

## 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*



David Mallory  
*Interim Chief Financial Officer*

Calgary, Alberta, Canada  
March 22, 2005

## AUDITORS' REPORT

### To the Shareholders of Questerre Energy Corporation

We have audited the consolidated balance sheets of Questerre Energy Corporation as at December 31, 2004 and 2003 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, 2004 and 2003 and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

*PricewaterhouseCoopers LLP*

*Chartered Accountants*

Calgary, Alberta Canada  
March 22, 2005

## CONSOLIDATED BALANCE SHEETS

	December 31 2004	December 31 2003
		(as restated – note 3)
<b>Assets</b>		
Current assets		
Cash	2,701,477	\$ 1,678,611
Accounts receivable	218,249	623,544
Inventory	141,373	680,036
Deposits and cash calls paid	502,522	–
	<b>3,563,621</b>	2,982,191
Restricted Cash (note 7)	100,000	100,000
Petroleum and natural gas properties – net of accumulated depletion and depreciation (note 5)		
British Columbia	3,346,186	3,262,696
Alberta	1,024,584	182,387
Quebec	1,769,288	1,713,563
	<b>6,140,058</b>	5,158,646
	<b>9,803,679</b>	8,240,837
<b>Liabilities</b>		
Current liabilities		
Accounts payable and accrued liabilities	572,033	\$ 7,225,137
Bank loan (note 7)	234,500	314,900
	<b>806,533</b>	7,540,037
Promissory note payable (note 8)	600,000	–
Asset retirement obligation (notes 2 and 10)	1,848,503	848,134
	<b>3,255,036</b>	8,388,171
<b>Shareholders' Equity</b>		
Common shares (note 11)	31,339,389	25,308,340
Contributed surplus (note 11)	41,952	–
Deficit	(24,832,698)	(25,455,674)
	<b>6,548,643</b>	(147,334)
Going Concern Matters (notes 1 and 2)		
	<b>9,803,679</b>	\$ 8,240,837

See accompanying notes to consolidated financial statements.

Approved by the Board of Directors

  
Director

  
Director

## CONSOLIDATED STATEMENTS OF INCOME AND DEFICIT

	For the years ended December 31,	
	2004	2003
	(as restated – note 3)	
<b>Revenue</b>		
Petroleum and natural gas revenue	1,942,523	1,495,702
Royalties	(306,427)	(146,410)
Recovery of deferred crown royalties (note 9)	–	1,439,409
	<b>1,636,096</b>	<b>2,788,701</b>
<b>Expenses</b>		
Operating	1,718,803	1,141,527
General and administrative, net of overhead	737,600	1,001,874
Restructuring costs	430,219	–
Stock-based compensation (note 3)	(28,575)	–
Interest expense	69,984	64,754
Interest income	(25,033)	(53,022)
Gain on settlement of obligations (note 1)	(7,630,778)	–
Foreign exchange gain	1,803	–
Depletion and depreciation	7,402,949	17,303,209
Accretion on asset retirement obligation (notes 3 and 10)	91,190	55,485
	<b>2,768,162</b>	<b>19,513,827</b>
<b>Net income (loss) before income taxes</b>	<b>(1,132,066)</b>	<b>(16,725,126)</b>
<b>Taxes</b>		
Future tax recovery	1,825,569	–
	<b>1,825,569</b>	<b>–</b>
<b>Net income (loss)</b>	<b>693,503</b>	<b>(16,725,126)</b>
Deficit, beginning of period	(25,455,674)	(8,322,347)
<b>Restatement for changes in accounting policies</b>		
Stock-based compensation (note 3)	(70,527)	–
Asset retirement obligation (note 3)	–	(408,201)
<b>Deficit, end of period</b>	<b>(24,832,698)</b>	<b>(25,455,674)</b>
<b>Net income (loss) per share</b>		
Basic and diluted (note 11 (c))	<b>0.02</b>	<b>(0.54)</b>

*See accompanying notes to consolidated financial statements.*

## CONSOLIDATED STATEMENTS OF CASH FLOWS

	For the years ended December 31,	
	2004	2003
	(as restated – note 3)	
<b>Cash provided by (used in):</b>		
<b>Operating Activities</b>		
Net income (loss)	693,503	(16,725,126)
Items not affecting cash		
Depletion and depreciation	7,402,949	17,303,209
Accretion on asset retirement obligation	91,190	55,485
Gain on settlement of obligations	(7,630,778)	–
Stock-based compensation expense	(28,575)	–
Future tax recovery	(1,825,569)	–
	(1,297,280)	633,568
Deferral of crown royalties	–	(1,439,409)
Net change in non-cash working capital	377,459	(18,382)
	(919,821)	(824,223)
<b>Financing Activities</b>		
Issue of common shares	8,238,452	10,355,593
Share issue costs	(353,234)	(1,056,032)
Proceeds of promissory note	600,000	–
Repayment of bank loan	(80,400)	(51,600)
Net change in non-cash working capital	7,602,180	–
	16,006,998	9,247,961
<b>Investing Activities</b>		
Expenditures on petroleum and natural gas properties	(7,475,182)	(13,287,416)
Net change in non-cash working capital	(6,589,129)	5,987,285
	(14,064,311)	(7,300,131)
Increase in cash	1,022,866	1,123,607
Cash, beginning of period	1,678,611	555,004
<b>Cash, end of period</b>	<b>2,701,477</b>	<b>1,678,611</b>

See accompanying notes to consolidated financial statements.

During the year ended December 31, 2004, the Company paid \$69,984 (2003 – \$64,754) of cash interest and \$Nil in cash taxes (2003 – \$Nil).

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*For the years ended December 31, 2004 and 2003*

## 1 Corporate Restructuring

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

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

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

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

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

The Common Shares that would otherwise have been issued to these unsecured creditors were issued to Terrenex Acquisition Corporation ("Terrenex"), a related party, pursuant to the terms of the Liquidity Option Agreement (See Note 14). In consideration, Terrenex established a fund to finance the liquidity option up to a maximum of \$668,500.

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

## 2 Nature of Operations and Basis of Presentation

Questerre is primarily involved in the exploration and development of naturally fractured and hydrothermally dolomitized reservoirs. As at December 31, 2004, the Company has four primary projects – the Beaver River Field in British Columbia (note 5), the St. Lawrence Lowlands in Quebec, Simonette, and Parkland and Vulcan areas in Alberta. Questerre also holds minority interests in producing, non-operated properties in Alberta.

The St. Lawrence Lowlands, Simonette and Parkland and Vulcan projects remained unproved at December 31, 2004.

Subsequent to year-end, the Company participated in the drilling of an exploration well at Simonette for an estimated net cost of \$1.0 million. The well did not encounter any commercial hydrocarbons and was subsequently abandoned. The Company does not have any further financial commitments with regard to this project.

The Company has participated in the drilling of three wells in the Parkland and Vulcan areas at a cost of \$1.4 million during the last quarter of 2004 and first quarter of 2005. Subject to successful production testing, the Company anticipates these wells will be tied in and placed on production. Questerre plans to participate in further drilling in these areas in 2005.

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

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

## 3 Change in Accounting Policies

### *a) Full cost accounting guideline*

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

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

The Company recorded a \$6.2 million ceiling test write-down for the year ended December 31, 2004 related to the Field. In addition, the Company recorded a \$0.2 million write-down relating to its share of an unsuccessful well drilled in Quebec. The write-down is included in the depletion and depreciation provision on the income statement.

*b) Asset retirement obligation*

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

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

The previously reported amounts for 2003 have been restated due to the retroactive application of this new standard. Adoption of this standard had the following effects on the Company's consolidated balance sheet and statement of income and deficit for the year ended December 31, 2003 :

Increase in petroleum and natural gas properties	\$ 20,600
Decrease in future site restoration and abandonment liability	878,833
Increase in asset retirement obligation	(848,134)
Increase in opening deficit	408,201
Decrease in site restoration expense	(525,285)
Increase in depletion and depreciation expense	10,300
Increase in asset retirement obligation accretion expense	55,485

*c) Stock based compensation plan*

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

Under this amended standard, the Company must account for compensation expense based on the fair value of rights granted under its stock-based compensation plan (see note 11(e)). Compensation cost attributable to share options granted to employees or directors is measured at fair value at the grant date and expensed over the expected exercise time frame with a corresponding increase to contributed surplus. Upon exercise of the stock options, consideration paid by the unit holder together with the amount previously recognized in contributed surplus is recorded as an increase to share capital.

As a result of adopting this change in accounting policy, the consolidated financial statements at January 1, 2004 were changed as follows: contributed surplus increased by \$70,527 and the opening deficit was increased by \$70,527. Net income for 2004 included stock-based compensation expense of (\$28,575) for the year ended December 31, 2004. This was due to a recovery realized on the cancellation of share options previously expensed during the year, partially offset by the expense for share options subsequently issued.

## 4 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.

### *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) Measurement Uncertainty*

Depletion and depreciation, amounts used for ceiling test calculations and asset retirement obligations are estimates. The cost recovery ceiling test is based on estimates of oil and natural gas reserves and commodity prices, production expenses and capital costs required to develop and produce those reserves. By their nature, these estimates are subject to measurement uncertainty, and the impact of differences between actual and estimated amounts on the consolidated financial statements of future periods could be material.

### *d) Inventory*

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

### *e) Revenue recognition*

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

### *f) 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 Company reviews the carrying amount of its oil and natural gas properties (“the properties”) relative to their recoverable amount (“the ceiling test”) at each annual balance sheet date, or earlier if circumstances or events indicate impairment may have occurred. The recoverable amount is calculated as the undiscounted cash flow from the properties using proved reserves and expected future prices and costs. If the carrying amount of the properties exceeds their recoverable amount, then an impairment loss, equal to the amount by which the carrying amount of the properties exceeds the undiscounted cash flow from those properties using proved and probable reserves and expected future prices and costs, is recognized in depletion.

*f) Asset retirement obligation*

The fair value of asset retirement obligations related to long-term assets are recognized as a liability in the period in which they are incurred. The fair value of the asset retirement obligation is estimated by discounting the expected future cash flows to settle the asset retirement obligation at the Company’s credit adjusted risk free rate. Asset retirement costs equal to the discounted asset retirement obligation are capitalized as part of the cost of the associated capital asset and amortized to expense through depletion over the life of the asset. In subsequent periods, the asset retirement obligation is adjusted for the passage of time and for any changes in the amount or timing of the underlying future cash flows.

*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 11. The compensation cost attributable to share options granted is measured at fair value at the grant date and expensed over the expected exercise time frame with a corresponding increase in contributed surplus.

*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.

## 5 Capital Assets

	December 31 2004	December 31 2003
		(as restated – note 3)
Petroleum and natural gas properties	40,075,517	31,980,355
Less: Accumulated depletion and depreciation	(33,935,459)	(26,821,709)
	<b>6,140,058</b>	5,158,646

During the year ended December 31, 2004, the Company capitalized administrative overhead charges of \$326,619 (year ended December 31, 2003 – \$594,911) relating to exploration and development activities.

The Company incurred a ceiling testwrite-down of \$6.2 million for the year ended December 31, 2004 (December 31, 2003 – \$16.7 million) related to the Beaver River Field (see note 1). In addition, the Company incurred a depletion charge of \$0.8 million during the second quarter of the year for production from the Beaver River Field. The Company also incurred a write-down of \$0.2 million representing its share of costs of an unsuccessful well in Quebec. These amounts are included in the depletion and depreciation provision on the income statement.

At December 31, 2004, petroleum and natural gas properties included \$5.7 million (December 31, 2003 – \$4.3 million) relating to unproved properties which have been excluded from the depletion and depreciation calculation. All costs associated with the Beaver River Field, net of estimated salvage values, have been written down and included in depletion expense except \$2.9 million of geological and geophysical costs. These costs primarily relate to the 3-D seismic survey acquired over the Field in 2002. Management does not believe these assets are impaired as the data is a key component of the Company's plan for future development of the Field. Questerre does not include costs of \$1.8 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 \$1.0 million related to its exploration projects in the Simonette and Parkland/Vulcan areas in Alberta in its calculation of depletion or in costs subject to the ceiling test calculation. Both the projects in Alberta and in Quebec remain unproved at December 31, 2004.

## 6 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 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 a priority right to 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) Any remaining cash flow or deficiency is subsequently shared according to the partners working interest.
- d) Effective April 1, 2002 the specified work program was completed. At December 31, 2004, the Payout Amount balance was \$10,923,075. For the year ended December 31, 2004, the Company received \$nil (2003 – \$221,932) of cash flow applicable to the Payout Amount.
- e) In August 2003 QBR began the A-5 re-entry operation at 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.

## **7 Bank Loan**

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

## **8 Promissory Note Payable**

In June 2004, the Company obtained \$0.5 million on the issue of a \$0.5 million promissory note to Rupert's Crossing, an Investment Corporation ("Rupert's"). Rupert's is a private investment holding company controlled by the President and Chief Executive Officer of Questerre. The promissory note was originally due on November 14, 2004 with interest calculated at 12% per annum, payable monthly. The promissory note is secured by a General Security Agreement over the assets of the Company and the hypothecation of the Company's exploration licenses in Quebec.

In August 2004, the Company amended its \$0.5 million financing agreement with Rupert's when Rupert's advanced an additional \$0.1 million which was placed in trust with the Company's legal counsel. Upon the approval of the Plans, these funds were advanced to the Company on the same terms as the original \$0.5 million. The funds were used to finance a portion of the cash component of the Plans.

In October 2004, the Company further amended the terms of the \$0.5 million financing agreement with Rupert's when Rupert's advanced an additional \$0.08 million to the Company for general working capital. The advance was made on the same terms as the original advance of \$0.5 million. The \$0.08 million was repaid in December 2004.

In November 2004, the Company and Rupert's amended the terms of the financing agreement extending the due date of the promissory note from November 14, 2004 to November 14, 2006 and reducing the interest rate from 12% per annum to 8% per annum. The Company has been granted the right to prepay the entire amount or any portion thereof with 30 days' notice in writing to Rupert's. Rupert's has been granted an option, subject to regulatory approval, to convert the entire amount into Common Shares of the Company at a conversion rate of \$0.30 per Common Share. As at December 31, 2004, a total of \$0.6 million is due to Rupert's under this financing agreement.

## 9 Deferred Crown Royalties

Royalties payable to the Province of British Columbia on production from the Beaver River Field 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 Field, 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 adjusted the liability to Nil on the basis that the conditions for repayment do not exist. On the same basis, the Company did not accrue crown royalties on its Beaver River production in the first and second quarters of 2004.

The Company has accrued Crown royalties of \$0.14 million for the year ended December 31, 2004 on production from the Beaver River Field during the second half of 2004. Payment of this royalty is contingent on the Company reaching an agreement with the Ministry of Energy and Mines in British Columbia regarding its qualification for a deep royalty credit of \$2.2 million. Discussions are ongoing with the Ministry regarding the Company's qualification for this credit.

## 10 Asset Retirement Obligation

The total future asset retirement obligation was estimated by management based on Questerre's net ownership interest in all wells and facilities, estimated costs to reclaim and abandon the wells and facilities and the estimated timing of the costs to be incurred in future periods. The Company estimates its total asset retirement obligations to be \$1,848,503 at December 31, 2004. Questerre used a credit adjusted risk free rate of seven per cent and an inflation rate of two per cent to calculate the present value of the asset retirement obligation.

The following table provides a reconciliation of the Company's total asset retirement obligation:

	<b>December 31 2004</b>	December 31 2003
		(as restated – note 2)
Balance, beginning of period	\$ 848,134	\$ 792,646
Increase in estimate of obligation	909,179	
Accretion expense	91,190	55,488
<b>Balance, end of period</b>	<b>\$ 1,848,503</b>	<b>\$ 848,134</b>

## 11 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, 2004, there were no Class B common voting shares or preferred shares outstanding.

*b) Issued and outstanding – Class A common shares and common share warrants*

	Number	Amount
<b>Common Shares</b>		
Balance, December 31, 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)
Balance, December 31, 2003	42,112,246	\$ 25,279,580
Issued for cash	3,280,860	1,373,075
Flow through shares issued for cash	11,703,791	5,389,928
Issued for cash on exercise of warrants	31,995	32,155
Issued under Plans	9,623,012	1,443,454
Tax effect of flow-through share issue		(1,825,569)
Share issue costs	–	(353,234)
<b>Balance, December 31, 2004</b>	<b>66,751,904</b>	<b>\$ 31,339,389</b>
<b>Warrants</b>		
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)
Balance, December 31, 2003	8,232,256	\$ 28,760
Exercised for common shares	(31,995)	(160)
Expired	(8,200,261)	(28,600)
<b>Balance, December 31, 2004</b>	<b>–</b>	<b>\$ –</b>
<b>Total Common Share Capital</b>		<b>\$ 31,339,389</b>

**Common Shares**

In May 2003, the Company issued Terrenex Acquisition Corporation (“Terrenex”), a related party with common directors and officers, 750,000 common shares at a deemed price of \$1.00 per common share on the termination of a farmout agreement covering the St. Lawrence Lowlands licenses.

In July 2003, the Company successfully completed its initial public offering raising gross proceeds of \$7.4 million. The offering consisted of the issuance of 4,137,700 common shares, issued on a flow-through basis and 3,269,480 common shares.

The Company also completed three additional private placements in 2003 for combined gross proceeds of \$1.275 million on the issuance of 209,500 common shares and 900,900 flow-through shares.

On December 22, 2003, Terrenex and its wholly owned subsidiary, Cabernet Holdings Limited redeemed their 4,500,000 preferred shares for common shares at a deemed price of \$1.00 per common share.

In February 2004, the Company completed a private placement of 2,521,651 common shares for gross proceeds of \$3.156 million (\$2.945 million net of expenses). The placement consisted of the issuance of 1,878,791 common shares, on a flow-through basis, at a price of \$1.30 per common share and the issuance of 642,860 common shares at a price of \$1.11 per common share.

In September 2004, a total of 9,623,012 common shares were issued in connection with the implementation of the Plans of Arrangement in connection with the implementation of the corporate restructuring at a deemed price of \$0.15 per common share.

In December 2004, the Company completed a private placement of 12,463,000 common shares for gross proceeds of \$3.6 million (\$3.414 million net of expenses). The placement consisted of the issuance of 9,825,000 common shares, on a flow-through basis, at a price of \$0.30 per common share and the issuance of 2,638,000 common shares at a price of \$0.25 per common share.

#### **Warrants**

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. The warrants are exercisable for a period of two years from February 28, 2003, at a price of US\$0.83 per common share. These warrants were exercised in December 2003.

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. 31,995 broker warrants were exercised in January 2004. The remainder broker warrants and common share warrants expired on December 31, 2004.

#### *c) Per share amounts*

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

	<b>2004</b>	2003
Basic	<b>48,273,347</b>	30,816,683
Diluted	<b>48,817,849</b>	30,816,683

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

#### *d) Stock options*

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

The following table sets forth a reconciliation of the stock option plan activity for the year ended December 31, 2004:

	Number of Options	Weighted Avg. Exercise Price
Outstanding, December 31, 2003	3,643,500	\$ 1.28
Granted		
January 2004	313,000	1.41
September 2004	2,315,000	0.10
November 2004	50,000	0.25
December 2004	1,000,000	0.30
Cancelled	(3,956,500)	1.29
Outstanding, December 31, 2004	3,365,000	\$ 0.16
Exercisable, December 31, 2004	192,917	\$ 0.10

The outstanding options have a range of exercise prices from \$0.10 to \$0.30, and a weighted average number of years to expiry of 5.0 (2003 – 3.0). The exercisable options have an exercise price of \$0.10 and 5.0 years to expiry (2003 – 2.4).

*e) Stock-based compensation costs*

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

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

	2004	2003
Risk free interest rate (%)	3.0	3.0
Expected life (years)	3.0	3.0
Expected volatility (%)	173	60

*f) Contributed surplus*

The following table sets forth a reconciliation of contributed surplus for the year ended December 31, 2004:

Balance, December 31, 2003	\$	–
Adoption of stock based compensation		70,527
Stock based compensation expense		136,350
Cancellation of options		(164,925)
<b>Balance, December 31, 2004</b>	<b>\$</b>	<b>41,952</b>

## 12 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:

	Year ended December 31,	
	2004	2003
Net loss before income taxes	(1,131,066)	\$ (16,725,126)
Combined federal and provincial tax rate	38.66%	35.22%
Computed "expected" income tax recovery	(437,657)	(5,890,589)
Increase in income taxes resulting from:		
Non-deductible crown charges and recoveries	73,451	(481,285)
Tax rate reduction	45,208	(495,148)
Unrecognized tax benefit of accounting losses	318,908	6,867,022
Recognition of future income tax in recognition of tax on flow-through shares	(1,825,569)	
Future income tax recovery	(1,825,569)	\$ —

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

	December 31	December 31
	2004	2003
Future income tax assets:		
Property, plant and equipment	\$ 5,214,245	\$ 5,325,981
Asset retirement obligation	626,088	234,489
Share issue expenses	401,459	293,051
Non-capital loss carryforwards (expire 2011)	276,024	1,199,865
Valuation adjustment	(4,692,247)	(6,707,186)
	—	346,200
Future income tax liabilities:		
Flow through share renouncements to be incurred	(1,825,569)	(346,200)
	(1,825,569)	(346,200)
Net future income tax liability	\$ —	\$ —

Non-capital loss carryforwards at December 31, 2004 represent non-capital losses created in 2004 and, therefore, expire in 2011. The non-capital losses accumulated to December 31, 2003 were used to partially offset the taxable income related to the gain on settlement of obligations.

### **13 Financial Instruments**

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

Virtually all of the company's accounts receivable are for revenue due on production from the Field and the Company's minority interest in non-operated properties in Alberta. The Company is not exposed to significant credit risks.

### **14 Related Party Transactions**

At December 31, 2004, Questerre had amounts owing to Terrenex totaling \$5,040 (December 31, 2003 – \$1,237). All of the directors of Terrenex serve as directors or officers of Questerre.

In August 2004, the Company entered into a Liquidity Option Agreement with Terrenex to facilitate acceptance of the Plans by the unsecured creditors of Questerre and QBR. Pursuant to the Liquidity Option Agreement, Terrenex funded a payment of \$0.07 per Common Share to those unsecured creditors that did not wish to hold the Common Shares received under the Plans (the "Liquidity Option"). In consideration for this payment, Terrenex was issued that number of Common Shares that, but for their election to participate in the Liquidity Option, would have been issued to the unsecured creditors. The Common Shares issued to Terrenex are subject to the same contractual hold period were they issued to these unsecured creditors. For fulfilling its obligations under the Liquidity Option Agreement, Terrenex was issued 300,000 Common Shares of the Company.

On the approval of the Plans on August 31, 2004, unsecured creditors of Questerre and QBR with claims totalling \$6.7 million elected to participate in the Liquidity Option. Terrenex funded a payment of \$0.47 million to these unsecured creditors and was issued 6,756,102 Common Shares.

Questerre incurred fees of \$126,000 for the year ended December 31, 2004 (2003 – \$126,000) to a company with common directors and officers. The transactions were in the normal course of business paid pursuant to an Office Rental Agreement for the provision of office space, office equipment and support personnel. The agreement may be terminated by either party with six months' written notice.

In June 2004, Questerre entered into a farmout agreement with a director of the Company. The farmout agreement covers the Company's exploration acreage in the St. Lawrence Lowlands, Quebec utilizing the same terms and conditions of a farmout agreement with independent arms-length parties.

See Note 8 for an additional related party transaction.

### **15 Subsequent Events**

In January 2005, the Company filed a statement of claim against a seismic processing company in relation to seismic processing services provided to the Company and QBR. The seismic processing company is anticipated to file its statement of defence during the second quarter of 2005. At the present time, the Company is unable to ascertain the impact of this legal action on its financial position.