



NOVEMBER 08/04 – QUARTERLY REPORT TO THE SHAREHOLDERS FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2004

*Fairborne reports Q3 results — Production increases  
83% over same period last year.*

S U M M A R Y

	Three months ended September 30		Nine months ended September 30	
	2004	2003	2004	2003
<b>Financial</b> (\$ thousands, except per share amounts)		<i>(restated)*</i>		<i>(restated)*</i>
Gross revenue	35,349	15,712	83,534	35,397
Funds generated from operations	19,784	9,056	44,830	20,742
Per share - basic	0.48	0.30	1.17	0.89
Per share - diluted	0.44	0.28	1.09	0.86
Net income	3,463	3,069	9,544	8,015
Per share - basic	0.08	0.10	0.25	0.35
Per share - diluted	0.08	0.09	0.23	0.33
Capital expenditures	35,988	15,384	76,078	23,644
Debt, net of working capital	95,091	17,463	95,091	17,463
<b>Operations</b> (Units as noted)				
Production				
Crude oil (bbls per day)	3,038	2,291	2,497	1,778
Natural gas liquids (bbls per day)	348	147	243	158
Natural gas (Mcf per day)	32,569	14,265	26,964	9,077
Total production (boe/d @ 6:1)	8,814	4,815	7,234	3,449
Average sales price				
Crude oil (\$/bbl)	49.16	33.54	45.22	36.26
Natural gas liquids (\$/bbl)	47.65	38.05	44.65	37.20
Natural gas (\$/Mcf)	6.66	6.07	6.69	6.40
Netback per boe (6:1) (\$)				
Petroleum and natural gas sales	43.59	35.47	42.14	37.59
Royalties	9.13	7.26	9.14	7.07
Operating expenses	7.46	5.29	7.46	5.92
Operating netback	27.00	22.94	25.54	24.60

\* Restated due to Change In Accounting Policy – Asset Retirement Obligation

## H I G H L I G H T S

- Record third quarter production of 8,814 BOE per day, an 83% increase over third quarter 2003 production of 4,815 BOE per day.
- Record third quarter funds generated from operations of \$19.8 million more than doubling the \$9.1 million for the third quarter 2003. On a per share basis, third quarter funds generated from operations increased 60% to \$0.48 from \$0.30 in the third quarter of 2003
- The Company participated in 23 (20.2 net) wells during the third quarter with a 100% success rate bringing the total for the year to 77 (58.6 net) wells.
- Fairborne participated in new pool discoveries at Columbia, Harlech, Gordondale, Saddle Hills, Rycroft /Woking and Westeros.
- Current production of 10,200 to 10,400 BOE per day is 16% higher than third quarter average.
- Activity at Columbia/Harlech in west central Alberta and Clive in central Alberta has begun to delineate large, resource type plays in each area.
- Major construction projects are underway in three areas (Westerose, Clive and Columbia/Harlech) that will bring new production volumes on by year end.
- Completed the acquisition of Case Resources Inc. ("Case") including operated oil and gas properties located adjacent to Fairborne's properties at Clive
- Closed a public placement of 1.6 million flow-through common shares at a price of \$12.50 each for net proceeds of \$18.8 million allowing Fairborne to expand its 2004 capital budget.

## R E P O R T T O T H E S H A R E H O L D E R S

Fairborne Energy Ltd. ("Fairborne" or the "Company") is pleased to present the results of its operations for the third quarter of 2004. The third quarter saw an increase in activity in a number of areas with significant discoveries that will be brought on production through the end of the year and into 2005. The Company also closed the acquisition of Case on July 27, 2004 which provides an expanded production base in the Clive area including a number of development opportunities as well as a 10% increase in the Company's coal bed methane ("CBM") land holdings in the area.

The Company is on track to drill a record number of wells in 2004 and will continue this activity into 2005. There are currently three significant construction projects underway that will all deliver new, organic production by year end. The first at Westeros involves a seven mile, six inch pipeline and compression facilities that will initially deliver up to 2.5 MMcf per day of gas, net to Fairborne's 50% working interest. Development drilling will continue into 2005 at Westeros once this pipeline is operational and additional volumes can be processed. The second project at Clive involves installing CBM gathering lines and compression for 20 to 30 new wells bringing the total CBM producers, at year end 2004, to 40.

The third is located at Columbia/Harlech and will involve 11 miles of pipeline and compression and dehydration facilities to bring several recently drilled wells on production. The first phase of development will involve bringing on six wells by year end and another four wells in the first quarter of 2005.

Current production is approximately 10,200 to 10,400 BOE per day consisting of 70% gas and 30% oil and NGL's. The Company has approximately 7.5 MMcf per day of natural gas awaiting tie in at Westeros, Clive, Columbia/Harlech, Marlboro and Gage. All these projects are planned to be completed and on production late in the fourth quarter or early in 2005.

### OPERATIONS UPDATE

#### *West Central Alberta and Deep Basin*

Fairborne recently added 7,360 net acres (11.5 net sections) to its large acreage position of 83 gross sections (55 net sections) in the Columbia/Harlech area of west central Alberta. Four separate sweet gas plays have been developed by the Company utilizing approximately 2,000 sq km of 3D seismic data acquired during the second quarter of this year.

Since August of 2004, the Company has drilled eight wells at Columbia/Harlech. There is currently 5 MMcf per day (3.5 MMcf per day net to FEL) awaiting tie in and facilities construction. Completion operations are planned or currently underway on five of these wells. The Company has tested gas from three different formations and believes the gas trend, delineated by these first wells and with seismic mapping, extends over approximately 100 sections. Fairborne is the operator of the majority of its acreage on the trend. Initial production from these recently drilled wells is expected to commence late in 2004. Drilling in the Columbia /Harlech area will continue through 2005 with up to three operated drilling rigs employed to extend and develop all four gas plays.

The Company participated (42% working interest) in the first well at Marlboro targeting a new pool in the Cadomin Formation at a depth of 3,000m. This well is cased and completion and production testing is underway. A second Marlboro Cadomin well operated by Fairborne (54% working interest) has spudded. There is potential for an additional three development wells in this area.

The Company will drill three deep (4,000m) Nisku exploration wells in the Brazeau area during the fourth quarter. The first two wells are currently drilling ahead and the third well (60% working interest) will spud in November. A fourth well is planned to spud in the first quarter of 2005. The Company also will participate (35% working interest) in a deep Leduc (5,000m) test in the Pedley area of the deep basin scheduled to spud in the first quarter of 2005.

#### *Central Alberta:*

At Clive, the Company has drilled a total of 41 wells for coal bed methane ("CBM") in the Edmonton Group (Horseshoe Canyon Formation). Currently, 20 of these are on production. Construction of the main gas gathering pipeline has been completed for the first phase of CBM development with drilling and completions continuing through the end of the year and into 2005. The Company expects to have a total of 40 CBM wells on production by the end of 2004. The Company plans to drill up to 100 CBM wells next year.

CBM wells at Clive exhibit production profiles of increasing rates over the first 30 to 60 days reaching stabilized rates between 100 to 300 Mcf per day. The Company has received regulatory approval to start development on an

additional 10 sections of land, bringing the total to 28 sections where holding applications have been approved.

At Haynes the Company has recently drilled two development wells and these began production at a combined rate of 200 BOE per day from both the Nisku and Leduc formations at the end of October.

At Westerose, three more sweet gas wells have been drilled and production tested. Pipeline and facilities construction is underway with production from these wells commencing in mid-November at 2.5 MMcf per day net to Fairborne's 50% interest.

#### *Peace River Arch ("PRA")*

At Rycroft, the Company recently completed its gas plant expansion increasing plant capacity to 17 MMcf per day (8.5 MMcf per day net to FEL). This capacity will be restricted to approximately 13 MMcf per day until the operator of the sales gas pipeline increases the capacity of its sales meter system. This is scheduled for completion during the first quarter of 2005. Gas from two development wells drilled in the first half of 2004 has already been tied in and the Rycroft Plant is currently operating at approximately 13 MMcf per day (6.5 MMcf per day net to FEL).

The Company has drilled two successful development wells following an oil discovery, drilled in the first quarter of 2004, at Progress. A total of five to eight additional wells are currently planned to develop this pool with additional potential existing with the application of a water flood. The Company has committed to pipeline capacity on a new sour gas pipeline being constructed by a midstream company and is anticipating production start up in early 2005, upon the completion of this pipeline.



*Richard A. Walls*

President & CEO

November 4, 2004



## MANAGEMENT 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 November 4, 2004 and is provided by the management of Fairborne Energy Ltd. (“Fairborne” or the “Company”) to review third quarter 2004 activities and the results as compared to the previous period. This MD&A should be read in conjunction with the unaudited consolidated interim financial statements for the nine months ended September 30, 2004 and 2003 and the audited consolidated financial statements for the year ended December 31, 2003.

Fairborne was incorporated as a private company and commenced active operations in June, 2002. In 2003, Fairborne became a publicly traded 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 select acquisitions.

This MD&A contains forward-looking statements. Forward-looking statements are based on current expectations that involve a number of risks and uncertainties which could cause events or results to differ materially from those reflected in the MD&A. Forward-looking statements are based on the estimates and opinions of Fairborne’s management at the time the statements were made. Fairborne assumes no obligation to update forward-looking statements should circumstances or management’s estimates change.

This document contains the terms “funds generated from operations” and “netbacks” which are non-GAAP terms. The Company evaluates its performance based on these measures. The Company considers corporate netbacks a key measure as it demonstrates its profitability relative to current commodity prices. The Company considers funds generated from operations a key measure as it demonstrates the Company’s ability to generate cash flow necessary to fund future growth through capital investment and to repay debt. 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 net income and funds generated from operations can be found in the statement of cash flows in the financial statements. Fairborne also presents funds generated from operations per share whereby per share amounts are calculated using weighted average shares outstanding consistent with the calculation of income per share.

When discussing unit costs, barrel of oil equivalent (“BOE”) amounts may be misleading, particularly if used in isolation. A BOE conversion ratio has been calculated using a conversion rate of six thousand cubic feet of natural gas to one barrel and is based on an energy equivalent conversion method application at the burner tip and does not necessarily represent an economic value equivalency at the wellhead.

### QUARTERLY FINANCIAL INFORMATION

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

	Q3	Q2	Q1	Q4
(\$ thousands, except per share amounts)	2004	2004	2004	2003
				<i>(restated)</i>
Petroleum and natural gas sales, before royalties	35,349	29,756	18,429	15,492
Funds generated from operations	19,784	15,083	9,963	8,407
Per share – basic	\$ 0.48	\$ 0.39	\$ 0.31	\$ 0.27
Per share – diluted	\$ 0.44	\$ 0.36	\$ 0.28	\$ 0.21
Net income	3,463	2,786	3,295	2,344
Per share – basic	\$ 0.08	\$ 0.07	\$ 0.10	\$ 0.06
Per share – diluted	\$ 0.08	\$ 0.07	\$ 0.09	\$ 0.05
Total assets	379,450	272,115	266,338	139,925
Debt net of working capital	95,091	84,785	90,870	9,371

	Q3	Q2	Q1	Q4
<i>(\$ thousands, except per share amounts)</i>	2003	2003	2003	2002
	<i>(restated)</i>	<i>(restated)</i>	<i>(restated)</i>	<i>(restated)</i>
Petroleum and natural gas sales, before royalties	15,712	10,154	9,531	8,368
Funds generated from operations	9,056	5,985	5,701	4,396
Per share – basic	\$ 0.30	\$ 0.30	\$ 0.29	\$ 0.22
Per share – diluted	\$ 0.28	\$ 0.30	\$ 0.29	\$ 0.22
Net income	3,069	2,723	2,222	1,316
Per share – basic	\$ 0.10	\$ 0.14	\$ 0.11	\$ 0.06
Per share – diluted	\$ 0.09	\$ 0.13	\$ 0.11	\$ 0.06
Total assets	124,928	60,629	55,769	51,544
Debt net of working capital	17,463	Nil	Nil	Nil

### THIRD QUARTER 2004 FINANCIAL RESULTS

#### PRODUCTION

Fairborne's total production for the third quarter of 2004 averaged 8,814 BOE per day, representing an 83% increase from the average production of 4,815 BOE per day recorded in the third quarter of 2003. Similarly, production for the nine months ended September 30, 2004 increased 110% from 3,449 BOE per day in 2003 to 7,234 BOE per day in 2004. Fairborne continued to strengthen its position as a natural gas producer during the third quarter of 2004 with natural gas representing 62% of the Company's production compared to 49% for the same period in 2003.

Crude oil and NGL production averaged 3,386 bbls per day for the three months ended September 30, 2004 (2003 – 2,438 bbls per day) and 2,740 bbls per day for the nine months ended September 30, 2004 (2003 – 1,936 bbls per day). The increase in oil production during the third quarter is primarily attributable to the acquisition of Case Resources Inc. ("Case") on July 27, 2004. Case's production was heavily weighted towards oil, with the majority of production coming from the Haynes property, which is adjacent to and complements the Company's existing property base in central Alberta.

Natural gas production averaged 32.6 MMcf per day in the third quarter 2004 (2003 - 14.3 MMcf per day) and 27.0 MMcf per day for the first nine months of 2004 (2003 – 9.1 MMcf per day). The increase in natural gas production from 2003 is attributable to the results of Fairborne's drilling program in 2004 which has been focused on natural gas properties and the acquisition of the West Pembina assets completed on March 31, 2004. Successful drilling on the Company's Rycroft, Basset Lake and Wild River areas contributed to increased natural gas production in 2004 compared to 2003. Start-up of the expanded Rycroft gas processing facility and completion of the pipeline at Wild River both occurred late in the third quarter of 2004 and will contribute to higher natural gas production through the remainder of the year.

#### COMMODITY PRICES

Fairborne's crude oil and NGL price reflected the consistent increase in world oil prices during the first nine months of 2004, increasing 42% to Cdn. \$49.08 per barrel during the quarter ended September 30, 2004 compared to Cdn.\$34.49 per barrel for the third quarter 2003. The year-to-date price also increased 23% to average Cdn.\$45.46 per barrel for the nine months ended September 30, 2004 compared to Cdn.\$36.96 in the first nine months of 2003.

Fairborne realized an average natural gas price of \$6.66 per Mcf for the three months ended September 30, 2004 compared to \$6.07 per Mcf for the same period in 2003. For the nine months ended September 30, 2004 the average natural gas price was \$6.69 per Mcf, up from \$6.40 per Mcf for the nine months ended September 30, 2003. Commodity prices for both crude oil and natural gas have remained strong throughout 2004 and the outlook for future prices is expected to be high by historical standards.

## HEDGING ACTIVITIES

When Fairborne hedges oil and gas prices, the hedging strategy is intended to provide certainty to cash flow by fixing the price on a portion of the production portfolio. During the three months ended September 30, 2004 Fairborne did not have any natural gas production hedged, however an average of 350 barrels per day (12%) of crude oil production was hedged. Hedging in the three months ended September 30, 2004 reduced Fairborne's crude oil price received by \$1.53 per barrel. During the first nine months of 2004, Fairborne hedged an average of 584 barrels per day (23%) of total crude oil production and 1.5 MMcf per day (5%) of natural gas production. Hedging activity for the first nine months of 2004 reduced the crude oil price received by \$2.27 per barrel and increased the natural gas price received by \$0.02 per Mcf.

Fairborne also had a foreign exchange hedge in place from January 27, 2004 to June 30, 2004 on US\$1.6 million at a rate of Cdn \$1.323 to U.S. \$1.00 (U.S. \$0.7559 to Cdn \$1.00). From July 1 to September 30, 2004, the Company had hedged U.S. \$1.0 million of foreign exchange exposure at a rate of Cdn \$1.3468 to U.S. \$1.00 (U.S. \$0.7425 to Cdn \$1.00). The Company recognized a nominal gain from these foreign exchange hedges, with no additional foreign exchange hedges outstanding after September 30, 2004.

## PETROLEUM AND NATURAL GAS REVENUE

Fairborne's revenues of \$35.3 million for the three months and \$83.5 million for the nine months ended September 30, 2004 reflected the higher production levels and higher realized commodity prices compared to the same periods in 2003.

(\$ thousands, except per unit amounts)	Three months ended September 30		Nine months ended September 30	
	2004	2003	2004	2003
<b>Revenues</b>				
Natural gas	20,059	7,975	49,398	15,859
Oil and NGLs	15,290	7,737	34,136	19,538
<b>Total</b>	<b>35,349</b>	<b>15,712</b>	<b>83,534</b>	<b>35,397</b>
<b>Prices</b>				
Natural gas (\$/Mcf)	6.66	6.07	6.69	6.40
Oil and NGLs (\$/bbl)	49.08	34.49	45.46	36.96
<b>Total (\$/BOE)</b>	<b>43.59</b>	<b>35.47</b>	<b>42.14</b>	<b>37.59</b>

## ROYALTIES

The Company recorded \$18.1 million in royalties for the nine months ended September 30, 2004, representing a royalty rate of 21.7%. The 2004 royalty rate is higher than the previous year rate of 18.8% primarily due to new acquisitions including Pivotal (July 2003), West Pembina (March 2004) and Case (July 2004). All of the new areas acquired have royalty rates in excess of the rates associated with Fairborne's initial properties which formed the Company's revenue base through the first six months of 2003.

Royalties for the third quarter of 2004 totaled \$7.4 million which represented a royalty rate of 20.9%, consistent with the 20.5% reported for the third quarter of 2003. The royalty rate for the third quarter of 2004 is lower than the year-to-date rate partially due to the impact of a deep well royalty holiday on the Company's new gas well at Wild River. The royalty rate for the remainder of 2004 is expected to average between 20% and 22%.

## PRODUCTION EXPENSES

Fairborne operates substantially all of its producing properties and consequently maintains a degree of control over field operating costs. Operating costs were \$7.46 per BOE or \$6.0 million in total during the three months ended September 30, 2004

compared to \$5.28 per BOE or \$2.3 million during the same period in 2003. For the nine months ended September 30, 2004 operating costs were \$7.46 per BOE or \$14.8 million compared to \$5.92 per BOE or \$5.6 million during the same period in 2003.

The increase in costs for the quarter and for the nine months ended September 30, 2004 is mainly due to the addition of the West Pembina assets beginning in April 2004. Much of this production is sour gas which has above-average operating costs compared to Fairborne's other principle properties. Despite an increase in costs compared to 2003, unit operating costs for the third quarter were 9% lower compared to unit operating costs for the immediately preceding second quarter of 2004. For the remainder of 2004 operating costs per unit are expected to trend lower as operational efficiencies are gained on new properties and production levels increase.

#### GENERAL AND ADMINISTRATIVE EXPENSES

The substantial growth in Fairborne's production and asset base combined with the active acquisition, exploration and development programs undertaken by the Company has led to an increased need for staff and support services. Total general and administrative expenses of \$1.5 million for the third quarter of 2004 (2003 - \$0.9 million) and \$4.4 million for the first nine months of 2004 (2003 - \$2.0 million) reflects the Company's growth. On a BOE basis, Fairborne's general and administrative costs, excluding non-cash stock based compensation costs, have been reduced from \$2.15 per BOE for the first three quarters of 2003 to \$1.93 for the same period in 2004. Similarly, third quarter 2004 expenses were down from \$1.93 per BOE in 2003 to \$1.50 per BOE in 2004.

#### INTEREST EXPENSE

Interest expense for the third quarter of 2004 was \$0.7 million compared to \$0.2 million in the third quarter of 2003. For the nine months ended September 30, 2004, the Company recorded \$1.6 million in interest expense compared to \$0.3 million for the same period in 2003.

Prior to the acquisition of Pivotal Energy in July 2003, Fairborne had not drawn on its available bank lines. The Pivotal acquisition and subsequent corporate and property acquisitions have been financed through a combination of debt and equity. As such, interest expense in 2004 is higher than the prior year and will continue to increase in the fourth quarter of 2004 as the Company draws on its credit facilities to fund a portion of its fourth quarter capital program.

#### DEPLETION, DEPRECIATION AND ACCRETION

Fairborne's depletion and depreciation rate for the third quarter of 2004 was \$15.52 per BOE (2003 - \$9.37 per BOE), which resulted in total depletion and depreciation expense of \$12.6 million for the third quarter (2003 - \$4.2 million). The rate for the nine months ended September 30, 2004 was \$13.88 per BOE (2003 - \$8.86 per BOE) for a total nine month expense of \$27.5 million (2003 - \$8.3 million). The increase in depletion expense from 2003 is a direct result of increased production levels and increased depletion rates. The increase in BOE rates during 2004 reflects the acquisition of the West Pembina and Case properties.

Acquisitions completed in 2004 also resulted in an increased liability for asset retirement costs and associated accretion expense. The Company estimates its total undiscounted future liability for asset retirement obligations to be \$44.0 million, the present value of which is \$13.0 million at September 30, 2004. Accretion of asset retirement obligations in the third quarter of 2004 was \$266,000 (2003 - \$157,000) and \$641,000 for the nine months ended September 30, 2004 (2003 - \$403,000).

#### TAXES

Fairborne's tax rate for the first nine months of 2004 was 42.1%, the majority of which was future income taxes. Fairborne's rate is higher than the average combined Federal and Provincial rate primarily due to non-deductible crown royalties which exceed resource allowance deductions.

## FUNDS GENERATED FROM OPERATIONS AND NET INCOME

Strong commodity prices and increased production levels contributed to funds generated from operations of \$19.8 million (\$0.48 per share) for the three months ended September 30, 2004 and \$44.8 million (\$1.17 per share) for the nine months ended September 30, 2004. Higher depletion, depreciation and future income tax charges impacted net income at \$3.5 million (\$0.08 per share) for the third quarter and \$9.5 million (\$0.25 per share) on a year-to-date basis.

### UNIT ANALYSIS

(\$ thousands, except per BOE amounts)	Three Months ended September 30			
	2004	\$/BOE	2003	\$/BOE
			<i>(restated)</i>	<i>(restated)</i>
Production revenue	35,349	43.59	15,712	35.47
Royalties	7,404	9.13	3,217	7.26
Operating expenses	6,048	7.46	2,342	5.28
General and administrative *	1,214	1.50	856	1.93
Interest	687	0.85	204	0.46
Capital taxes	212	0.26	37	0.08
Funds generated from operations	19,784	24.39	9,056	20.46
Stock based compensation expense	259	0.31	—	—
Depletion, depreciation and accretion	12,853	15.85	4,309	9.72
Future income taxes	3,209	3.96	1,678	3.79
Net income	3,463	4.27	3,069	6.95

\* net of stock based compensation expense (non-cash)

(\$ thousands, except per BOE amounts)	Nine Months Ended September 30,			
	2004	\$/BOE	2003	\$/BOE
			<i>(restated)</i>	<i>(restated)</i>
Production revenue	83,534	42.14	35,397	37.59
Royalties	18,117	9.14	6,653	7.06
Operating expenses	14,789	7.46	5,575	5.92
General and administrative *	3,836	1.93	2,024	2.15
Interest	1,575	0.79	336	0.36
Capital taxes	387	0.20	67	0.07
Funds generated from operations	44,830	22.62	20,742	22.03
Stock based compensation expense	580	0.29	—	—
Depletion, depreciation and accretion	28,146	14.20	8,746	9.29
Future income taxes	6,560	3.31	3,981	4.23
Net income	9,544	4.82	8,015	8.51

\* net of stock based compensation expense (non-cash)

## LIQUIDITY AND CAPITAL RESOURCES

### CAPITAL EXPENDITURES

Fairborne's capital program for the first nine months of 2004 totaled \$245.1 million including the acquisition of assets in West Pembina at the end of the first quarter and the acquisition of Case in the third quarter. The following table provides a summary of expenditures compared to the previous year:

<i>(\$ thousands)</i>	For the three months ended September 30		For the nine months ended September 30	
	2004	2003	2004	2003
Exploration and development				
Land and lease acquisitions	1,510	1,543	3,633	3,572
Geological and geophysical	87	146	7,173	1,457
Drilling, completions and workovers	25,411	9,015	42,985	12,774
Well equipment and facilities	8,899	4,473	22,005	5,583
Corporate assets	81	207	282	258
	<b>35,988</b>	<b>15,384</b>	<b>76,078</b>	<b>23,644</b>
Acquisitions, net of dispositions				
Acquisitions	68,416	47,426	179,656	47,426
Dispositions	10	(1,543)	(10,668)	(1,543)
	<b>68,426</b>	<b>45,883</b>	<b>168,988</b>	<b>45,883</b>
<b>Total</b>	<b>104,414</b>	<b>61,627</b>	<b>245,066</b>	<b>69,527</b>

Fairborne's capital expenditure program in the third quarter of 2004 included the acquisition of Case Resources Inc., two significant facility projects and a concentration on drilling activities. During the third quarter, the Company drilled a total of 23 (20.2 net) wells which were all cased as potential gas wells. Facility projects included construction of a ten mile, six inch pipeline and associated dehydration facilities at Wild River as well as expansion of the gas processing facility at Rycroft.

Exploration and development expenditures in the third quarter of 2004 were financed from \$19.8 million funds generated from operations as well as a portion of the proceeds of a \$20 million flow-through share offering. The acquisition of Case was financed through a combination of debt and equity including the issuance of 5.4 million common shares at a deemed value of \$51.5 million and the assumption of \$12.5 million of debt.

The capital budget for the last three months of 2004 totals \$35 million. Fairborne plans to utilize funds generated from operations combined with available bank credit facilities to fund the fourth quarter capital and operating activities.

### WORKING CAPITAL

Fairborne had a working capital deficit of \$25.4 million at September 30, 2004 compared to \$10.6 million at September 30, 2003, excluding bank indebtedness. The increase is consistent with the substantial increase in spending on exploration and development projects in 2004 as well as the significant growth in the Company's operations over the past year.

### BANK INDEBTEDNESS

Fairborne has a revolving demand loan based on a borrowing base determined by the Company's bankers. During the first nine months of 2004, the amount available under the loan has been increased first to \$85 million in the first quarter with the acquisition of West Pembina properties, and subsequently to \$105 million in the third quarter coincident with the Case acquisition. At September 30, 2004, the Company had drawn \$69.7 million on the facility.

## SHARE CAPITAL

In summary, during the first nine months of 2004, Fairborne issued a total of 13.7 million common shares, of which 6.2 million were issued in connection with the West Pembina acquisition; 5.4 million were issued on the acquisition of Case Resources Inc.; 1.6 million were issued on the third quarter flow-through financing and 0.5 million were issued on exercise of stock options.

On July 27, 2004 Fairborne issued 5.4 million common shares at a deemed value of \$51.5 million and assumed \$12.5 million of debt to acquire all of the outstanding shares of Case Resources Inc. As consideration for the transaction, Case shareholders received 0.0909 of a Fairborne common share for each Case common share held.

In August 2004, Fairborne completed a flow-through equity financing with 1.6 million flow-through common shares issued at \$12.50 per share for gross proceeds of \$20 million. Pursuant to the flow-through agreements, the Company has a commitment to spend \$20 million prior to December 31, 2005 on qualifying Canadian exploration expenditures and renounce those expenditures to subscribers effective December 31, 2004.

The Company is authorized to issue an unlimited number of common shares and an unlimited number of preferred shares. The following table provides a summary of outstanding common shares and other equity instruments:

<i>(thousands)</i>	As at and for the three months ended September 30, 2004	As at and for the nine months ended September 30, 2004
Common shares	46,059	46,059
Warrants	1,960	1,960
Stock options	3,551	3,551
Weighted average common shares		
Basic	41,620	38,248
Diluted	44,851	41,235

From September 30 to November 4, 2004, 38,000 stock options were exercised and an additional 18,000 stock options were issued. There were no other changes in outstanding equity instruments

## 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 – these external risk factors impact the industry and influence the nature of control and management of 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.

## SIGNIFICANT ACCOUNTING POLICIES

### USE OF ESTIMATES


The amounts for depletion and depreciation of petroleum and natural gas properties and equipment and the asset retirement obligations are based on estimates. The ceiling test is based on estimates of proved reserves, production rates, oil and gas prices, future costs and other relevant 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 OBLIGATIONS

The Company retroactively adopted the new accounting standard for asset retirement obligations at January 1, 2004. All existing reclamation and abandonment liabilities were reversed and the new standard was set up with prior years being restated. The asset retirement obligation was measured and recorded at fair market value with a corresponding increase in oil and gas properties. The asset retirement obligation increases over time with a corresponding accretion expense until the obligations are settled.

### FULL COST ACCOUNTING FOR OIL AND GAS

The Company adopted the revised full cost method of accounting for oil and gas as outlined in Accounting Guideline 16, which includes limiting the carrying value of oil and gas properties to their estimated fair value. The fair value is estimated to be the future cash flow from proved and probable reserves using future price forecasts and costs discounted at a risk-free rate. This differs from the prior ceiling test calculation that used undiscounted cash flows and constant prices, adjusted for general and administrative and financing costs.




# INTERIM CONSOLIDATED FINANCIAL STATEMENTS

## INTERIM CONSOLIDATED BALANCE SHEETS

<i>(\$ thousands)</i>	September 30, 2004 <i>(unaudited)</i>	December 31, 2003 <i>(restated, see Note 1)</i>
<b>Assets</b>		
Current assets		
Cash and cash equivalents	\$ 1,787	\$ 6,152
Accounts receivable	25,166	14,126
Prepaid expenses and deposits	2,279	1,997
	<b>29,232</b>	<b>22,275</b>
Fixed assets	<i>(Note 3)</i>	
Petroleum and natural gas properties and equipment	377,883	127,666
Office furniture and equipment	889	843
Accumulated depletion and depreciation	(44,724)	(17,219)
	<b>334,048</b>	<b>111,290</b>
Goodwill	<i>(Note 2)</i>	
	<b>16,170</b>	<b>6,360</b>
	<b>\$ 379,450</b>	<b>\$ 139,925</b>
<b>Liabilities</b>		
Current liabilities		
Accounts payable and accrued liabilities	\$ 54,625	\$ 21,132
Equipment lease	<i>(Note 4)</i>	2,573
Bank indebtedness	<i>(Note 5)</i>	7,941
	<b>124,323</b>	<b>31,646</b>
Asset retirement obligations	<i>(Note 6)</i>	6,165
Future income taxes	34,086	15,913
<b>Shareholders' Equity</b>		
Capital stock	<i>(Note 7)</i>	73,040
Contributed surplus	<i>(Note 7)</i>	331
Retained earnings	22,374	12,830
	<b>208,044</b>	<b>86,201</b>
	<b>\$ 379,450</b>	<b>\$ 139,925</b>

See accompanying notes to the interim consolidated financial statements.




# INTERIM CONSOLIDATED FINANCIAL STATEMENTS

## INTERIM CONSOLIDATED STATEMENTS OF OPERATIONS AND RETAINED EARNINGS

<i>(Unaudited)</i> (\$ thousands, except per share amounts)	For the three months ended September 30		For the nine months ended September 30	
	2004	2003	2004	2003
		<i>(restated, see Note 1)</i>		<i>(restated, see Note 1)</i>
Revenue				
Petroleum and natural gas	\$ 35,349	\$ 15,712	\$ 83,534	\$ 35,397
Less: Royalties	7,404	3,217	18,117	6,653
	27,945	12,495	65,417	28,744
Expenses				
Production	6,048	2,342	14,789	5,575
General and administrative	1,473	856	4,416	2,024
Interest	687	204	1,575	336
Depletion, depreciation and accretion	12,853	4,309	28,146	8,746
	21,061	7,711	48,926	16,681
Income before taxes	6,884	4,784	16,491	12,063
Taxes				
Future income taxes	3,209	1,678	6,560	3,981
Capital taxes	212	37	387	67
	3,421	1,715	6,947	4,048
Net income	3,463	3,069	9,544	8,015
Retained earnings				
beginning of period, as previously reported	18,911	7,419	12,613	2,439
Retained earnings adjustment, asset retirement obligation	<i>(Note 1)</i> –	35	217	69
Retained earnings, end of period	\$ 22,374	\$ 10,523	\$ 22,374	\$ 10,523
Net income per share	<i>(Note 7)</i>			
Basic	\$ 0.08	\$ 0.10	\$ 0.25	\$ 0.35
Diluted	\$ 0.08	\$ 0.09	\$ 0.23	\$ 0.33

*See accompanying notes to the interim consolidated financial statements*



# INTERIM CONSOLIDATED FINANCIAL STATEMENTS

## INTERIM CONSOLIDATED STATEMENTS OF CASH FLOWS

<i>(Unaudited)</i> (\$ thousands)	For the three months ended September 30		For the nine months ended September 30	
	2004	2003 <i>(restated, see Note 1)</i>	2004	2003 <i>(restated, see Note 1)</i>
Cash provided by (used in):				
Operating activities				
Net income	\$ 3,463	\$ 3,069	\$ 9,544	\$ 8,015
Items not involving cash				
Depletion, depreciation and accretion	12,853	4,309	28,146	8,746
Stock based compensation expense	259	-	580	-
Future income taxes	3,209	1,678	6,560	3,981
	19,784	9,056	44,830	20,742
Asset retirement expenditures	(96)	(174)	(113)	(467)
Change in non-cash working capital	3,946	2,860	(7,024)	1,357
	23,634	11,742	37,693	21,632
Financing activities				
Issuance of common shares, net of costs	18,773	87	58,982	87
Equipment lease payments	-	(32)	(2,573)	(93)
Bank indebtedness	(18,977)	(5,398)	49,241	(5,398)
	(204)	(5,343)	105,650	(5,404)
Investing activities				
Capital expenditures	(35,988)	(15,384)	(76,078)	(23,644)
Dispositions	(10)	1,543	10,668	1,543
Acquisition of petroleum and natural gas properties	(293) <i>(Note 2)</i>	-	(111,533)	-
Corporate acquisition	(400) <i>(Note 2)</i>	(800)	(400)	(800)
Change in non-cash working capital	14,742	2,991	29,635	3,165
	(21,949)	(11,650)	(147,708)	(19,736)
Change in cash and cash equivalents	1,481	(5,251)	(4,365)	(3,508)
Cash and cash equivalents, beginning of period	306	5,330	6,152	3,587
Cash and cash equivalents, end of period	\$ 1,787	\$ 79	\$ 1,787	\$ 79
Cash interest paid	\$ 719	\$ 203	\$ 1,607	\$ 335
Cash taxes paid	\$ 160	\$ 37	\$ 335	\$ 67

See accompanying notes to the interim consolidated financial statements.



## SELECTED NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

*For the nine months ended September 30, 2004 (unaudited)  
(tabular amounts are stated in thousands and thousands of dollars except per share amounts)*

*The interim financial statements of Fairborne Energy Ltd. (the “Company” or “Fairborne”) have been prepared by management in accordance with accounting principles generally accepted in Canada. The interim financial statements have been prepared following the same accounting policies and methods of computation as the financial statements for the year ended December 31, 2003, except as noted below. The disclosure which follows is incremental to the disclosure included with the annual financial statements. These interim financial statements should be read in conjunction with the financial statements and notes thereto for the year ended December 31, 2003.*

### **NOTE 1: CHANGES IN ACCOUNTING POLICIES**

#### ***Full Cost Accounting Guideline***

Effective January 1, 2004, Fairborne adopted a new Canadian accounting standard relating to full cost accounting for oil and gas entities.

Fairborne 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.

Prior to adopting the new standards, the limit on aggregate carrying value of the petroleum and natural gas properties and equipment that may be carried forward for depletion against future revenues was based on the sum of the undiscounted cash flows expected from the production of proved reserves, the lower of cost or market of unproved properties and the cost of major development projects less the estimated future costs for administration, financing, asset retirement obligations and income taxes.

There were no changes to net income, petroleum and natural gas properties and equipment or any other reported amounts in the financial statements as a result of adopting the standard.

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

Effective January 1, 2004, Fairborne retroactively adopted, with restatement of prior periods, a new accounting standard relating to asset retirement obligations.

Fairborne 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.

Prior to adopting the standard, Fairborne recognized a provision for future site restoration costs over the life of the oil and gas properties and facilities using a unit of production method.

The effect of adopting the new ARO accounting standard is presented below as increases (decreases):

<i>BALANCE SHEET</i> (\$ thousands)	As at December 31,	
	2003	2002
Net asset retirement costs, included in fixed assets	3,740	3,158
Asset retirement obligations	6,165	4,135
Accumulated provision for future site restoration	(2,764)	(1,086)
Future income taxes	122	40
Retained earnings	217	69

<i>STATEMENT OF OPERATIONS</i> (\$ thousands)	Nine months ended September 30,		Year ended December 31,
	2004	2003	2003
Accretion expense	641	403	558
Depletion and depreciation on asset retirement costs	776	461	619
Future site restoration expense	(1,410)	(846)	(1,405)
Future income taxes	(3)	(6)	82
Net earnings impact	(4)	(12)	146

### *Flow Through Shares*

The resource expenditure deductions for income tax purposes related to exploratory and development activities funded by flow-through share arrangements are renounced to investors in accordance with tax legislation. A future tax liability is recognized upon the renunciation of tax pools and share capital is reduced by the estimated costs of the renounced tax deductions.

### **NOTE 2: ACQUISITIONS**

On July 27, 2004 the Company acquired all of the outstanding shares of Case Resources Inc. ("Case") pursuant to an Arrangement Agreement dated June 25, 2004 between Case and Fairborne. Case was a publicly traded oil and gas company with properties located in western Canada. As consideration for the transaction, Case shareholders received 0.0909 of a Fairborne common share for each Case common share held. Fairborne issued 5.4 million shares to acquire Case at a deemed value of \$51.5 million, based on the trading price of Fairborne shares on or about the date of acquisition. The results of operations for Case have been included in Fairborne's Financial Statements beginning July 27, 2004. Details of the acquisition are as follows:

Cost of Acquisition:	
Shares	\$ 51,518
Transaction costs	400
	\$ 51,918
Allocated:	
Current assets	\$ 1,443
Petroleum and natural gas properties	68,121
Goodwill	9,810
Current liabilities	(1,003)
Bank debt	(12,516)
Asset retirement obligations	(1,105)
Future income taxes	(12,832)
	\$ 51,918

On March 31, 2004, the Company acquired certain petroleum and natural gas assets located in the West Pembina area of West Central Alberta. The acquisition has been accounted for by the purchase method. The results of operations from the assets acquired have been included in Fairborne's Financial Statements beginning March 31, 2004.

Details of the acquisition are as follows:

Net assets acquired:				
Petroleum and natural gas properties and equipment		\$		115,904
Asset retirement obligations				(4,664)
		\$		111,240
Consideration:				
Cash		\$		71,907
Cash from private placement of common shares				38,859
Transaction costs				474
		\$		111,240

### NOTE 3: PETROLEUM AND NATURAL GAS PROPERTIES AND EQUIPMENT

Fairborne performed a ceiling test calculation at January 1, 2004 and September 30, 2004 to assess the recoverable value of petroleum and natural gas properties and equipment. The oil and gas future prices are based on the April 1, 2004 commodity price forecast of our independent reserve evaluators. These prices have been adjusted for commodity price differentials specific to Fairborne. 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 January 1, 2004 and September 30, 2004.

Year	WTI	Foreign	Edmonton	AECO
	Oil	Exchange	Light	Gas
	(\$US/bbl)	Rate	Crude Oil (\$Cdn/bbl)	(\$Cdn/mmBtu)
2004	34.25	0.75	40.86	6.62
2005	28.50	0.75	34.62	5.50
2006	26.25	0.75	32.26	5.14
2007	24.00	0.75	29.45	4.93
2008	23.50	0.75	29.41	4.93
2009-14	23.25	0.75	29.40	4.92
Escalate thereafter 1.5% per year				

### NOTE 4: EQUIPMENT LEASE

The Company repaid the equipment lease in April 2004.

### NOTE 5: BANK INDEBTEDNESS

At September 30, 2004 the Company has available \$105 million of demand operating credit facilities from two Canadian chartered banks subject to the bank's valuation of the petroleum and natural gas properties owned by the Company. The facilities bear interest at the bank's prime rate. At September 30, 2004, \$69.7 million was drawn under the facilities. The scheduled review date of the facility is May 30, 2005. The facilities are secured by a first ranking floating charge on all real property of the Company and a general security agreement.

### NOTE 6: ASSET RETIREMENT OBLIGATIONS

The Company's asset retirement obligations result from net ownership interests in petroleum and natural gas assets including well site, gathering systems and processing facilities. The Company estimates the total undiscounted amount of cash flows required to settle its asset retirement obligations to be approximately \$44 million which is scheduled to be incurred between 2014 and 2034. The majority of the costs are scheduled to be incurred between 2014 and 2020. A credit-adjusted risk-free interest rate of 8.5 percent and an inflation rate of 1.5 percent was used to calculate the fair value of the asset retirement obligations.

A reconciliation of the asset retirement obligations is provided below:

<i>(\$ thousands)</i>	Nine months ended September 30, 2004	Year ended December 31, 2003
Balance, beginning of period	6,165	4,135
Acquisitions in the period	5,769	1,055
Liabilities incurred in period	535	1,200
Liabilities settled in period	(113)	(783)
Accretion expense	641	558
<b>Balance, end of period</b>	<b>12,997</b>	<b>6,165</b>

#### NOTE 7: CAPITAL STOCK

##### a) Common shares – issued and outstanding

<i>(thousands)</i>	Number	Amount
Balance, December 31, 2003	32,328	\$ 73,040
Private placement of common shares for cash	6,178	41,084
Issue of flow through shares for cash	1,600	20,000
Issued on acquisition of Case	5,423	51,518
Issued on exercise of options	530	1,363
Share issue costs	–	(3,407)
Future tax benefit of issue costs	–	1,219
<b>Balance, September 30, 2004</b>	<b>46,059</b>	<b>\$ 184,817</b>

Fairborne has a commitment to spend \$20 million on or before December 31, 2005 on qualifying Canadian exploration expenditures pursuant to the August 10, 2004 flow through share issue and to renounce those expenditures to subscribers, effective December 31, 2004. As of September 30, 2004, Fairborne has incurred approximately \$6 million of qualifying expenditures.

##### b) Contributed surplus

<i>(thousands)</i>	Amount
Balance, December 31, 2003	\$ 331
Options granted	580
Options exercised	(58)
<b>Balance, September 30, 2004</b>	<b>\$ 853</b>

The weighted average fair value of stock options granted in 2004 was \$2.30 per option using the Black-Scholes option pricing model with the following weighted average assumptions: risk free interest rate of 4 percent, expected volatility of 30 percent and 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:

<i>(thousands)</i>	Three months ended September 30,		Nine months ended September 30,	
	2004	2003	2004	2003
Basic	41,620	30,101	38,248	23,238
Diluted	44,851	32,421	41,235	24,157

The reconciling items between the basic and diluted average common shares are outstanding stock options and outstanding warrants.

*d) Stock options*

There are 3,550,583 stock options outstanding at September 30, 2004 with a weighted average exercise price of \$5.08 per option. The options expire between January 23, 2006 and September 3, 2009.

The following table sets forth a reconciliation of the stock option plan activity through to September 30, 2004:

	Number of options	Weighted average exercise price
Balance December 31, 2003	2,861	\$ 2.90
Granted	1,219	\$ 9.05
Exercised	(529)	\$ 2.47
<b>Balance September 30, 2004</b>	<b>3,551</b>	<b>\$ 5.08</b>

The following table summarizes stock options outstanding under the plan at September 30, 2004:

Exercise Price	Options outstanding (thousands)	Remaining term (years)	Options exercisable
\$ 1.75 - \$ 1.84	46	1.3	46
\$ 2.40 - \$ 3.09	1,601	2.8	1,032
\$ 3.42 - \$ 4.76	378	3.6	126
\$ 5.20 - \$ 7.40	379	3.2	41
\$ 8.00 - \$10.35	1,147	4.1	–
	<b>3,551</b>	<b>3.6</b>	<b>1,245</b>

*e) Warrants*

There are 1,960,000 warrants to purchase common shares at \$3.50 per share exercisable at any time prior to close of business on May 31, 2006.

**NOTE 8: FINANCIAL INSTRUMENTS**

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

The following table summarizes the fixed price physical sales contracts outstanding at September 30, 2004:

Commodity	Period	Volume	Price
Crude Oil	October 1 to December 31, 2004	500 bbls/day	WTI US\$35.30
Crude Oil	October 1 to December 31, 2004	500 bbls/day	WTI US\$35.00 -US\$44.05
Crude Oil	January 1 to March 31, 2005	1,000 bbls/day	WTI US\$34.70
Natural Gas	November 1 to December 31, 2004	13,000 GJ/day	CDN AECO \$7.00 – 9.35

## S H A R E H O L D E R   I N F O R M A T I O N

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### STOCK EXCHANGE LISTING

*The Toronto Stock Exchange*  
Trading Symbol: FEL

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)