

**August 6, 2004**

**FAIRBORNE REPORTS Q2 RESULTS – Production increases 167 percent over same period last year**

SUMMARY <i>(\$ thousands, except per share amounts)</i>	Three Months Ended June 30		Six Months Ended June 30	
	2004	2003	2004	2003
<b>Financial</b>		<i>(restated)*</i>		<i>(restated)*</i>
Gross revenue	29,756	10,154	48,185	19,685
Funds generated from operations	15,083	5,985	25,046	11,686
Per share - basic	0.39	0.30	0.70	0.59
Per share - diluted	0.36	0.30	0.64	0.58
Net income	2,786	2,723	6,081	4,946
Per share - basic	0.07	0.14	0.17	0.25
Per share - diluted	0.07	0.13	0.16	0.25
Capital expenditures	20,956	3,659	40,090	8,260
West Pembina Acquisition	-	-	115,904	-
Net Debt	84,785	-	84,785	-
<b>Operations</b>				
<b>Production</b>				
Crude oil ( <i>bbls/d</i> )	2,492	1,542	2,224	1,520
Natural gas liquids ( <i>bbls/d</i> )	241	167	190	164
Natural gas ( <i>mcf/d</i> )	30,410	7,283	24,131	6,444
Total production ( <i>boe/d @ 6:1</i> )	7,801	2,922	6,436	2,758
<b>Average sales price</b>				
Crude oil ( <i>\$/bbl</i> )	44.10	36.07	42.26	38.29
Natural gas liquids ( <i>\$/bbl</i> )	50.11	32.06	47.66	36.81
Natural gas ( <i>\$/mcf</i> )	6.74	6.75	6.68	6.76
<b>Netback per boe (6:1) (\$)</b>				
Petroleum and natural gas sales	41.91	38.18	41.06	39.14
Royalties	9.15	6.66	9.15	6.88
Operating expenses	8.17	5.95	7.46	6.47
Operating netback	24.59	25.57	24.45	25.79

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

**HIGHLIGHTS:**

- The Company drilled 54 (38.4 net) wells during the first half of the year and plans to drill another 50 (40 net) wells prior to year end. This program includes 7 deeper ( more than 3,000 meters) high potential gas tests.
- Increased production by 54 percent over the first quarter of this year.
- Increased cash flow per share by 26 percent over the first quarter of this year.
- Current production of 9,200 BOE per day is 18 percent higher than the second quarter average.
- Purchase of Case Resources Inc. (“Case”) including operated oil, natural gas and natural gas liquids (“NGL”) properties located in the Haynes area of central Alberta. This acquisition adds approximately 1,300 BOE per day and 11,000 net acres of undeveloped land and closed on July 27, 2004.
- Obtained regulatory and working interest partner approval for four significant pipeline projects (Wild River, Clive Coal Bed Methane, Westeros, Rycroft) and one facility

- expansion (Rycroft), all of which are currently under construction with production startup scheduled by the end of the third quarter for all five projects.
- A total of 12 (9.1 net) wells were drilled resulting in 11 (8.1 net) natural gas wells and 1 (1.0 net) well was dry and abandoned for an overall net success rate of 89 percent and an average working interest of 76 percent. In addition, one crude oil well was drilled at no cost to the Company.
  - Fairborne's production during the second quarter was 35 percent light crude oil and NGL and 65 percent natural gas and averaged 2,733 barrels per day of crude oil and NGL and 30.4 million cubic feet ("Mmcf") per day of natural gas resulting in a total of 7,801 BOE per day in the quarter. During the quarter the Company divested 460 BOE per day of production (130 BOE per day average for the quarter) and experienced temporary production interruptions and start up delays that had an additional net effect of reducing quarterly production by approximately 500 BOE per day.

## **REPORT TO THE SHAREHOLDERS**

Fairborne Energy Ltd. ("Fairborne" or "Company") is pleased to present the results of its operations for the second quarter of 2004. The second quarter of 2004 saw significant changes in Fairborne's size and level of operations with the addition of the West Pembina assets. In addition, the Company purchased Case Resources Inc. whose principal producing property is immediately south of our Clive property and will provide us with an expanded production base in the Clive area and an undeveloped land base in the West Pembina area.

During the quarter the Company closed a small divestiture in east central and southern Alberta that brought in net proceeds of \$10.7 million. In total, approximately 460 BOE per day was sold effective June 7, 2004 and the proceeds were used to reduce total bank debt.

Fairborne originally budgeted \$40 million for its 2004 capital program. This was increased to \$80 million to exploit the West Pembina and Case opportunities and was subsequently expanded to \$100 million as a result of further exploration and development opportunities identified. The total capital program for the remaining six months of the year is \$60 million and will be split approximately \$25 million to land, seismic and exploration, \$20 million to development and exploitation and \$15 million for related facilities.

Current production is approximately 9,200 BOE per day consisting of 60% natural gas and 40% oil and NGL's. The Company has approximately 10 Mmcf per day of natural gas that is currently being tied in from Wild River, Rycroft and Westeros. All these projects are anticipated to be completed and on production by the end of third quarter.

### **Central Alberta:**

At Clive, there were seven wells drilled for coal bed methane ("CBM") in the Edmonton Group (Horseshoe Canyon Formation) in the quarter, bringing the total CBM wells drilled by the Company to date to 26. There are currently five of these wells on production at a total of 600 Mcf per day. The Company has received regulatory approval to start a larger scale development program on 19 sections of land. Pipeline construction of the main gas pipeline is underway for the first phase of this development, drilling has begun and will continue through September, 2004 and is expected to bring the total number of CBM wells drilled by the Company to 40. The Company also plans to drill several infill locations in Clive and Haynes targeting the Nisku and Leduc formations during the second half of 2004.

At Westeros three sweet gas wells have been drilled and are expected to be brought on production in the fourth quarter upon completion of pipeline and facilities construction which is currently underway.

**Bassett Lake Area:**

As noted in the first quarter information, the Company experienced 45 days of delay in production start up of 19 gas wells from the winter drilling program due to the presence of hydrocarbon liquids associated with the natural gas production. It was necessary to construct and install new facilities to handle these liquids. Production commenced in late May at a gross rate of approximately 4 Mmcf per day (3.5 Mmcf per day net to Fairborne) and has been very steady since that time. This delayed start up at Bassett had the effect of reducing second quarter production by approximately 300 BOE per day.

**Peace River Arch (“PRA”) Area:**

The Company made two discoveries in the PRA during the quarter. The first at Progress is an oil discovery that has now been confirmed by a second well and development drilling is expected to commence in the fourth quarter when facilities and pipeline capacity have been secured. A total of 5 to 8 additional wells are currently planned to develop this pool with additional potential existing with the application of a water flood.

At Rycroft, a new gas pool was discovered in a well targeting a deeper horizon. This well is currently testing and two delineation wells are planned for the near future. The first well is scheduled to be tied into the Rycroft plant and on production by the end of the quarter.

The Company plans to drill another 5 wells during the remainder of the year in the Rycroft, Gage and Gordondale areas.

**Deep Basin Area:**

Construction of the Wild River pipeline is currently underway and involves a 10 mile, 6 inch pipeline and associated dehydration facilities. This project has experienced minor delays as a result of weather and is scheduled to be completed in September.

Licensing is underway for a non-operated exploration well at Pedley targeting deep sour gas and the well is scheduled to spud in late September or October.

The Company also plans to drill two wells at Marlboro and to tie in a well that was completed and production tested at 0.7 Mmcf per day during the second quarter. This production is expected to commence in the fourth quarter.

**West Pembina Area:**

The West Pembina area continues to provide numerous opportunities as well as operating challenges. The non-operated West Pembina Gas Plant experienced a number of operating difficulties during the quarter and had a total of 34 days with gas plant capacity being restricted. As a result of this downtime, the average production of the Company in the quarter was reduced by approximately 200 BOE per day.

The Company also has two Nisku gas wells shut-in due to pipeline constraints and high operating pressures. These two wells were producing approximately 2.6 Mmcf per day net to the company prior to being shut-in. New equipment to rectify the pipeline constraints is being installed. It is anticipated these wells will be back on line in the fourth quarter.

The Company was very busy on the recompletion/workover front and had successes that have mitigated some of the production downtime.

Two wells were also completed and production tested in the Columbia/Harlech area and yielded a net of 2.5 Mmcf per day of sweet gas on a combined basis. These results in combination with detailed mapping from a large 3D seismic survey have provided a number of

follow-up locations. The Company plans to commence drilling the first well of an eight well program in this area in August, 2004.

Two exploration wells (3,500 to 4,000 meters in depth) targeting new Nisku pools are planned for the remainder of the year in the West Pembina area. Also planned are two operations to re-enter existing wells and drill a deviated hole to access Nisku reservoirs in more optimal locations.

**Fairborne Energy Ltd.**  
**Interim Consolidated Balance Sheets**  
(\$ thousands)

	June 30, 2004 <i>(unaudited)</i>	December 31 2003 <i>(restated, see Note 1)</i>
<b>Assets</b>		
Current assets		
Cash and cash equivalents	\$306	\$6,152
Accounts receivable	21,477	14,126
Prepaid expenses and deposits	1,968	1,997
	<u>23,751</u>	<u>22,275</u>
Fixed assets (Note 3)		
Petroleum and natural gas properties and equipment	273,097	127,666
Office furniture and equipment	1,044	843
Accumulated depletion and depreciation	(32,137)	(17,219)
	<u>242,004</u>	<u>111,290</u>
Goodwill	6,360	6,360
	<u>\$272,115</u>	<u>\$139,925</u>
<b>Liabilities</b>		
Current liabilities		
Accounts payable and accrued liabilities	\$32,377	\$21,132
Equipment lease (Note 4)	-	2,573
Bank indebtedness (Note 5)	76,159	7,941
	<u>108,536</u>	<u>31,646</u>
Asset retirement obligations (Note 6)	11,503	6,165
Future income taxes	18,485	15,913
<b>Shareholders' Equity</b>		
Capital stock (Note 7)	114,086	73,040
Contributed surplus (Note 7)	594	331
Retained earnings	18,911	12,830
	<u>133,591</u>	<u>86,201</u>
Subsequent events (Note 9)	<u>\$272,115</u>	<u>\$139,925</u>

*See accompanying notes to the interim consolidated financial statements*

**Fairborne Energy Ltd.**  
**Interim Consolidated Statements of Operations**  
**and Retained Earnings**

(\$ thousands, except per share amounts)

(Unaudited)	For the Three Months Ended June 30		For the Six Months Ended June 30	
	2004	2003	2004	2003
		(restated, see Note 1)		(restated, see Note 1)
<b>Revenue</b>				
Petroleum and natural gas	\$ 29,756	\$10,154	\$ 48,185	\$19,685
Less: Royalties	6,493	1,771	10,713	3,436
	<b>23,263</b>	<b>8,383</b>	<b>37,472</b>	<b>16,249</b>
<b>Expenses</b>				
Production	5,801	1,581	8,741	3,233
General and administrative	1,805	738	2,943	1,168
Interest	728	67	888	132
Accretion	239	133	375	246
Depletion and depreciation	9,935	2,085	14,918	4,191
	<b>18,508</b>	<b>4,604</b>	<b>27,865</b>	<b>8,970</b>
<b>Income before taxes</b>	<b>4,755</b>	<b>3,779</b>	<b>9,607</b>	<b>7,279</b>
Taxes				
Future income taxes	1,875	1,044	3,351	2,303
Capital taxes	94	12	175	30
	<b>1,969</b>	<b>1,056</b>	<b>3,526</b>	<b>2,333</b>
<b>Net Income</b>	<b>2,786</b>	<b>2,723</b>	<b>6,081</b>	<b>4,946</b>
Retained earnings beginning of period, as previously reported	16,125	4,668	12,830	2,438
Retained earnings adjustment, asset retirement obligation (Note 6)	-	27	-	34
<b>Retained earnings, end of period</b>	<b>\$ 18,911</b>	<b>\$ 7,418</b>	<b>\$ 18,911</b>	<b>\$ 7,418</b>
<b>Net income per share (Note 7)</b>				
Basic	\$ 0.07	\$ 0.14	\$ 0.17	\$ 0.25
Diluted	\$ 0.07	\$ 0.13	\$ 0.16	\$ 0.25

See accompanying notes to the interim consolidated financial statements.

**Fairborne Energy Ltd.**  
**Interim Consolidated Statements of Cash Flows**  
(\$ thousands)

<b>(Unaudited)</b>	<b>For the Three Months Ended June 30</b>		<b>For the Six Months Ended June 30</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
Cash Provided by (used in):		(restated, see Note 1)		(restated, see Note 1)
<b>Operating Activities</b>				
Net income	\$ 2,786	\$2,723	\$ 6,081	\$4,946
Items not involving cash				
Depletion and depreciation	9,935	2,085	14,918	4,191
Compensation expense	248	-	321	-
Accretion	239	133	375	246
Future income taxes	1,875	1,044	3,351	2,303
	15,083	5,985	25,046	11,686
Asset retirement expenditures	-	(293)	(17)	(293)
Change in non-cash working capital	43	(1,038)	(10,970)	(1,503)
	15,126	4,654	14,059	9,890
<b>Financing Activities</b>				
Issuance of common shares net of costs	1,308	-	40,209	-
Equipment lease payments	(2,540)	(30)	(2,573)	(61)
Bank Indebtedness	2,485	-	68,218	-
	1,253	(30)	105,854	(61)
<b>Investing Activities</b>				
Capital expenditures	(20,956)	(3,659)	(40,090)	(8,260)
Dispositions	10,678	-	10,678	-
Acquisition of petroleum and natural gas properties (Note 2)	(28)	-	(111,240)	-
Change in non-cash working capital	(5,902)	459	14,893	174
	(16,208)	(3,200)	(125,759)	(8,086)
Change in cash and cash equivalents	171	1,424	(5,846)	1,743
Cash and cash equivalents, beginning of period	135	3,906	6,152	3,587
<b>Cash and cash equivalents, end of period</b>	<b>\$ 306</b>	<b>\$ 5,330</b>	<b>\$ 306</b>	<b>\$ 5,330</b>
Cash interest paid	728	67	888	132
Cash taxes paid	94	12	175	30

See accompanying notes to the interim consolidated financial statements.

## **Fairborne Energy Ltd.**

### **Selected Notes to the Interim Consolidated Financial Statements**

**For the six months ended June 30, 2004** (*unaudited*)  
**(tabular amounts are stated in thousands of dollars except per share amount)**

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 the adoption is presented below as increases (decreases):

<b>Balance sheet</b>	<b>As at December 31, 2003</b>	<b>As at December 31, 2002</b>
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

<b>Statement of operations</b>	<b>Six month Period ended June 30, 2004</b>	<b>Six month Period ended June 30, 2003</b>	<b>Year ended December 31, 2003</b>
Accretion expense	375	246	558
Depletion and depreciation on asset retirement costs	545	316	619
Future site restoration expense	(1,901)	(508)	(1,405)
Future income taxes	353	(20)	82
Net earnings impact	628	(34)	146

#### **Note 2: Acquisition of petroleum and natural gas properties**

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. Details of the acquisition are as follows:

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

#### **Note 3: Petroleum and natural gas properties and equipment**

Fairborne performed a ceiling test calculation at January 1, 2004 and June 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 June 30, 2004.

Year	WTI Oil (\$U.S./bbl)	Foreign Exchange Rate	Edmonton Light Crude Oil (\$Cdn/bbl)	AECO Gas (\$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

As at June 30, 2004, Fairborne has incurred all exploration expenditures to meet its December 9, 2003, flow through share commitment.

**Note 4: Equipment lease**

The Company repaid the equipment lease in April 2004.

**Note 5: Bank indebtedness**

At June 30, 2004 the Company has available \$85 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 June 30, 2004 \$76.2 million was drawn under the facilities. The scheduled review date of the facility is May 31, 2005. The facilities are secured by a first ranking floating charge on all real property of the Company and a general security agreement. On July 29, 2004, the two Canadian chartered banks increased the credit facilities to \$105 million.

**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 estimated the total undiscounted amount of cash flows required to settle its asset retirement obligations is approximately \$38.7 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:

<b>Asset retirement obligations (000's)</b>	<b>Six month Period ended June 30, 2004</b>	<b>Year ended December 31, 2003</b>
Balance, beginning of period	6,165	4,135
Acquisition in the period	4,664	1,055
Liabilities incurred in period	316	1,200
Liabilities settled in period	(17)	(783)
Accretion expense	375	558
Balance, end of period	11,503	6,165

## Note 7: Capital stock

### a) Common shares

<b>Common shares, issued and outstanding (000's)</b>	<b>Number</b>	<b>Amount</b>
Balance, December 31, 2003	32,328	\$ 73,040
Shares issued on exercise of options	530	1,363
Private placement of common shares for cash	6,178	41,084
Share issue costs	-	(2,180)
Future tax benefit of issue costs	-	779
Balance, June 30, 2004	39,036	114,086

### b) Contributed surplus

<b>(000's)</b>	
Balance, December 31, 2003	\$ 331
Options granted	321
Options exercised	(58)
Balance, June 30, 2004	\$ 594

The weighted average fair value of stock options granted in 2004 was \$1.84 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:

	<b>For the Three Months Ended June 30, 2004</b>	<b>For the Three Months Ended June 30, 2003</b>	<b>For the Six Months Ended June 30, 2004</b>	<b>For the Six Months Ended June 30, 2003</b>
Basic	38,984,482	19,750,000	35,692,522	19,750,000
Diluted	41,954,914	20,191,019	38,558,112	20,185,841

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

### d) Stock options

There are 3,465,583 stock options outstanding at June 30, 2004 with a weighted average exercise price of \$4.98 per option. The options expire between January 23, 2006 and June 8, 2009.

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

	<b>Number of Options</b>	<b>Weighted average exercise price</b>
Balance December 31, 2003	2,861,049	\$ 2.90
Granted	1,134,000	\$9.07
Exercised	(529,466)	\$2.47
Balance June 30, 2004	3,465,583	\$4.98

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

<b>Exercise Price</b>	<b>Options Outstanding</b>	<b>Remaining Term (years)</b>	<b>Options Exercisable</b>
\$ 1.75 - \$ 1.84	45,729	1.6	45,729
\$ 2.40 - \$ 3.09	1,600,965	3.0	785,957
\$ 3.42 - \$ 4.76	378,000	3.8	125,999
\$ 5.20 - \$ 7.40	379,389	3.4	5,889
\$ 8.00 - \$ 10.35	1,061,500	4.7	-
	<b>3,465,583</b>	<b>3.6</b>	<b>963,574</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 hedges outstanding at June 30, 2004:

<b>Commodity</b>	<b>Period</b>	<b>Volume</b>	<b>Price</b>
Crude Oil	July 1 to September 30, 2004	350 bbls/day	WTI US\$32.25
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

The Company has sold forward US\$1,039,000 of foreign exchange exposure at Cdn \$1.3468 to US \$1.00 (US \$0.7425 to Cdn \$1.00) from July 1, 2004 to September 30, 2004. At June 30, 2004 the estimated fair value of the foreign exchange contract was a nominal amount.

#### Note 9: Subsequent events

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. 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 approximately \$51.5 million. In addition, \$12 million of net debt was assumed.

On July 15, 2004 Fairborne entered into an agreement to issue and sell on a "bought deal" basis, 1,600,000 flow-through common shares of Fairborne at an issue price of \$12.50 each, resulting in gross proceeds of \$20,000,000. Proceeds of the offering are planned for Canadian exploration expenses on Fairborne's oil and natural gas properties and will be renounced to subscribers effective on or before December 31, 2004. Closing is scheduled to occur on or about August 10, 2004.

## **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") is provided by the management of Fairborne Energy Ltd. ("Fairborne" or the "Company") to review second 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 six months ended June 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 and became a publicly traded company in 2003. 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.

Per 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.

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 term "funds generated from operations", which 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.

### **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.

## SELECTED FINANCIAL INFORMATION

The following table sets forth selected financial information of the Company for the period indicated:

	Six Months Ended June 30	
	2004	2003 (restated)
<i>(\$ thousands, except per share amounts)</i>		
Petroleum and Natural Gas Sales, Before Royalties	48,185	19,685
Funds Generated from Operations	25,046	11,686
Per Share – Basic	\$ 0.70	\$ 0.59
Per Share – Diluted	\$ 0.64	\$ 0.58
Net Income	6,081	4,946
Per Share – Basic	\$ 0.17	\$ 0.25
Per Share – Diluted	\$ 0.16	\$ 0.25
Total Assets	272,115	60,629
Debt including Working Capital Deficit	84,785	Nil

## QUARTERLY FINANCIAL INFORMATION

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

	June 30,	March 31,	Dec 31,	Sept 30,
	2004	2004	2003 (restated)	2003 (restated)
<i>(\$ thousands, except per share amounts)</i>				
Petroleum and Natural Gas Sales, Before Royalties	29,756	18,429	15,492	15,711
Funds Generated from Operations	15,083	9,963	8,407	9,056
Per Share – Basic	\$ 0.39	\$ 0.31	\$ 0.27	\$ 0.30
Per Share – Diluted	\$ 0.36	\$ 0.28	\$ 0.21	\$ 0.30
Net Income	2,786	3,295	2,344	3,019
Per Share – Basic	\$ 0.07	\$ 0.10	\$ 0.06	\$ 0.09
Per Share – Diluted	\$ 0.07	\$ 0.09	\$ 0.05	\$ 0.09
Total Assets	272,115	266,338	139,925	124,928
Debt including Working Capital Deficit	84,785	90,870	9,371	17,643

  

	June 30,	Mar 31,	Dec 31,	Sept 30,
	2003 (restated)	2003 (restated)	2002 (restated)	2002 (restated)
<i>(\$ thousands, except per share amounts)</i>				
Petroleum and Natural Gas Sales, Before Royalties	10,154	9,531	8,368	6,084
Funds Generated from Operations	5,985	5,701	4,396	3,411
Per Share – Basic	\$ 0.30	\$ 0.29	\$ 0.22	\$ 0.17
Per Share – Diluted	\$ 0.30	\$ 0.29	\$ 0.22	\$ 0.17
Net Income	2,723	2,222	1,316	902
Per Share – Basic	\$ 0.14	\$ 0.11	\$ 0.06	\$ 0.05
Per Share – Diluted	\$ 0.13	\$ 0.11	\$ 0.06	\$ 0.05
Total Assets	60,629	55,769	51,544	51,652
Debt including Working Capital Deficit	Nil	Nil	Nil	Nil

## **PRODUCTION**

Crude oil and NGL production averaged 2,733 bbls/day and natural gas averaged 30.4 million cubic feet ("Mmcf") per day for a total of 7,801 BOE/day for the quarter ended June 30, 2004. This compares favorably with the 2,922 BOE per day recorded in the second quarter of 2003 and represents a 167 percent increase in average production.

Crude oil and NGL production averaged 2,414 bbls/day and natural gas averaged 24.1 million cubic feet ("Mmcf") per day for a total of 6,436 BOE/day for the six months ended June 30, 2004. Similarly this compares favorably with the 2,758 BOE per day recorded in the first six months of 2003 and represents a 133 percent increase in average production.

In comparing the average production volumes in the two periods, it is important to consider the effect of the acquisition of Pivotal Energy Ltd. ("Pivotal") completed on July 2, 2003 which resulted in an approximate 50 percent increase in Fairborne's productive capability at that time and to consider the effect of the acquisition of the West Pembina assets completed on March 31, 2004 which resulted in an additional 3,150 BOE per day of production in the second quarter of 2004. Production during the quarter was negatively impacted by 300 BOE per day in the Basset Lake area due to liquid loading problems and the need for additional facilities and by 200 BOE per day due to operational problems at the non-operated West Pembina gas plant.

Fairborne's drilling program has been more focused on adding volumes of natural gas and, as such, the production mix in the second quarter of 2004 is 65 percent natural gas compared to 41 percent natural gas in the same period in 2003. The West Pembina properties presently produce approximately 74 percent natural gas, which further strengthens Fairborne as a natural gas producer.

## **COMMODITY PRICES**

Fairborne's Crude oil and NGL price averaged \$44.63 per barrel during the quarter ended June 30, 2004 compared to \$35.69 during the quarter ended June 30, 2003. In the first six months of 2004 the crude oil and NGL price averaged \$42.90 which was higher than the \$38.18 in the first six months of 2003. Fairborne's natural gas prices were consistent quarter over quarter. For the three months ended June 30, 2004 the natural gas price was \$6.74 and \$6.75 for the same period in 2003. For the six months ended June 30, 2004 the natural gas price was \$6.68 and \$6.76 for the six months ended June 30, 2003. Commodity prices for crude oil and natural gas are both maintaining these high levels 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 June 30, 2004 Fairborne did not have any natural gas production hedged however an average of 700 barrels per day (28 percent) of crude oil production was hedged. Hedging in the three months ended June 30, 2004 reduced Fairborne's crude oil price received by \$3.21. During the first six months of 2004, Fairborne hedged an average of 700 barrels per day (31 percent of total crude oil production) and 1,920 Mmcf per day (9 percent of natural gas production). Hedging activity in the first half of 2004 reduced the crude oil price received by \$2.80 per barrel and increased the natural gas price received by \$0.03 per Mcf.

In addition, Fairborne has hedged U.S. \$1,039,000 of foreign exchange exposure at Cdn \$1.3468 to U.S. \$1.00 (U.S. \$0.7425 to Cdn \$1.00). At June 30, 2004 the estimated fair value of the foreign exchange contract is a nominal amount.

## PRODUCTION REVENUE

For the three months ended June 30, 2004, revenues increased 193 percent to \$29.8 million from \$10.2 million for the same period in 2003 due mainly to higher production volumes combined with higher prices for crude oil and NGL's.

Similarly, for the six months ended June 30, 2004, revenues increased 145 percent to \$48.2 million from \$19.7 million for the same period in 2003.

(\$ thousands, except per unit amounts)	Three Months Ended June 30		Three Months Ended June 30	
	2004	\$/Unit	2003	\$/Unit
Natural Gas	18,652	6.74	4,474	6.75
Oil and NGL	11,104	44.63	5,680	35.69
Total Revenue	29,756	41.91	10,154	38.18

(\$ thousands, except per unit amounts)	Six Months Ended June 30		Six Months Ended June 30	
	2004	\$/Unit	2003	\$/Unit
Natural Gas	29,339	6.68	7,884	6.76
Oil and NGL	18,846	42.90	11,801	38.15
Total Revenue	48,185	41.06	19,685	39.14

## ROYALTIES

Royalties consist of payments made to the Alberta government, freehold landowners and overriding royalty owners. Some of the Fairborne properties are located on freehold land on which royalty rates tend to be lower. For the three months ended June 30, 2004 the royalty rate was 21.8 percent, 4.4 percent higher than the royalty rate of 17.4 percent for the three months ended June 30, 2003. For the six months ended June 30, 2004 royalties totaled \$10.7 million which is an overall royalty rate of 22.2 percent. For the same period in 2003 royalties were \$3.4 million and the overall royalty rate was 17.4 percent. The increase in the rate is due to the addition of the Pivotal properties which were not added until the third quarter of 2003. The royalty rate for the remainder of 2004 is expected to average about 22 percent and has remained constant with the addition of the West Pembina properties.

## EXPENSES

Fairborne operates in excess of 95 percent of its production and consequently maintains a high degree of control over operating costs. Operating costs were \$8.17 per BOE or \$5.8 million in total during the three months ended June 30, 2004 compared to \$5.95 per BOE or \$1.6 million during the same period in 2003. For the six months ended June 30, 2003 operating costs were \$7.46 per BOE or \$8.7 million compared to \$6.47 per BOE or \$3.2 million during the same period in 2003. Quarter over quarter this is an increase of 17 percent due mainly to the addition of the West Pembina assets which were not included in operating costs until April of 2004 as well as operational problems at both West Pembina and Basset Lake. For the remainder of 2004 operating costs per unit are expected to trend lower as operational difficulties are reduced and production levels increase.

During the second quarter of 2003, net general and administrative expenses were \$1.8 million or \$2.54 per BOE in comparison to the first quarter of 2003 whereby net general and administrative costs were \$0.7 million or \$2.77 per BOE. In the first six months of the year, general and administrative expenses were \$2.9 million or \$2.51 per BOE compared to \$1.2 million or \$2.34 per BOE in the first six months of 2003. As the Company grows and adds staff connected with the additional requirement of operating the West Pembina production, these costs will increase on an absolute basis but Fairborne does anticipate reducing these costs, on a BOE basis.

Interest for the three months ended June 30, 2004 increased to \$0.7 million compared to \$0.1 million during the same period in 2003. Interest for the six months ended June 30, 2004 increased to \$0.9 million compared to \$0.1 million during the same period in 2003. This increase is the result of higher average debt associated with the purchase of the West Pembina assets during the period compared to 2003.

#### FUNDS GENERATED FROM OPERATIONS AND NET INCOME

(\$ thousands, except per unit amounts)	Three Months Ended June 30		Three Months Ended June 30	
	2004	\$/BOE	2003	\$/BOE (restated)
Production Revenue	29,756	41.91	10,154	38.18
Royalties	6,493	9.15	1,771	6.66
	23,263	32.76	8,383	31.52
Operating Expenses	5,801	8.17	1,581	5.95
	17,462	24.59	6,802	25.57
General & Administrative (Net of non-cash compensation expense)	1,557	2.19	738	2.77
Interest	728	1.03	67	0.25
Capital Taxes	94	0.13	12	0.05
Funds Generated From Operations	15,083	21.24	5,985	22.50
Compensation Expense	248	0.35	-	-
Depletion and Depreciation	9,935	14.00	2,085	7.84
Accretion	239	0.34	133	0.50
Future Income Taxes	1,875	2.64	1,044	3.93
Net Income	2,786	3.91	2,723	10.23

(\$ thousands, except per unit amounts)	Six Months Ended June 30		Six Months Ended June 30	
	2004	\$/BOE	2003	\$/BOE (restated)
Production Revenue	48,185	41.06	19,685	39.14
Royalties	10,713	9.15	3,436	6.88
	37,472	31.91	16,249	32.26
Operating Expenses	8,741	7.46	3,233	6.47
	28,731	24.45	13,016	25.79
General & Administrative (Net of non-cash compensation expense)	2,622	2.24	1,168	2.34
Interest	888	0.76	132	0.26
Capital Taxes	175	0.15	30	0.06
Funds Generated From Operations	25,046	21.30	11,686	23.13
Compensation Expense	321	0.27	-	-
Depletion and Depreciation	14,918	12.74	4,191	8.40
Accretion	375	0.32	246	0.49
Future Income Taxes	3,351	2.86	2,303	4.62
Net Income	6,081	5.11	4,946	9.62

For the three months ended June 30, 2004 the depletion expense increased 371 percent to \$9.9 million from \$2.1 million. For the six months ended June 30, 2004 depletion expense increased 255 percent to \$14.9 million from \$4.2 million for the same period in 2003. The increase for both the three and six month periods is largely due to increased production. On a BOE basis, depletion for the three months ended June 30, 2004 increased to \$14.00 from \$7.84 in 2003 and to \$12.74

from \$8.40 for the six months ended June 30, 2003. The increase in BOE depletion charges is a result of the acquisition of the West Pembina properties and the higher cost of reserve additions.

Effective January 1, 2004, Fairborne retroactively adopted, with restatement of prior periods, a new accounting standard relating to asset retirement obligations. The effect of the adoption on income is presented below as increases (decreases):

<b>Statement of Operations</b>	<b>Six-month Period ended June 30, 2004</b>	<b>Six-month Period ended June 30, 2003</b>	<b>Year ended December 31, 2003</b>
Accretion expense	375	246	558
Depletion and depreciation on asset retirement costs	545	316	619
Future site restoration expense	(1,901)	(508)	(1,405)
Future income taxes	353	(20)	82
Net earnings impact	628	(34)	146

Fairborne's effective income tax rate is 37 percent consisting primarily of future income taxes. In 2004, Fairborne does not envision paying cash income taxes.

#### **FUNDS GENERATED FROM OPERATIONS**

The combination of production levels, commodity prices and expenses detailed above resulted in funds generated from operations of \$25.0 million (\$0.70 per share) for the six months ended June 30, 2004. With the inclusion of the acquisition of Case Resources Inc. as at July 27, 2004, present production is approximately 9,200 BOE per day and additional production of 1,500 BOE per day is to be connected in the next 60 days, therefore the level of funds generated should increase in the remaining six months of 2004.

#### **SUBSEQUENT EVENTS**

On July 27, 2004 Fairborne acquired all of the outstanding shares of Case Resources Inc. pursuant to an Arrangement Agreement dated June 25, 2004 between Case and Fairborne. 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 approximately \$51.5 million. In addition, \$12.0 million of net debt was assumed.

On July 15, 2004 Fairborne entered into an agreement to issue and sell on a "bought deal" basis, 1,600,000 flow-through common shares of Fairborne at an issue price of \$12.50 each, resulting in gross proceeds of \$20,000,000. Proceeds of the offering are planned for Canadian exploration expenses on Fairborne's oil and natural gas properties and will be renounced to subscribers effective on or before December 31, 2004. Closing is scheduled to occur on or about August 10, 2004.

#### **LIQUIDITY AND CAPITAL RESOURCES**

Fairborne's capital program for the first six month of 2004 totaled \$140.7 million including the acquisition of assets connected with the West Pembina acquisition as detailed in the following table:

## Capital Expenditures

(\$ thousands)	For the three months ended June 30,		For the six months ended June 30,	
	2004	2003	2004	2003
<b>Exploration and Development</b>				
Land and Lease Acquisitions	\$ 542	\$2,037	\$ 2,123	\$2,223
Geological and Geophysical	5,712	164	7,086	1,311
Drilling, Completions and Workovers	6,996	1,159	17,574	3,565
Well Equipment and Facilities	7,554	253	13,106	1,110
Corporate Assets	152	46	201	51
	20,956	3,659	40,090	8,260
<b>Acquisitions, net of Dispositions</b>				
Acquisitions	28	-	111,240	-
Dispositions	(10,678)	-	(10,678)	-
	10,306	3,659	140,652	8,260

Expenditures for land and leases during the first quarter of 2004 combined with the West Pembina acquisition resulted in Fairborne holding 219,705 net acres of undeveloped land at June 30, 2004 with an average working interest of 65 percent. In the three months ended June 30, 2004 drilling expenditures resulted in a total of 12 (9.1 net) wells drilled resulting in 11 (8.1 net) natural gas wells and 1 (1.0 net) well was dry and abandoned for an overall net success rate of 89 percent. Fairborne operated all but one well in this program. The capital program for the second quarter was financed by funds generated from operations of \$15.1 million. For the six months ended June 30, 2004, drilling expenditures resulted in a total of 54 (38.4 net) wells drilled resulting in 2 (2.0 net) crude oil wells, 47 (32.4 net) natural gas wells and 5 (4.0 net) wells were dry and abandoned for an overall success rate of 91 percent. The capital program for the six months ended June 30, 2004 was financed by funds generated from operations and additional bank debt.

Fairborne has a revolving demand loan based on a borrowing base determined by the Company's bankers. In connection with the acquisition of West Pembina properties, the bankers increased the line to \$85 million and this was further increased to \$105 million with the Case acquisition. The amount of the line drawn at June 30, 2004 is \$76.2 million.

The capital budget for the remainder of 2004 totals \$60 million. Fairborne anticipates utilizing funds generated from operations, bank borrowings and new equity issued to fund its capital and operating activities.

## SHARE CAPITAL

During the first six months of 2004, Fairborne issued a total of 6,708,000 common shares, of these, 6,178,000 were issued in connection with the West Pembina acquisition and 530,000 were issued on exercise of share options. The following chart shows the common share equity outstanding.

***Equity Outstanding:***

<i>(thousands)</i>	Three months ended June 30, 2004	Six months ended June 30, 2004
Common shares	39,036	39,036
Warrants	1,960	1,960
Stock Options	3,466	3,466
Weighted average shares outstanding for the period		
Basic	38,984	35,693
Diluted	41,955	38,558

**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.