 for additional drilling, completion and tie-in costs. 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.

### **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 December 31, 2003, there were no Class B common voting shares or preferred shares outstanding.

In July 2003, Questerre successfully completed its Initial Public Offering ("IPO") and obtained a listing on the Toronto Stock Exchange. The initial prospectus financing raised gross proceeds of \$7.4 million with 4,137,700 flow-through shares, 3,269,480 common share shares, and 5,751,922 common share warrants.

Prior to completing the IPO, the shareholders of the company, at the annual and special meeting of the shareholders, approved a subdivision of the company's common shares on a three-for-one basis. The effect on the company's common shares at January 1, 2003 was an increase from 8,945,000 common shares to 26,835,000 common shares.

In addition to the IPO financing, Questerre completed 3 smaller private placement financings which raised combined gross proceeds of \$1,275,200 on the issue of 209,500 common shares and 900,900 flow through shares. The flow through shares were issued to Terrenex Acquisition Corporation ("Terrenex"), a related party.

Throughout 2003, the Company entered into several capital transactions with Terrenex Acquisition Corporation. Terrenex is a related party with three directors who also serve as directors for Questerre. In May 2003, the Company issued 750,000 common shares at a deemed price of \$1.00/share, to Terrenex Acquisition Corporation ("Terrenex") on the termination of a Farmout agreement covering the St. Lawrence Lowlands licenses. In December 2003, Terrenex converted \$4.5 million of Series I Preferred shares into common shares at a conversion price of \$1.00/share. In addition, Terrenex exercised 1,509,666 common share purchase warrants to purchase common shares at an exercise price of \$1.11/share for proceeds of \$1.7 million.

Subsequent to year end, 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 \$3,156,003. Proceeds from the offering were primarily used to finance the completion and tie-in of the A-5 well at Beaver River.

## QUARTERLY INFORMATION

### PERIOD ENDED DECEMBER 31, 2003

<i>(\$ thousands except where noted)</i>	Q1	Q2	Q3	Q4	Total
Production revenue, net of royalties	491,366	490,265	124,850	242,811	1,349,292
Net loss	(262,986)	(245,196)	(544,271)	(16,132,172)	(17,184,625)
Per share – basic	(0.01)	(0.01)	(0.02)	(0.52)	(0.56)
Per share – diluted	(0.01)	(0.01)	(0.02)	(0.52)	(0.56)

### PERIOD ENDED DECEMBER 31, 2002

<i>(\$ thousands except where noted)</i>	Q1	Q2	Q3	Q4	Total
Production revenue, net of royalties	335,918	616,194	162,675	686,465	1,801,252
Net loss	(4,983,524)	(158,646)	(375,538)	(38,907)	(5,556,615)
Per share – basic	(0.19)	(0.01)	(0.01)	–	(0.21)
Per share – diluted	(0.19)	(0.01)	(0.01)	–	(0.21)

## 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 policies and practices 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.

### OIL AND GAS RESERVES

Questerre's year end 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.

## **FUTURE SITE RESTORATION AND ABANDONMENT COSTS**

The Company recognizes a provision for future site reclamation and abandonment costs calculated on the unit-of-production basis over the life of the petroleum and natural gas properties based on total estimated reserves (see above) and an estimated future abandonment liability. The estimate of the future abandonment liability is determined by management based on the best available information using current costs and current technology. These estimates are subject to change over time and, as such, may impact the charge against income for future site reclamation and abandonment costs.

## **IMPACT OF NEW ACCOUNTING PRONOUNCEMENTS**

### **STOCK BASED COMPENSATION**

Effective January 1, 2004, the CICA Section 3870, "Stock-based compensation and other stock-based payments" will require all stock based compensation, including stock options, to be expensed at fair value. Under existing standards, companies have the option of disclosing this information in the notes to the financial statements rather than expensing stock options. The Company will be retroactively adopting the new requirements January 1, 2004 which results in an increase in deficit of \$70,527.

### **ASSET RETIREMENT OBLIGATIONS**

In December 2002, the Accounting Standards Board approved a standard on accounting for asset retirement obligation to be applied for fiscal years beginning on or after January 1, 2004. The new standard requires recognition of a liability for obligations associated with the retirement of property, plant and equipment. The liability would be recognized initially at the fair value with the resulting amount capitalized as part of the asset cost, subsequently increasing depletion and depreciation expense. In subsequent periods, the liability is accreted for the change in the present value in each period. The Company will be retroactively adopting the new requirements January 1, 2004. Questerre is assessing the new requirements but does not anticipate a material effect on its financial statements based on the significant ceiling test write-downs recorded to date and the full recognition of site restoration liabilities in its 2003 financial statements.

### **FULL COST ACCOUNTING GUIDELINE**

In September 2003, the CICA issued a new accounting guideline "Oil and Gas Accounting - Full Cost" effective for years beginning after January 1, 2004. The new guideline amends the ceiling test calculations to be a two step process. The first step would determine whether a write-down is required by comparing the carrying value of the properties to the undiscounted cash flow of the 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 will be 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. Questerre is assessing the new requirements but does not anticipate a material effect on its financial statements based on the significant ceiling test write-downs recorded to date and based on the reserve evaluation with no proved and no probable reserves at December 31, 2003.

## 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.

Questerre's wholly owned subsidiary, QBR filed for and obtained creditor protection under CCAA in April 2004. The future outlook and plans of operation for QBR and the Beaver River project will be determined by the outcome of the restructuring of QBR under CCAA.

Statements of claim have been filed by various parties against the Company and its subsidiary, QBR. All of the claims relate to the provision of services and materials for the drilling of the Beaver River well. The amounts claimed have been fully provided for as part of accounts payable at December 31, 2003. The outcome of the lawsuits is dependent, in part, on the CCAA process and is unknown at this time.

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 Canada Customs and 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. Being the operator and maintaining a high working interest in its properties allows the Company to best manage operational risk by giving the Company control over costs and timing of expenditures, and the method and sales of production. Where the Company is not the operator of a property, it strives to develop a good working relationship with the operator and the other partners in the property and 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.

## Management's Report

### TO THE SHAREHOLDERS OF QUESTERRE ENERGY CORPORATION

The accompanying consolidated financial statements of Questerre Energy Corporation and all the information in this Annual Report are the responsibility of management and have been approved by the Board of Directors.

The consolidated financial statements have been prepared by management in accordance with generally accepted accounting principles. When alternative accounting methods exist, management has chosen those it deems most appropriate in the circumstances. Financial statements are not precise since they include certain amounts based on estimates and judgments. Management has determined such amounts on a reasonable basis in order to ensure that the consolidated financial statements are presented fairly, in all material respects. The financial information contained elsewhere in this report has been reviewed to ensure consistency with the consolidated financial statements.

Management has established systems of internal controls, which are designed to provide reasonable assurance that assets are safeguarded from loss or unauthorized use and to produce reliable accounting records for the preparation of financial information.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal control. It exercises its responsibilities primarily through the Audit Committee, which is comprised of non-management directors. The Audit Committee has reviewed the consolidated financial statements with management and the auditors and has reported to the Board of Directors which have approved the consolidated financial statements.

The consolidated financial statements have been audited by Pricewaterhouse Coopers LLP, the external auditors, in accordance with auditing standards generally accepted in Canada on behalf of the shareholders.



Michael Binnion  
*President and Chief Executive Officer*



Jackie Cugnet, CA  
*Vice-President, Finance and  
Chief Financial Officer*

Calgary, Canada  
April 30, 2004

## Auditors' Report

### TO THE SHAREHOLDERS OF QUESTERRE ENERGY CORPORATION

We have audited the consolidated balance sheets of Questerre Energy Corporation as at December 31, 2003 and 2002 and the consolidated statements of loss and deficit and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2003 and 2002 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

*PricewaterhouseCoopers LLP*

Chartered Accountants

Calgary, Canada  
April 30, 2004

## Questerre Energy Corporation Consolidated Balance Sheets

<i>As at December 31</i>	<b>2003</b>	2002
<b>Assets</b>		
Current assets		
Cash	\$ 1,678,611	\$ 555,004
Accounts receivable	623,544	752,013
Inventory	680,036	135,742
	<b>2,982,191</b>	1,442,759
Restricted cash (note 6)	100,000	100,000
Petroleum and natural gas properties – net of accumulated depletion and depreciation (note 4)	5,138,047	8,392,789
	<b>\$ 8,220,238</b>	\$ 9,935,548
<b>Liabilities</b>		
Current liabilities		
Accounts payable and accrued liabilities	\$ 7,225,137	\$ 840,409
Bank loan (note 6)	314,900	366,500
	<b>7,540,037</b>	1,206,909
Deferred crown royalties (note 7)	–	1,439,409
Future site restoration and abandonment	878,833	353,548
	<b>8,418,870</b>	2,999,866
<b>Shareholders' Equity</b>		
Common shares (note 8)	25,308,340	10,758,029
6% Cumulative redeemable convertible preferred shares (note 8)	–	4,500,000
Deficit	(25,506,972)	(8,322,347)
	<b>(198,632)</b>	6,935,682
<b>Going Concern Matters</b> (note 1 and 2)	<b>\$ 8,220,238</b>	\$ 9,935,548

See accompanying notes to consolidated financial statements.

Approved by the Board of Directors



Director



Director

## Questerre Energy Corporation Consolidated Statements of Loss and Deficit

<i>For the years ended December 31</i>	<b>2003</b>	<b>2002</b>
<b>Revenue</b>		
Petroleum and natural gas, net of royalties	\$ 1,349,292	\$ 1,801,252
Recovery of deferred crown royalties (note 7)	1,439,409	–
Interest income	53,022	22,061
Other income	–	20,000
	<b>2,841,723</b>	<b>1,843,313</b>
<b>Expenses</b>		
Operating	1,141,527	1,460,810
General and administrative	1,001,874	486,571
Interest on bank debt	64,754	23,031
Depletion, depreciation and site restoration	17,818,193	5,418,117
	<b>20,026,348</b>	<b>7,388,529</b>
<b>Loss before income taxes</b>	<b>(17,184,625)</b>	<b>(5,545,216)</b>
Current and capital taxes (note 9)	–	11,399
	<b>(17,184,625)</b>	<b>(5,556,615)</b>
<b>Net loss</b>	<b>(17,184,625)</b>	<b>(5,556,615)</b>
Deficit, beginning of period	(8,322,347)	(2,765,732)
Deficit, end of period	<b>\$ (25,506,972)</b>	<b>\$ (8,322,347)</b>
<b>Net loss per share</b>		
Basic and diluted (note 8d)	\$ (0.56)	\$ (0.21)

*See accompanying notes to consolidated financial statements.*

## Questerre Energy Corporation Consolidated Statements of Cash Flows

<i>For the years ended December 31</i>	<b>2003</b>	2002
<b>Cash provided by (used in):</b>		
<b>Operating Activities</b>		
Net loss	\$ (17,184,625)	\$ (5,556,615)
Items not affecting cash		
Depletion, depreciation and amortization	17,818,193	5,418,117
	<b>633,568</b>	(138,498)
Deferral of crown royalties	(1,439,409)	405,598
Net change in non-cash working capital	(18,382)	(238,230)
	<b>(824,223)</b>	28,870
<b>Financing Activities</b>		
Issue of common shares and warrants	5,228,237	–
Issue of flow-through shares	5,127,356	–
Share issue costs	(1,056,032)	–
Proceeds (repayment) of bank loan	(51,600)	366,500
Restricted cash	–	(100,000)
	<b>9,247,961</b>	266,500
<b>Investing Activities</b>		
Expenditures on petroleum and natural gas properties	(13,287,416)	(4,494,630)
Net change in non-cash working capital	5,987,285	(1,293,908)
	<b>(7,300,131)</b>	(5,788,538)
Increase (decrease) in cash	1,123,607	(5,493,168)
Cash, beginning of period	555,004	6,048,172
<b>Cash, end of period</b>	<b>\$ 1,678,611</b>	<b>\$ 555,004</b>

*See accompanying notes to consolidated financial statements.*

During the year ended December 31, 2003, the Company paid \$64,754 (2002 – \$23,031) of interest on bank indebtedness and \$Nil in cash taxes (2002 – \$11,399).

# Questerre Energy Corporation

## Notes to Consolidated Financial Statements

For the Years ended December 31, 2003 and 2002

### 1. CREDITOR PROTECTION – QUESTERRE BEAVER RIVER INC.

On April 1, 2004, Questerre Beaver River Inc. (“QBR”), a wholly owned subsidiary of Questerre Energy Corporation (“Questerre” or the “Company”), 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”). The Initial Order was amended by the Court on April 30, 2004 to provide for a general stay period that expires on June 30, 2004. The order may be further amended by the Court throughout the CCAA proceedings based on motions from QBR, its creditors and other interested parties.

QBR’s current financial difficulty is the result of significant problems and cost overruns associated with a re-entry operation undertaken at the Beaver River field (note 5). QBR holds a 60% working interest and a 100% priority right to cash flow (subject to payouts) in the Beaver River natural gas field (“the Beaver River field”) which is located approximately 100 miles northwest of Fort Nelson, British Columbia. In August 2003 QBR began a re-entry operation on a wellbore 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 well was completed, tied-in and commenced production in April 2004.

The filing under CCAA is intended to allow QBR to restructure its affairs while continuing operations on a normalized basis. The court order prohibits creditors from taking action against QBR and prevents QBR from paying most claims which arose before April 1, 2004. QBR is working to put together a plan of arrangement between QBR and its creditors and other stakeholders. If the restructuring can not be completed, the Company may not be able to realize its assets and discharge its liabilities in the normal course of business.

### 2. NATURE OF OPERATIONS AND BASIS OF PRESENTATION

Questerre Energy Corporation and its subsidiary, QBR, are primarily involved in the exploration and development of two large scale natural gas projects. One project, the Beaver River Field, is a discovered hydrothermal dolomite natural gas reservoir in northeast British Columbia (note 5). The second project is the exploration for hydrothermal dolomite reservoirs in the St. Lawrence Lowlands in Quebec. The Quebec project remains undeveloped at December 31, 2003. In addition to the Company’s two major projects, Questerre also holds minority interests in producing, non-operated properties in Alberta.

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 on the restructuring of its subsidiary under CCAA. If the going concern basis is not appropriate for the Company’s subsidiary, adjustments may be necessary in the carrying amounts and/or classification of assets, liabilities, revenues and expenses in these financial statements.

### 3. SIGNIFICANT ACCOUNTING POLICIES

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that effect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Accordingly, actual results could differ from estimated amounts.

#### *a) Principles of consolidation*

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries, Questerre Beaver River Inc. and 6058931 Canada Inc.

## Questerre Energy Corporation Notes to Consolidated Financial Statements

For the Years ended December 31, 2003 and 2002

### *b) Cash and cash equivalents*

Cash consists of cash in the bank, less outstanding cheques and short term deposits with a maturity of less than three months.

### *c) Inventory*

Inventory is recorded at the lower of weighted average cost and market, measured by replacement cost.

### *d) Revenue recognition*

Revenue from the sale of petroleum and natural gas are recorded when the title passes to a third party.

### *e) Oil and natural gas operations*

The Company follows the full cost method of accounting whereby all costs related to the acquisition, exploration and development of petroleum and natural gas reserves are capitalized. Such costs include lease acquisition costs, geological and geophysical expenses, carrying charges of non-producing property, costs of drilling both productive and non-productive wells, petroleum and natural gas production equipment and overhead charges related to exploration and development activities. Proceeds received from the disposition of oil and gas properties and equipment are credited against the capitalized costs unless the disposition would significantly alter the rate of depletion and depreciation, in which case a gain or loss on disposal would be recorded.

All costs of acquisition, exploration and development of oil and gas reserves, associated tangible plant and equipment costs, and estimated costs of future development of proven undeveloped reserves are depleted and depreciated using the unit of production method based on estimated proven reserves before royalties as determined by independent engineers. For purposes of this calculation, reserves and production are converted to equivalent units of oil based on relative energy content.

Depreciation of capital assets not related to oil and gas properties is provided using the straight line method over periods ranging from five to ten years.

Costs of unproved properties are initially excluded from oil and gas properties for the purpose of calculating depletion. These properties are assessed periodically to determine whether impairment has occurred. When proven reserves are assigned or the property is considered to be impaired, the cost of the property or the amount of the impairment is added to costs subject to depletion.

The net carrying cost of the Company's petroleum and natural gas properties is limited to an estimated net recoverable amount. The net carrying cost is the capitalized costs less accumulated depletion and depreciation, future income taxes and the accumulated provision for future site restoration. The net recoverable amount is the estimated future net revenues from proven reserves using prices and costs in effect at year end, plus the cost of unproved properties, less estimated future capital costs and estimated costs for future general and administrative expenses, financing and income taxes. Any costs carried on the balance sheet in excess of the net recoverable amount are charged to current operations as additional depletion.

### *f) Future site restoration*

Estimated future site restoration costs for petroleum and natural gas properties are provided for over the life of the proven reserves on a unit of production basis. Costs are estimated each year by management based upon current regulations and industry practices. The annual charge is recorded as part of depletion expense. Actual costs incurred are charged against the accumulated liability.

# Questerre Energy Corporation

## Notes to Consolidated Financial Statements

For the Years ended December 31, 2003 and 2002

### *g) Joint operations*

Significant portions of the Company's exploration and production activities are conducted jointly with others and accordingly, the financial statements reflect only the Company's proportionate interest in such activities.

### *h) Foreign currency translation*

Monetary assets and liabilities, denominated in foreign currencies, are translated into Canadian dollars at rates of exchange in effect at the balance sheet date. Other assets and revenue and expense items are translated at rates prevailing when they were acquired or incurred. Foreign exchange gains and losses are included in income.

### *i) Flow-through shares*

The resource expenditure deductions for income tax purposes related to exploratory and development activities funded by flow-through share arrangements are renounced to investors in accordance with tax legislation. Future tax liabilities and share capital are adjusted by the estimated cost of the renounced tax deductions when the expenses are renounced.

### *j) Stock based compensation plan*

The company has a stock option plan for directors and employees. The stock option plan is described in note 8. Any consideration paid by holders of the stock options is credited to share capital. No compensation expense is recorded either on the granting or exercise of options under the plan.

### *k) Per share information*

Basic per share amounts are calculated using the weighted average number of shares outstanding during the year. Diluted per share amounts are calculated based on the treasury-stock method, which assumes that any proceeds obtained on exercise of options would be used to purchase common shares at the average market price during the period. The weighted average number of shares outstanding is then adjusted by the net change.

## 4. CAPITAL ASSETS

	2003	2002
Petroleum and natural gas properties	\$ 31,959,756	\$ 17,921,591
Less: Accumulated depletion and depreciation	(26,821,709)	(9,528,802)
	<b>\$ 5,138,047</b>	<b>\$ 8,392,789</b>

During the year ended December 31, 2003, the company capitalized administrative overhead charges of \$594,911 (2002 – \$512,554) relating to exploration and development activities.

The Company incurred a ceiling test writedown of \$16.7 million for the year ended December 31, 2003 (2002 – \$3.7 million) related to the Beaver River Project (see note 1). This amount is included in the depletion, depreciation and amortization provision on the income statement.

At December 31, 2003, petroleum and natural gas properties included \$4.3 million (2002 - \$3.5 million) relating to unproved properties which have been excluded from the depletion and depreciation calculation. All costs associated with the Beaver River property, excluding geological and geophysical costs of \$2.6 million were written down and included in depletion for the year. Questerre does not include costs of \$1.7 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 Quebec property remains undeveloped at December 31, 2003.

# Questerre Energy Corporation

## Notes to Consolidated Financial Statements

For the Years ended December 31, 2003 and 2002

### 5. BEAVER RIVER PROJECT

On January 12, 2001, the company executed the Beaver River Farmout and Operating Agreement (the "Beaver River Agreement") whereby the company earned a 60% interest in the Beaver River natural gas field and project (collectively, the "project") subject to a lien until the company has completed a specified work program and spent a minimum \$5,000,000 on the project (increased to \$9,000,000 effective June 2001). Any amounts spent by the company under the Beaver River Agreement for the specified work program are accumulated in an account (the "Payout Amount") and cash flow is shared by the company and the Farmers as follows:

- a) 4% override payable to the Farmers until the company receives 6 times the Payout Amount
- b) then, the company receives cash flow as follows:
  - 100% until 1 times Payout Amount received;
  - 80% until 2 times Payout Amount received and an Environmental Reserve has been fully funded, such Environmental Reserve to be determined by the company and set aside to cover future abandonment and reclamation expenses;
  - 70% until 6 times Payout Amount received;
  - 60% thereafter
- c) Effective April 1, 2002 the specified work program was completed. At December 31, 2003, the Payout Amount balance was \$10,923,075. For the year ended December 31, 2003, the company received \$221,932 (2002 – \$119,146) of cash flow applicable to the Payout Amount.
- d) In August 2003 QBR began a re-entry operation on the A-5 wellbore 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 a 600% penalty. Operating cash flows from the well must be applied against the 600% penalty payout prior to being applied against the Payout Amount noted in c) above.

### 6. 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 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.

### 7. DEFERRED CROWN ROYALTIES

Royalties payable to the Province of British Columbia on production from the Beaver River Project are governed by a Royalty Agreement between the Province and the Joint Venture partners dated April 1, 1999 and amended October 1, 2001. Until the earlier of June 30, 2004 and cumulative production of 13 bcf from the Project, royalties payable to the Crown are deferred. Repayment of deferred royalties is contingent on the success of the experimental project for which the deferral was granted and on monthly production exceeding volumes established by the Crown. At December 31, 2003, the Company has adjusted the liability to Nil (2002 - \$1,439,409) on the basis that the conditions for repayment do not exist.

# Questerre Energy Corporation

## Notes to Consolidated Financial Statements

For the Years ended December 31, 2003 and 2002

### 8. 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 December 31, 2003, 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, 2001 and 2002	26,835,000	\$ 10,758,029
Issued on termination of Terrenex farmout agreement	750,000	750,750
Issued for cash	3,478,980	3,528,333
Flow through shares issued for cash	5,038,600	5,127,356
Issued on conversion of preferred shares	4,500,000	4,500,000
Issued for cash on exercise of warrants	1,509,666	1,673,212
Share issue costs	–	(1,058,100)
<b>Balance, December 31, 2003</b>	<b>42,112,246</b>	<b>\$ 25,279,580</b>
<b>Warrants</b>		
Balance, December 31, 2001	3,690,000	\$ –
Issued to Terrenex on extension of farmout agreement	150,000	–
Balance, December 31, 2002	3,840,000	\$ –
Issued for cash	5,338,330	26,692
Issued for broker commission	413,592	2,068
Issued to Terrenex on extension of farmout agreement	150,000	750
Exercised for common shares	(1,509,666)	(750)
<b>Balance, December 31, 2003</b>	<b>8,232,256</b>	<b>\$ 28,760</b>
<b>Total Common Share Capital</b>		<b>\$ 25,308,340</b>

On June 18, 2003, the shareholders of the company, at the annual and special meeting of the shareholders, approved a subdivision of the company's common shares on a three-for-one basis. The effect on the company's common shares at December 31, 2002 was an increase from 8,945,000 common shares to 26,835,000 common shares. All common share and per share information in these financial statements has been restated to give effect to the subdivision.

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.

The Company has a commitment to spend \$1.0 million in 2004 on qualifying expenditures pursuant to the December 31, 2003 flow through private placement. All of the expenditures were renounced effective December 31, 2003 but were incurred in 2004.

## Questerre Energy Corporation

### Notes to Consolidated Financial Statements

For the Years ended December 31, 2003 and 2002

#### c) Issued and outstanding

6% cumulative redeemable convertible preferred shares Series I issued January 19, 2001

	Number	Amount
Balance, December 31, 2001 and 2002	4,500,000	\$ 4,500,000
Converted into Class A common shares	(4,500,000)	(4,500,000)
<b>Balance, December 31, 2003</b>	<b>-</b>	<b>\$ -</b>

On December 22, 2003, Terrenex Acquisition Corporation and its wholly owned subsidiary Cabernet Holdings Ltd. redeemed their preferred shares for Class A common shares at a deemed price of \$1.00 per share.

#### d) Per share amounts

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

	2003	2002
Basic and Diluted	<b>30,816,683</b>	26,835,000

There are no reconciling items between the basic and diluted average common shares.

#### e) Warrants

On August 23, 2002, the company signed an agreement with Terrenex to extend the deadline for drilling a test well under the St. Lawrence Lowlands Farmout agreement to February 28, 2003 in exchange for 150,000 common share warrants in the company. Such warrants are exercisable for a period of 2 years from September 1, 2002, at a price of US\$0.83 for each common share.

On February 28, 2003, the Company issued 150,000 common share warrants to Terrenex Acquisition Corporation in exchange for an extension under the St. Lawrence Lowlands Farmout agreement. The warrants are exercisable for a period of two years from February 28, 2003, at a price of US\$0.83 per common share.

On July 18, 2003 pursuant to a prospectus offering, the Company issued 5,338,330 common share warrants. The Company also issued 413,592 common share warrants to brokers as commission on the financing. Each warrant entitles the holder to acquire one common share at a price of \$1.50 per common share until December 31, 2003 and thereafter at \$2.00 per common share until December 31, 2004. All of the warrants issued remain outstanding at December 31, 2003.

#### f) 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.

## Questerre Energy Corporation

### Notes to Consolidated Financial Statements

For the Years ended December 31, 2003 and 2002

The following table sets forth a reconciliation of the stock option plan activity for the years ended December 31, 2002 and December 31, 2003:

	2003		2002	
	Number of Options	Weighted Avg Exercise Price	Number of Options	Weighted Avg Exercise Price
Outstanding, beginning of year	2,788,500	\$ 1.30	2,659,500	\$ 1.29
Granted	1,020,000	1.23	633,000	1.50
Expired / Forfeited	(165,000)	1.35	(504,000)	1.50
Outstanding, end of year	3,643,500	\$ 1.28	2,788,500	\$ 1.30
Exercisable, end of year	2,242,542	\$ 1.28	1,491,363	\$ 1.29

The outstanding options have a range of exercise prices between \$1.00 per share and \$1.50 per share, and a weighted average number of years to expiry of 3.0 (2002 – 1.4). 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 2.4 (2002 – 1.28).

#### g) Stock-based compensation costs

The Company accounts for its stock based compensation plan using the settlement value method. Under this method, no costs are recognized in the financial statements for share options granted to employees or directors when the options are issued at market value. If the fair value method had been used, the Company's net loss would have approximated the following pro forma amounts:

	2003	2002
Stock based compensation costs	\$ 70,527	\$ –
Net loss		
As reported	\$ (17,184,625)	\$ (5,556,615)
Pro forma	\$ (17,255,152)	\$ (5,556,615)
Net loss per share		
As reported	\$ (0.56)	\$ (0.21)
Pro forma	\$ (0.56)	\$ (0.21)

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

# Questerre Energy Corporation

## Notes to Consolidated Financial Statements

For the Years ended December 31, 2003 and 2002

### 9. 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:

	2003	2002
Loss before income taxes	\$ (17,184,625)	\$ (5,545,216)
Combined federal and provincial tax rate	35.22%	42.24%
Computed "expected" income tax expense	(6,052,425)	(2,342,299)
Increase (decrease) in income taxes resulting from:		
Non-deductible crown charges and recoveries	(481,285)	171,325
Resource allowance	-	(38,906)
Tax rate reduction	(495,148)	-
Unrecognized tax benefit of accounting losses	7,028,858	2,209,880
Future income taxes	-	-
Capital taxes	-	11,399
	\$ -	\$ 11,399

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

	2003	2002
Future income tax assets:		
Property, plant and equipment	\$ 5,325,981	\$ 2,730,808
Future site restoration	234,489	102,916
Share issue expenses	293,051	-
Non-capital loss carryforwards (expire 2007-2011)	1,199,865	232,053
Valuation adjustment	(6,707,186)	(3,065,777)
	346,200	-
Future income tax liabilities:		
Flow through share renouncements to be incurred	(346,200)	-
	(346,200)	-
Net future income tax liability	\$ -	\$ -

### 10. FINANCIAL INSTRUMENTS

The company's financial instruments included in the balance sheet are comprised of accounts receivable, accounts payable and accrued liabilities and bank debt. 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 debt approximates its carrying amount as the interest rate approximates market.

The fair value of current liabilities is indeterminable at this time and is subject to proceedings under CCAA as disclosed in note 1.

Virtually all of the company's accounts receivable are for refundable taxes. The Company is not exposed to significant credit risks. At December 31, 2003, the Company recorded an allowance for doubtful accounts in the amount of \$650,000 (2002 - Nil) related to outstanding accounts receivable from industry partners.

# Questerre Energy Corporation

## Notes to Consolidated Financial Statements

For the Years ended December 31, 2003 and 2002

### 11. RELATED PARTY TRANSACTIONS

In July 2002, the company exchanged an asset valued at \$20,000 for a fixed asset valued at the same amount from a company with two directors who are also directors of the company. The transactions were recorded at the exchange amount and were in the normal course of business.

On August 23, 2002, the company signed an agreement with Terrenex Acquisition Corporation to extend the deadline for drilling a test well under the St. Lawrence Lowlands Farmout agreement to February 28, 2003 in exchange for 150,000 common share warrants in the company. Three directors of Questerre are also directors of Terrenex.

On February 28, 2003, the Company issued 150,000 common share warrants to Terrenex in exchange for an extension under the St. Lawrence Lowlands Farmout agreement. On May 12, 2003, the Company issued 750,000 common shares to Terrenex as consideration for the termination of the St. Lawrence Lowlands Farmout agreement. Subsequent to the termination of the agreement, Questerre successfully obtained the gas exploration licenses previously held by Terrenex which had been covered by the Farmout agreement.

At December 31, 2003, Questerre had amounts owing to Terrenex totalling \$1,237 (2002 – \$2,333).

Questerre incurred fees of \$126,000 in the year ended December 31, 2003 (2002 – \$126,000) with a company with common directors and officers. The transactions were in the normal course of business as the fees were 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.

### 12. SUBSEQUENT EVENTS

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 \$3,156,003. Proceeds from the offering will be used to finance the completion and tie-in of the exploration well at the Beaver River Field.

On April 1, 2004, Questerre Beaver River Inc., a wholly owned subsidiary of Questerre Energy Corporation, was granted an order by the Court of Queen's Bench of Alberta providing for creditor protection under the *Companies' Creditors Arrangement Act* ("CCAA"). The initial order was amended by the Court on April 30, 2004 to provide for a general stay period that expires on June 30, 2004. The order may be further amended by the Court throughout the CCAA proceedings based on motions from the Company, its creditors and other interested parties.

Subsequent to year end, statements of claim have been filed by various parties against the Company and its subsidiary, QBR. All of the claims relate to the provision of services and materials for the drilling of the Beaver River well. The amounts claimed have been fully provided for as part of accounts payable at December 31, 2003. The outcome of the lawsuits is dependent, in part, on the CCAA process (note 1) and is unknown at this time.

## 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

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### LEGAL COUNSEL

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#### STOCK INFORMATION

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Warrants: QEC.WT



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