



## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following Management Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") was prepared at, and is dated, March 2, 2010. This MD&A is provided by the management of Fairborne Energy Ltd. ("Fairborne" or the "Company") to review 2009 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, 2009 and 2008. 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. 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. Fairborne resulted from the reorganization of Fairborne Energy Trust (the "Trust") effective December 19, 2007 (the "Reorganization"). If the context requires, reference herein to "Fairborne" or the "Company" also includes a reference to the Trust prior to the Reorganization and reference to "common shares" or "shares" may be a reference to "trust units" or "units" and a reference to "shareholders" may be referenced to "unitholders" prior to the Reorganization.

**Forward Looking Statements:** This document contains forward-looking statements. Management's assessment of future plans and operations, drilling plans and the timing thereof and anticipated incentives to be received in connection therewith, anticipated timing to bring on additional production, use of proceeds from the recently completed financing and timing and renunciation of flow through expenditures to subscribers, timing of the waterflood project at Sinclair, planned capital expenditures, nature of capital expenditures, timing of capital expenditures and methods of financing capital expenditures (and assumptions related thereto) and expected volatility of commodity prices and its impact on realized prices, expectation that amount of sulphur revenue will be minimal in 2010, estimated cash receipts in 2010 from the sale of Pembina sulphur block and the timing of completion thereof, expectation that the Company will have adequate liquidity to fund financial liabilities, plans to continue to re-evaluate capital expenditure programs in light of cash flows and timing of IFRS adoption and conversion, certain elections anticipated to be made thereunder and the effects thereof 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", "net debt" and "netbacks" which are non-GAAP terms. The Company uses these measures to help evaluate its performance. The Company uses net debt (bank indebtedness plus working capital) as an alternative measure of outstanding debt. The Company considers corporate netbacks a key measure as it demonstrates its profitability relative to current commodity prices. Netbacks have no GAAP equivalent and are calculated on a BOE basis by deducting royalties, operating costs, and transportation from petroleum and natural gas sales and sulphur block sales. 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 one tonne of sulphur to one barrel and six thousand cubic feet of natural gas 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.



## Management's Discussion &amp; Analysis

## HIGHLIGHTS

	2009	2008	CHANGE
<b>Financial</b> ( <i>\$thousands, except per share amounts</i> )			
Petroleum and natural gas revenue	<b>240,557</b>	338,942	(29%)
Funds generated from operations <sup>(1)</sup>	<b>143,811</b>	189,175	(24%)
Per share – basic	<b>\$1.59</b>	\$2.20	(28%)
Per share – diluted	<b>\$1.59</b>	\$2.19	(27%)
Cash flow from operations (including changes in working capital)	<b>141,233</b>	187,798	(25%)
Per share – basic	<b>\$1.56</b>	\$2.19	(29%)
Per share – diluted	<b>\$1.56</b>	\$2.18	(28%)
Net income (loss)	<b>(25,645)</b>	44,701	(157%)
Per share – basic	<b>(\$0.28)</b>	\$0.52	(154%)
Per share – diluted	<b>(\$0.28)</b>	\$0.52	(154%)
Exploration and development expenditures	<b>110,389</b>	238,128	(54%)
Acquisitions, net of dispositions	<b>(24,844)</b>	135,544	(118%)
Working capital deficit	<b>6,370</b>	27,917	(77%)
Bank indebtedness	<b>103,738</b>	196,282	(47%)
Convertible debentures	<b>96,510</b>	94,522	2%
<b>Operations</b> ( <i>Units as noted</i> )			
Average production			
Natural gas ( <i>Mcf per day</i> )	<b>62,509</b>	62,122	1%
Crude oil ( <i>bbls per day</i> )	<b>3,368</b>	3,083	9%
Natural gas liquids ( <i>bbls per day</i> )	<b>596</b>	611	(2%)
Sulphur ( <i>tonnes per day</i> ) <sup>(2), (4)</sup>	<b>72</b>	146	(51%)
Total ( <i>BOE per day</i> )	<b>14,454</b>	14,193	2%
Average sales price			
Natural gas ( <i>\$ per Mcf</i> ) <sup>(3)</sup>	<b>5.74</b>	8.51	(33%)
Crude oil ( <i>\$ per bbl</i> ) <sup>(3)</sup>	<b>65.50</b>	86.34	(24%)
Natural gas liquids ( <i>\$ per bbl</i> )	<b>31.10</b>	61.62	(50%)
Sulphur ( <i>\$ per tonne</i> ) <sup>(4)</sup>	<b>75.73</b>	257.87	(71%)
Netback per BOE ( <i>\$ per BOE</i> )			
Petroleum and natural gas sales <sup>(3)</sup>	<b>41.91</b>	61.89	(32%)
Sulphur block revenue	<b>5.28</b>	1.81	192%
Royalties	<b>(3.28)</b>	(11.07)	(70%)
Operating expenses	<b>(10.25)</b>	(10.07)	2%
Transportation	<b>(1.07)</b>	(1.01)	6%
Operating netback	<b>32.59</b>	41.55	(22%)

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 the change in fair value of derivatives.

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

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<i>(\$thousands, except per share amounts)</i>	<b>2009</b>	2008	2007
Petroleum and natural gas revenue	<b>240,557</b>	338,942	213,791
Funds generated from operations	<b>143,811</b>	189,175	108,107
Per share – basic	<b>\$1.59</b>	\$2.20	\$1.84
Per share – diluted	<b>\$1.59</b>	\$2.19	\$1.78
Cash flow from operations (including changes in working capital)	<b>141,233</b>	187,798	115,637
Per share – basic	<b>\$1.56</b>	\$2.19	\$1.96
Per share – diluted	<b>\$1.56</b>	\$2.18	\$1.90
Net income (loss)	<b>(25,645)</b>	44,701	15,034
Per share – basic	<b>(\$0.28)</b>	\$0.52	\$0.26
Per share – diluted	<b>(\$0.28)</b>	\$0.52	\$0.25
Total assets	<b>940,443</b>	1,013,177	749,715
Working capital deficit	<b>6,370</b>	27,917	7,467
Long term financial liabilities			
Bank indebtedness	<b>103,738</b>	196,282	86,866
Convertible debentures	<b>96,510</b>	94,522	92,455
Asset retirement obligations	<b>11,200</b>	11,904	9,084
Future income taxes	<b>89,919</b>	81,860	45,039
Cash distributions per unit	–	–	\$1.07
Shareholders' equity	<b>589,325</b>	537,775	457,188

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 from a trust to a corporation. 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, 41 (28.4 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 at that time of \$220 million.



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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 Energy Corporation ("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 fund Fairborne's exploration program.

Fairborne recorded \$189.2 million in funds generated from operations in 2008 (\$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 (82.9 net) wells drilled, 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.

The year 2009 was marked by weak global economics and low natural gas prices. As a result, Fairborne was focused on financial resource management with a lower risk tolerance. The Company made a decision to shut in production on its higher operating cost properties at Wild River and West Pembina for a portion of the year in order to preserve cash flow. Despite this decision, average production of 14,454 for 2009 was 2% higher than the prior year as a result of Fairborne's successful capital program. Benefiting from an active risk management program, Fairborne's realized natural gas prices were 45% higher than the average AECO daily index prices in 2009, contributing to strong funds generated from operations of \$143.8 million (\$1.59 per share). Exploration and development spending of \$110.4 million, which was funded entirely by funds generated from operations, included drilling 53 (42.1 net) wells resulting in 19 (13.8 net) natural gas wells, 21 (17.1 net) CBM wells and 13 (11.2 net) oil wells.

A disciplined financial focus in 2009 resulted in a 51% reduction in net debt with \$110.1 million of net debt at December 31, 2009 on an available credit facility of \$285 million. Debt was reduced through a number of initiatives including non-core property dispositions, the disposition of a portion of the Company's interest in the West Pembina gas plant and completion of an equity financing which resulted in the issue of 11.6 million common shares and 3.8 million flow-through shares for gross proceeds of \$69.5 million.

## Management's Discussion &amp; Analysis

## QUARTERLY FINANCIAL INFORMATION

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

	2009			
	Q4	Q3	Q2	Q1
<b>Financial</b> ( <i>\$thousands, except per share amounts</i> )				
Petroleum and natural gas revenue	58,338	55,244	58,430	68,545
Funds generated from operations	37,863	37,236	35,742	32,970
Per share – basic	\$0.37	\$0.43	\$0.41	\$0.38
Per share – diluted	\$0.37	\$0.43	\$0.41	\$0.38
Cash flow from operations (including changes in working capital)	38,750	40,048	27,653	34,782
Per share – basic	\$0.38	\$0.46	\$0.32	\$0.40
Per share – diluted	\$0.38	\$0.46	\$0.32	\$0.40
Net Income (loss)	(3,124)	(497)	(17,333)	(4,691)
Per share – basic	\$(0.02)	\$(0.01)	\$(0.20)	\$(0.05)
Per share – diluted	\$(0.02)	\$(0.01)	\$(0.20)	\$(0.05)
Total assets	940,443	961,920	1,001,840	1,023,526
Working capital deficit (surplus)	6,370	(1,539)	(7,227)	31,641
Bank indebtedness	103,738	204,046	232,184	209,925
Convertible debentures	96,510	96,027	95,525	95,024
<b>Operations</b>				
Average production				
Natural gas ( <i>Mcf per day</i> )	59,132	56,797	66,744	67,520
Crude oil ( <i>bbls per day</i> )	3,037	3,292	3,552	3,599
Natural gas liquids ( <i>bbls per day</i> )	617	563	632	572
Sulphur ( <i>tonnes per day</i> ) <sup>(1)</sup>	33	100	64	93
Total ( <i>BOE per day</i> )	13,542	13,421	15,372	15,517

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



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	2008			
	Q4	Q3	Q2	Q1
<b>Financial</b> ( <i>\$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
<b>Operations</b>				
Average production				
Natural gas ( <i>Mcf per day</i> )	69,460	62,601	59,529	56,813
Crude oil ( <i>bbls per day</i> )	4,086	3,312	2,506	2,413
Natural gas liquids ( <i>bbls per day</i> )	657	580	610	597
Sulphur ( <i>tonnes per day</i> ) <sup>(1)</sup>	138	129	106	210
Total ( <i>BOE per day</i> )	16,458	14,454	13,143	12,689

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

Fairborne's production level increased consistently throughout 2008, following the Company's conversion from a trust to a growth-oriented exploration and production company in December 2007. Fairborne's extensive capital program and the acquisition of Grand Banks in June 2008 directly contributed to the quarterly increases in production during 2008. During the first two quarters of 2009, Fairborne continued to realize increased production as a result of the Company's 2008 capital expenditure program. In the second half of 2009 natural gas prices declined significantly and Fairborne made the economic decision to shut in production on its higher operating cost properties at Wild River and West Pembina. At the same time, Fairborne restricted its capital expenditure program. These decisions resulted in a decrease in production during the last two quarters of 2009.

Fairborne's revenue and funds generated from operations over the past two years reflect the shift from a trust to a growth oriented exploration and production company. As Fairborne began 2008 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. In the fourth quarter revenue and funds generated from operations began to decrease when prices for oil and natural gas began to decline more than offsetting increased production. Throughout 2009 Fairborne's revenue and funds generated from operations remained lower as a direct result of weakened commodity prices. The dramatic decrease in natural gas prices in 2009 was partially mitigated by Fairborne's risk management program which had a significant impact on revenue and funds generated from

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operations. The risk management program, along with the revenue received from the sale of inventory from the West Pembina sulphur block enabled Fairborne to maintain consistent funds generated from operations throughout 2009 despite low natural gas prices.

Fluctuations in Fairborne's net income over the past two years can be attributed to increased production, the acquisition of Grand Banks in 2008 and decreases in natural gas prices in late 2008 and 2009. 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 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, when prices for oil and natural gas decreased significantly and 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. In the first quarter of 2009, net income shifted to a net loss primarily due to the continued decline in natural gas prices. The increased net loss in the second quarter of 2009 was a result of compensation expense of \$12.6 million recorded related to the accelerated compensation expense for the remaining life of 6.6 million stock options that were surrendered on June 1, 2009. The third quarter's net loss improved with higher oil and natural gas prices realized in the quarter. The fourth quarter followed with an increased net loss due to additional compensation expense recorded relating to the November 2009 option grant as well as increased general and administrative costs.

**FOURTH QUARTER 2009 RESULTS**

Fairborne's average production of 13,542 BOE per day during the fourth quarter of 2009 was 18% lower than average production for the fourth quarter of the previous year (Q4 2008 – 16,458 BOE per day) and consistent with the average production during the immediately preceding quarter (Q3 2009 – 13,421 BOE per day). Revenue of \$58.3 million for the fourth quarter was 6% higher than the preceding quarter (Q3 2009 – \$55.2 million) primarily due to increasing oil prices and more favorable gas prices as compared to the third quarter of 2009. Fairborne reported a net loss of \$3.1 million in the fourth quarter of 2009 compared to the \$0.5 million loss reported in the third quarter of 2009. The increase was a result of higher compensation expense relating to a November 2009 option grant as well as increased general and administrative expenses.

Fairborne recorded funds generated from operations of \$37.9 million (\$0.37 per share) during the fourth quarter which was consistent with the immediately preceding quarter (Q3 2009 – \$37.2 million) and 6% lower than the funds generated from operations for the fourth quarter of the previous year (Q4 2008 – \$40.3 million). This decrease from 2008 reflects the decrease in production and commodity prices realized in 2009.

Capital expenditures in the fourth quarter totaled \$23.1 million which included \$17.4 million for drilling and completions and \$1.5 million for well equipment and facilities. Fairborne drilled 10 (7.3 net) wells during the fourth quarter, resulting in nine (6.3 net) natural gas wells and one (1.0 net) oil well. The fourth quarter capital program was financed through funds generated from operations. Also in the fourth quarter Fairborne disposed of part of the Company's interest in the West Pembina gas plant with proceeds from the sale applied against outstanding bank debt.



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In October 2009, Fairborne closed an equity financing for gross proceeds of \$69.5 million and decreased net debt to \$110.1 million at December 31, 2009 down 46% from the \$202.5 million at September 30, 2009.

**2009 FINANCIAL RESULTS****Production**

	2009	2008	CHANGE
Natural gas ( <i>Mcf per day</i> )	<b>62,509</b>	62,122	1%
Crude oil ( <i>bbls per day</i> )	<b>3,368</b>	3,083	9%
Natural gas liquids ( <i>bbls per day</i> )	<b>596</b>	611	(2%)
Sulphur ( <i>tonnes per day</i> ) <sup>(1) (2)</sup>	<b>72</b>	146	(51%)
Total ( <i>BOE per day</i> )	<b>14,454</b>	14,193	2%
Natural gas % of production	<b>72%</b>	73%	(1%)

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 14,454 BOE per day in 2009, an increase of 2% from 14,193 BOE per day in 2008. The increase in production was achieved as a result of a successful drilling program in 2009 which more than offset natural declines despite the economic decision to shut in some of the Company's production for part of the year.

Natural gas production of 62.5 MMcf per day in 2009 represents a 1% increase from 2008 (62.1 MMcf per day). Throughout 2009, Fairborne's successful drilling program in the Harlech, Clive CBM and Marlboro properties increased gas production. The increase was offset by natural declines as well as the shut in of sour gas production on the Company's Wild River and West Pembina properties.

Crude oil and NGL production of 3,964 bbls per day for 2009 was 7% higher than the 2008 average of 3,694 bbls per day. The increase in 2009 was primarily attributable to the continued development of the Company's Sinclair property.

Sulphur production during 2009 averaged 72 tonnes per day reflecting a 51% decrease when compared to the daily average in 2008 (146 tonnes per day). Fairborne continued to record sulphur production as a separate revenue stream in 2009; however sulphur production was negatively impacted by the shut in of the Wild River and West Pembina properties as well as the disposition of Fairborne's interest in the Pedley/Lambert area.

**Commodity Prices & Risk Management Activities**

	2009	2008	CHANGE
Average Prices			
Natural gas ( <i>\$ per Mcf</i> ) <sup>(1)</sup>	<b>5.74</b>	8.51	(33%)
Crude oil ( <i>\$ per bbl</i> ) <sup>(1)</sup>	<b>65.50</b>	86.34	(24%)
Natural gas liquids ( <i>\$ per bbl</i> )	<b>31.10</b>	61.62	(50%)
Sulphur ( <i>\$ per tonne</i> ) <sup>(2)</sup>	<b>75.73</b>	257.87	(71%)
BOE ( <i>\$ per BOE</i> ) <sup>(1),(2)</sup>	<b>41.74</b>	61.30	(32%)
Benchmark Prices			
AECO Daily Index ( <i>Cdn\$ per Mcf</i> )	<b>3.97</b>	8.15	(51%)
AECO Monthly Index ( <i>Cdn\$ per Mcf</i> )	<b>4.14</b>	8.13	(49%)
Edmonton Par ( <i>Cdn\$ per bbl</i> )	<b>65.70</b>	102.87	(36%)
Nymex Calendar Average ( <i>US\$ per bbl</i> )	<b>61.80</b>	99.65	(38%)

1) Excludes the change in the fair value of derivatives.

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

*Management's Discussion & Analysis***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 2009, Fairborne realized natural gas prices that were 33% lower than the average price received in 2008. The majority of the decrease from the previous year was due to overall lower spot prices. The Company's risk management program had a significant effect on gas prices received in 2009 with an average of 25,361 Mcf per day sold under fixed price physical sales contracts, representing 41% of the Company's natural gas production. Risk management activities increased the Company's natural gas revenue by an estimated \$35.5 million in 2009 which had the effect of increasing Fairborne's realized natural gas price by \$1.56 per Mcf to \$5.74 per Mcf.

Fairborne's realized prices for 2010 will be impacted by continued volatility in natural gas markets.

The following table summarizes the outstanding fixed price physical sales contracts for natural gas, including contracts outstanding at December 31, 2009 as well as contracts entered into after December 31, 2009:

	2010			
	Q4	Q3	Q2	Q1
Swaps				
Volume (Mcf per day)	25,692	20,982	24,554	24,554
Average price (\$ per Mcf)	6.63	6.66	6.63	6.63

Conversion factor: 1 Mcf = 1.12 GJ

**CRUDE OIL**

During 2009, Fairborne had an average of 1,083 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 increased the Company's crude oil revenue by an estimated \$1.8 million for the year (\$1.46 per bbl). The Company's realized crude oil price of \$65.50 per bbl for 2009 decreased 24% from 2008 which reflected an overall decrease in average market prices.

At December 31, 2009, Fairborne had two crude oil collars for a total of 1,000 bbls per day for the full year of 2010. These contracts were accounted for as derivative contracts and the combined mark-to-market value of these contracts was recorded as a liability of \$0.4 million at December 31, 2009.

The following table summarizes the outstanding fixed price physical sales contracts and derivative contracts on crude oil, including contracts outstanding at December 31, 2009 as well as contracts entered into after December 31, 2009:

	2010
Collars	
Volume (bbls per day)	1,500
Average floor (CDN\$ per bbl)	\$60.00
Average ceiling (CDN\$ per bbl)	\$103.72



*Management's Discussion & Analysis*

## SULPHUR

The Company's average realized sulphur price for 2009 was \$75.73 per tonne excluding sales from the West Pembina sulphur block. Sulphur prices significantly decreased during 2009 and it is anticipated that Fairborne will derive minimal revenue from new sulphur production in 2010.

In July 2008, Fairborne executed a contract for the sale of its share of sulphur inventory at the storage block in West Pembina. \$27.8 million of revenue was recorded from the sale of sulphur inventory during 2009. 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 is recorded as revenue; however, if the purchaser does not take delivery, the cash received is recorded as deferred revenue. At December 31, 2009, \$4.3 million was recorded as deferred revenue, which represented payments received in excess of deliveries. Fairborne estimates that this contract will provide cash receipts of approximately US\$8.0 million in 2010. The contract is expected to be completed in the first half of 2010.

**Petroleum and Natural Gas Revenue**

<i>(\$thousands except as noted)</i>	<b>2009</b>	2008	CHANGE
Petroleum and natural gas sales:			
Natural gas	<b>130,921</b>	193,514	(32%)
Crude oil	<b>80,531</b>	97,415	(17%)
Natural gas liquids	<b>6,766</b>	13,780	(51%)
Sulphur	<b>2,000</b>	13,746	(85%)
Total	<b>220,218</b>	318,455	(31%)
Per BOE	<b>\$41.74</b>	\$61.30	(32%)
Other revenue items:			
Sulphur block	<b>27,836</b>	9,416	196%
Change in the fair value of derivatives	<b>(8,382)</b>	8,011	(205%)
Other income	<b>885</b>	3,060	(71%)
Total	<b>20,339</b>	20,487	(1%)
Total petroleum and natural gas revenue	<b>240,557</b>	338,942	(29%)
Per BOE	<b>\$45.59</b>	\$65.24	(30%)

Petroleum and natural gas sales of \$220.2 million were reported in 2009, a 31% decrease from the \$318.5 reported in 2008. The decrease was a direct result of weakened commodity prices realized throughout 2009.

Other items impacting total revenue in 2009 included \$27.8 million recorded on the sale of inventory from the West Pembina sulphur block (2008 – \$9.4 million), a foreign currency exchange gain of \$1.4 million (2008 – \$nil) as well as a revenue adjustment of \$2.3 million (2008 – \$nil) for prior periods while ATCO operated the West Pembina plant.

The change in fair value of derivatives represents the change in the mark-to-market value of derivatives during 2009. The \$8.4 million decrease recorded in 2009 (2008 – \$8.0 million increase) reflects both the changes in the fair value of existing contracts as well as a reduction for amounts realized on contracts that settled during the period. Fairborne's risk management program, including derivative contracts and physical sales contracts, increased the Company's realized revenue by an estimated \$37.3 million in 2009.

## Management's Discussion &amp; Analysis

## Royalties

<i>(\$thousands except as noted)</i>	<b>2009</b>	2008	CHANGE
Crown	<b>9,893</b>	46,127	(79%)
Freehold and overriding	<b>7,389</b>	11,396	(35%)
Total	<b>17,282</b>	57,523	(70%)
Crown (% of P&NG sales)	<b>4.5%</b>	14.5%	(69%)
Freehold and overriding (% of P&NG sales)	<b>3.4%</b>	3.6%	(6%)
Total (% of P&NG sales)	<b>7.9%</b>	18.1%	(56%)
Per BOE	<b>\$3.28</b>	\$11.07	(70%)

Fairborne recorded \$17.3 million of royalties in 2009 representing a royalty rate of 7.9%, a 56% decrease from the 18.1% (\$57.5 million) recorded in 2008. Freehold and overriding royalties remain consistent averaging between 3% and 4%; however, crown royalty rates decreased from 14.5% in 2008 to 4.5% in 2009. Fairborne's risk management program in 2009 increased natural gas revenues resulting in higher realized prices than the prices utilized in calculating royalties. Other factors contributing to the reduced effective royalty rate in 2009 were increased deductions for allowable operating costs and gas cost allowance as well as a \$2.3 million credit received in 2009 for deep gas royalty holidays on 2008 production from Fairborne's Harlech, Pedley and Marlboro properties. Actual crown royalty rates throughout 2009 have also been substantially lower than the prior year due to significantly depressed natural gas prices and the resulting impact on crown royalty calculations under the new royalty regime in Alberta which was effective January 1, 2009.

## Operating Costs

<i>(\$thousands except as noted)</i>	<b>2009</b>	2008	CHANGE
Operating costs			
Natural gas	<b>38,859</b>	38,312	1%
Oil and NGLs	<b>15,232</b>	14,016	9%
Total	<b>54,091</b>	52,328	3%
Per BOE	<b>\$10.25</b>	\$10.07	2%

Operating costs of \$54.1 million (\$10.25 per BOE) were recorded in 2009, representing a 2% increase from the \$10.07 per BOE recorded in 2008. Factors contributing to the marginally higher operating costs in 2009 include increased third party operating charges at third party operated plants as well as additional water trucking at the Company's Wild River and Sinclair properties, prior to cost reduction initiatives implemented in the first half of 2009.

## Transportation Expenses

	<b>2009</b>	2008	CHANGE
Transportation <i>(\$thousands)</i>	<b>5,622</b>	5,241	7%
Per BOE	<b>\$1.07</b>	\$1.01	6%

Transportations costs of \$5.6 million (\$1.07 per BOE) recorded in 2009 includes 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 in 2009 have increased 6% when compared to 2008 primarily due to the increase in clean oil trucking costs and NGL trucking costs at the Company's Sinclair and Harlech properties.



*Management's Discussion & Analysis***Operating Netbacks**

<i>(\$ per BOE)</i>	<b>2009</b>	2008	CHANGE
Petroleum and natural gas sales <sup>(1)</sup>	<b>41.74</b>	61.30	(32%)
Sulphur block revenue	<b>5.28</b>	1.81	192%
Other income <sup>(1)</sup>	<b>0.17</b>	0.59	(71%)
Royalties	<b>(3.28)</b>	(11.07)	(70%)
Operating costs	<b>(10.25)</b>	(10.07)	2%
Transportation	<b>(1.07)</b>	(1.01)	6%
Operating netback	<b>32.59</b>	41.55	(22%)

1) Excludes the change in fair value of derivatives.

Fairborne's operating netback of \$32.59 per BOE in 2009 decreased 22% compared to 2008 (\$41.55 per BOE) as a result of weaker commodity prices partially offset by decreased royalties.

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

<i>(\$thousands except as noted)</i>	<b>2009</b>	2008	CHANGE
G&A expenses, net of recoveries	<b>13,322</b>	13,351	—
Compensation costs	<b>17,822</b>	8,324	114%
Total G&A expenses	<b>31,144</b>	21,675	44%
G&A expenses, per BOE	<b>\$2.52</b>	\$2.57	(2%)
Compensation costs, per BOE	<b>\$3.38</b>	\$1.60	111%

Fairborne recorded \$13.3 million (\$2.52 per BOE) of G&A expenses, net of recoveries, in 2009, consistent with the \$13.4 million (\$2.57 per BOE) recorded in 2008. Fairborne does not capitalize G&A expenses, other than recoveries permitted under joint operating agreements.

During 2009, the Board of Directors approved a voluntary stock option surrender program, under which various employees, officers and directors surrendered previously issued stock options for cancellation. Compensation expense of \$17.8 million in 2009 is comprised of \$12.6 million of accelerated compensation expense for the 6.6 million stock options that were surrendered on June 1, 2009, \$0.5 million of amortization related to the Restricted Units and Performance Units and \$5.2 million of compensation expense related to the stock option plan offset by a \$0.5 million recovery of compensation expense due to the decrease in the intrinsic value of the retention award program. As at December 31, 2009 the intrinsic value of the retention award program was zero. 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 \$8.3 million in 2008 included \$0.4 million representing the intrinsic value of the retention award program for the year, \$1.3 million related to the amortization of the Restricted Units and Performance Units and \$6.6 million related to the stock option plan.

**Interest**

<i>(\$thousands except as noted)</i>	<b>2009</b>	2008	CHANGE
Interest expense	<b>14,661</b>	13,313	10%
Accretion of convertible debentures	<b>1,988</b>	2,067	(4%)
Total interest	<b>16,649</b>	15,380	8%
Per BOE	<b>\$3.16</b>	\$2.96	7%

Fairborne recorded \$14.7 million in interest expense in 2009, an increase of 10% from \$13.3 million in 2008.

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The increase in interest expense in 2009 reflects the increase in borrowing margins and stamping fees initiated by the Company's lenders with the May 2009 borrowing base renewal. Also included in total interest is the amortization of financing charges associated with the issuance of the convertible debentures. The financing charges recorded in 2009 were consistent with the charges recorded during the prior year. These costs will continue to be expensed over the term of the debentures.

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

	2009	2008	CHANGE
Depletion, depreciation and accretion ( <i>\$thousands</i> )	<b>139,558</b>	124,622	12%
Per BOE	<b>\$26.45</b>	\$23.99	10%

Fairborne recorded \$139.6 million in depletion and depreciation of capital assets and accretion of asset retirement obligations during 2009. On a BOE basis, the DD&A rate of \$26.45 per BOE in 2009 was 10% higher than the prior year's rate of \$23.99 per BOE. Capital expenditures in 2009 increased reserves at a higher cost than the average cost of reserve additions during the prior year, resulting in an increased DD&A rate in 2009.

**Taxes**

	2009	2008	CHANGE
Future tax expense ( <i>\$thousands</i> )	<b>1,856</b>	17,472	(89%)
Per BOE	<b>\$0.35</b>	\$3.36	(90%)

Fairborne recorded a future tax expense of \$1.9 million in 2009 compared to \$17.5 million in 2008. The expense reflects a provision for future taxes at rates expected to apply when the related temporary differences reverse. The decline in tax expense is consistent with the decrease in net earnings in 2009.

**Net Income and Funds Generated from Operations**

<i>(\$thousands except as noted)</i>	2009	2008	CHANGE
Funds generated from operations	<b>143,811</b>	189,175	(24%)
Per share – basic	<b>\$1.59</b>	\$2.20	(28%)
Per share – diluted	<b>\$1.59</b>	\$2.19	(27%)
Cash flow from operations (including changes in working capital)	<b>141,233</b>	187,798	(25%)
Per share – basic	<b>\$1.56</b>	\$2.19	(29%)
Per share – diluted	<b>\$1.56</b>	\$2.18	(28%)
Net income (loss)	<b>(25,645)</b>	44,701	(157%)
Per share – basic	<b>\$(0.28)</b>	\$0.52	(154%)
Per share – diluted	<b>\$(0.28)</b>	\$0.52	(154%)

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

<i>(\$thousands except as noted)</i>	2009	2008
Cash flow from operating activities	<b>141,233</b>	187,798
Change in non-cash working capital	<b>1,168</b>	(367)
Asset retirement expenditures	<b>1,410</b>	1,744
Funds generated from operations	<b>143,811</b>	189,175



*Management's Discussion & Analysis***BOE ANALYSIS**

	2009		2008	
	(\$thousands)	(\$ per BOE)	(\$thousands)	(\$ per BOE)
Petroleum and natural gas revenue <sup>(1)</sup>	<b>240,557</b>	<b>45.59</b>	338,942	65.24
Royalties	<b>(17,282)</b>	<b>(3.28)</b>	(57,523)	(11.07)
Operating costs	<b>(54,091)</b>	<b>(10.25)</b>	(52,328)	(10.07)
Transportation costs	<b>(5,622)</b>	<b>(1.07)</b>	(5,241)	(1.01)
Change in fair value of derivatives	<b>8,382</b>	<b>1.59</b>	(8,011)	(1.54)
General & administrative <sup>(2)</sup>	<b>(13,322)</b>	<b>(2.52)</b>	(13,351)	(2.57)
Compensation expense <sup>(3)</sup>	<b>(150)</b>	<b>(0.03)</b>	–	–
Interest expense <sup>(4)</sup>	<b>(14,661)</b>	<b>(2.78)</b>	(13,313)	(2.56)
Funds generated from operations	<b>143,811</b>	<b>27.25</b>	189,175	36.42
Change in fair value of derivatives	<b>(8,382)</b>	<b>(1.59)</b>	8,011	1.54
Compensation expense – non-cash	<b>(17,672)</b>	<b>(3.34)</b>	(8,324)	(1.60)
Accretion of convertible debentures	<b>(1,988)</b>	<b>(0.38)</b>	(2,067)	(0.40)
Depletion, depreciation and accretion	<b>(139,558)</b>	<b>(26.45)</b>	(124,622)	(23.99)
Future tax expense	<b>(1,856)</b>	<b>(0.35)</b>	(17,472)	(3.36)
Net income (loss)	<b>(25,645)</b>	<b>(4.86)</b>	44,701	8.61

1) Including the change in fair value of derivatives (non-cash) and revenue from the sale of inventory at the West Pembina sulphur block.

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

3) Cash component of compensation expense which resulted from the cash settlement of Restricted Units and Performance Units.

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

**LIQUIDITY AND CAPITAL RESOURCES****Capital Expenditures**

(\$thousands)	2009	2008
Exploration and development		
Land and lease acquisitions	<b>10,138</b>	11,026
Geological and geophysical	<b>(45)</b>	3,242
Drilling, completions and workovers	<b>74,385</b>	172,611
Well equipment and facilities	<b>25,601</b>	50,837
Corporate assets	<b>310</b>	412
	<b>110,389</b>	238,128
Property acquisitions	<b>5,196</b>	1,683
Property dispositions	<b>(30,040)</b>	–
Corporate acquisitions	–	133,861
Total	<b>85,545</b>	373,672

During 2009, Fairborne's exploration and development expenditures totaled \$110.4 million with capital expenditures financed entirely through funds generated from operations. The Company also completed a number of property acquisitions and dispositions throughout 2009. Property acquisitions of \$5.2 million included additional working interests at Wild River, West Marlboro, Sinclair and Bonnie Glen. Property dispositions of \$30.0 million included \$19.2 million for the disposition of a portion of Fairborne's working interest in the West Pembina gas plant and \$10.8 for the disposition of non-core properties in the Deep Basin.

Fairborne was active in provincial land sales during the year, spending \$10.1 million to acquire new lands, primarily in the Harlech and Marlboro areas.

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Fairborne spent \$74.4 million on drilling and completion activities in 2009 with a total of 53 (42.1 net) wells drilled resulting in 19 (13.8 net) natural gas wells, 21 (17.1 net) CBM wells and 13 (11.2 net) oil wells. Drilling activities during 2009 were focused primarily on Fairborne's Harlech, Clive, Sinclair and Deep Basin properties with nine (6.2 net) wells drilled in Harlech, 27 (22.6 net) wells (CBM or Belly River) drilled on the Company's Clive, Haynes, Wood River and Erskine properties, six (4.3 net) wells drilled on Deep Basin properties and seven (7.0 net) wells drilled on Fairborne's Sinclair property in Manitoba.

In 2009 tangible capital expenditures of \$25.6 million included the installation of a battery and extensive oil gathering system in the Sinclair field, the installation of a central compression facility in Harlech as well as an upgrade to the existing water disposal pipeline in the Wild River area. The expenditures also included the construction of numerous well tie-ins in the Clive, Haynes, Sinclair, Columbia/Harlech and Marlboro areas.

**Working Capital and Bank Indebtedness**

At December 31, 2009, Fairborne had drawn \$103.7 million (2008 – \$196.3 million) against its credit facilities and had a working capital deficit of \$6.4 million (2008 – \$27.9 million) for a net debt position (excluding convertible debentures) of \$110.1 million (2008 – \$224.2 million). In 2009, Fairborne's total capital expenditure program of \$110.4 million was financed entirely by funds generated from operations of \$143.8 million. The excess of funds generated from operations along with proceeds from property dispositions and the equity financing completed in October 2009 were applied against outstanding bank debt resulting in the significant decrease from 2008.

Fairborne's credit facilities at December 31, 2009 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 28, 2010 (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, 2011. 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 0.75% to 4.25% 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 Company anticipates it will have adequate liquidity to fund its financial liabilities as they come due. Fairborne is not in default or breach of any of its covenants under its current facilities or any of its financial liabilities.

During periods of extreme volatility in both commodity and capital markets, such as experienced in 2009, 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 well, through periods of extreme market fluctuations, the Company strives to maintain flexibility and liquidity in its capital structure. 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 2009 and continuing into 2010, the ability to issue additional shares may become 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.



### *Management's Discussion & Analysis*

In order to maintain or adjust the capital structure, Fairborne considers various factors including: its forecast debt to forecast 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 2009 and moving into 2010, the Company will continually re-evaluate its capital expenditure program in light of projected cash flows.

#### **Convertible Debentures**

At December 31, 2009, Fairborne had 100,000 Convertible Unsecured Subordinated Debentures (the "Debentures") with a face value 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.

In October 2009 the Company closed a bought deal share financing for aggregate gross proceeds of approximately \$69.5 million, comprised of \$49.5 million through the issuance of 11.6 million common shares at an issue price of \$4.25 and \$20 million through the issuance of 3.8 million flow-through common shares at an issue price of \$5.30. Net proceeds were initially applied against outstanding bank debt. Proceeds from the issuance of the flow-through common shares will be renounced to subscribers effective on or before December 31, 2009. As a result of the flow-through share issue, Fairborne has a commitment to spend \$20 million on qualifying Canadian exploration expenditures. As at December 31 2009, \$2.8 million of qualifying exploration expenditures have been incurred.

During 2009 99,604 common shares were issued on the exercise of 99,987 RTU's and PTU's and 60,000 RTU's and PTU's were settled for cash. Pursuant to the terms of the plans, settlements of restricted and performance units can be made in cash, common shares or some combination thereof at the discretion of the Board of Directors. As such, the incentive plan is now accounted for as a liability based plan rather than an equity based plan.

During 2009, the Board of Directors approved a voluntary stock option surrender program. Under the program various employees, officers and directors surrendered for cancellation effective June 1, 2009, 6.6 million stock options with exercise prices ranging from \$10.00 to \$13.16 per share.

In November 2009, the Company issued 3.1 million stock options to employees, officers and directors with an exercise price of \$4.81. Concurrent with this issue, 6.2 million RAP's were voluntarily surrendered by employees, officers and directors.

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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>March 2, 2010</b>	<b>December 31, 2009</b>	December 31, 2008
Common shares	<b>102,461</b>	<b>102,462</b>	86,933
Warrants <sup>(1)</sup>	<b>4,406</b>	<b>4,406</b>	4,406
Convertible debentures <sup>(2)</sup>	<b>\$100,000</b>	<b>\$100,000</b>	\$100,000
Incentive plans			
Restricted units <sup>(3)</sup>	<b>30</b>	<b>30</b>	78
Performance units <sup>(4)</sup>	<b>92</b>	<b>92</b>	204
Stock options	<b>5,401</b>	<b>5,235</b>	6,904
Weighted average shares <sup>(5)</sup>			
Basic	<b>n/a</b>	<b>90,609</b>	85,854
Diluted	<b>n/a</b>	<b>90,609</b>	86,216

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, 2009, the Restricted Units entitle the holders to acquire an aggregate of 35,125 common shares of the Company (March 3, 2010 – 35,125 common shares), subject to vesting in accordance with the restricted unit and performance unit incentive plan (the "Incentive Plan").*

4) *At December 31, 2009, the Performance Units entitle the holders to acquire an aggregate of 84,714 common shares of the Company (March 3, 2010 – 84,174 common shares), subject to vesting in accordance with the Incentive Plan.*

5) *Weighted average common shares are for the twelve months ended December 31, 2009 and 2008.*

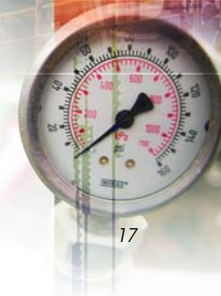
## CONTRACTUAL OBLIGATIONS & COMMITMENTS

Fairborne has certain lease commitments for its office premises through to June 2011. As at December 31, 2009, the payments due under these leases are approximately \$1.1 million per year (2008 – \$0.9 million per year).

As a result of the equity financing in October 2009, Fairborne has a commitment to spend \$20.0 million on qualifying Canadian exploration expenditures. As at December 31, 2009, \$2.8 million of qualifying exploration expenditures have been incurred.

## OFF-BALANCE-SHEET ARRANGEMENTS

Fairborne has no off-balance-sheet arrangements.



*Management's Discussion & Analysis***BUSINESS ENVIRONMENT AND RISK**

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.

**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.

**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.

**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****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.

In order to transition to IFRS, management has formed an executive steering committee which oversees the project team. A transition plan is in place to convert the financial statements to IFRS. Training has been provided to key employees and the Company continues to assess the effect of the transition on information systems, internal controls over financial reporting and disclosure controls and procedures. Systems and controls are being updated as IFRS accounting processes are implemented. Analysis and quantification of differences between IFRS and Fairborne's current accounting policies is continuing. Some accounting policies may change on adoption of IFRS even though Fairborne's current accounting policies are acceptable under IFRS. Changes in accounting policy may materially impact the financial statements.

There are several significant accounting policy changes anticipated on adoption of IFRS. Changes in IFRS prior to adoption may result in other accounting policy changes which could significantly impact the financial statements. Numerous accounting policy changes will be made under IFRS, with the most significant changes expected to include accounting for petroleum and natural gas assets and equipment ("P&NG assets"), accounting for business combinations and accounting for future taxes.

**PETROLEUM AND NATURAL GAS ASSETS**

IFRS standards require that a company choose to report their petroleum and natural gas ("P&NG") assets either at the amount which would have been recorded had the company always followed current IFRS standards or at fair value on the date of adoption of IFRS. Alternatively, IFRS standards allow for a conversion exemption whereby companies can choose to record opening petroleum and natural gas properties at a deemed cost equal to historic cost as calculated under Canadian GAAP. Fairborne currently intends to elect to record P&NG assets at either historic cost as calculated under Canadian GAAP on January 1, 2010 or at fair value on that date. Fairborne has not yet determined which of these options will be chosen as the opening IFRS deemed cost basis.

Under Canadian GAAP, all petroleum and natural gas assets are accounted for under the full cost accounting guideline. Under IFRS, P&NG assets will be divided into exploration and evaluation properties ("E&E assets") and petroleum and natural gas properties and equipment ("development assets"). E&E assets will initially be capitalized and accumulated pending determination of technical feasibility and economic viability. E&E assets will



*Management's Discussion & Analysis*

not be depreciated and will be carried at cost less any accumulated impairment losses. Development assets will be measured at cost less accumulated depletion and depreciation and any accumulated impairment losses.

Both E&E assets and development assets will be assessed to determine whether impairment losses exist under IFRS as at January 1, 2010. These impairment tests will differ from the current Canadian GAAP full cost ceiling test in several significant ways. Assets (including goodwill) will be allocated to Cash Generating Units ("CGU"s) and a separate impairment test will be completed for each CGU identified. Under current Canadian GAAP the ceiling test is a two step test. The carrying value of assets is first compared to the undiscounted future cash flows. If the carrying value of the assets exceeds the undiscounted future cash flows, then the second step of the test is required whereby the assets are written down to the value of the discounted future cash flows. Under IFRS, the impairment test compares the carrying value of the assets to the greater of the fair value of the assets and the value-in-use of the assets, which is a discounted cash flow measure. As a result, impairments will be recorded more frequently under IFRS. Future impairment tests may be required when management determines that indicators of impairment exist. Should impairment losses be recorded in accordance with IFRS, certain of those losses can reverse in the future if facts and circumstances change.

Depreciation under Canadian GAAP is calculated using a unit-of-production method based on total proved reserves for all accumulated costs (excluding unproved properties). Under IFRS, the net carrying value of development assets will still be depleted using a unit of production method; however, significant components with different useful lives, will be accounted for as separate items and depreciated separately. In addition, IFRS allows depreciation to be calculated using either proved reserves or proved plus probable reserves. Fairborne has not yet determined whether depreciation will be calculated using proved or proved plus probable reserves.

Under the full cost accounting guideline, gains or losses are not recognized upon the disposition of P&NG assets unless the disposition results in a significant change in the depletion rate. Under IFRS, gains and losses are recognized in net income on the disposal of an item of P&NG assets. The amount of the gain or loss is determined by comparing the proceeds from disposal with the carrying amount of the item. This will include transactions such as sales of assets, farm-outs, asset swaps and other non-monetary transactions which typically did not result in gains or losses being recorded under Canadian GAAP.

The quantitative impact to Fairborne of these changes to accounting for P&NG assets has not been determined.

#### BUSINESS COMBINATIONS

Accounting for business combinations also differs under IFRS. Fairborne intends to elect not to restate business combinations recorded prior to January 1, 2010 in accordance with IFRS standards. As a result, in respect of acquisitions prior to January 1, 2010, goodwill continues to represent the amount recognized under Canadian GAAP. However, goodwill recognized in business combinations after January 1, 2010 recorded under IFRS will represent the excess of the cost of the acquisition over the net fair value of the identifiable assets, liabilities and contingent liabilities of the acquired entity. When the excess is negative, it will be recognized immediately in profit and loss. In addition, transaction costs which are included in the cost of the acquisition under Canadian GAAP will be expensed under IFRS. The Company has the option to early adopt the IFRS standard for business combinations. The Company will assess this option if the Company enters into a business combination in 2010.

#### DEFERRED INCOME TAXES

Deferred income taxes are calculated under IFRS using a liability approach which is conceptually similar to Canadian GAAP however there are differences in the manner in which deferred income taxes are calculated. The impact of these changes is being assessed and has not been quantified.

*Management's Discussion & Analysis***OTHER ITEMS**

There are other accounting policy changes with potentially material impacts, including accounting for asset retirement obligations (ARO) and accounting for convertible debentures. The ARO calculation differs under IFRS in some respects. On initial adoption of IFRS, the ARO liability will be recorded at its revised amount and the difference from the amount recorded under Canadian GAAP will be recorded as an adjustment to retained earnings at January 1, 2010.

Fairborne's convertible debentures are currently recorded under Canadian GAAP as a compound instrument with a debt component and an equity component. On adoption of IFRS, Fairborne expects to recognize the entire fair value of the convertible debentures as a liability, again with the difference from the amount recorded under Canadian GAAP being an adjustment to retained earnings at January 1, 2010. Subsequent changes in the value of the convertible debentures will be recorded in net income under IFRS.

**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 2008 and 2009 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, 2009 and ended on December 31, 2009 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.

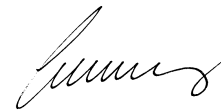
Management has established systems of internal controls, which are designed to provide reasonable assurance that assets are safeguarded from loss or unauthorized use and to produce reliable accounting records for the preparation of financial information.

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  
March 2, 2010

**AUDITORS' REPORT****To the Shareholders of Fairborne Energy Ltd.**

We have audited the consolidated balance sheets of Fairborne Energy Ltd. as at December 31, 2009 and 2008 and the consolidated statements of operations and retained earnings 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, 2009 and 2008 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

March 2, 2010



## Consolidated Financial Statements

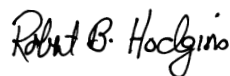
**CONSOLIDATED BALANCE SHEETS**

As at December 31,

<i>(\$thousands)</i>	2009	2008
<b>Assets</b>		
Current assets		
Cash and cash equivalents	\$ 147	\$ 126
Accounts receivable	35,155	47,915
Derivative asset <i>(Note 10)</i>	-	8,023
Prepaid expenses and deposits	8,079	6,742
	43,381	62,806
Petroleum and natural gas properties and equipment <i>(Note 3)</i>	880,892	934,201
Goodwill	16,170	16,170
	<b>\$ 940,443</b>	<b>\$ 1,013,177</b>
<b>Liabilities</b>		
Current liabilities		
Accounts payable and accrued liabilities	\$ 44,602	\$ 88,877
Derivative liability <i>(Note 10)</i>	359	-
Current portion of compensation plan <i>(Note 8)</i>	505	396
Deferred revenue	4,285	1,450
	49,751	90,723
Bank indebtedness <i>(Note 4)</i>	103,738	196,282
Convertible debentures <i>(Note 5)</i>	96,510	94,522
Compensation plan <i>(Note 8)</i>	-	111
Asset retirement obligation <i>(Note 6)</i>	11,200	11,904
Future income taxes <i>(Note 7)</i>	89,919	81,860
<b>Shareholders' Equity</b>		
Common shares <i>(Note 8)</i>	536,789	475,908
Warrants <i>(Note 8)</i>	2,721	2,721
Equity component of convertible debentures <i>(Note 5)</i>	5,581	5,581
Contributed surplus <i>(Note 8)</i>	24,827	8,513
Retained earnings	19,407	45,052
	589,325	537,775
Commitments <i>(Note 11)</i>	<b>\$ 940,443</b>	<b>\$ 1,013,177</b>

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**

For the years ended December 31,

<i>(\$thousands except per share amounts)</i>	<b>2009</b>	2008
<b>Revenue</b>		
Petroleum and natural gas	<b>\$ 240,557</b>	\$ 338,942
Royalties	<b>(17,282)</b>	(57,523)
	<b>223,275</b>	281,419
<b>Expenses</b>		
Operating	<b>54,091</b>	52,328
Transportation	<b>5,622</b>	5,241
General and administrative	<b>31,144</b>	21,675
Interest	<b>16,649</b>	15,380
Depletion, depreciation and accretion	<b>139,558</b>	124,622
	<b>247,064</b>	219,246
<b>Income (loss) before taxes</b>	<b>(23,789)</b>	62,173
Future taxes	<b>1,856</b>	17,472
<b>Net income (loss) and comprehensive income (loss)</b>	<b>(25,645)</b>	44,701
Retained earnings, beginning of year	<b>45,052</b>	351
<b>Retained earnings, end of year</b>	<b>\$ 19,407</b>	\$ 45,052
<b>Net income (loss) per share</b> <i>(Note 8)</i>		
Basic	<b>\$ (0.28)</b>	\$ 0.52
Diluted	<b>\$ (0.28)</b>	\$ 0.52

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>	2009	2008
<b>Cash provided by (used in):</b>		
<b>Operating activities</b>		
Net income (loss)	\$ (25,645)	\$ 44,701
Items not involving cash:		
Depletion, depreciation and accretion	139,558	124,622
Compensation expense	17,672	8,324
Future taxes	1,856	17,472
Accretion of convertible debentures	1,988	2,067
Change in fair value of derivatives	8,382	(8,011)
Asset retirement expenditures	(1,410)	(1,744)
	142,401	187,431
Change in non-cash working capital	(1,168)	367
	141,233	187,798
<b>Financing activities</b>		
Bank indebtedness	(92,544)	97,831
Issuance of common shares, net of costs	65,724	27,552
	(26,820)	125,383
<b>Investing activities</b>		
Expenditures on petroleum and natural gas properties	(110,389)	(238,128)
Acquisition of petroleum and natural gas properties	(5,196)	(1,683)
Disposition of petroleum and natural gas properties	30,040	-
Corporate acquisitions <i>(Note 2)</i>	-	(102,054)
Change in non-cash working capital	(28,847)	28,694
	(114,392)	(313,171)
Change in cash and cash equivalents	21	10
Cash and cash equivalents, beginning of year	126	116
<b>Cash and cash equivalents, end of year</b>	<b>\$ 147</b>	<b>\$ 126</b>
Interest paid	\$ 15,485	\$ 12,781

See accompanying notes to the consolidated financial statements.

*Consolidated Financial Statements***NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS***For the Years Ended December 31, 2009 and 2008**(tabular amounts are stated in thousands or thousands of dollars except per share amounts)***NATURE OF OPERATIONS**

Fairborne Energy Ltd. (the “Company” or “Fairborne”) is incorporated under the Business Corporations Act (Alberta) and is a public company listed on the Toronto Stock Exchange. 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.

**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 the 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 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.



## *Consolidated Financial Statements*

### **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.

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.

*Consolidated Financial Statements***g) Equity based compensation**

Prior to the reorganization of Fairborne Energy Ltd. on December 19, 2007, Fairborne Energy Trust (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 can be settled in cash, common shares, or some combination thereof at the discretion of the Board of Directors. Prior to 2009, all settlements were in the form of equity. As such, the plan was accounted for as an equity settled award, whereby compensation cost was estimated at the date of the grant and recognized in earnings over the vesting period with the offset included in contributed surplus. In 2009, certain Restricted and Performance Units were settled for cash. As a result of these cash settlements the incentive plan is currently accounted for as a liability based plan rather than an equity based plan. Accordingly, as future awards vest a liability will be recorded equal to the number of awards vested multiplied by the Company’s share price at the balance sheet date.

In 2007, the Company instituted a retention award plan which is described in Note 8(d). The intrinsic value of vested cash settled compensation awards is calculated at each reporting period and recorded as a liability. Compensation expense associated with liability based compensation plans is recognized in income over the vesting period of the plans based on the intrinsic value of the plans 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.

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 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 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.

**h) Income taxes**

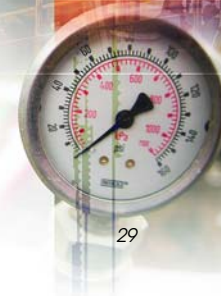
Fairborne uses the liability method of accounting for future income taxes. Under the liability method, future income tax assets and liabilities are determined based on “temporary differences” (differences between the accounting basis and the tax basis of the assets and liabilities), and are measured 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 less accumulated depreciation. Depreciation is provided on a declining balance basis at a rate of 20%.

**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.



## *Consolidated Financial Statements*

### **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 other relevant assumptions. The fair value of the Company used to assess goodwill impairment is based on estimates, particularly the premium that would be paid to acquire a controlling interest in the Company. 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.

## **2. 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 \$101.7 million for the Grand Banks common shares. The acquisition has been accounted for using the 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:

## Consolidated Financial Statements

Cost of Acquisition:	
Cash	\$ 101,704
Transaction costs	350
	\$ 102,054
Allocated:	
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)
	\$ 102,054

## 3. PETROLEUM AND NATURAL GAS PROPERTIES AND EQUIPMENT

	2009	2008
Petroleum and natural gas properties and equipment	\$ 1,435,282	\$ 1,350,355
Accumulated depletion and depreciation	(556,289)	(418,156)
Corporate assets	4,307	4,037
Accumulated depreciation	(2,408)	(2,035)
	\$ 880,892	\$ 934,201

At December 31, 2009, future development costs of \$193.8 million (2008 – \$189.0 million) were included in the depletion calculation and costs of acquiring unproved properties in the amount of \$48.2 million (2008 – \$59.1 million) were excluded from the depletion calculation.

Fairborne performed a ceiling test calculation at December 31, 2009 and December 31, 2008 to assess the recoverable value of petroleum and natural gas properties and equipment. The oil and gas future prices for the December 31, 2009 ceiling test are based on the January 1, 2010 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, 2009.

Year	WTI Oil (\$U.S./bbl)	Foreign Exchange Rate	Edmonton Light Crude Oil (\$Cdn/bbl)	AECO Gas (\$Cdn/mmBtu)
2010	80.00	1.05	83.26	5.96
2011	83.00	1.05	86.42	6.79
2012	86.00	1.05	89.58	6.89
2013	89.00	1.05	92.74	6.95
2014	92.00	1.05	95.90	7.05
2015	93.84	1.05	97.84	7.16
2016	95.72	1.05	99.81	7.42
2017	97.64	1.05	101.83	7.95
2018	99.59	1.05	103.88	8.52
2019	101.58	1.05	105.98	8.69
Escalate thereafter 2.0% per year				



*Consolidated Financial Statements***4. BANK INDEBTEDNESS**

At December 31, 2009 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 28, 2010 (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 28, 2011. 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 0.75% to 4.25% 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, 2009 letters of credit totaling \$0.7 million were outstanding.

**5. CONVERTIBLE DEBENTURES**

The following table sets forth a reconciliation of the convertible debentures for the years ended December 31, 2009 and 2008:

	Number of Debentures	Debt component	Equity component
Balance, December 31, 2007	100,000	\$ 92,455	\$ 5,581
Accretion	—	2,067	—
Balance, December 31, 2008	100,000	94,522	5,581
Accretion	—	1,988	—
Balance, December 31, 2009	<b>100,000</b>	<b>\$ 96,510</b>	<b>\$ 5,581</b>

At December 31, 2009, the Company had 100,000 convertible unsecured subordinated debentures outstanding with a face value of \$100 million that mature on December 31, 2011. 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 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 has 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.

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.

*Consolidated Financial Statements***6. 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 at December 31, 2009 to be approximately \$39.7 million (2008 – \$40.3 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:

	<b>2009</b>	2008
Balance, beginning of year	<b>\$ 11,904</b>	\$ 9,084
Grand Banks acquisition <i>(Note 2)</i>	–	1,342
Revision of estimates	<b>51</b>	1,519
Liabilities incurred	<b>498</b>	796
Liabilities settled	<b>(1,410)</b>	(1,744)
Liabilities disposed	<b>(854)</b>	–
Accretion expense	<b>1,011</b>	907
Balance, end of year	<b>\$ 11,200</b>	\$ 11,904

**7. 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:

	<b>2009</b>	2008
Income (loss) before taxes	<b>\$ (23,789)</b>	\$ 62,173
Combined federal and provincial tax rate	<b>29.2%</b>	29.7%
Computed "expected" income tax expense (recovery)	<b>(6,946)</b>	18,465
Increase (decrease) in income taxes resulting from:		
Non-deductible unit based compensation	<b>5,352</b>	2,360
Effect of change in tax rate	<b>3,295</b>	(3,155)
Other	<b>155</b>	(198)
Future taxes	<b>\$ 1,856</b>	\$ 17,472



*Consolidated Financial Statements*

The components of the future income tax liability at December 31, 2009 and 2008 are as follows:

	2009	2008
Future income tax liabilities:		
Petroleum and natural gas properties and equipment	\$ 112,108	\$ 100,856
Derivative asset	-	2,022
	<b>112,108</b>	102,878
Future income tax assets:		
Asset retirement obligation	(2,820)	(2,997)
Share issue costs	(1,618)	(1,316)
Income tax losses (expire 2010 to 2029)	(17,751)	(16,705)
	<b>(22,189)</b>	(21,018)
Net future income tax liability	<b>\$ 89,919</b>	\$ 81,860

**8. 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.**

	2009		2008	
	Number of Shares	Amount	Number of Shares	Amount
Balance, beginning of year	86,933	\$ 475,908	84,282	\$ 445,105
Flow through shares issued for cash	3,780	20,034	2,300	28,405
Common shares issued for cash	11,649	49,508	-	-
Issued on vesting of Restricted Units and Performance Units	100	1,360	264	2,727
Issued on exercise of warrants	-	-	87	837
Share issue costs	-	(3,818)	-	(1,554)
Future tax benefit of share issue costs	-	955	-	388
Tax effect of flow-through shares issued	-	(7,158)	-	-
Balance, end of year	<b>102,462</b>	<b>\$ 536,789</b>	86,933	\$ 475,908

As a result of the 2009 flow-through financing, Fairborne has a commitment to spend \$20.0 million on qualifying Canadian exploration expenditures. The expenditures will be renounced to investors with an effective date of renunciation of December 31, 2009. As at December 31 2009, \$2.8 million of qualifying exploration expenditures have been incurred.

Pursuant to a Plan of Arrangement effective December 19, 2007, Fairborne Energy Trust converted to Fairborne Energy Ltd. As part of the arrangement, stated capital was reduced by the deficit balance of \$72.1 million.

*Consolidated Financial Statements***b) Warrants**

The following table sets forth a reconciliation of the warrants issued and outstanding for the years ended December 31, 2009 and 2008:

	2009		2008	
	Number of Warrants	Amount	Number of Warrants	Amount
Balance, beginning of year	4,406	\$ 2,721	4,627	\$ 2,857
Exercised for common shares	–	–	(221)	(136)
Balance, end of year	4,406	\$ 2,721	4,406	\$ 2,721

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. 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.

**c) Per share amounts**

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

	2009	2008
Numerator		
Net income (loss) – basic and diluted	\$ (25,645)	\$ 44,701
Denominator		
Weighted average shares – basic	90,609	85,854
Restricted Units	–	114
Performance Units	–	248
Denominator for diluted net income per share	90,609	86,216
Basic net income (loss) per share	\$ (0.28)	\$ 0.52
Diluted net income (loss) per share	\$ (0.28)	\$ 0.52

Excluded from the diluted number of shares for the year ended December 31, 2009 is the effect of convertible debentures (7.4 million shares), warrants (1.7 million shares) and 3.4 million stock options as they are out of the money based on average market prices for the period. A further 1.8 million stock options are excluded as they are anti-dilutive to the net loss for the period. 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.



*Consolidated Financial Statements***d) 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, 2009 and 2008:

	2009		
	Number of Performance Units	Number of Restricted Units	Total
Balance, beginning of year	78	204	282
Exercised	(48)	(112)	(160)
Balance, end of year	30	92	122
Exercisable, end of year	-	-	-
Equivalent common shares, end of year <sup>(1)</sup>	35	85	120

	2008		
	Number of Performance Units	Number of Restricted 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

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.

Restricted Units vest annually over a three-year period and, upon vesting, entitle the holder to receive Fairborne common shares equal to the number of Restricted Units plus the value of accumulated distributions prior to December 17, 2007. Performance Units vest on the third anniversary of the date of grant and entitle the holder to receive common shares equal to the number of Performance Units multiplied by a set performance factor of 0.92 including distributions.

Pursuant to the terms of the plans, settlements of Restricted and Performance units can be made in cash, common shares or some combination thereof at the discretion of the Board of Directors. Prior to January 1, 2009, all settlements were in the form of equity, either in trust units or common shares. During 2009, 60,000 Restricted Units and Performance Units were settled for cash of \$0.1 million. As such, the incentive plan is accounted for as a liability based plan rather than an equity based plan resulting in the recognition of a \$0.4 million liability on reclassification of the plan to a liability settled award with a corresponding reduction in contributed surplus. As future awards vest a liability will be recorded equal to the number of awards vested multiplied by the Company's share price at the balance sheet date. Included in the current liability for compensation plans at December 31, 2009 is \$0.5 million (2008 - \$nil) related to the Restricted and Performance units.

**ii) STOCK OPTION PLAN**

Fairborne has 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 not less than the volume weighted average trading price of common shares for the five trading days

*Consolidated Financial Statements*

prior to the date of grant. The maximum number of shares reserved for issuance under the stock option plan is 10.2 million (10% of the outstanding common shares at December 31, 2009), of which 5.2 million are outstanding.

The following table sets forth a reconciliation of the stock option plan activity for the years ended December 31, 2009 and 2008:

	2009		2008	
	Number of awards	Weighted average exercise price	Number of awards	Weighted average exercise price
Balance, beginning of year	6,904	\$ 12.74	–	\$ –
Granted	5,118	4.00	7,027	12.73
Forfeited	(200)	9.43	(123)	12.62
Cancelled	(6,587)	12.79	–	–
Balance, end of year	5,235	\$ 4.25	6,904	\$ 12.74
Exercisable, end of year	94	\$ 11.29	–	\$ –

The weighted average fair value of options granted in 2009 was \$1.68 (2008 – \$3.36) per option using the Black-Scholes option pricing model with the following assumptions: risk free interest rate of 1.5 percent (2008 – 3 percent), expected volatility of 59 percent (2008 – 37 percent), average expected life of three years and a dividend rate of nil. An estimated forfeiture rate of two percent has been applied to the compensation costs recognized.

During 2009, the Board of Directors approved a voluntary stock option surrender program. Under the program various employees, officers and directors surrendered previously issued stock options for cancellation. The options surrendered by holders were cancelled effective June 1, 2009 and had an average exercise price of \$12.79. The Company recognized the remaining unamortized stock based compensation costs associated with the cancelled options of \$12.6 million.

The following table summarizes stock options outstanding at December 31, 2009:

Exercise Price	Options outstanding	Remaining term (years)
\$ 2.00 – \$ 4.99	5,055	4.6
\$ 5.00 – \$ 7.99	30	3.8
\$ 8.00 – \$ 10.99	64	3.8
\$ 11.00 – \$ 13.99	86	3.6
	5,235	4.6

### III) RETENTION AWARD PLAN

Fairborne has 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.

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).



### Consolidated Financial Statements

During 2009, the Board of Directors approved a voluntary Retention Award surrender program. Under the program various employees, officers and directors surrendered 6.2 million previously issued Retention Awards for cancellation. In conjunction with the voluntary surrender, Fairborne issued 3.1 million options with an exercise price of \$4.81.

At December 31, 2009, the liability associated with the Retention Awards is \$nil (2008 – \$0.5 million).

The following table sets forth a reconciliation of the retention award plan activity for the years ended December 31, 2009 and 2008:

	2009		2008	
	Number of awards	Weighted average grant price	Number of awards	Weighted average grant price
Balance, beginning of year	8,005	\$ 5.87	7,420	\$ 5.75
Exercised	(25)	5.75	–	–
Granted	–	–	975	6.88
Forfeited	(395)	5.72	(390)	5.78
Cancelled	(6,195)	5.93	–	–
Balance, end of year	1,390	\$ 5.74	8,005	\$ 5.87
Exercisable, end of year	907	\$ 5.74	2,277	\$ 5.75

#### e) Contributed Surplus

The following table sets forth a reconciliation of the contributed surplus for the years ended December 31, 2009 and 2008:

	2009	2008
Balance, beginning of year	\$ 8,513	\$ 3,294
Equity based compensation	18,173	7,972
Restricted and Performance Units exercised	(1,360)	(2,727)
Compensation plan forfeitures	(116)	(26)
Reclassification to compensation plan liability <i>(Note 8 (d)(i))</i>	(383)	–
Balance, end of year	\$ 24,827	\$ 8,513

#### f) Management of Capital Structure

Fairborne 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

*Consolidated Financial Statements*

acquisition and disposition transactions which all carry varying amounts of risk. Fairborne continually strives to balance the proportion of debt 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.

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 no more than 1 to 1, excluding convertible debentures. However, this ratio may increase at certain times as a result of acquisitions or 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, 2009, Fairborne's ratio of net debt to annualized cash flow was 0.77 to 1 (2008 – 1.19 to 1).

## 9. 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, 2009, the Company's accounts receivable consisted of \$16.2 million from joint venture partners, \$18.2 million from petroleum and natural gas marketers and \$0.8 million of other trade receivables.

The carrying amount of accounts receivable and cash and cash equivalents represents the maximum credit exposure. Fairborne does not have an allowance for doubtful accounts as at December 31, 2009 and 2008 and did not provide for any doubtful accounts nor was it required to write-off any receivables for the years ended December 31, 2009 and 2008. The amounts outstanding for more than 90 days are predominantly due from large well established joint venture partners.

As at December 31, 2009, the Company's accounts receivable is aged as follows:

Aging	
Current (less than 90 days)	\$ 31,282
Past due (more than 90 days)	3,873
Total	\$ 35,155



## Consolidated Financial Statements

### 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, derivative liability, 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 4. The \$285 million 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 two 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 the 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 of 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 that are not accounted for as normal sales contracts are directly impacted by changes in the foreign exchange rate. A \$0.10 change to the foreign exchange rate would have an immaterial impact on the derivative liability at December 31, 2009 (2008 – \$0.7 million).

#### COMMODITY PRICE RISK

Commodity price risk is the risk that the fair value of 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 10. The derivative contracts resulted in a loss on the fair value of derivatives of \$8.4 million (2008 – gain of \$ 8.0 million) for the year ended December 31, 2009 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, 2009 increased realized revenue by an estimated \$35.5 million (2008 – \$1.1 million). The fixed price physical delivery contracts for oil that settled during the year ended December 31, 2009 increased realized revenue by an estimated \$1.8 million (2008 – reduced realized revenue by \$8.3 million). A one dollar change to the price per barrel of oil would have a \$0.4 million impact on the value of the derivative liability at December 31, 2009 (2008 – \$0.2 million). A \$0.25 change to the price per thousand cubic feet of natural gas would have no impact on the value of the derivative liability at December 31, 2009 and an immaterial impact 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, 2009 by approximately \$1.5 million (2008 – \$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, 2009 and 2008.

## d) Fair value of financial instruments:

The carrying value of Fairborne's financial instruments, other than bank indebtedness and convertible debentures, approximate their 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 and the margins charged by the lenders are indicative of current credit spreads. The fair value of the convertible debentures at December 31, 2009 was \$100.3 million (2008 – \$74.5 million), based on observable trading prices. The fair value of the Company's financial instruments, excluding working capital, are attributable to the following fair value hierarchy levels as at December 31, 2009:

	Fair Value	Level 1	Level 2	Level 3
Derivative liability	359	–	359	–
Bank indebtedness	103,738	–	103,738	–
Convertible debentures	100,250	100,250	–	–

## 10. COMMODITY CONTRACTS

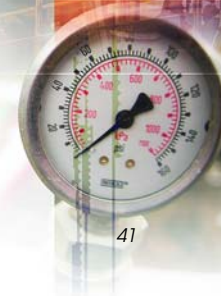
Fairborne has a risk management program whereby the Company sells forward a portion of its future production through fixed price physical sales contracts with customers.

## a) Commodity Contracts Recorded at Fair Value:

At December 31, 2009, certain physical sales contracts have been recorded on the balance sheet at their estimated fair value as a \$0.4 million liability (2008 – asset of \$8.0 million). The change in the fair value has been recorded in petroleum and natural gas sales.

## Oil:

	Volume (bbls per day)	Price (US\$ per bbl)	Settlement Index
Collars			
Jan 1, 2010 – Dec 31, 2010	500	55.00 – 108.00	WTI
Jan 1, 2010 – Dec 31, 2010	500	70.00 – 100.15	WTI



*Consolidated Financial Statements***b) Commodity Contracts not Recorded at Fair Value:**

The following oil and natural gas fixed price physical sales contracts outstanding at December 31, 2009 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 (GJs per day)	Price (CDN\$ per GJ)	Settlement Index
AECO Swaps			
Jan 1, 2010 – Mar 31, 2010	5,275	5.77	AECO C Monthly
Jan 1, 2010 – Dec 31, 2010	5,000	5.86	AECO C Monthly
Jan 1, 2010 – Dec 31, 2010	2,500	5.67	AECO C Monthly
Jan 1, 2010 – Dec 31, 2010	1,500	5.90	AECO C Monthly
Jan 1, 2010 – Dec 31, 2010	1,500	5.86	AECO C Monthly
Jan 1, 2010 – Dec 31, 2010	1,500	5.88	AECO C Monthly
Jan 1, 2010 – Dec 31, 2010	1,500	6.00	AECO C Monthly
Jan 1, 2010 – Dec 31, 2010	4,000	6.00	AECO C Monthly
Jan 1, 2010 – Dec 31, 2010	2,000	6.13	AECO C Monthly
Jan 1, 2010 – Dec 31, 2010	2,000	6.15	AECO C Monthly
Jan 1, 2010 – Dec 31, 2010	2,000	6.16	AECO C Monthly

**Oil:**

	Volume (bbls per day)	Price (US\$ per bbl)	Settlement Index
Collars			
Jan 1, 2010 – Dec 31, 2010	500	55.00 – 103.00	WTI

**11. COMMITMENTS**

The Company has certain lease commitments for its office premises through to June 2011. As at December 31, 2009 the payments due under these commitments are approximately \$1.1 million per annum.

As a result of a private placement financing in October 2009, Fairborne has a commitment to spend \$20.0 million on qualifying Canadian exploration expenditures prior to December 31, 2010. As at December 31, 2009, \$2.8 million of qualifying exploration expenditures have been incurred.

*Corporate Directory***FAIRBORNE ENERGY LTD.**

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**AUDITORS****KPMG LLP****RESERVE EVALUATORS****GLJ Petroleum Consultants Ltd.****BANKERS**

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

**LEGAL COUNSEL**

**Burnet, Duckworth & Palmer LLP**  
**McCarthy Tetrault 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**  
 General Partner  
 KERN Partners Ltd.

**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. Cymbalisky**  
 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 May 26th, 2010 in the Grand Lecture Room at the Metropolitan Conference Centre, 333 – 4th Avenue S.W. Calgary, Alberta.





**FAIRBORNE  
ENERGY LTD.**

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