

## Management's Discussion and Analysis of Financial Condition and Results of Operations

The following Management Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") was prepared at, and is dated, February 27, 2009. This MD&A is provided by the management of Fairborne Energy Ltd. ("Fairborne" or the "Company") to review 2008 activities and results as compared to the previous year, and should be read in conjunction with the audited consolidated financial statements including notes for the years ended December 31, 2008 and 2007. Additional information relating to Fairborne, including Fairborne's annual information form, is available on SEDAR at [www.sedar.com](http://www.sedar.com).

**Nature of Business:** Fairborne is a growth-oriented exploration and production company resulting from the reorganization of Fairborne Energy Trust (the "Trust") on December 19, 2007 (the "Reorganization"). If the context requires, reference herein to "Fairborne" also includes a reference to the Trust prior to the Reorganization.

The Company maintains its head office in Calgary and is engaged in the business of exploring for, developing, acquiring and producing crude oil and natural gas in Western Canada. Fairborne follows a strategy of balancing risk and reward by focusing on opportunities by geographic area and prospect type. Within these selected areas, the Company develops a portfolio of exploration and development prospects in conjunction with an active acquisition strategy.

**Forward Looking Statements:** This document contains forward-looking statements. Management's assessment of future plans and operations, capital expenditures, methods of financing capital expenditures and the ability to fund financial liabilities, expected commodity prices and the impact on Fairborne, expected increase in royalty rates, and the timing of and impact of adoption of IFRS and other accounting policies may constitute forward-looking statements under applicable securities laws and necessarily involve risks including, without limitation, risks associated with oil and gas exploration, development, exploitation, production, marketing and transportation, loss of markets, volatility of commodity prices, currency fluctuations, imprecision of reserve estimates, environmental risks, competition from other producers, inability to retain drilling rigs and other services, incorrect assessment of the value of acquisitions, failure to realize the anticipated benefits of acquisitions, the inability to fully realize the benefits of the acquisitions, delays resulting from or inability to obtain required regulatory approvals and ability to access sufficient capital from internal and external sources. As a consequence, the Company's actual results may differ materially from those expressed in, or implied by, the forward looking statements. Forward looking statements or information are based on a number of factors and assumptions which have been used to develop such statements and information but which may prove to be incorrect. Although Fairborne believes that the expectations reflected in such forward looking statements or information are reasonable, undue reliance should not be placed on forward looking statements because the Company can give no assurance that such expectations will prove to be correct. In addition to other factors and assumptions which may be identified in this document and other documents filed by the Company, assumptions have been made regarding, among other things: the impact of increasing competition; the general stability of the economic and political environment in which Fairborne operates; the ability of the Company to obtain qualified staff, equipment and services in a timely and cost efficient manner; drilling results; the ability of the operator of the projects which the Company has an interest in to operate the field in a safe, efficient and effective manner; Fairborne's ability to obtain financing on acceptable terms; field production rates and decline rates; the ability to replace and expand oil and natural gas reserves through acquisition, development or exploration; the timing and costs of pipeline, storage and facility construction and expansion; the ability of the Company to secure adequate product transportation; future oil and natural gas prices; currency, exchange and interest rates; the regulatory framework regarding royalties, taxes and environmental matters in the jurisdictions in which the Company operates; and Fairborne's ability to successfully market its oil and natural gas products. Readers are cautioned that the foregoing list of factors is not exhaustive. Additional information on these and other factors that could affect the Company's operations and financial results are included in reports on file with Canadian securities regulatory authorities and may be accessed through the SEDAR website ([www.sedar.com](http://www.sedar.com)) or at the Company's website ([www.fairborne-energy.com](http://www.fairborne-energy.com)). Furthermore, the forward looking statements contained in this document are made as at the date of this document and the Company does not undertake any obligation to update publicly or to revise any of the included forward looking statements, whether as a result of new information, future events or otherwise, except as may be required by applicable securities laws.

**Non-GAAP Terms:** This document contains the terms "funds generated from operations", "funds generated from operations per share", "cash flow from operations per share" and "netbacks" which are non-GAAP terms. The Company uses these measures to help evaluate its performance. The Company considers corporate netbacks a key measure as it demonstrates its profitability relative to current commodity prices. The Company considers funds generated from operations a key measure as it demonstrates Fairborne's ability to generate funds necessary to repay debt and to fund future growth through capital investment. Funds generated from operations should not be considered as an alternative to, or more meaningful than, cash flow from operating activities as determined in accordance with Canadian GAAP as an indicator of Fairborne's performance. Fairborne's determination of funds generated from operations may not be comparable to that reported by other companies. The reconciliation between cash flow from operations and funds generated from operations can be found in the statement of cash flows in the consolidated financial statements with funds generated from operations calculated before non-cash working capital and asset retirement expenditures. Fairborne also presents funds generated from operations per share and cash flow from operations per share whereby per share amounts are calculated using weighted average shares outstanding consistent with the calculation of income per share.

**BOE Conversions:** Barrel of oil equivalent ("BOE") amounts may be misleading, particularly if used in isolation. A BOE conversion ratio has been calculated using a conversion rate of six thousand cubic feet of natural gas to one barrel and one tonne of sulphur to one barrel. This conversion ratio of six thousand cubic feet of natural gas to one barrel is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead.

## M D & A

### HIGHLIGHTS

*Financial* (\$thousands, except per share amounts)

	2008	2007	change
Petroleum and natural gas revenue	<b>338,942</b>	213,791	59%
Funds generated from operations <sup>(1)</sup>	<b>189,175</b>	108,107	75%
Per share – basic	<b>\$2.20</b>	\$1.84	20%
Per share – diluted	<b>\$2.19</b>	\$1.78	23%
Cash flow from operations (including changes in working capital)	<b>187,798</b>	115,637	62%
Per share - basic	<b>\$2.19</b>	\$1.96	12%
Per share - diluted	<b>\$2.18</b>	\$1.90	15%
Net income	<b>44,701</b>	15,034	197%
Per share – basic	<b>\$0.52</b>	\$0.26	100%
Per share – diluted	<b>\$0.52</b>	\$0.25	108%
Exploration and development expenditures	<b>238,128</b>	71,959	231%
Acquisitions, net of dispositions	<b>135,544</b>	237,461	(43%)
Working capital deficit	<b>27,917</b>	7,467	274%
Bank indebtedness	<b>196,282</b>	86,866	126%
Convertible debentures	<b>94,522</b>	92,455	2%

*Operations* (Units as noted)

Average production			
Natural gas (Mcf per day)	<b>62,122</b>	52,899	17%
Crude oil (bbls per day)	<b>3,083</b>	2,480	24%
Natural gas liquids (bbls per day)	<b>611</b>	490	25%
Sulphur (tonnes per day) <sup>(2), (4)</sup>	<b>146</b>	–	–
Total (BOE per day)	<b>14,193</b>	11,786	20%
Average sales price			
Natural gas (\$ per Mcf) <sup>(3)</sup>	<b>8.51</b>	7.16	19%
Crude oil (\$ per bbl) <sup>(3)</sup>	<b>86.34</b>	73.57	17%
Natural gas liquids (\$ per bbl)	<b>61.62</b>	47.64	29%
Sulphur (\$ per tonne) <sup>(3)</sup>	<b>257.87</b>	–	–
Netback per BOE (\$ per BOE)			
Petroleum and natural gas sales <sup>(3)</sup>	<b>61.89</b>	49.95	24%
Royalties	<b>(11.07)</b>	(7.93)	40%
Operating expenses	<b>(10.07)</b>	(8.96)	12%
Transportation	<b>(1.01)</b>	(0.83)	22%
Operating netback	<b>39.74</b>	32.23	23%

(1) Funds generated from operations is calculated using cash flow from operations as presented in the consolidated statement of cash flows before non-cash working capital and asset retirement expenditures.

(2) A BOE conversion ratio has been calculated using a conversion rate of one tonne of sulphur to one barrel.

(3) Excludes unrealized gains and losses on derivatives and revenue from the sale of inventory at the West Pembina sulphur block.

(4) Excludes the sale of inventory at the West Pembina sulphur block.

## M D & A

### CORPORATE ACQUISITION – GRAND BANKS ENERGY CORPORATION (“GRAND BANKS”)

In June 2008, Fairborne Energy Ltd. (“Fairborne” or the “Company”) acquired all of the issued and outstanding common shares of Grand Banks by way of a takeover bid. As consideration for the acquisition, Fairborne paid Grand Banks shareholders \$2.90 per share for a total of \$102.1 million and assumed \$10.7 million of net debt. With operations focused in southeast Saskatchewan, southwest Manitoba and west central Alberta, the acquisition provided Fairborne with the opportunity to establish a new core operated area in a favourable royalty environment, providing premium netbacks. Production from Grand Banks’ properties at the time of the acquisition was approximately 1,500 BOE per day (50% oil and 50% gas). Results of operations from Grand Banks have been included in Fairborne’s results beginning June 13, 2008.

### COMPARATIVE INFORMATION – RESTRUCTURING

On December 19, 2007, Fairborne Energy Trust (the “Trust”) converted into Fairborne, a growth-oriented, exploration and production company (the “Reorganization”). The Reorganization of Fairborne from a trust to a company has been accounted for on a continuity of interest basis and, accordingly, the comparative consolidated financial statements for 2007 reflect the financial position, results of operations and cash flows as if the Company had always carried on the business formerly carried on by the Trust.

### SELECT ANNUAL INFORMATION

<i>(\$thousands, except per share amounts)</i>	2008	2007	2006 <sup>(1)</sup>
Petroleum and natural gas revenue	<b>338,942</b>	213,791	204,129
Funds generated from operations	<b>189,175</b>	108,107	112,897
Per share – basic	<b>\$2.20</b>	\$1.84	\$2.39
Per share – diluted	<b>\$2.19</b>	\$1.78	\$2.05
Cash flow from operations (including changes in working capital)	<b>187,798</b>	115,637	107,774
Per share – basic	<b>\$2.19</b>	\$1.96	\$2.28
Per share – diluted	<b>\$2.18</b>	\$1.90	\$1.97
Net income	<b>44,701</b>	15,034	44,079
Per share – basic	<b>\$0.52</b>	\$0.26	\$0.93
Per share – diluted	<b>\$0.52</b>	\$0.25	\$0.90
Total assets	<b>1,013,177</b>	749,715	539,579
Working capital (surplus) deficit	<b>27,917</b>	7,467	(7,158)
Long term financial liabilities			
Bank indebtedness	<b>196,282</b>	86,866	101,156
Convertible debentures	<b>94,522</b>	92,455	90,302
Non-controlling interest	–	–	27,132
Asset retirement obligations	<b>11,904</b>	9,084	10,994
Future income taxes	<b>81,860</b>	45,039	41,592
Cash distributions per unit	–	\$1.07	\$1.56
Shareholders’ equity/unitholders’ equity	<b>537,775</b>	457,188	200,715

(1) Amounts shown prior to the effective date of the Reorganization are in respect of the Trust and per share numbers are per unit.

## M D & A

In 2006, in its first full year as a trust, Fairborne met its objective to maintain stable production, funds generated from operations and distributions to unitholders by focusing on the development of its core properties and using an active commodity price risk management program. In a year marked by volatility in natural gas prices, the Trust recorded \$112.9 million in funds generated from operations (\$2.39 per unit), of which 65% was distributed to unitholders (\$1.56 per unit) through consistent monthly distributions of \$0.13 per unit. The balance of funds generated from operations was used, in part, to fund capital expenditures of \$92.0 million, which included a property acquisition of \$22.4 million. The Trust's capital program was focused on the development of core properties with 62 wells drilled (32.3 net) resulting in 24 (9.7 net) natural gas wells, 30 (17.9 net) coal bed methane ("CBM") wells and five (3.2 net) oil wells. Financing for the remainder of the 2006 capital program was obtained through a combination of bank debt and proceeds from a \$100 million convertible debenture financing completed in October 2006.

The year 2007 was a year of repositioning and restructuring for Fairborne. In response to the federal government's announcement to tax trusts beginning in 2011, Fairborne began evaluating alternatives that would add more value for its stakeholders. Effective June 4, 2007 Fairborne acquired Fairquest Energy Limited ("Fairquest") and added approximately 2,800 BOE per day of production, 11.3 million proved plus probable reserves and over 68,000 net acres of undeveloped land. The Fairquest acquisition provided the Trust with the unique opportunity to increase its interest and participation in exploitation and exploration prospects in its existing areas of focus. Fairborne recorded \$108.1 million in funds generated from operations (\$1.84 per share) in 2007, and paid total distributions of \$1.07 per unit prior to the Reorganization. The balance of funds generated from operations was used primarily to fund capital expenditures of \$72.0 million. During 2007, and prior to the Reorganization, Fairborne's capital program was focused on maintaining stable production through the development of its core properties. This program resulted in 62 wells drilled (39.1 net) which included 20 (9.7 net) natural gas wells, 40 (28.0 net) CBM wells and one (1.0 net) oil well.

In December 2007, Fairborne successfully completed its plan to convert into a growth-oriented, exploration and production company. Concurrent with the closing of the Reorganization, Fairborne completed a private placement equity financing by issuing approximately 13.4 million common shares for aggregate proceeds of \$100 million. The restructuring coupled with the equity financing of \$100 million significantly improved Fairborne's financial flexibility and positioned the Company as a high growth natural gas focused exploration and production company. Proceeds from the private placement were used to reduce outstanding indebtedness, leaving Fairborne with \$86.9 million of bank debt on December 31, 2007 drawn against its borrowing base of \$220 million.

The year 2008 marked the first full year for Fairborne as a growth-oriented exploration and production company, following the conversion from a trust at the end of 2007. Fairborne successfully executed its new strategy of growth by increasing average daily production by 20% from 11,786 BOE per day in 2007 to 14,193 BOE per day in 2008. Fairborne achieved this level of growth in 2008 through an extensive capital program, with capital expenditures totaling \$238.1 million for the year, as well as the corporate acquisition of Grand Banks in June 2008 for \$102.1 million plus the assumption of \$10.7 million of net debt. In May 2008, the Company completed a private placement flow-through financing of 2.3 million common shares at a price of \$12.35 per flow-through common share for gross proceeds of \$28.4 million. Proceeds of the financing were used to partially fund Fairborne's exploration program.

## M D & A

Fairborne recorded \$189.2 million in funds generated from operations (\$2.20 per share) which was a 75% increase from the prior year, primarily due to higher production year over year and higher average prices for oil and natural gas in 2008. The increase in funds generated from operations during 2008 was used to fund an extensive capital program during the year which translated into 114 wells drilled (82.9 net), resulting in 57 (35.9 net) natural gas wells, 32 (24.1 net) CBM wells, 24 (21.9 net) oil wells and one (1.0 net) dry hole.

## QUARTERLY FINANCIAL INFORMATION

The following is a summary of select financial information for the quarterly periods indicated:

	2008			
	Q4	Q3	Q2	Q1
<i>Financial (\$thousands, except per share amounts)</i>				
Petroleum and natural gas revenue	85,165	97,489	85,670	70,618
Funds generated from operations	40,309	55,307	51,458	42,101
Per share – basic	\$0.46	\$0.64	\$0.60	\$0.50
Per share – diluted	\$0.46	\$0.63	\$0.60	\$0.50
Cash flow from operations (including changes in working capital)	37,693	65,598	41,650	42,857
Per share – basic	\$0.43	\$0.76	\$0.49	\$0.51
Per share – diluted	\$0.43	\$0.76	\$0.48	\$0.51
Net income	11,657	19,182	3,717	10,145
Per share – basic	\$0.14	\$0.22	\$0.04	\$0.12
Per share – diluted	\$0.14	\$0.22	\$0.04	\$0.12
Total assets	1,013,177	999,065	946,025	792,918
Working capital deficit	27,917	64,814	7,363	27,255
Bank indebtedness	196,282	161,302	180,977	85,634
Convertible debentures	94,522	94,020	93,499	92,977
<i>Operations</i>				
Average production				
Natural gas (Mcf per day)	69,460	62,601	59,529	56,813
Crude oil (bbls per day)	4,086	3,312	2,506	2,413
Natural gas liquids (bbls per day)	657	580	610	597
Sulphur (tonnes per day) <sup>(1)</sup>	138	129	106	210
Total (BOE per day)	16,458	14,454	13,143	12,689

(1) Excludes the sale of inventory at the West Pembina sulphur block.

## M D & A

	2007			
	Q4	Q3 <sup>(1)</sup>	Q2 <sup>(1)</sup>	Q1 <sup>(1)</sup>
<b>Financial</b> (\$thousands, except per share amounts)				
Petroleum and natural gas revenue	59,976	54,648	49,501	49,666
Funds generated from operations	29,363	27,164	25,547	26,033
Per share – basic	\$0.43	\$0.41	\$0.45	\$0.55
Per share – diluted	\$0.43	\$0.38	\$0.41	\$0.48
Cash flow from operations (including changes in working capital)	36,004	24,159	27,724	27,750
Per share – basic	\$0.53	\$0.37	\$0.47	\$0.59
Per share – diluted	\$0.53	\$0.34	\$0.43	\$0.52
Net income (loss)	(1,136)	2,271	6,739	7,160
Per share – basic	(\$0.03)	\$0.03	\$0.11	\$0.15
Per share – diluted	(\$0.03)	\$0.03	\$0.10	\$0.15
Total assets	749,715	732,276	753,661	561,906
Working capital (surplus) deficit	7,467	27,051	(11,594)	(7,093)
Bank indebtedness	86,866	159,834	179,120	119,645
Convertible debentures	92,455	91,933	91,389	90,819
<b>Operations</b>				
Average production				
Natural gas (Mcf per day)	59,194	58,435	48,689	45,060
Crude oil (bbls per day)	2,616	2,600	2,303	2,396
Natural gas liquids (bbls per day)	524	582	449	402
Total (BOE per day)	13,005	12,921	10,867	10,308

(1) Amounts shown prior to the effective date of the Reorganization are in respect of the Trust and per share numbers are per unit.

During the first two quarters of 2007, Fairborne's production remained stable, with fluctuations from quarter to quarter primarily due to interruptions on sales pipelines and gas facility turnarounds. Production levels increased during the third and fourth quarters of 2007 primarily as a result of the Fairquest acquisition in June 2007 and a successful drilling program throughout 2007. Production continued to increase throughout 2008, following the Company's conversion from a trust to a growth-oriented exploration and production company. Fairborne's extensive capital program and the acquisition of Grand Banks in June 2008 directly resulted in the consistent increases in production during 2008.

Fairborne's revenue and funds generated from operations over the past two years reflect the shift in Fairborne's strategy from a stable income generating trust to a growth-oriented exploration and production company. Throughout most of 2007, while Fairborne was still a trust, revenue and funds generated from operations reflected its stable production base with revenue variances from quarter to quarter largely influenced by changes in natural gas prices. Fairborne's active risk management program helped to stabilize revenues and funds generated from operations throughout 2007. In addition, increased revenues during the third and

## M D & A

fourth quarters of 2007 reflected the increase in production levels from the Fairquest acquisition. As Fairborne began 2008 as an exploration and production company, revenue and funds generated from operations began to increase in conjunction with a continual increase in prices for oil and natural gas and consistent production growth from an extensive exploration and development program. These increases continued throughout the first three quarters of 2008, with revenue and funds generated from operations decreasing in the fourth quarter with significant decreases in the prices for oil and natural gas more than offsetting increased production.

Fluctuations in Fairborne's net income over the past two years can be attributed to the conversion from a trust to a growth-oriented exploration and production company in December 2007 as well as the acquisitions of Fairquest in June 2007 and Grand Banks in June 2008. Net income during the first half of 2007 remained flat, consistent with stable cash flows. During the third quarter of 2007, net income decreased significantly as a result of the Fairquest acquisition which increased the Company's depletable asset base resulting in an increase to the DD&A rates. Net income during the fourth quarter of 2007 decreased further due to corporate reorganization costs of \$9.3 million that were incurred as a result of the Reorganization in December 2007. Net income increased significantly during the first quarter of 2008 with increased production and increasing prices. The decrease in net income during the second quarter of 2008 was directly attributable to increased compensation expense associated with the retention award program which began in December 2007. Compensation expense associated with this compensation plan is based on increases or decreases in the intrinsic value of the plan, being the difference between Fairborne's share price at the end of the period and the exercise price of the award. The intrinsic value of the plan is calculated at each reporting date and recognized in income using an accelerated accrual method. The Company's share price reached a peak during the second quarter of 2008 which resulted in a significant increase in compensation expense. Compensation expense of \$16.8 million related to the retention award program was recorded during that period. Net income increased again in the third quarter due to unprecedented high prices for oil and natural gas. This was followed by a decrease in net income during the fourth quarter of 2008 resulting from a significant decrease in the prices for oil and natural gas which more than offset a recovery of compensation expense of \$12.7 million in the same period due to the sharp decline in the Company's share price.

### FOURTH QUARTER 2008 RESULTS

Fairborne's average production of 16,458 BOE per day during the fourth quarter of 2008 was 27% higher than average production for the fourth quarter of the previous year (Q4 2007 – 13,005 BOE per day) and 14% higher than average production during the immediately preceding quarter (Q3 2008 – 14,454 BOE per day). Revenues of \$85.2 million for the fourth quarter were 13% lower than the preceding quarter (Q3 2008 – \$97.5 million) primarily due to the substantial decline in prices for oil and natural gas as compared to the third quarter of 2008. Fairborne reported net income of \$11.7 million in the fourth quarter of 2008, a decrease of 39% from the preceding quarter, primarily due to lower prices received for oil and natural gas, partially offset by increased production during the same period.

Fairborne recorded funds generated from operations of \$40.3 million (\$0.46 per share) during the fourth quarter of 2008 which was 37% higher than funds generated from operations for the fourth quarter of the previous year (Q4 2007 - \$29.4 million) and 27% lower than the immediately preceding quarter (Q3 2008 – \$55.3 million). This reflects the significant increase in production and the addition of sulphur revenue in the fourth quarter of 2008 as compared to the same period in 2007. The decrease in funds generated from operations in the fourth quarter of 2008 compared to the preceding third quarter highlights the impact of the sharp decline in average prices realized which more than offset the continued increase in production during the fourth quarter.

## M D & A

Capital expenditures in the fourth quarter of 2008 totaled \$51.3 million which included \$33.8 million for drilling and completions and \$15.4 million for well equipment and facilities. Fairborne drilled 9 (4.3 net) wells during the fourth quarter, resulting in seven (2.3 net) natural gas wells and two (2.0 net) oil wells. The fourth quarter capital program was financed through a combination of bank debt and funds generated from operations.

### 2008 FINANCIAL RESULTS

#### *Production*

	2008	2007	change
Natural gas ( <i>Mcf per day</i> )	<b>62,122</b>	52,899	17%
Crude oil ( <i>bbls per day</i> )	<b>3,083</b>	2,480	24%
Natural gas liquids ( <i>bbls per day</i> )	<b>611</b>	490	25%
Sulphur ( <i>tonnes per day</i> ) <sup>(1) (2)</sup>	<b>146</b>	–	–
Total ( <i>BOE per day</i> )	<b>14,193</b>	11,786	20%
Natural gas % of production	<b>73%</b>	75%	–

(1) A BOE conversion ratio has been calculated using a conversion rate of one tonne of sulphur to one barrel.

(2) Excludes the sale of inventory at the West Pembina sulphur block.

Fairborne reported average production of 14,193 BOE per day in 2008, an increase of 20% from 11,786 BOE per day in 2007. The increase in production was primarily due to a successful drilling program during 2008 which increased production and offset natural declines. In addition, the acquisition of Grand Banks in June 2008 added approximately 1,500 BOE per day (50% oil and 50% natural gas) at the time of the acquisition.

Natural gas production of 62.1 MMcf per day for 2008 (2007 – 52.9 MMcf per day) reflected the addition of approximately 4.5 MMcf per day from Grand Banks properties during the second half of the year; however, the majority of the increase was a direct result of Fairborne's successful drilling program in Harlech, Clive CBM and the Deep Basin.

Crude oil and NGL production of 3,694 bbls per day for 2008 was 24% higher than the 2007 average of 2,970 bbls per day, with additional volumes added through the Grand Banks acquisition and through further development of the oil producing properties in Sinclair, Manitoba which were acquired from Grand Banks.

Sulphur production during 2008 averaged 146 tonnes per day. In 2007 and prior years, Fairborne accounted for sulphur as an operating cost with no associated production volumes. This treatment reflected the financial impact of sulphur disposal as a cost to Fairborne. However, early in 2008 Fairborne began recording sulphur production as a separate revenue stream in response to the material increase in sulphur prices which began at the end of 2007. Sulphur prices remained strong through most of the year until the fourth quarter during which sulphur prices declined significantly.

## M D &amp; A

*Commodity Prices & Risk Management Activities*

	2008	2007	change
<b>Average Prices</b>			
Natural gas (\$ per Mcf) <sup>(1)</sup>	<b>8.51</b>	7.16	19%
Crude oil (\$ per bbl) <sup>(1)</sup>	<b>86.34</b>	73.57	17%
Natural gas liquids (\$ per bbl)	<b>61.62</b>	47.64	29%
Sulphur (\$ per bbl) <sup>(2)</sup>	<b>257.87</b>	–	–
BOE (\$ per BOE) <sup>(1),(2)</sup>	<b>61.30</b>	49.60	24%
<b>Benchmark Prices</b>			
AECO Daily Index (Cdn\$ per Mcf)	<b>8.15</b>	6.44	27%
AECO Monthly Index (Cdn\$ per Mcf)	<b>8.13</b>	6.61	23%
Edmonton Par (Cdn\$ per bbl)	<b>102.87</b>	77.02	34%
Nymex Calendar Average (US\$ per bbl)	<b>99.65</b>	72.31	38%

(1) Excludes unrealized gains and losses on derivatives.

(2) Excludes revenue from the sale of inventory at the West Pembina sulphur block.

*Risk Management – Physical Sales Contracts*

Fairborne's risk management strategy is based on the following objectives:

- ▶ protect shareholder return on investment;
- ▶ reduce risk exposure in budgeted annual funds flow projections; and
- ▶ help ensure transaction economics on acquisitions.

**NATURAL GAS**

In 2008, Fairborne realized natural gas prices that were 19% higher than the average price received in the prior year. The majority of the increase from the previous year was due to the overall higher average spot prices received in 2008 and the higher heat content of Fairborne's production. The Company's risk management program had a minimal effect on the gas prices received in 2008. An average of 19,948 Mcf per day was sold under fixed price physical sales contracts during 2008 representing 32% of the Company's natural gas production. Risk management activities during 2008 increased the Company's natural gas revenue by \$1.1 million which had an effect of increasing Fairborne's realized natural gas price by \$0.05 per Mcf to \$8.51 per Mcf.

Subsequent to the end of December 2008, natural gas prices have experienced significant volatility, with the AECO Daily Index reaching a low of \$4.81 per Mcf. Fairborne's realized prices for 2009 will be impacted by continued volatility in the natural gas markets.

## M D & A

The following table summarizes the outstanding fixed price physical sales contracts for natural gas, including contracts outstanding at December 31, 2008 as well as contracts entered into after December 31, 2008:

	Q1 2009	Q2 2009	Q3 2009	Q4 2009
<b>Collars</b>				
Volume ( <i>Mcf per day</i> )	3,153	–	–	–
Average floor ( <i>\$ per Mcf</i> )	9.99	–	–	–
Average ceiling ( <i>\$ per Mcf</i> )	18.87	–	–	–
<b>Swaps</b>				
Volume ( <i>Mcf per day</i> )	20,269	24,774	24,774	24,774
Average price ( <i>\$ per Mcf</i> )	8.36	7.96	7.96	7.96
Total volume ( <i>Mcf per day</i> )	23,422	24,774	24,774	24,774
Average floor price ( <i>\$ per Mcf</i> )	8.58	7.96	7.96	7.96

*Conversion factor: 1 Mcf = 1.11 GJ*

Fairborne has also locked in the AECO basis on 5,000 mmbtu per day at NYMEX less US\$0.765 per mmbtu for the period April 1, 2009 to October 31, 2009. This basis swap contract is accounted for as a derivative contract whereby the mark-to-market value of the contract has been recorded as a liability of \$130,000 at December 31, 2008.

### CRUDE OIL

During 2008, Fairborne had an average of 1,000 bbls per day of crude oil under fixed price physical sales contracts representing 32% of crude oil production. Risk management activities, including option costs for puts purchased during the year reduced the Company's crude oil revenue by \$7.9 million for the year (\$7.06 per bbl). The Company's realized crude oil price of \$86.34 per bbl for 2008 represented an increase of 17% from 2007 which reflects the overall increase in average market prices.

At December 31, 2008, Fairborne had two crude oil collars for a total of 1,000 bbls per day for the full year of 2009. These contracts were accounted for as derivative contracts and the combined mark-to-market value of these contracts was recorded as an asset of \$8.0 million at December 31, 2008. Subsequent to December 31, 2008, one of the contracts on 500 bbls per day was unwound and a gain of \$7.5 million was realized. The mark-to-market value on this contract at December 31, 2008 was \$8.2 million. The realized gain offset the premium on a new natural gas swap effective for the period March 2009 to December 2009 on 15,000 GJ per day at an average price of \$6.77 per GJ.

Subsequent to the end of December 2008, oil prices have experienced significant volatility, with the NYMEX reaching a low of US\$33.87 per bbl. Fairborne's realized prices for 2009 will be impacted by continued volatility in the commodity markets.

## M D & A

The following table summarizes the outstanding fixed price physical sales contracts on crude oil, including contracts outstanding at December 31, 2008 as well as contracts entered into after December 31, 2008:

	January 2009	February 2009	March – December 2009
<b>Collars</b>			
Volume ( <i>bbls per day</i> )	1,000	1,000	500
Average floor ( <i>\$ per bbl</i> )	US\$65.00	US\$65.00	Cdn\$50.00
Average ceiling ( <i>\$ per bbl</i> )	US\$140.23	US\$140.23	Cdn\$94.65

## SULPHUR

The Company's average realized sulphur price for 2008 was \$257.87 per tonne. Sulphur prices significantly decreased during the fourth quarter of 2008 and it is anticipated that Fairborne will derive no revenue from new sulphur production in 2009.

In July 2008, Fairborne executed a contract for the sale of its share of sulphur inventory at the storage block in West Pembina. Deliveries under the contract commenced in the third quarter of 2008, with \$9.4 million of revenue recorded from the sale of sulphur inventory during 2008. Pursuant to the contract, the purchaser is committed to make monthly payments to Fairborne. To the extent that the purchaser takes delivery from the sulphur block, the cash received will be recorded as revenue; however, if the purchaser does not take delivery, the cash received will be recorded as deferred revenue. Since mid-November 2008, no deliveries have been taken by the purchaser and, as a result, deferred revenue of \$1.5 million has been recorded as at December 31, 2008. Pursuant to the terms of the contract, Fairborne is scheduled to receive approximately US\$27.0 million in 2009.

### *Petroleum and Natural Gas Revenue*

<i>(\$thousands except as noted)</i>	2008	2007	change
Petroleum and natural gas sales:			
Natural gas	193,514	138,269	40%
Crude oil	97,415	66,587	46%
Natural gas liquids	13,780	8,516	62%
Sulphur	13,746	–	–
Total	318,455	213,372	49%
Per BOE	\$61.30	\$49.60	24%
Other revenue items:			
Sulphur block	9,416	–	–
Unrealized gain (loss) on derivatives	8,011	(1,087)	n/a
Other income	3,060	1,506	103%
Total	20,487	419	n/a
Total petroleum and natural gas revenue	338,942	213,791	59%
Per BOE	\$65.24	\$49.70	31%

## M D & A

Fairborne reported a 49% increase in petroleum and natural gas sales for 2008 to \$318.5 million from \$213.4 million in 2007. This significant increase was a result of increased production levels, higher realized prices as well as the addition of sulphur revenue in 2008. Also included in 2008 revenue was \$9.4 million (2007 – nil) received on the sale of sulphur inventory from Fairborne's West Pembina sulphur storage block as well as an \$8.0 million unrealized gain (2007 – loss of \$1.1 million) resulting from the estimated fair market value of outstanding derivatives contracts.

### Royalties

<i>(\$thousands except as noted)</i>	2008	2007	change
Crown	46,127	25,523	81%
Freehold and overriding	11,396	8,578	33%
Total	57,523	34,101	69%
Crown (% of P&NG sales)	14.5%	12.0%	21%
Freehold and overriding (% of P&NG sales)	3.6%	4.0%	(10%)
Total (% of P&NG sales)	18.1%	16.0%	13%
Per BOE	\$11.07	\$7.93	40%

Fairborne recorded \$57.5 million of royalties for 2008 representing a royalty rate of 18.1%, up from 16.0% reported in 2007. The Company's risk management program in 2008 reduced oil and natural gas revenues resulting in realized prices below the reference prices utilized in calculating royalties. In addition, royalty holidays which were in place on a portion of Fairborne's Harlech property in 2007 ended in 2008 resulting in higher crown royalties.

Fairborne anticipates that crown royalties on properties in Alberta will increase in 2009 due to Alberta's New Royalty Framework which came into effect January 1, 2009.

### Operating Costs

<i>(\$thousands except as noted)</i>	2008	2007	change
Operating costs			
Natural gas	38,312	28,630	34%
Oil and NGLs	14,016	9,895	42%
Total	52,328	38,525	36%
Per BOE	\$10.07	\$8.96	12%

Operating costs of \$52.3 million (\$10.07 per BOE) were recorded in 2008, an increase from \$38.5 million (\$8.96 per BOE) recorded in 2007. Several factors negatively impacted operating costs in 2008, including increased processing costs at Fairborne's Marlboro property, trucking costs in the Sinclair area, water trucking at the Company's Wild River area and annual turnarounds and overhauls. 2007 operating costs were also reduced by approximately \$0.44 per BOE to \$8.96 per BOE in 2007 by facility equalization credits related to 2005 and 2006 operating costs at third party facilities.



**M D & A**

*Transportation Expenses*

	<b>2008</b>	2007	change
Transportation ( <i>\$thousands</i> )	<b>5,241</b>	3,585	46%
Per BOE	<b>\$1.01</b>	\$0.83	22%

Transportation costs of \$5.2 million (\$1.01 per BOE) were recorded in 2008, up from \$3.6 million (\$0.83 per BOE) in 2007. Transportation costs include clean oil trucking, trucking of natural gas liquids, certain third party fuel charges and transportation and fuel costs associated with the usage of natural gas pipelines. Transportation costs have increased in 2008 primarily due to the increase in clean oil trucking costs associated with properties acquired from Grand Banks as well as NGL trucking costs at the Company's Harlech property.

*Operating Netbacks*

<i>(\$ per BOE)</i>	<b>2008</b>	2007	change
Petroleum and natural gas sales <sup>(1)</sup>	<b>61.30</b>	49.60	24%
Other income	<b>0.59</b>	0.35	69%
Royalties	<b>(11.07)</b>	(7.93)	40%
Operating costs	<b>(10.07)</b>	(8.96)	12%
Transportation	<b>(1.01)</b>	(0.83)	22%
Operating netback	<b>39.74</b>	32.23	23%

(1) Excludes unrealized gains and losses on derivatives and sulphur block revenue.

Fairborne's operating netback of \$39.74 for 2008 increased 23% compared to 2007. This increase was due to stronger commodity prices and the addition of sulphur revenue in 2008, partially offset by increased royalties and operating costs.

*General and Administrative ("G&A") Expenses*

<i>(\$thousands except as noted)</i>	<b>2008</b>	2007	change
G&A expenses, net of recoveries	<b>13,351</b>	12,294	9%
Compensation costs	<b>8,324</b>	6,545	27%
Total G&A expenses	<b>21,675</b>	18,839	15%
G&A expenses, per BOE	<b>\$2.57</b>	\$2.86	(10%)
Compensation costs, per BOE	<b>\$1.60</b>	\$1.52	5%

Fairborne recorded \$13.4 million (2007 – \$12.3 million) of G&A expenses, net of recoveries, in 2008, representing \$2.57 per BOE (2007 – \$2.86 per BOE). In total, G&A costs, net of recoveries, have increased by 9% due to higher salaries and benefits and increased corporate costs when compared to the prior year. However, on a BOE basis, G&A expenses, net of recoveries, have decreased by 10% compared to 2007, consistent with increased production year over year.

## M D & A

Compensation expense of \$8.3 million in 2008 was 27% higher than the amount expensed during the prior year (2007 – \$6.5 million) primarily due to compensation expense recorded for the retention awards program instituted in December 2007 and the stock option plan which commenced in July 2008. Also included in compensation expense is the amortization of the remaining Restricted Units and Performance Units for senior officers and directors who waived their accelerated vesting rights at the time of the Reorganization. Compensation expense recorded during 2007 only included the amortization of Restricted Units and Performance Units.

Concurrent with the Reorganization, Fairborne instituted a cash settled retention award program which is designed to compensate and retain officers, directors, employees and other service providers through cash payments available annually over a three year term. Compensation expense associated with the retention award program is based on increases and decreases in the intrinsic value of the plan, being the difference between Fairborne's share price at the end of the period and the grant price of the award. The intrinsic value of the plan is calculated at each reporting date and recognized in income using an accelerated accrual method which results in the majority of the intrinsic value of the plan being recorded in the first year. Compensation expense of \$0.4 million has been recorded for the retention award program for the year ended December 31, 2008. In July 2008, most of the retention awards were capped at a ceiling price of \$12.85 concurrent with the issue of options under the Company's new stock option plan. No additional retention awards will be issued.

In July 2008, Fairborne instituted a stock option plan which provides for the granting of stock options to directors, officers, employees, consultants and other service providers to the Company and its subsidiaries. Compensation expense associated with the stock option plan is recognized in income over the vesting period of the options and is based on the estimated fair value of the options at the date of grant. Compensation expense of \$6.6 million has been recorded for the year ended 2008 under the stock option plan.

### *Interest*

<i>(\$thousands except as noted)</i>	<b>2008</b>	2007	change
Interest expense	<b>13,313</b>	15,348	(13%)
Accretion of convertible debentures	<b>2,067</b>	2,153	(4%)
Total interest	<b>15,380</b>	17,501	(12%)
Per BOE	<b>\$2.96</b>	\$4.07	(27%)

Fairborne recorded \$13.3 million in interest expense in 2008, a decrease of 13% from \$15.3 million in 2007. The decrease in interest expense reflects lower average debt levels throughout 2008 as compared to 2007. Fairborne's debt levels increased during the second quarter of 2008 following the acquisition of Grand Banks in June 2008 and were partially offset by the \$28.4 million equity financing in May 2008. Also included in total interest is the amortization of financing charges associated with the issuance of the convertible debentures. The financing charges recorded in 2008 were consistent with the charges recorded during the prior year. These costs will continue to be amortized to expense over the term of the debentures.



**M D & A**

*Depletion, Depreciation and Accretion (DD&A)*

	2008	2007	change
Depletion, depreciation and accretion ( <i>\$thousands</i> )	<b>124,622</b>	97,050	28%
Per BOE	<b>\$23.99</b>	\$22.56	6%

Fairborne recorded \$124.6 million in depletion and depreciation of capital assets and accretion of asset retirement obligations during 2008. On a BOE basis, the DD&A rate of \$23.99 per BOE in 2008 was 6% higher than the prior year's rate of \$22.56 per BOE. The increase in the DD&A rate in 2008 is primarily attributable to an increase in Fairborne's depletable asset base resulting from the acquisition of Grand Banks' assets at their estimated fair market value.

*Taxes*

	2008	2007	change
Future tax expense (reduction) ( <i>\$thousands</i> )	<b>17,472</b>	(21,433)	n/a
Per BOE	<b>\$3.36</b>	\$(4.98)	n/a

Fairborne recorded a future tax expense of \$17.5 million in 2008 compared to a recovery of \$21.4 million in 2007. As a trust in 2007, Fairborne was able to record interest deductions on outstanding notes payable resulting in a future tax recovery. Following the Reorganization, the interest deductions and resulting future tax recoveries are no longer applicable. As such, Fairborne is now recording a future tax expense at current tax rates.

*Net Income and Funds Generated from Operations*

<i>(\$thousands except as noted)</i>	2008	2007	change
Funds generated from operations	<b>189,175</b>	108,107	75%
Per share – basic	<b>\$2.20</b>	\$1.84	20%
Per share – diluted	<b>\$2.19</b>	\$1.78	23%
Cash flow from operations (including changes in working capital)	<b>187,798</b>	115,637	62%
Per share – basic	<b>\$2.19</b>	\$1.96	12%
Per share – diluted	<b>\$2.18</b>	\$1.90	15%
Net income	<b>44,701</b>	15,034	197%
Per share – basic	<b>\$0.52</b>	\$0.26	100%
Per share – diluted	<b>\$0.52</b>	\$0.25	108%

The following table provides a reconciliation between cash flow from operations and funds generated from operations.

<i>(\$thousands except as noted)</i>	2008	2007
Cash flow from operating activities	<b>187,798</b>	115,637
Change in non-cash working capital	<b>(367)</b>	(12,313)
Asset retirement expenditures	<b>1,744</b>	4,783
Funds generated from operations	<b>189,175</b>	108,107

## M D & A

### BOE Analysis

	2008		2007	
	(\$thousands)	(\$ per BOE)	(\$thousands)	(\$ per BOE)
Petroleum and natural gas revenue <sup>(1)</sup>	338,942	65.24	213,791	49.70
Royalties	(57,523)	(11.07)	(34,101)	(7.93)
Operating expenses	(52,328)	(10.07)	(38,525)	(8.96)
Transportation costs	(5,241)	(1.01)	(3,585)	(0.83)
Unrealized (gain)loss on derivatives	(8,011)	(1.54)	1,087	0.25
General & administrative <sup>(2)</sup>	(13,351)	(2.57)	(12,294)	(2.86)
Corporate reorganization costs <sup>(3)</sup>	–	–	(2,918)	(0.68)
Interest expense <sup>(4)</sup>	(13,313)	(2.56)	(15,348)	(3.57)
Funds generated from operations	189,175	36.42	108,107	25.12
Unrealized gain(loss) on derivatives	8,011	1.54	(1,087)	(0.25)
Compensation expense	(8,324)	(1.60)	(6,545)	(1.52)
Compensation expense				
– corporate reorganization	–	–	(6,403)	(1.49)
Accretion of convertible debentures	(2,067)	(0.40)	(2,153)	(0.50)
Depletion, depreciation and accretion	(124,622)	(23.99)	(97,050)	(22.56)
Future tax (expense)reduction	(17,472)	(3.36)	21,433	4.98
Non-controlling interest	–	–	(1,268)	(0.29)
Net income	44,701	8.61	15,034	3.49

(1) Including unrealized gain/loss on derivatives (non-cash).

(2) Net of compensation expense (non-cash).

(3) Net of compensation expense resulting from the Reorganization (non-cash).

(4) Net of accretion on convertible debentures (non-cash).

## LIQUIDITY AND CAPITAL RESOURCES

### Capital Expenditures

(\$thousands)	2008	2007
Exploration and development		
Land and lease acquisitions	11,026	2,945
Geological and geophysical	3,242	1,391
Drilling, completions and workovers	172,611	41,726
Well equipment and facilities	50,837	25,897
Corporate assets	412	–
	238,128	71,959
Property acquisitions, net of dispositions	1,683	16,035
Corporate acquisitions	133,861	221,426
Conversion of exchangeable shares	–	19,594
Total	373,672	329,014



## M D & A

During 2008, Fairborne's exploration and development expenditures totaled \$238.1 million with capital expenditures financed through a combination of funds generated from operations, bank debt and proceeds from the flow-through financing, completed in May 2008. The Company also completed a few small property acquisitions throughout the year and the corporate acquisition of Grand Banks during the second quarter of 2008. The Grand Banks' corporate takeover was financed primarily through Fairborne's bank credit facilities.

Fairborne was very active in provincial land sales during the year, spending \$11.0 million to acquire new lands, primarily in the Harlech area. Geological and geophysical expenditures of \$3.2 million included \$2.5 million related to a 42 square mile seismic program shot in the Sinclair, Manitoba area.

Fairborne also spent \$172.6 million on drilling and completion activities in 2008 with a total of 114 wells drilled (82.9 net), resulting in 57 (35.9 net) natural gas wells, 32 (24.1 net) CBM wells, 24 (21.9 net) oil wells and one (1.0 net) dry hole. Drilling activities during 2008 were focused primarily on Fairborne's Harlech, Clive, Sinclair and Deep Basin properties with 29 (21.7 net) wells drilled in Harlech, 39 (30.2 net) wells drilled on the Company's Clive, Haynes, Wood River and Erskine properties that were either CBM or Belly River gas wells, 20 (10.9 net) wells drilled on Deep Basin properties and 11 (10.9 net) wells drilled on Fairborne's Sinclair property in Manitoba.

Tangible capital expenditures of \$50.8 million included a major Harlech de-bottlenecking project as well as construction of gathering system pipelines in the Harlech, Marlboro, and Peppers areas. The expenditures also included the installation of field compression for the Haynes, Erskine, Wood River and Harlech areas as well as various other smaller projects in Sinclair, Manitoba and the Deep Basin.

### *Working Capital and Bank Indebtedness*

At December 31, 2008, Fairborne had drawn \$196.3 million (2007 – \$86.9 million) against its credit facilities and had a working capital deficit of \$27.9 million (2007 – \$7.5 million) for a net debt position of \$224.2 million. At the end of December 2007, Fairborne's net debt was \$94.3 million which reflected the \$100 million proceeds of the private placement completed in December 2007. The increase in net debt at the end of 2008 reflects an increase in debt levels associated with 2008 capital expenditures and property acquisitions as well as the corporate acquisition of Grand Banks.

Fairborne's credit facilities at December 31, 2008 included a \$270 million extendible revolving term credit facility and a \$15 million demand operating credit facility for a total available facility of \$285 million. The extendible revolving term facility is available on a revolving basis until May 30, 2009 (364 day facility) at which time it may be extended, at the lenders option. If the revolving period is not extended, the undrawn portion of the facility will be cancelled and the amount outstanding would convert to a 365 day non-revolving term facility. The amounts outstanding under the non-revolving term facility are required to be repaid at the end of the term facility being May 30, 2010. Interest payable on amounts drawn under the facilities is at the prevailing bankers' acceptance rates plus stamping fees, lenders' prime rate or LIBOR rates plus applicable margins, depending on the form of borrowing by the Company. The margins and stamping fees vary from 0.35% to 3.25% depending on financial statement ratios and the form of borrowing. The credit facilities are secured by a general security agreement and a first ranking floating charge on the assets of the Company. The facility is subject to a semi-annual valuation of Fairborne's petroleum and natural gas assets. The extendible revolving term credit facility was increased in November 2008 from \$255 million to \$285 million following an unscheduled review by its banking syndicate. The Company anticipates it will have adequate liquidity to fund its financial liabilities as they come due. Fairborne has no defaults or breaches on its bank debt or any of its financial liabilities.

## M D & A

During periods of extreme volatility in both commodity and capital markets, such as experienced at the end of 2008, Fairborne actively manages its capital structure. The Company's objective when managing capital is to maintain a flexible capital structure which will allow it to execute on its capital investment program, including investing in oil and gas activities which may or may not be successful. As a result, Fairborne continually works to balance the proportion of debt and equity in its capital structure to take into account the level of risk being incurred in its capital expenditures. With depressed market prices at the end of 2008 and continuing into 2009, the ability to issue additional shares has become very restricted. As such, the Company has limited its capital expenditure program to a level which it anticipates will be able to be funded entirely from cash flow from operations.

In order to maintain or adjust the capital structure, Fairborne considers various factors including: its forecasted debt to forecasted funds from operations ratio while attempting to finance an acceptable investment program including incremental investment and acquisition opportunities; the current level of bank credit available from the banking syndicate; the level of bank credit that may be obtainable from the banking syndicate as a result of reserve growth; the availability of other sources of debt with different characteristics than the existing bank debt; the sale of assets; limiting the size of the investment program; and new common equity if available on favorable terms. In the midst of financial uncertainty at the end of 2008 and moving into 2009, the Company will continually re-evaluate its capital expenditure program in light of reduced cash flows.

### *Convertible Debentures*

On October 31, 2006, Fairborne issued 100,000 Convertible Unsecured Subordinated Debentures (the "Debentures") through a public issue for gross proceeds of \$100 million. The Debentures bear interest at a rate of 6.5% per annum, which is payable semi-annually in arrears on December 31 and June 30 of each year. The Debentures mature on December 31, 2011 and can be converted into common shares of Fairborne at any time at the option of the holders at a conversion price of \$13.50 per share.

### *Shareholders' Equity*

The Company is authorized to issue an unlimited number of common shares and an unlimited number of preferred shares, issuable in series.

On May 28, 2008, pursuant to a private placement, Fairborne issued 2.3 million flow-through common shares at a price of \$12.35 per flow-through common share, resulting in gross proceeds of \$28.4 million. As a result of the financing, the Company has a commitment to spend \$28.4 million on qualifying Canadian exploration expenditures. The expenditures will be renounced to investors with an effective date of renunciation of December 31, 2008. As at December 31, 2008, \$24.2 million of qualifying exploration expenditures have been incurred.

On May 29, 2008, at the Company's Annual and Special Meeting, shareholders approved the Company's stock option plan. In July 2008, 6.6 million stock options were issued to Fairborne employees, officers and directors at an average exercise price of \$12.85. In conjunction with the issuance of the stock options, most of the retention awards granted to Fairborne employees, officers and directors in December 2007 have been capped at a ceiling price of \$12.85 and no additional retention awards will be granted.

During the year ended December 31, 2008, 264,262 common shares were issued on the vesting of Performance and Restricted Units and 86,138 common shares were issued on the exercise of outstanding warrants.

## M D & A

The following table provides a summary of outstanding common shares, warrants, convertible debentures, shares under Incentive Plans and stock options at the dates indicated:

<i>(thousands)</i>	<b>February 27, 2009</b>	<b>December 31, 2008</b>	December 31, 2007
Common shares	<b>86,944</b>	<b>86,933</b>	84,282
Warrants <sup>(1)</sup>	<b>4,406</b>	<b>4,406</b>	4,627
Convertible debentures <sup>(2)</sup>	<b>\$100,000</b>	<b>\$100,000</b>	\$100,000
Incentive plans			
Restricted units <sup>(3)</sup>	<b>75</b>	<b>78</b>	176
Performance units <sup>(4)</sup>	<b>196</b>	<b>204</b>	356
Stock options	<b>6,812</b>	<b>6,904</b>	–
Weighted average shares			
Basic	<b>n/a</b>	<b>85,854</b>	58,856
Diluted	<b>n/a</b>	<b>86,216</b>	60,729

(1) Each warrant entitles the holder to acquire 0.39 of a common share at an exercise price of \$8.13 per common share, exercisable until June 1, 2010.

(2) The convertible debentures are convertible into common shares at a conversion price of \$13.50 per share.

(3) At December 31, 2008, the Restricted Units entitle the holders to acquire an aggregate of 91,429 common shares of the Company (February 27, 2009 – 87,873 common shares), subject to vesting in accordance with the restricted unit and performance unit incentive plan (the “Incentive Plan”).

(4) At December 31, 2008, the Performance Units entitle the holders to acquire an aggregate of 187,565 common shares of the Company (February 27, 2009 – 180,118 common shares), subject to vesting in accordance with the Incentive Plan.

### Cash Flow and Distributions

<i>(\$thousands except as noted)</i>	<b>2008</b>	2007
Cash flow from operating activities	<b>187,798</b>	115,637
Net income	<b>44,701</b>	15,034
Cash distributions declared	–	61,037
Excess of cash flow from operating activities over cash distributions	<b>n/a</b>	54,600
Shortfall of net income over cash distributions	<b>n/a</b>	(46,003)

Upon the completion of the Reorganization in December 2007, Fairborne became a growth oriented exploration and production company. Fairborne ceased making monthly distributions following the close of the Reorganization. The final cash distribution was payable on December 17, 2007 to unitholders of record on November 30, 2007. Fairborne did not pay any cash distributions to its shareholders during 2008 and the Company does not currently anticipate paying distributions or dividends to its shareholders.

## **M D & A**

During 2007, cash distributions exceeded net income by \$46.0 million however net income for the year included \$93.1 million of non-cash items that do not impact cash flow from operating activities. Non-cash charges such as DD&A are not representative of the costs of maintaining the Company's productive capacity as they are based on the historical costs of capital assets and not the fair market value of replacing those assets within the context of the current commodity price environment. Consistent with prior years, for tax purposes, all 2007 distributions were taxable as a return on capital with no return of capital.

## **CONTRACTUAL OBLIGATIONS & COMMITMENTS**

Fairborne has certain lease commitments for its office premises through to June 2011. As at December 31, 2008, the payments due under these leases is approximately \$0.9 million per year (2007 – \$0.9 million per year).

Fairborne entered into a three year contractual agreement with a third party drilling company for the use of one of their drilling rigs. The contract has a remaining commitment of \$3.7 million for the year ending December 31, 2009.

As a result of a private placement financing in May 2008, Fairborne has a commitment to spend \$28.4 million on qualifying Canadian exploration expenditures. As at December 31, 2008, \$24.2 million of qualifying exploration expenditures have been incurred.

## **OFF-BALANCE-SHEET ARRANGEMENTS**

Fairborne has no off-balance-sheet arrangements.

## **BUSINESS ENVIRONMENT AND RISK**

### *General*

The business risks the Company is exposed to are those inherent in the oil and gas industry as well as those governed by the individual nature of Fairborne's operations. Geological and engineering risks, the uncertainty of discovering commercial quantities of new reserves, commodity prices, interest rate and foreign exchange risks, competition and government regulations – all of these govern the businesses and influence the controls and management at the Company. Fairborne manages these risks by:

- ▶ attracting and retaining a team of highly qualified and motivated professionals who have a vested interest in the success of the Company;
- ▶ operating properties in order to maximize opportunities;
- ▶ employing risk management instruments to minimize exposure to volatility of commodity prices, interest rate and foreign exchange rates;
- ▶ maintaining a strong financial position; and
- ▶ maintaining strict environmental, safety and health practices.

### *Global Financial Crisis*

Recent market events and conditions, including disruptions in the international credit markets and other financial systems and the deterioration of global economic conditions, have caused significant volatility to commodity prices. These conditions worsened in 2008 and are continuing in 2009, causing a loss of confidence in the broader U.S. and global credit and financial markets and resulting in the collapse of, and government intervention in, major banks, financial institutions and insurers and creating a climate of greater volatility, less liquidity, widening of credit spreads, a lack of price transparency, increased credit losses and tighter credit

## M D & A

conditions. Notwithstanding various actions by governments, concerns about the general condition of the capital markets, financial instruments, banks, investment banks, insurers and other financial institutions caused the broader credit markets to further deteriorate and stock markets to decline substantially. These factors have negatively impacted company valuations and will impact the performance of the global economy going forward.

Oil and natural gas prices are expected to remain volatile for the near future as a result of market uncertainties over the supply and demand of these commodities due to the current state of the world economies, OPEC actions and the ongoing global credit and liquidity concerns.

### *Substantial Capital Requirements*

Fairborne anticipates making substantial capital expenditures for the acquisition, exploration, development and production of oil and natural gas reserves in the future. As the Company's revenues may decline as a result of decreased commodity pricing, Fairborne may be required to reduce capital expenditures. In addition, uncertain levels of near term industry activity coupled with the present global credit crisis exposes the Company to additional access to capital risk. There can be no assurance that debt or equity financing, or cash generated by operations will be available or sufficient to meet these requirements or for other corporate purposes or, if debt or equity financing is available, that it will be on terms acceptable to the Company. The inability of the Company to access sufficient capital for its operations could have a material adverse effect on Fairborne's business, financial condition, results of operations and prospects.

### *Third Party Credit Risk*

Fairborne may be exposed to third party credit risk through its contractual arrangements with its current or future joint venture partners, marketers of its petroleum and natural gas production and other parties. In the event such entities fail to meet their contractual obligations to the Company, such failures may have a material adverse effect on Fairborne's business, financial condition, results of operations and prospects.

## CRITICAL ACCOUNTING ESTIMATES

### *Depletion and Depreciation Expense*

Fairborne uses the full cost method of accounting for exploration and development activities whereby all costs associated with these activities are capitalized, whether successful or not. The aggregate of capitalized costs, including future development costs, net of certain costs related to unproved properties is subject to amortization as depletion and depreciation expense. Depletion and depreciation expense is calculated on a unit-of-production method based on estimated proved reserves.

The costs of acquiring and evaluating unproved properties are initially excluded from depletion calculations. These properties are assessed periodically to ascertain whether impairment has occurred. When proved reserves are assigned or the property is considered to be impaired, the cost of the property or the amount of impairment is added to the costs subject to depletion.

### *Full Cost Accounting Ceiling Test*

The carrying value of petroleum and natural gas properties and equipment is reviewed at least annually for impairment. Any impairment would be included as additional depletion and depreciation in the period in which it occurred. The carrying value is based on estimates of proved reserves, production rates, commodity prices, future capital costs, royalty rates and other assumptions. By their nature, these estimates are subject to measurement uncertainty and the effect on the financial statements of changes in such estimates in future periods could be significant.

## **M D & A**

### *Asset Retirement Obligation (“ARO”)*

Fairborne estimates the fair value of ARO in the period in which it is incurred and records an ARO liability with a corresponding increase in the carrying amount of the related asset. The capitalized amount is depleted on the unit-of-production method based on estimated proved reserves. The liability amount is increased each reporting period due to the passage of time based on an estimated risk-free interest rate, and the amount of accretion is expensed to income in the period.

### *Goodwill*

Fairborne records goodwill relating to acquisitions when the total purchase price exceeds the fair value of the net identifiable assets and liabilities acquired. Goodwill is assessed for impairment annually at year-end or if events occur that could result in impairment. Impairment is recognized if the estimated fair value of the Company is less than the book value of the Company. Any excess of the book value of goodwill over this implied fair value is the impairment amount. Impairment is charged to income in the period in which it occurs.

### *Income Taxes*

Fairborne follows the liability method of accounting for income taxes. The determination of the Company’s income and other tax liabilities requires interpretation of laws and regulations, which are revised periodically. All tax filings are subject to audit and could be reassessed after a considerable period of time. Future tax assets and liabilities are booked at substantively enacted future income tax rates which include changes over a period of time. The rate used by Fairborne is based on estimated future net revenues, estimated future depletion rates and other assumptions. Accordingly, the actual income tax liability may differ significantly from the amounts estimated and can impact the current and future income tax expense recorded in future periods.

## **CHANGE IN ACCOUNTING POLICIES**

### *Financial Instruments – Disclosures*

On January 1, 2008, Fairborne adopted the new Canadian Institute of Chartered Accountants (“CICA”) Handbook Section 3862 Financial Instruments – Disclosures which applies to both recognized and unrecognized financial instruments. These disclosures, which include the nature and extent of risks arising from financial instruments, are included in Note 11 of the consolidated financial statements.

### *Capital Disclosures*

On January 1, 2008, Fairborne adopted the new recommendations of the CICA, Handbook section 1535, for disclosure of the Company’s objectives, policies and processes for managing capital as discussed in Note 10(g) of the consolidated financial statements.

### *International Financial Reporting Standards (“IFRS”)*

Effective January 1, 2011, Canadian public companies are required to adopt International Financial Reporting Standards (“IFRS”). In the time leading up to the conversion date, some existing Canadian standards will change to converge with IFRS. Fairborne’s financial statements up to and including the December 31, 2010 financial statements will continue to be reported in accordance with Canadian GAAP as it exists on each reporting date. Financial statements for the quarter ended March 31, 2011, including comparative amounts, will be prepared on an IFRS basis.



## **M D & A**

In order to transition to IFRS, management has established a project team and formed an executive steering committee. A transition plan has been developed to convert the financial statements to IFRS. Training has been provided to key employees and the Company is monitoring the effect of the transition on information systems, internal controls over financial reporting and disclosure controls and procedures. An analysis of the difference between IFRS and Fairborne's current accounting policies is underway, and the impact of various alternatives are being assessed. Changes in accounting policy are likely and may materially impact the financial statements. Due to anticipated changes in IFRS prior to the conversion date, the final impact of the conversion on Fairborne's financial statements cannot be measured.

### **CONTROLS AND PROCEDURES**

#### *Disclosure Controls and Procedures*

Fairborne's Chief Executive Officer and Chief Financial Officer have designed, or caused to be designed under their supervision, disclosure controls and procedures to provide reasonable assurance that: (i) material information relating to the Company is made known to Fairborne's Chief Executive Officer and Chief Financial Officer by others, particularly during the period in which the annual and interim filings are being prepared; and (ii) information required to be disclosed by the Company in its annual filings, interim filings or other reports filed or submitted by it under securities legislation is recorded, processed, summarized and reported within the time period specified in securities legislation. Such officers have evaluated, or caused to be evaluated under their supervision, the effectiveness of Fairborne's disclosure controls and procedures at the financial year end of the Company and have concluded that the Company's disclosure controls and procedures are effective at the financial year end of the Company for the foregoing purposes.

#### *Internal Controls over Financial Reporting*

Fairborne's Chief Executive Officer and Chief Financial Officer have designed, or caused to be designed under their supervision, internal controls over financial reporting to provide reasonable assurance regarding the reliability of the Company's financial reporting and the preparation of financial statements for external purposes in accordance with Canadian GAAP. Such officers have evaluated, or caused to be evaluated under their supervision, the effectiveness of Fairborne's internal controls over financial reporting at the financial year end of the Company and concluded that Fairborne's internal controls over financial reporting are effective, at the financial year end of the Company, for the foregoing purpose. During 2006, 2007 and 2008, Fairborne engaged external consultants to assist in documenting and assessing the Company's internal controls over financial reporting.

Fairborne is required to disclose herein any change in the Company's internal controls over financial reporting that occurred during the period beginning on October 1, 2008 and ended on December 31, 2008 that has materially affected, or is reasonably likely to materially affect, the Company's internal controls over financial reporting. No material changes in Fairborne's internal controls over financial reporting were identified during such period that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

It should be noted that a control system, including the Company's disclosure and internal controls and procedures, no matter how well conceived, can provide only reasonable, but not absolute, assurance that the objectives of the control system will be met and it should not be expected that the disclosure and internal controls and procedures will prevent all errors or fraud.

## Financial Reports

### MANAGEMENT'S REPORT

#### *To the Shareholders of Fairborne Energy Ltd.*

The accompanying consolidated financial statements of Fairborne Energy Ltd. 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 Canadian 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.

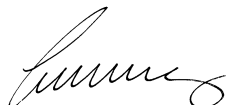
The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal controls. It exercises its responsibilities primarily through the Audit Committee, which is comprised of independent, non-management directors. The Audit Committee has 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 KPMG LLP, the external auditors, in accordance with auditing standards generally accepted in Canada on behalf of the shareholders.



*Steven R. VanSickle*

President and Chief Executive Officer



*Aaron G. Grandberg*

Chief Financial Officer

Calgary, Canada

February 27, 2009

## Financial Reports

### AUDITORS' REPORT

*To the Shareholders of Fairborne Energy Ltd.*

We have audited the consolidated balance sheets of Fairborne Energy Ltd. as at December 31, 2008 and 2007 and the consolidated statements of operations and retained earnings (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, 2008 and 2007 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

*KPMG LLP*

*KPMG LLP*

Chartered Accountants

Calgary, Canada

February 27, 2009

## Consolidated Financial Statements

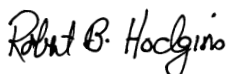
### CONSOLIDATED BALANCE SHEETS

As at December 31,

<i>(\$thousands)</i>	<b>2008</b>	2007
<b>Assets</b>		
Current assets		
Cash and cash equivalents	\$ 126	\$ 116
Accounts receivable	47,915	45,473
Derivative asset (Note 12)	8,023	12
Prepaid expenses and deposits	6,742	6,015
	<b>62,806</b>	51,616
Petroleum and natural gas properties and equipment (Note 5)	934,201	681,929
Goodwill	16,170	16,170
	<b>\$ 1,013,177</b>	\$ 749,715
<b>Liabilities</b>		
Current liabilities		
Accounts payable and accrued liabilities	\$ 88,877	\$ 58,954
Current portion of compensation plan (Note 10)	396	129
Deferred revenue	1,450	–
	<b>90,723</b>	59,083
Bank indebtedness (Note 6)	196,282	86,866
Convertible debentures (Note 7)	94,522	92,455
Compensation plan (Note 10)	111	–
Asset retirement obligation (Note 8)	11,904	9,084
Future income taxes (Note 9)	81,860	45,039
<b>Shareholders' Equity</b>		
Common shares (Note 10)	475,908	445,105
Warrants (Note 10)	2,721	2,857
Equity component of convertible debentures (Note 7)	5,581	5,581
Contributed surplus (Note 10)	8,513	3,294
Retained earnings (Note 3)	45,052	351
	<b>537,775</b>	457,188
Commitments (Note 13)	<b>\$ 1,013,177</b>	\$ 749,715

See accompanying notes to the consolidated financial statements.

Approved on behalf of the Board:



**Robert B. Hodgins**  
Director



**Richard A. Walls**  
Director



## Consolidated Financial Statements

### CONSOLIDATED STATEMENTS OF OPERATIONS AND RETAINED EARNINGS (DEFICIT)

For the years ended December 31,

*(\$thousands except per share amounts)*

	2008	2007
<b>Revenue</b>		
Petroleum and natural gas	\$ 338,942	\$ 213,791
Royalties	(57,523)	(34,101)
	<b>281,419</b>	<b>179,690</b>
<b>Expenses</b>		
Operating	52,328	38,525
Transportation	5,241	3,585
General and administrative	21,675	18,839
Interest	15,380	17,501
Corporate reorganization costs <i>(Note 3)</i>	–	9,321
Depletion, depreciation and accretion	124,622	97,050
	<b>219,246</b>	<b>184,821</b>
<b>Income (loss) before taxes and non-controlling interest</b>	<b>62,173</b>	<b>(5,131)</b>
Future taxes (reduction)	17,472	(21,433)
<b>Income before non-controlling interest</b>	<b>44,701</b>	<b>16,302</b>
Non-controlling interest	–	1,268
<b>Net income and comprehensive income</b>	<b>44,701</b>	<b>15,034</b>
Retained earnings (deficit), beginning of year	351	(25,729)
Reclassification of deficit pursuant to Reorganization <i>(Note 3)</i>	–	72,083
Distributions declared	–	(61,037)
<b>Retained earnings, end of year</b>	<b>\$ 45,052</b>	<b>\$ 351</b>
<b>Net income per share <i>(Note 10)</i></b>		
Basic	<b>\$ 0.52</b>	<b>\$ 0.26</b>
Diluted	<b>\$ 0.52</b>	<b>\$ 0.25</b>

See accompanying notes to the consolidated financial statements.

## Consolidated Financial Statements

### CONSOLIDATED STATEMENTS OF CASH FLOWS

For the years ended December 31,

<i>(\$thousands)</i>	<b>2008</b>	2007
Cash provided by (used in):		
<b><i>Operating activities</i></b>		
Net income	\$ 44,701	\$ 15,034
Items not involving cash:		
Depletion, depreciation and accretion	124,622	97,050
Compensation expense	8,324	6,545
Future taxes (reduction)	17,472	(21,433)
Accretion of convertible debentures	2,067	2,153
Unrealized (gain) loss on derivatives	(8,011)	1,087
Corporate reorganization costs <i>(Note 3)</i>	–	6,403
Non-controlling interest	–	1,268
Asset retirement expenditures	(1,744)	(4,783)
	<b>187,431</b>	103,324
Change in non-cash working capital	367	12,313
	<b>187,798</b>	115,637
<b><i>Financing activities</i></b>		
Bank indebtedness	97,831	(14,290)
Issuance of common shares, net of costs	27,552	100,111
Distributions to unitholders	–	(67,235)
Change in non-cash working capital <i>(Note 4)</i>	–	(32,372)
	<b>125,383</b>	(13,786)
<b><i>Investing activities</i></b>		
Expenditures on petroleum and natural gas properties	(238,128)	(71,959)
Acquisition of petroleum and natural gas properties	(1,683)	(16,035)
Corporate acquisitions <i>(Note 4)</i>	(102,054)	(2,500)
Change in non-cash working capital	28,694	(12,005)
	<b>(313,171)</b>	(102,499)
Change in cash and cash equivalents	10	(648)
Cash and cash equivalents, beginning of year	116	764
<b><i>Cash and cash equivalents, end of year</i></b>	<b>\$ 126</b>	<b>\$ 116</b>
Interest paid	<b>\$ 12,781</b>	<b>\$ 16,233</b>

See accompanying notes to the consolidated financial statements.

## Consolidated Financial Statements

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

For the Years Ended December 31, 2008 and 2007

*(tabular amounts are stated in thousands and thousands of dollars except per share amounts)*

#### NATURE OF OPERATIONS

Fairborne Energy Ltd. (the “Company” or “Fairborne”) is a resource-based company engaged in the exploration for, and the development and production of natural gas, natural gas liquids and crude oil in Western Canada. The Company resulted from a reorganization effective December 19, 2007 as part of a Plan of Arrangement involving, among others, Fairborne Energy Trust (the “Trust”), Fairborne and the securityholders of the Trust (“Reorganization”).

Pursuant to the Reorganization, the Trust was restructured from an open-end unincorporated trust to Fairborne Energy Ltd., a publicly traded exploration and development corporation. Unitholders of the Trust received an equal number of common shares of Fairborne which holds the assets and liabilities previously held, directly or indirectly, by the Trust. Exchangeable shares of the Trust were exchanged for common shares of the Company at the exchange ratio in effect on December 18, 2007.

The reorganization to a corporation has been accounted for on a continuity of interest basis and accordingly, the comparative consolidated financial statements for 2007 reflect the financial position, results of operations and cash flows as if the Company had always carried on the business formerly carried on by the Trust.

#### 1. SIGNIFICANT ACCOUNTING POLICIES

##### *a) Basis of presentation*

The consolidated financial statements of the Company have been prepared by management in accordance with generally accepted accounting principles in Canada and they include the accounts of the Company and its wholly owned subsidiaries. All inter-company transactions have been eliminated.

##### *b) Petroleum and natural gas operations*

The Company follows the full cost method of accounting for petroleum and natural gas properties and facilities whereby all costs associated with the exploration for and development of petroleum and natural gas reserves are capitalized. Such costs include land acquisition costs, geological and geophysical costs, lease rental costs on non-producing properties, costs of both productive and unproductive drilling and production equipment. Gains or losses are not recognized upon disposition of petroleum and natural gas properties unless crediting the proceeds against accumulated costs would result in a change in the depletion rate of 20% or more.

The accumulated costs, less the costs of unproved properties, are depleted and depreciated using the unit-of-production method based on total proved reserves before royalties as determined by independent evaluators. Natural gas reserves and production are converted into equivalent barrels of oil based upon the estimated relative energy content.

The costs of acquiring and evaluating unproved properties are initially excluded from depletion calculations. These properties are assessed periodically to ascertain whether impairment has occurred. When proved reserves are assigned or the property is considered to be impaired, the cost of the property or the amount of impairment is added to the costs subject to depletion.

The Company places a limit on the carrying value of petroleum and natural gas properties and equipment, which may be depleted against revenues of future periods (the “ceiling test”). The carrying value is assessed to be recoverable when the sum of the

## Consolidated Financial Statements

undiscounted cash flows expected from the production of proved reserves, the lower of cost and market of unproved properties and the cost of major development projects exceeds the carrying value. When the carrying value is not assessed to be recoverable, an impairment loss is recognized to the extent that the carrying value of assets exceeds the sum of the discounted cash flows expected from the production of proved and probable reserves, the lower of cost and market of unproved properties and the cost of major development projects. The cash flows are estimated using expected future product prices and costs and are discounted using a risk-free interest rate.

Repairs and maintenance are expensed as operating costs as incurred.

### *c) Asset retirement obligation (“ARO”)*

The Company recognizes the fair value of ARO in the period in which it is incurred when a reasonable estimate of the fair value can be made. The fair value of the estimated ARO is recorded as a liability, with a corresponding increase in the carrying amount of the related asset. The capitalized amount is depleted on the unit-of-production method based on proved reserves. The liability amount is increased each reporting period due to the passage of time and the amount of accretion is expensed to income in the period. Actual costs incurred upon the settlement of the ARO are charged against the ARO.

### *d) Joint arrangements*

Substantially all of the Company’s oil and gas exploration and development activities are conducted jointly with others and, accordingly, the financial statements reflect only the Company’s interest in such activities.

### *e) Goodwill*

The Company records goodwill relating to acquisitions when the total purchase price exceeds the fair value of the net identifiable assets and liabilities acquired. Goodwill is assessed for impairment annually at year-end or if events occur that could result in an impairment. Impairment is recognized if the estimated fair value of the Company is less than the book value of the Company. If the fair value of the Company is less than the book value, impairment is measured by allocating the fair value to the identifiable assets and liabilities as if the Company had been acquired for a purchase price equal to its fair value. The excess of the fair value of the Company over the amounts assigned to the assets and liabilities is the fair value of the goodwill. Any excess of the book value of goodwill over this implied fair value of goodwill is the impairment amount. Impairment is charged to income in the period in which it occurs.

### *f) Financial instruments*

Financial instruments may be utilized by the Company to manage its exposure to commodity price fluctuations and foreign currency exposures. The Company’s practice is not to utilize financial instruments for trading or speculative purposes.

Fairborne recognizes all financial instruments, including embedded derivatives, on the balance sheet initially at fair value. Measurement in subsequent periods depends on whether the financial instrument has been classified as “held-for-trading”, “available-for-sale”, “other accounts receivables or payable” or “held-to-maturity”.

Cash and cash equivalents and certain derivative contracts, as discussed below, are classified as held for trading. All of Fairborne’s other financial instruments have been designated as other accounts receivable or payable. Fairborne has not elected to designate any financial instruments as held for trading.

## Consolidated Financial Statements

Fairborne manages its exposure to commodity price fluctuations by using physical delivery contracts with fixed prices, collars, puts or participating swaps. The majority of these contracts have been designated as “normal sale” contracts; therefore, these commodity contracts are not recorded on the balance sheet at fair value. Amounts received on the settlement of the commodity contracts are included in petroleum and natural gas revenue as the contracts settle. Certain of these contracts do not qualify as “normal sale” contracts and, as such, are accounted for as derivative contracts and recorded on the balance sheet at fair value. Changes in the fair value of derivative contracts are included in petroleum and natural gas revenue for the corresponding period.

Transaction costs associated with Fairborne’s financial instruments are shown net of the related financial instrument and accreted using the effective interest rate method.

### *g) Equity based compensation*

Prior to the Reorganization, the Trust had a Trust Incentive Plan which included granting of restricted trust units (“Restricted Units”) and performance trust units (“Performance Units”) to directors, officers, employees and consultants and other service providers to the Trust and its subsidiaries. The Plan was modified as part of the Reorganization as described in Note 10(e).

In July 2008, Fairborne instituted a stock option plan which provides for the granting of stock options to directors, officers, employees, consultants and other service providers to the Company and its subsidiaries.

Compensation expense associated with equity based compensation plans is recognized in income over the vesting period of the plan with a corresponding increase in contributed surplus. Compensation expense is based on the fair value of the equity based compensation at the date of the grant and for the stock option plan, it is determined using the Black Scholes option pricing model. Fairborne estimates the number of options that are anticipated to be forfeited over the life of the options and incorporates this estimate into the compensation expense on the grant date. The amount of non-cash compensation expense for equity based plans is recognized in contributed surplus and is recorded as an increase in shareholders’ equity when equity based compensation plans are exercised.

In 2007, the Company instituted a retention award plan which is described in Note 10(e). The intrinsic value of vested cash settled compensation awards is calculated at each reporting period and recorded as a liability. Compensation expense associated with the liability based compensation plan is recognized in income over the vesting period of the plan based on the intrinsic value of the plan at each reporting period. Cash payments on exercise of liability based compensation plans are recorded as a reduction in the liability at the exercise date.

### *h) Income taxes*

Fairborne uses the liability method of accounting for future income taxes. Under the liability method, future income tax assets and liabilities are determined based on “temporary differences” (differences between the accounting basis and the tax basis of the assets and liabilities), and are measured using the substantively enacted tax rates and laws expected to apply when these differences reverse. A valuation allowance is recorded against any future income tax assets if it is more likely than not that the asset will not be realized. Tax benefits associated with tax uncertainties, if any, are recognized to the extent it is probable that they will be sustained.

### *i) Corporate assets*

Corporate assets are stated at cost. Depreciation is provided on a declining balance basis at a rate of 20%.

## Consolidated Financial Statements

### *j) Cash and cash equivalents*

The Company considers cash and short term deposits with original maturities of three months or less as cash and cash equivalents.

### *k) Measurement uncertainty*

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and revenue and expenses for the period then ended. Actual results could differ from those estimates.

The amount recorded for depletion is based on the estimates of reserve volumes and ARO is based on estimated costs and timing of expenditures. The ceiling test calculation is based on estimates of proved and probable reserves, production rates, petroleum and natural gas prices, future costs and relevant assumptions. The fair value of the Company used to assess goodwill impairment is based on estimates. By their nature, these estimates are subject to measurement uncertainty and may impact the consolidated financial statements of future periods.

### *l) 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 using the treasury stock method which is based on shares that would be issued under the Company's incentive plans. The dilutive effect of convertible debentures is calculated using the if-converted method which is based on the number of shares issuable on conversion of outstanding convertible debentures. In addition, in calculating diluted net income per share, net income is increased by the interest on the convertible debentures and accretion of the convertible debenture discount.

### *m) Revenue recognition*

Revenue from the sale of petroleum and natural gas is recognized when the product is delivered and collection is reasonably assured. Revenue from processing and other miscellaneous sources is recognized upon completion of the relevant service. Payments received prior to delivery of products, including sulphur sales, are recorded as deferred revenue.

### *n) Comparative numbers*

Certain of the comparative numbers have been restated to conform to the current year presentation.

## 2. CHANGES IN ACCOUNTING POLICIES AND PRACTICES

### *Financial instruments - disclosures*

On January 1, 2008, Fairborne adopted the new Canadian accounting standards with respect to disclosures of financial instruments which applies to both recognized and unrecognized financial instruments. These disclosures, which include the nature and extent of risk arising from the financial instruments and how Fairborne manages those risks, are included in Note 11.

### *Capital disclosures*

On January 1, 2008, Fairborne adopted the new Canadian accounting standards with respect to disclosures regarding the Company's objectives, policies and processes for managing capital. These disclosures are included in Note 10(g).

## Consolidated Financial Statements

### *International Financial Reporting Standards (“IFRS”)*

Effective January 1, 2011, Canadian public companies are required to adopt International Financial Reporting Standards (“IFRS”). In the time leading up to the conversion date, some existing Canadian standards will change to converge with IFRS. Fairborne’s financial statements up to and including the December 31, 2010 financial statements will continue to be reported in accordance with Canadian GAAP as it exists on each reporting date. Financial statements for the quarter ended March 31, 2011, including comparative amounts, will be prepared on an IFRS basis.

### **3. REORGANIZATION AND EQUITY FINANCING**

Pursuant to a Plan of Arrangement effective December 19, 2007, the Trust converted into Fairborne Energy Ltd., an exploration and production company. As a result of the Reorganization, unitholders of the Trust received common shares of the Company, which now holds the assets and liabilities previously held, directly or indirectly, by the Trust. The Trust’s outstanding convertible debentures bearing a coupon rate of 6.5% and a conversion price of \$13.50 were assumed by the Company and became convertible into common shares of the Company with no other change in the terms.

As part of the Reorganization, 3.1 million outstanding exchangeable shares were converted into 4.2 million common shares based on the exchange ratio of 1:1.35931 on December 18, 2007. In addition, 0.9 million trust units were issued on the accelerated vesting of certain rights under the Trust Incentive Plan. In aggregate, a total of 70.9 million common shares were issued by the Company in exchange for all outstanding trust units and all outstanding exchangeable shares on the closing date of the Reorganization.

Pursuant to the Reorganization, the Board of Directors, the Chief Executive Officer, the Chief Operating Officer, and the Chief Financial Officer all waived their rights to accelerated vesting of 175,711 Restricted Units and 356,275 Performance Units outstanding under the Trust Incentive Plan. These units continue to follow the predetermined vesting schedule in accordance with the original Trust Incentive Plan; however, holders of the remaining incentive rights will receive Fairborne common shares rather than trust units upon vesting of such incentive rights (Note 10(e)).

All remaining Restricted Units and Performance Units outstanding under the Trust Incentive Plan vested as part of the Reorganization. As a result, the remaining unamortized stock based compensation costs of \$6.4 million were charged to earnings. The Company also incurred \$2.9 million of restructuring costs, which together with unit-based compensation expense, has been included in the corporate reorganization costs on the consolidated statement of operations. Also pursuant to the Reorganization, stated capital was reduced by the deficit balance of \$72.1 million.

Concurrent with the closing of the Reorganization, Fairborne issued 13.4 million common shares at a subscription price of \$7.45 per share for aggregate proceeds of \$100 million.

### **4. ACQUISITIONS**

In June 2008 Fairborne acquired all of the outstanding shares of Grand Banks Energy Corporation (“Grand Banks”) pursuant to a takeover bid. Grand Banks was a publicly traded junior exploration and production company with operations focused in southeast Saskatchewan, southwest Manitoba and west central Alberta. As consideration for the transaction, Grand Banks shareholders received \$102.1 million for the Grand Banks common shares. The acquisition has been accounted for using the

## Consolidated Financial Statements

purchase method. The results of operations for Grand Banks have been included in the Company's financial statements beginning June 13, 2008. Details of the acquisition are as follows:

<b>Cost of Acquisition:</b>	
Cash	\$ 101,704
Transaction costs	350
	<b>\$ 102,054</b>
<b>Allocated:</b>	
Current assets	\$ 6,712
Petroleum and natural gas properties and equipment	133,861
Current liabilities	(5,855)
Bank indebtedness	(11,585)
Asset retirement obligation	(1,342)
Future income taxes	(19,737)
	<b>\$ 102,054</b>

On June 4, 2007, Fairborne acquired all of the outstanding shares of Fairquest Energy Limited ("Fairquest") pursuant to a plan of arrangement under the Business Corporations Act (Alberta) and an Arrangement Agreement dated March 11, 2007. Fairquest was a publicly traded oil and gas company with properties located in western Canada. As consideration for the transaction, Fairborne issued 15.8 million units to acquire Fairquest at a deemed value of \$145 million, based on the trading price of trust units on or about the date the acquisition was announced. Fairborne also issued 4.6 million warrants to acquire an additional 1.8 million trust units in exchange for outstanding Fairquest warrants. The acquisition has been accounted for using the purchase method. The results of operations for Fairquest have been included in Fairborne's financial statements beginning June 4, 2007. Details of the acquisition are as follows:

<b>Cost of Acquisition:</b>	
Trust units	\$ 144,801
Transaction costs	2,500
Warrants	2,879
	<b>\$ 150,180</b>
<b>Allocated:</b>	
Current assets	\$ 9,373
Petroleum and natural gas properties and equipment	221,426
Current liabilities	(61,096)
Asset retirement obligations	(1,471)
Future income taxes	(18,052)
	<b>\$ 150,180</b>

Included in current assets acquired was \$1.1 million receivable from the Trust and included in current liabilities was \$50.1 million payable to the Trust. The total amount payable to the Trust included a \$32.4 million advance received from Fairborne to repay amounts outstanding under Fairquest's credit facilities which were due prior to the date of acquisition (May 30, 2007).

## Consolidated Financial Statements

### 5. PETROLEUM AND NATURAL GAS PROPERTIES AND EQUIPMENT

	2008	2007
Petroleum and natural gas properties and equipment	<b>\$ 1,350,355</b>	\$ 974,780
Accumulated depletion and depreciation	<b>(418,156)</b>	(294,701)
Corporate assets	<b>4,037</b>	3,672
Accumulated depreciation	<b>(2,035)</b>	(1,822)
	<b>\$ 934,201</b>	\$ 681,929

At December 31, 2008, future development costs of \$189.0 million (2007 – \$126.0 million) were included in the depletion calculation and costs of acquiring unproved properties in the amount of \$59.1 million (2007 – \$50.0 million) were excluded from the depletion calculation.

Fairborne performed a ceiling test calculation at December 31, 2008 and December 31, 2007 to assess the recoverable value of petroleum and natural gas properties and equipment. The oil and gas future prices for the December 31, 2008 ceiling test are based on the January 1, 2009 commodity price forecast of our independent reserve evaluators. The following table summarizes the benchmark prices used in the ceiling test calculation. Based on these assumptions, the undiscounted value of future net revenues from Fairborne's proved reserves exceeded the carrying value of petroleum and natural gas properties and equipment at December 31, 2008.

Year	WTI Oil	Foreign	Edmonton	
	(\$U.S./bbl)	Exchange	Light	AECO Gas
		Rate	Crude Oil	(\$Cdn/mmbtu)
		(\$US:Cdn)	(\$Cdn/bbl)	
2009	57.50	1.21	68.61	7.58
2010	68.00	1.18	78.94	7.94
2011	74.00	1.14	83.54	8.34
2012	85.00	1.08	90.92	8.70
2013	92.01	1.05	95.91	8.95
2014	93.85	1.05	97.84	9.14
2015	95.73	1.05	99.82	9.34
2016	97.64	1.05	101.83	9.54
2017	99.59	1.05	103.89	9.75
2018	101.59	1.05	105.99	9.95
Escalate thereafter 2.0% per year				

## Consolidated Financial Statements

### 6. BANK INDEBTEDNESS

At December 31, 2008 the Company had a \$270 million extendible revolving term credit facility and a \$15 million demand operating credit facility available from a syndicate of Canadian chartered banks, subject to the banks' semi-annual valuation of Fairborne's petroleum and natural gas properties. The extendible revolving term facility is available on a revolving basis until May 30, 2009 (364 day facility) at which time it may be extended, at the lenders option. If the revolving period is not extended, the undrawn portion of the facility will be cancelled and the amount outstanding will convert to a 365 day non-revolving term facility. The amounts outstanding under the non-revolving term facility are required to be repaid at the end of the term facility being May 30, 2010. Interest payable on amounts drawn under the facilities is at the prevailing bankers' acceptance rates plus stamping fees, lenders' prime rate or LIBOR rates plus applicable margins, depending on the form of borrowing by the Company. The margins and stamping fees vary from 0.35% to 3.25% depending on financial statement ratios and the form of borrowing. The credit facilities are secured by a general security agreement and a first ranking floating charge on the assets of the Company. At December 31, 2008 letters of credit totaling \$0.6 million were outstanding.

### 7. CONVERTIBLE DEBENTURES

The following tables set forth a reconciliation of the convertible debentures for the years ended December 31, 2008 and 2007:

	2008		
	Number of Debentures	Debt component	Equity component
Balance, beginning of year	100,000	\$ 92,455	\$ 5,581
Accretion	–	2,067	–
Balance, end of year	100,000	\$ 94,522	\$ 5,581

	2007		
	Number of Debentures	Debt component	Equity component
Balance, beginning of year	100,000	\$ 90,302	\$ 5,581
Accretion	–	2,153	–
Balance, end of year	100,000	\$ 92,455	\$ 5,581

On October 31, 2006, the Trust issued 100,000 convertible unsecured subordinated debentures for gross proceeds of \$100 million. Pursuant to the Reorganization, Fairborne assumed the liability for the convertible debentures and the debentures became convertible into common shares of Fairborne at the same conversion price in effect prior to the Reorganization. The debentures bear interest at a rate of 6.5% per annum, which is payable semi-annually in arrears on December 31 and June 30 of each year. The debentures have a face value of \$1,000 per debenture and mature on December 31, 2011. The debentures can be converted into common shares of Fairborne at any time at the option of the holders at a conversion price of \$13.50 per share. After December 31, 2009 and prior to December 31, 2010, the Company will have the right to redeem all or a portion of the debentures at a price of \$1,050 plus accrued and unpaid interest. After December 31, 2010 and prior to the maturity date, the debentures will be redeemable in whole or in part at the option of the Company at a redemption price of \$1,025 plus accrued and unpaid interest.

## Consolidated Financial Statements

As the debentures are convertible into common shares, they are considered to represent both debt and equity to the Company under generally accepted accounting principles. The debt component of the debentures was recorded at the fair value of the obligation without the conversion feature. This fair value was calculated based on the present value of all future payments of principal and interest using a discount rate applicable to similar debt instruments absent the conversion feature. The balance of the proceeds, \$5.6 million, represents the fair value of the conversion feature and is recorded as the equity component of the debentures. Issue costs of \$4.5 million have been offset against the debt component and are being amortized using the effective interest rate method. The debt component will accrete up to the principal balance at maturity and the accretion is included in interest expense.

### 8. ASSET RETIREMENT OBLIGATION

The Company's asset retirement obligation results from ownership interests in petroleum and natural gas assets including well site, gathering systems and processing facilities. The Company estimated the total undiscounted amount required to settle its asset retirement obligation to be approximately \$40.3 million (2007 – \$49.0 million). The majority of the costs are scheduled to be incurred between 2019 and 2023. A credit-adjusted risk-free interest rate of 8.5 percent and an inflation rate of 2 percent was used to calculate the fair value of the asset retirement obligation.

A reconciliation of the asset retirement obligation is provided below:

	2008	2007
Balance, beginning of year	\$ 9,084	\$ 10,994
Corporate acquisitions ( <i>Note 4</i> )	1,342	1,471
Revision of estimates	1,519	–
Liabilities incurred	796	416
Liabilities settled	(1,744)	(4,783)
Accretion expense	907	986
Balance, end of year	\$ 11,904	\$ 9,084

### 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:

	2008	2007
Income (loss) before taxes	\$ 62,173	\$ (5,131)
Combined federal and provincial tax rate	29.7%	32.42%
Computed "expected" income tax expense	18,465	(1,663)
Increase (decrease) in income taxes resulting from:		
Non-deductible compensation expense	2,360	4,240
Effect of change in tax rate	(3,155)	(3,460)
Net income attributable to the Trust	–	(20,146)
Other	(198)	(404)
Future tax (reduction)	\$ 17,472	\$ (21,433)

## Consolidated Financial Statements

The components of the future income tax liability at December 31, 2008 and 2007 are as follows:

	2008	2007
Future income tax liabilities:		
Petroleum and natural gas properties and equipment	\$ 100,856	\$ 82,053
Derivative asset	2,022	–
	<b>102,878</b>	82,053
Future income tax assets:		
Asset retirement obligation	(2,997)	(2,287)
Share issue costs	(1,316)	(1,680)
Income tax losses (expire 2010 to 2028)	(16,705)	(33,047)
	<b>(21,018)</b>	(37,014)
Net future income tax liability	<b>\$ 81,860</b>	\$ 45,039

### 10. SHAREHOLDERS' EQUITY

The Company is authorized to issue an unlimited number of common shares and an unlimited number of preferred shares, issuable in series.

#### a) Common Shares of Fairborne Energy Ltd.

	2008		2007	
	Number of Shares	Amount	Number of Shares	Amount
Balance, beginning of year	84,282	\$ 445,105	–	\$ –
Flow through shares issued for cash	2,300	28,405	–	–
Issued on vesting of Restricted Units and Performance Units	264	2,727	–	–
Issued on exercise of warrants	87	837	–	–
Issued on corporate reorganization (Note 3)	–	–	66,612	320,684
Issued on conversion of exchangeable shares	–	–	4,247	24,421
Issued for cash (Note 3)	–	–	13,423	100,000
Share issue costs	–	(1,554)	–	–
Future tax benefit of issue costs	–	388	–	–
Balance, end of year	<b>86,933</b>	<b>\$ 475,908</b>	84,282	\$ 445,105

As a result of the flow-through financing, Fairborne has a commitment to spend \$28.4 million on qualifying Canadian exploration expenditures. The expenditures will be renounced to investors with an effective date of renunciation of December 31, 2008. As at December 31 2008, \$24.2 million of qualifying exploration expenditures have been incurred.

## Consolidated Financial Statements

### b) Trust Units of Fairborne Energy Trust

	2007	
	Number	Amount
Balance, beginning of year	47,677	\$ 216,575
Fairquest acquisition (Note 4)	15,833	144,801
Issued on exercise of warrants	14	133
Issued on conversion of exchangeable shares	1,851	16,910
Issued on vesting of Restricted Units	293	2,827
Balance, prior to Reorganization	65,668	381,246
Issued on vesting of Restricted and Performance Units	944	11,521
Reduction in capital for reclassification of deficit	–	(72,083)
Exchanged for Fairborne common shares (Note 3)	(66,612)	(320,684)
Balance, end of year	–	\$ –

During the period January 1 to December 18, 2007, 1.5 million exchangeable shares were converted into 1.9 million trust units. The market value of trust units issued on conversion was \$16.9 million resulting in a reduction in non-controlling interest of \$8.9 million, an increase in capital assets of \$12.0 million and a future tax liability of \$4.1 million. Pursuant to the Reorganization the 3.1 million outstanding exchangeable shares were converted into 4.2 million common shares based on the exchange ratio of 1:1.35931 on December 18, 2007. The market value of common shares issued on conversion was \$24.4 million resulting in a reduction in non-controlling interest of \$19.5 million, an increase in capital assets of \$7.5 million and a future tax liability of \$2.6 million.

### c) Warrants

The following table sets forth a reconciliation of the warrants issued and outstanding for the years ended December 31, 2008 and 2007:

	2008		2007	
	Number of Warrants	Amount	Number of Warrants	Amount
Balance, beginning of year	4,627	\$ 2,857	–	\$ –
Issued on acquisition of Fairquest (Note 4)	–	–	4,662	2,879
Exercised for common shares/units	(221)	(136)	(35)	(22)
Balance, end of year	4,406	\$ 2,721	4,627	\$ 2,857

Each warrant entitles the holder to acquire 0.39 of a common share of the Company at an exercise price of \$8.13 per common share and is exercisable at any time prior to June 1, 2010. Prior to the Reorganization the warrants were convertible into trust units at the same exchange ratio and exercise price. The fair value of the warrants of \$0.62 per warrant was calculated using the Black Scholes model with the following weighted average assumptions: risk free rate of 4 percent, expected volatility of 40 percent and an expected life of 3 years.

## Consolidated Financial Statements

### d) Per share amounts

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

	2008	2007
Numerator		
Net income – basic and diluted	\$ 44,701	\$ 15,034
Denominator		
Weighted average shares – basic	85,854	58,856
Restricted Units	114	811
Performance Units	248	1,062
Denominator for diluted net income per share	86,216	60,729
Basic net income per share	\$ 0.52	\$ 0.26
Diluted net income per share	\$ 0.52	\$ 0.25

Excluded from the diluted number of shares for the year ended December 31, 2008 is the effect of convertible debentures (7.4 million shares), warrants (1.7 million shares) and 6.9 million stock options as they are out of the money based on the average market prices for the period. Excluded from the diluted number of shares for the year ended December 31, 2007 is the effect of convertible debentures (7.4 million shares), warrants (1.8 million shares) and exchangeable shares (4.1 million shares).

### e) Equity based compensation

#### i) INCENTIVE PLAN

The following tables set forth a reconciliation of the equity based incentive plan activity for the years ended December 31, 2008 and 2007:

	2008		
	Number of Restricted Units	Number of Performance Units	Total
Balance, beginning of year	176	356	532
Exercised	(98)	(152)	(250)
Balance, end of year	78	204	282
Exercisable, end of year	–	–	–
Equivalent common shares, end of year <sup>(1)</sup>	91	188	279

## Consolidated Financial Statements

	2007		
	Number of Restricted Units	Number of Performance Units	Total
Balance, beginning of year	496	629	1,125
Issued	319	307	626
Exercised	(237)	(10)	(247)
Forfeited	(32)	(38)	(70)
Vested on Reorganization	(370)	(532)	(902)
Balance, end of year	176	356	532
Exercisable, end of year	–	–	–
Equivalent common shares, end of year <sup>(1)</sup>	215	328	543

(1) including additional common shares to be issued for accumulated distributions earned prior to the Reorganization and adjusted for the performance factor set in connection with the Reorganization.

Prior to the Reorganization the Trust had a Trust Incentive Plan (the “Plan”) which included granting of restricted trust units (“Restricted Units”) and performance trust units (“Performance Units”) to directors, officers, employees and consultants and other service providers to the Trust and its subsidiaries.

Under the Plan, Restricted Units vested annually over a three-year period and, upon vesting, entitled the holder to receive the number of trust units designated by the Restricted Unit plus the value of accumulated distributions on the vested Restricted Units. Performance Units vested on the third anniversary of the date of grant and actual payouts were to be determined based on the performance of the Trust compared to its peers. Performance factors could range from zero to 2.0 times the initial Performance Unit grant. Performance Units also received additional trust units equal to the value of accumulated distributions paid to unitholders during the vesting period. Payouts under the Trust Incentive Plan could be in cash, trust units or some combination thereof at the discretion of the Board of Directors.

As part of the Reorganization, all outstanding Restricted Units and Performance Units were eligible for accelerated vesting pursuant to the terms of the Trust Incentive Plan. However, the Board of Directors, the Chief Executive Officer, the Chief Operating Officer, and the Chief Financial Officer all waived their rights to accelerated vesting leaving an aggregate of 175,711 Restricted Units and 356,275 Performance Units outstanding under the Trust Incentive Plan. All remaining Restricted Units and Performance Units under the Trust Incentive Plan vested as part of the Reorganization. The performance factor for both vested and unvested Performance Units was determined in connection with the Reorganization to be 0.92 including accumulated distributions. Compensation expense of \$6.4 million related to Performance Units and Restricted Units, which received accelerated vesting, was included in corporate restructuring costs in the 2007 consolidated statement of operations.

Restricted Units and Performance Units which remain outstanding will continue to follow the predetermined vesting schedule in accordance with the original Trust Incentive Plan; however, holders of the remaining incentive rights will receive Fairborne common shares rather than trust units upon vesting of such incentive rights. The performance factor on the remaining Performance Units has been fixed at 0.92 including accumulated distributions.

## Consolidated Financial Statements

### II) STOCK OPTION PLAN

In July 2008, Fairborne instituted a stock option plan which provides for the granting of stock options to directors, officers, employees, consultants and other service providers to the Company and its subsidiaries. Stock options vest over a three year period and expire five years from the date of grant. Under the terms of the plan, stock options must be issued with exercise prices equal to the market price of common shares at the date of the grant. The maximum number of shares reserved for issuance under the stock option plan is 8.7 million of which 6.9 million are outstanding.

The following table sets forth a reconciliation of the stock option plan activity for the year ended December 31, 2008:

	Number of awards	Weighted average exercise price
Balance, beginning of year	–	\$ –
Granted	7,027	12.73
Forfeited	(123)	12.62
Balance, end of year	6,904	\$ 12.74
Exercisable, end of year	–	–

The weighted average fair value of options granted since inception of the plan was \$3.36 per option using the Black-Scholes option pricing model with the following assumptions: risk free interest rate of three percent, expected volatility of 37 percent, average expected life of three years and dividend rate of nil. An estimated forfeiture rate of two percent has been applied to the compensation costs recognized.

The following table summarizes stock options outstanding at December 31, 2008:

Exercise Price	Options outstanding	Remaining term (years)
\$5.00 – \$8.99	35	4.8
\$9.00 – \$12.99	6,844	4.5
\$13.00 – \$14.00	25	4.7
	6,904	4.5

### III) RETENTION AWARD PLAN

In conjunction with the Reorganization, Fairborne established a Retention Award Plan which includes granting of Retention Awards to directors, officers, employees, consultants and other service providers to the Company and its subsidiaries. The total number of Retention Awards which may be outstanding and not yet exercised shall not exceed 10% of the aggregate number of issued and outstanding common shares of the Company.

## Consolidated Financial Statements

Retention Awards vest annually over a three-year period and expire three years from the date of grant. Upon vesting, the holder is entitled to exercise the Retention Awards for cash equal to the amount by which the exercise price (the fair value of a Fairborne common share on the date of exercise) exceeds the grant price (the fair value of a Fairborne common share on the date of grant).

The following table sets forth a reconciliation of the retention award plan activity for the years ended December 31, 2008 and 2007:

	2008		2007	
	Number of awards	Weighted average exercise price	Number of awards	Weighted average exercise price
Balance, beginning of year	7,420	\$ 5.75	–	\$ –
Granted	975	6.88	7,420	5.75
Forfeited	(390)	5.78	–	–
Balance, end of year	8,005	\$ 5.87	7,420	\$ 5.75
Exercisable, end of year	2,277	\$ 5.75	–	\$ –

### f) Contributed Surplus

The following table sets forth a reconciliation of the contributed surplus for the years ended December 31, 2008 and 2007:

	2008	2007
Balance, beginning of year	\$ 3,294	\$ 4,694
Equity based compensation	7,972	6,644
Restricted and Performance Units exercised	(2,727)	(2,827)
Incentive plan grants forfeited	(26)	(99)
Trust unit based compensation on accelerated vesting	–	6,403
Restricted and Performance Units vested (Note 3)	–	(11,521)
Balance, end of year	\$ 8,513	\$ 3,294

### g) Management of capital structure

Consistently and especially during periods of extreme volatility in both commodity and capital markets, such as at the end of 2008, Fairborne actively manages its capital structure which includes shareholders' equity, bank debt, convertible debentures, compensation plan liabilities and working capital. Fairborne's objective in managing its capital structure is to maintain flexibility and liquidity through periods of market fluctuations. In order to maintain or adjust the capital structure, Fairborne considers the following: incremental investment and acquisition opportunities; the current level of bank credit available from the banking syndicate; the level of bank credit that may be obtainable from the banking syndicate as a result of reserve growth; the availability of other sources of debt with different characteristics than the existing bank debt; the sale of assets; limiting the size of the investment program; and new share issuances if available on favorable terms. The Company's objective is to maintain a flexible structure that will allow it to execute its investment program, including exploration and development of its oil and gas properties and acquisition and disposition transactions which all carry varying amounts of risk. Fairborne continually strives to balance the proportion of debt

## Consolidated Financial Statements

and equity in its capital structure to take into account the level of risk being incurred in its investment program. Fairborne may from time to time issue shares and adjust its capital spending to manage current and projected debt levels. With depressed market prices at the end of 2008, the ability to issue additional shares is very restricted. As such, the Company plans to limit its capital expenditure programs to a level which it anticipates will be able to be funded entirely from cash flow from operations.

The Company monitors capital based on the ratio of net debt to annualized cash flow. This ratio is calculated as net debt, defined as outstanding bank debt plus or minus working capital, divided by annualized cash flow from operations before changes in non-cash working capital and asset retirement expenditures. Fairborne's current strategy continues to be to maintain a ratio of 1 to 1, excluding convertible debentures. However, this ratio may increase at certain times as a result of acquisitions or dramatic commodity price fluctuations. In order to facilitate the management of this ratio, the Company prepares annual capital expenditure budgets, which are updated as necessary depending on varying factors including current and forecast prices, successful capital deployment and general industry conditions. The annual and updated budgets are approved by the Board of Directors. As at December 31, 2008, Fairborne's ratio of net debt to annualized cash flow was 1.19 to 1 as a result of the acquisition of Grand Banks in June 2008, as well as significant reductions in cash flow from operations due to decreased commodity prices in the fourth quarter of 2008.

### 11. FINANCIAL INSTRUMENTS

The Company has exposure to the following risks from its use of financial instruments:

- ▶ Credit risk
- ▶ Liquidity risk
- ▶ Market risk

#### *a) Credit risk:*

Credit risk is the risk of a financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligation and arises principally from joint venture partners and natural gas marketers. Virtually all of Fairborne's accounts receivable are from counterparties in the oil and gas industry and are subject to normal industry credit risks. As at December 31, 2008, the Company's accounts receivable consisted of \$23.5 million from joint venture partners, \$23.7 million from petroleum and natural gas marketers and \$0.7 million of other trade receivable. In addition, the Company had an \$8.0 million derivative asset.

The carrying amount of accounts receivable, derivative assets and cash and cash equivalents represents the maximum credit exposure. Fairborne does not have an allowance for doubtful accounts as at December 31, 2008 and did not provide for any doubtful accounts nor was it required to write-off any receivables for the year ended December 31, 2008. The amounts outstanding for more than 90 days are predominantly due from large well established joint venture partners. Subsequent to December 31, 2008, Fairborne monetized one derivative contract which was included as a derivative asset for proceeds of \$7.5 million, consistent with the mark-to-market value at December 31, 2008.

## Consolidated Financial Statements

As at December 31, 2008, the Company's accounts receivable is aged as follows:

Aging	
Current (less than 90 days)	\$ 41,844
Past due (more than 90 days)	6,071
Total	\$ 47,915

### b) *Liquidity risk:*

Liquidity risk relates to the risk that a company will not be able to meet its financial obligations as they become due. Fairborne's financial liabilities on the balance sheet consist of accounts payable, bank debt, incentive plan liabilities and convertible debentures. The Company expects to satisfy obligations under accounts payable in less than one year. Fairborne has a revolving reserve based credit facility and demand loan facility as outlined in Note 6. The credit facility was increased in November from \$255 million to \$285 million. The credit facility is available on a revolving basis which converts to a 365 day facility if not extended by the lenders and the convertible debentures mature on December 31, 2011. Fairborne anticipates it will have adequate liquidity to fund its financial liabilities as they come due and anticipates recoveries in both commodity prices and capital markets over the next three years. The Company has no defaults or breaches on its bank debt or any of its financial liabilities.

### c) *Market risk:*

Market risk is the risk that fluctuations in currency rates, interest rates and commodity prices will affect a Company's income or the value of its financial assets and liabilities.

#### FOREIGN CURRENCY EXCHANGE RATE RISK

Foreign currency exchange rate risk is the risk that the fair value or future cash flows will fluctuate as a result of changes in foreign exchange rates. The underlying market prices in Canada for petroleum and natural gas are impacted by changes in the exchange rate between the Canadian and United States dollar. In general, while the underlying foreign exchange rate affects oil and natural gas prices, Fairborne does not sell a significant amount of oil or natural gas denominated in U.S. dollars. Settlement of fixed price physical sales contracts denominated in U.S. dollars would have been directly impacted by changes in the foreign exchange rate. If the foreign exchange rate had changed by \$0.10 at December 31, 2008, the value of the derivative asset would have changed by \$0.7 million.

#### COMMODITY PRICE RISK

Commodity price risk is the risk that the fair value or future cash flows will fluctuate as a result of changes in commodity prices. Commodity prices for petroleum and natural gas are impacted by not only the relationship between the Canadian dollar and United States dollar, as outlined above, but also world economic events that dictate the levels of supply and demand. Fairborne has attempted to mitigate commodity price risk through the use of various financial derivatives and physical delivery sales contracts as outlined in Note 12. The derivative contracts resulted in unrealized gains of \$8.0 million (2007 – loss of \$1.1 million) for the year ended December 31, 2008 which have been included in petroleum and natural gas sales. In addition, fixed price physical delivery contracts for natural gas that settled during the year ended December 31, 2008 increased realized revenue by \$1.1 million (2007 - \$12.9 million). The fixed price physical delivery contracts for oil that settled during the year ended December 31, 2008, reduced realized revenue by \$8.3 million (2007 - \$1.3 million). A one dollar change to the price per barrel of oil would have an impact on the value of the derivative asset at December 31, 2008 of \$0.2 million. A \$0.25 change to the price per thousand cubic feet of natural gas would have an immaterial impact on the value of the derivative asset at December 31, 2008.

## Consolidated Financial Statements

### INTEREST RATE RISK

Interest rate risk is the risk that future cash flows will fluctuate as a result of changes in market interest rates. The Company is exposed to interest rate risk on its bank debt which has a floating interest rate. The convertible debentures do not bear interest rate risk as they are at a fixed rate. An increase in interest rates of 1% would reduce after tax net earnings for the year ended December 31, 2008 by approximately \$1.5 million based on the average amount of bank debt outstanding during the year. An opposite impact would have occurred to after tax net earnings had interest rates decreased 1%. The Company had no interest rate derivatives outstanding at December 31, 2008 or 2007.

#### *d) Fair value of financial instruments:*

The carrying value of Fairborne's financial instruments, other than bank indebtedness and convertible debentures, approximate fair value due to their short maturity. The fair value of the bank indebtedness approximates its carrying value as it bears interest at a floating rate. The fair value of the convertible debentures at December 31, 2008 was \$74.5 million (2007 - \$98.0 million).

## 12. COMMODITY CONTRACTS

Fairborne has a risk management program whereby the Company sells forward a portion of its future production through fixed price physical sales contracts with customers.

#### *a) Commodity contracts recorded at fair value:*

At December 31, 2008, certain physical sales contracts have been recorded on the balance sheet at their estimated fair value as an \$8.0 million asset (2007 - \$12,000). The change in the fair value has been recorded in petroleum and natural gas sales as an unrealized gain on derivatives for the year ended December 31, 2008.

#### NATURAL GAS:

	Volume <i>(mmbtu per day)</i>	Price <i>(US\$ per mmbtu)</i>	Settlement Index
<b>Basis Swaps</b>			
Apr 1, 2009 – Oct 31, 2009	5,000	Nymex – \$0.765	Nymex LD

#### OIL:

	Volume <i>(bbls per day)</i>	Price <i>(US\$ per bbl)</i>	Settlement Index
<b>Collars</b>			
Jan 1, 2009 – Dec 31, 2009	500	90.00 – 204.75	WTI
Jan 1, 2009 – Dec 31, 2009	500	40.00 – 75.72	WTI

## Consolidated Financial Statements

### b) *Commodity contracts not recorded at fair value:*

The following natural gas fixed price physical sales contracts outstanding at December 31, 2008 have been entered into for the purpose of physical delivery of a non-financial item; therefore, the physical delivery contracts are not fair valued. Settlements on these contracts are included in petroleum and natural gas revenue as they occur.

#### NATURAL GAS:

	Volume (GJ per day)	Price (CDN\$ per GJ)	Settlement Index
<b>AECO Collars</b>			
Jan 1, 2009 – Mar 31, 2009	3,500	9.00 – 17.00	AECO C Monthly
<b>AECO Swaps</b>			
Jan 1, 2009 – Mar 31, 2009	5,000	8.02	AECO C Monthly
Jan 1, 2009 – Dec 31, 2009	5,000	7.76	AECO C Monthly
Jan 1, 2009 – Dec 31, 2009	5,000	7.50	AECO C Monthly
Jan 1, 2009 – Dec 31, 2009	2,500	7.70	AECO C Monthly

### 13. COMMITMENTS

The Company has certain lease commitments for its office premises through to June 2011. As at December 31, 2008 the payments due under these commitments are approximately \$0.9 million per annum.

Fairborne entered into a three year contractual agreement with a third party drilling company for the use of one of their drilling rigs. The contract has a remaining commitment of \$3.7 million for the year ending December 31, 2009.

As a result of a private placement financing in May 2008, Fairborne has a commitment to spend \$28.4 million on qualifying Canadian exploration expenditures. As at December 31, 2008, \$24.2 million of qualifying exploration expenditures have been incurred.

## Corporate Information

### FAIRBORNE ENERGY LTD.

3400, 450 – 1st Street SW  
Calgary, Alberta T2P 5H1  
Telephone [403] 290-7750  
Fax [403] 290-7751

### AUDITORS

*KPMG LLP*

### RESERVE EVALUATORS

*GLJ Petroleum Consultants Ltd.*

### BANK

*Royal Bank of Canada*  
*National Bank of Canada*  
*Canadian Imperial Bank of Commerce*  
*Alberta Treasury Branch*

### LEGAL COUNSEL

*Burnet, Duckworth & Palmer LLP*  
*McCarthy Tetraault LLP*

### STOCK EXCHANGE LISTING

*The Toronto Stock Exchange*  
Trading Symbol: FEL  
Convertible Debentures: FEL.DB

### CORPORATE GOVERNANCE

A system of corporate governance for Fairborne has been established to provide the Board of Directors, management and shareholders of the Company with effective governance. A more detailed discussion of corporate governance is available in the Information Circular for the Annual Meeting of Shareholders.

### DIRECTORS

*Greg Bay*  
President and CEO  
Cypress Capital Management Ltd.

*Robert B. Hodgins*  
Investor and Corporate Director

*Johannes J. Nieuwenburg*  
Corporate Director  
and Private Businessman

*Carl J. Tricoli*  
Founder and Managing Partner  
Denham Capital Management LP

*Steven R. VanSickle*  
President and CEO  
Fairborne Energy Ltd.

*Richard A. Walls*  
Chairman  
Fairborne Energy Ltd.

*Rodney D. Wimer*  
President  
Mazama Capital Partners

### GENERAL INFORMATION

Shareholders and interested investors are encouraged to visit our web site:  
<http://www.fairborne-energy.com>  
Historical public documents, corporate information, latest presentation material and press releases are all available. Filings also available at: [www.sedar.com](http://www.sedar.com)

### OFFICERS

*Steven R. VanSickle*  
President  
and Chief Executive Officer

*David L. Summers*  
Chief Operating Officer

*Aaron G. Grandberg*  
Chief Financial Officer

*Jackie M. Cugnet*  
Vice President  
Finance

*David S. Cymbalisty*  
Vice President  
Engineering

*Scott W. Hadley*  
Vice President  
Exploration

*F. Tom Park*  
Vice President  
Marketing

*Gary M. Poirier*  
Vice President  
Production

*David E.T. Pyke*  
Vice President  
Land and Contracts

### ANNUAL MEETING

The Annual Meeting of the Shareholders of Fairborne Energy Ltd. will be held at 3:00 pm, on Wednesday May 27, 2009 in the McMurray Room of the Calgary Petroleum Club, 319 – 5th Avenue S.W. Calgary, Alberta.