



*2010 Management's Discussion and Analysis
& Consolidated Financial Statements*



2010 *accounts & accountability*



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

The following Management Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") was prepared at, and is dated, March 9, 2011. This MD&A is provided by the management of Fairborne Energy Ltd. ("Fairborne" or the "Company") to review 2010 activities and results as compared to the previous year, and should be read in conjunction with the audited consolidated financial statements including notes for the years ended December 31, 2010 and 2009. Additional information relating to Fairborne, including Fairborne's annual information form, is available on SEDAR at www.sedar.com.

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

Forward Looking Statements: This document contains forward-looking statements. Management's assessment of future plans and operations, timing and adoption of IFRS, policy choices to be made under IFRS and the impact of the adoption of IFRS, the Company's expectation that it will have adequate liquidity to fund financial liabilities as they become due, the effect of the non-core asset disposition and the Company's planned method of funding capital expenditures may constitute forward-looking statements under applicable securities laws and necessarily involve risks including, without limitation, risks associated with oil and gas exploration, development, exploitation, production, marketing and transportation, loss of markets, volatility of commodity prices, currency fluctuations, imprecision of reserve estimates, environmental risks, competition from other producers, inability to retain drilling rigs and other services, incorrect assessment of the value of acquisitions, failure to realize the anticipated benefits of acquisitions, the inability to fully realize the benefits of the acquisitions, delays resulting from or inability to obtain required regulatory approvals and ability to access sufficient capital from internal and external sources. As a consequence, the Company's actual results may differ materially from those expressed in, or implied by, the forward looking statements. Forward looking statements or information are based on a number of factors and assumptions which have been used to develop such statements and information but which may prove to be incorrect. Although Fairborne believes that the expectations reflected in such forward-looking statements or information are reasonable, undue reliance should not be placed on forward looking statements because the Company can give no assurance that such expectations will prove to be correct. In addition to other factors and assumptions which may be identified in this document and other documents filed by the Company, assumptions have been made regarding, among other things: the impact of increasing competition; the general stability of the economic and political environment in which Fairborne operates; the ability of the Company to obtain qualified staff, equipment and services in a timely and cost efficient manner; drilling results; the ability of the operator of the projects which the Company has an interest in to operate the field in a safe, efficient and effective manner; Fairborne's ability to obtain financing on acceptable terms; field production rates and decline

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rates; the ability to replace and expand oil and natural gas reserves through acquisition, development or exploration; the timing and costs of pipeline, storage and facility construction and expansion; the ability of the Company to secure adequate product transportation; future oil and natural gas prices; currency, exchange and interest rates; the regulatory framework regarding royalties, taxes and environmental matters in the jurisdictions in which the Company operates; and Fairborne's ability to successfully market its oil and natural gas products. Readers are cautioned that the foregoing list of factors is not exhaustive. Additional information on these and other factors that could affect the Company's operations and financial results are included in reports on file with Canadian securities regulatory authorities and may be accessed through the SEDAR website (www.sedar.com) or at the Company's website (www.fairborne-energy.com).

Furthermore, the forward looking statements contained in this document are made as at the date of this document and the Company does not undertake any obligation to update publicly or to revise any of the included forward looking statements, whether as a result of new information, future events or otherwise, except as may be required by applicable securities laws.

Non-GAAP Terms: This document contains the terms “funds generated from operations”, “funds generated from operations per share”, “cash flow from operations per share”, “net debt” and “netbacks” which are non-GAAP terms. The Company uses these measures to help evaluate its performance. The Company uses net debt (bank indebtedness plus negative working capital or less positive working capital, excluding convertible debentures) as an alternative measure of outstanding debt. The Company's calculation of net debt can be found under the heading Working Capital and Bank Indebtedness on page 16. The Company considers corporate netbacks a key measure as it demonstrates its profitability relative to current commodity prices. Netbacks which have no GAAP equivalent, are calculated on a BOE basis by deducting royalties, operating costs, and transportation from petroleum and natural gas sales and sulphur block sales. The Company considers funds generated from operations a key measure as it demonstrates Fairborne's ability to generate funds necessary to repay debt and to fund future growth through capital investment. Funds generated from operations should not be considered as an alternative to, or more meaningful than, cash flow from operating activities as determined in accordance with Canadian GAAP as an indicator of Fairborne's performance. Fairborne's determination of funds generated from operations may not be comparable to that reported by other companies. The reconciliation between cash flow from operations and funds generated from operations can be found in the statement of cash flows in the consolidated financial statements with funds generated from operations calculated before non-cash working capital and asset retirement expenditures. Fairborne also presents funds generated from operations per share and cash flow from operations per share whereby per share amounts are calculated using weighted average shares outstanding consistent with the calculation of income (loss) per share.

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

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HIGHLIGHTS

	2010	2009	CHANGE
Financial (\$THOUSANDS, EXCEPT PER SHARE AMOUNTS)			
Petroleum and natural gas revenue	234,637	240,557	(2%)
Funds generated from operations ⁽¹⁾	122,677	143,811	(15%)
Per share – basic	\$1.20	\$1.59	(25%)
Per share – diluted	\$1.20	\$1.59	(25%)
Cash flow from operations (including changes in working capital)	119,805	141,233	(15%)
Per share – basic	\$1.17	\$1.56	(25%)
Per share – diluted	\$1.17	\$1.56	(25%)
Net loss	(16,284)	(25,645)	37%
Per share – basic	\$(0.16)	\$(0.28)	43%
Per share – diluted	\$(0.16)	\$(0.28)	43%
Exploration and development expenditures	157,090	110,389	42%
Acquisitions, net of dispositions	77,572	(24,844)	–
Working capital deficit (excluding convertible debentures)	17,743	6,370	179%
Convertible debentures	98,397	96,510	2%
Bank indebtedness	206,331	103,738	99%
Operations			
Average production			
Natural gas (Mcf per day)	67,146	62,509	7%
Crude oil (bbls per day)	2,993	3,368	(11%)
Natural gas liquids (bbls per day)	976	596	64%
Sulphur (tonnes per day) ^{(2), (4)}	68	72	(6%)
Total (BOE per day)	15,228	14,454	5%
Average sales price			
Natural gas (\$ per Mcf) ⁽³⁾	5.04	5.74	(12%)
Crude oil (\$ per bbl) ⁽³⁾	77.01	65.50	18%
Natural gas liquids (\$ per bbl)	43.30	31.10	39%
Sulphur (\$ per tonne) ⁽⁴⁾	37.49	75.73	(50%)
Netback per BOE (\$ per BOE)			
Petroleum and natural gas sales ⁽³⁾	40.50	41.91	(3%)
Sulphur block revenue	1.89	5.28	(64%)
Royalties	(4.46)	(3.28)	36%
Operating expenses	(9.43)	(10.25)	(8%)
Transportation	(1.08)	(1.07)	1%
Operating netback	27.42	32.59	(16%)

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

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

(3) Excludes the change in fair value of derivatives.

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

*2010 Management's Discussion & Analysis***SUBSEQUENT EVENT – PROPOSED TRANSACTION**

On February 17, 2011, Fairborne entered into a property disposition which included undeveloped land, facilities and approximately 1,830 BOE per day (60% natural gas and 40% oil and NGL's) from producing properties in the Peace River Arch and Brazeau area of north and west central Alberta for \$125 million, subject to closing adjustments. The disposition is subject to customary closing conditions, including industry standard due diligence and regulatory approval, and is expected to close in March 2011. Proceeds from the disposition will be used initially to reduce bank indebtedness. In conjunction with the property disposition, Fairborne has revised its outlook for 2011 with cash flow expected to be reduced for the last three quarters as a result of the disposition. The initial capital budget will remain at \$140 million with capital spending in excess of cash flows to be financed from bank debt.

SELECT ANNUAL INFORMATION

(\$THOUSANDS, EXCEPT PER SHARE AMOUNTS)	2010	2009	2008
Petroleum and natural gas revenue	234,637	240,557	338,942
Funds generated from operations	122,677	143,811	189,175
Per share – basic	\$1.20	\$1.59	\$2.20
Per share – diluted	\$1.20	\$1.59	\$2.19
Cash flow from operations (including changes in working capital)	119,805	141,233	187,798
Per share – basic	\$1.17	\$1.56	\$2.19
Per share – diluted	\$1.17	\$1.56	\$2.18
Net income (loss)	(16,284)	(25,645)	44,701
Per share – basic	\$(0.16)	\$(0.28)	\$0.52
Per share – diluted	\$(0.16)	\$(0.28)	\$0.52
Total assets	1,036,377	940,443	1,013,177
Working capital deficit (excluding convertible debentures)	17,743	6,370	27,917
Convertible debentures	98,397	–	–
Long term financial liabilities			
Bank indebtedness	206,331	103,738	196,282
Convertible debentures	–	96,510	94,522
Asset retirement obligations	12,730	11,200	11,904
Future income taxes	89,405	89,919	81,860
Shareholders' equity	573,814	589,325	537,775

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

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

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

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

With the continuation of low natural gas prices in 2010, Fairborne's focus remained on financial resource management with an active risk management program. As a result, Fairborne's realized natural gas prices were 26% higher than the average AECO daily index prices in 2010 contributing to funds generated from operations of \$122.7 million in 2010 despite a depressed natural gas market. A successful drilling program combined with a property acquisition in 2010 resulted in an increase in average production to 15,228 BOE per day from 14,454 BOE per day in 2009.

Exploration and development spending of \$157.1 million in 2010 included drilling 40 (32.3 net) wells resulting in 28 (23.4 net) natural gas wells and 12 (8.9 net) oil wells. In 2010, Fairborne also completed a property acquisition which significantly expanded Fairborne's land position on the core asset at Marlboro/Pine Creek, as well as added a new producing property at McLeod River. The property acquisition was financed by debt resulting in bank indebtedness of \$206.3 million at December 31, 2010. In conjunction with the McLeod River acquisition and successful drilling results Fairborne's bank credit facilities were increased from \$285 million to \$325 million in 2010.

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QUARTERLY FINANCIAL INFORMATION

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

	2010			
	Q4	Q3	Q2	Q1
Financial (\$THOUSANDS, EXCEPT PER SHARE AMOUNTS)				
Petroleum and natural gas revenue	56,904	54,718	59,633	63,382
Funds generated from operations	27,470	28,204	27,448	39,555
Per share – basic	\$0.26	\$0.28	\$0.27	\$0.39
Per share – diluted	\$0.26	\$0.28	\$0.27	\$0.38
Cash flow from operations				
(including changes in working capital)	31,788	24,803	19,692	43,522
Per share – basic	\$0.32	\$0.24	\$0.19	\$0.42
Per share – diluted	\$0.32	\$0.24	\$0.19	\$0.42
Net Income (loss)	(5,372)	(7,600)	(7,121)	3,809
Per share – basic	\$(0.06)	\$(0.07)	\$(0.07)	\$0.04
Per share – diluted	\$(0.06)	\$(0.07)	\$(0.07)	\$0.04
Total assets	1,036,377	1,035,104	951,477	976,138
Working capital deficit				
(excluding convertible debentures)	17,743	22,621	6,352	34,611
Convertible debentures	98,397	97,959	97,476	96,993
Bank indebtedness	206,331	194,042	123,081	102,536
Operations				
Average production				
Natural gas (Mcf per day)	71,845	68,910	66,812	60,878
Crude oil (bbls per day)	2,946	2,916	3,110	3,000
Natural gas liquids (bbls per day)	1,028	1,036	1,149	686
Sulphur (tonnes per day) ⁽¹⁾	62	66	92	54
Total (BOE per day)	16,010	15,503	15,486	13,886

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

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

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

During the first two quarters of 2009, Fairborne realized increased production as a result of the Company's 2008 and first quarter 2009 capital expenditure program. In the second half of 2009 natural gas prices declined significantly and Fairborne made the economic decision to shut in production on its higher operating cost properties at Wild River and West Pembina. At the same time, Fairborne restricted its capital expenditure program. These decisions resulted in a decrease in production during the last two quarters of 2009 and first quarter of 2010. Production increased in the second quarter of 2010 as result of the successful first quarter drilling program. Fairborne maintained production levels in the third quarter and was able to increase production in the fourth quarter as a result of a successful 2010 drilling program and the McLeod River acquisition.

Beginning in the second quarter of 2009 Fairborne's revenue decreased as a direct result of weakened commodity prices. The decrease in natural gas prices was partially mitigated by Fairborne's risk management program as well as revenue received from the sale of inventory from the West Pembina sulphur block, which enabled Fairborne to maintain consistent funds generated from operations throughout 2009 despite low natural gas prices. In the first quarter of 2010, Fairborne's revenue and funds generated from operations increased as natural gas prices recovered for a short period. During the second quarter of 2010, natural gas prices began to decline again and continued to remain at low levels for the

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remainder of 2010. Fairborne's risk management program increased revenue and funds generated from operations throughout 2010, with revenues from the sale of West Pembina sulphur inventory recognized until the second quarter of 2010 when the contract was filled.

The net loss throughout 2009 was mainly attributable to decreases in natural gas prices as well as costs associated with employee compensation. The net loss in the second quarter of 2009 included \$12.6 million related to the accelerated compensation expense for the remaining life of 6.6 million stock options that were surrendered on June 1, 2009. Net income in the first quarter of 2010 was a result of increased commodity prices. Into the second, third and fourth quarters the net income shifted to a net loss as natural gas prices declined again. The loss decreased in the fourth quarter due to reduced depletion rates as a result of reserve additions associated with the 2010 capital expenditure program, including the McLeod River property acquisition.

Long term debt remained consistent through the first three quarters of 2009 with capital spending limited to funds generated from operations. In the fourth quarter of 2009, net debt was reduced significantly through a number of initiatives including property dispositions and an equity financing. Debt levels increased throughout 2010 as a result of capital expenditures exceeding cash flow and completion of the property acquisition which was financed by debt.

FOURTH QUARTER 2010 RESULTS

Fairborne's average production of 16,010 BOE per day during the fourth quarter of 2010 was 18% higher than average production for the fourth quarter of the previous year (Q4 2009 – 13,542 BOE per day) and 3% higher than the immediately preceding quarter (Q3 2010 – 15,503 BOE per day). The increase in production was a direct result of Fairborne's 2010 drilling program as well as the addition of McLeod River properties. Revenue of \$56.9 million for the fourth quarter was 4% higher than the preceding quarter (Q3 2010 – \$54.7 million) primarily due to increasing oil prices and more favorable gas prices as compared to the third quarter of 2010. Fairborne reported a net loss of \$5.4 million in the fourth quarter of 2010 compared to the \$7.6 million loss reported in the third quarter of 2010. The decrease was due to reduced depletion rates in the fourth quarter as a result of reserve additions associated with the 2010 capital expenditure program, including the McLeod River property acquisition.

Fairborne recorded funds generated from operations of \$27.5 million (\$0.26 per share) during the fourth quarter which was consistent with the immediately preceding quarter (Q3 2010 – \$28.2 million) and 27% lower than the funds generated from operations for the fourth quarter of the previous year (Q4 2009 – \$37.9 million). This decrease from 2009 reflects the decrease in commodity prices realized as well as the discontinuation of revenue received from the sale of the West Pembina sulphur block in 2010.

Capital expenditures in the fourth quarter totaled \$33.3 million which included \$23.8 million for drilling and completions and \$8.5 million for well equipment and facilities. Fairborne drilled seven (5.8 net) wells during the fourth quarter, resulting in six (5.5 net) natural gas wells and one (0.3 net) oil well. The fourth quarter capital program was financed by funds generated from operations and bank debt, resulting in a net debt position of \$224.1 million at December 31, 2010 (excluding convertible debentures).

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2010 FINANCIAL RESULTS

Production

	2010	2009	CHANGE
Natural gas (Mcf per day)	67,146	62,509	7%
Crude oil (bbls per day)	2,993	3,368	(11%)
Natural gas liquids (bbls per day)	976	596	64%
Sulphur (tonnes per day) ^{(1) (2)}	68	72	(6%)
Total (BOE per day)	15,228	14,454	5%
Natural gas % of production	73%	72%	1%

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

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

Fairborne reported average production of 15,228 BOE per day in 2010, an increase of 5% from 14,454 BOE per day in 2009. The increase in production was achieved as a result of a successful drilling program as well as the acquisition of producing properties in McLeod River during the third quarter of 2010. Production in 2009 reflected the economic decision to shut in some of the Company's production for part of the year.

Natural gas production of 67.1 MMcf per day in 2010 represents a 7% increase from 2009 (62.5 MMcf per day). The increase in 2010 was attributable to new wells drilled on the Marlboro and West Pembina properties as well as the McLeod River property acquisition. Production from the prior year was affected by the shut in of sour gas production on the Company's Wild River and West Pembina properties.

Crude oil and NGL production of 3,969 bbls per day for 2010 was consistent with the 2009 average of 3,964 bbls per day with new production offsetting natural declines.

Sulphur production during 2010 averaged 68 tonnes per day consistent with the daily average in 2009 (72 tonnes per day).

Commodity Prices & Risk Management Activities

	2010	2009	CHANGE
Average Prices ⁽¹⁾			
Natural gas (\$ per Mcf)	5.04	5.74	(12%)
Crude oil (\$ per bbl)	77.01	65.50	18%
Natural gas liquids (\$ per bbl)	43.30	31.10	39%
Sulphur (\$ per tonne) ⁽²⁾	37.49	75.73	(50%)
BOE (\$ per BOE)	40.30	41.74	(3%)
Benchmark Prices			
AECO Daily Index (Cdn\$ per Mcf)	4.00	3.97	1%
AECO Monthly Index (Cdn\$ per Mcf)	4.13	4.14	-
Edmonton Par (Cdn\$ per bbl)	77.64	65.70	18%
Nymex Calendar Average (US\$ per bbl)	79.53	61.80	29%

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

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

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Risk Management – Physical Sales Contracts

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

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

Financial instruments may be utilized by the Company to manage its exposure to commodity price fluctuations, foreign currency and interest rate exposures. The Company's policy is not to utilize financial instruments for trading or speculative purposes. Please see Note 1(f) in the audited consolidated financial statements for the year ended December 31, 2010 for a description of the accounting policies for financial instruments. Please see Notes 9 and 10 for additional information regarding market risk, credit risk, liquidity risk and fair value of the Company's financial instruments.

Natural Gas

In 2010, Fairborne's realized natural gas prices were 26% higher than the AECO Daily benchmark reference price due to corporate hedging activities and the higher heat content of Fairborne's production. Compared to the prior year, Fairborne's realized natural gas prices were 12% lower due to different physical sales and derivative contracts in 2010. An average of 23,902 Mcf per day was sold under fixed price physical sales contracts in 2010 representing 36% of the Company's natural gas production. Risk management activities increased the Company's natural gas revenue by an estimated \$20.8 million in 2010 which had the effect of increasing Fairborne's realized natural gas price by \$0.85 per Mcf to \$5.04 per Mcf.

At December 31, 2010, Fairborne had one natural gas swap that was accounted for as a derivative contract and the mark-to-market value of this contract was recorded as an asset of \$2.5 million at December 31, 2010.

The following table summarizes the outstanding fixed price physical sales contracts and derivative contracts for natural gas, including contracts outstanding at December 31, 2010 as well as contracts entered into after December 31, 2010:

	2011
Swaps	
Volume (Mcf per day)	13,298
Average price (\$ per Mcf)	\$5.70

Conversion factor: 1 Mcf = 1.128 GJ

Crude Oil

During 2010, Fairborne had an average of 1,500 bbls per day of crude oil under fixed price physical sales contracts representing 50% of crude oil production. Risk management activities, including option costs for puts purchased during the year did not have a significant impact on the Company's crude oil revenue. The Company's realized crude oil price of \$77.01 per bbl for 2010 increased 18% from 2009 which reflected the overall increase in average market prices.

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At December 31, 2010, Fairborne had one crude oil collar and one swap that were accounted for as derivative contracts and the combined mark-to-market value of these contracts was recorded as a liability of \$3.9 million at December 31, 2010. The liability was largely offset by the asset recorded on the derivative natural gas contract.

The following table summarizes the outstanding fixed price physical sales contracts and derivative contracts on crude oil, including contracts outstanding at December 31, 2010 as well as contracts entered into after December 31, 2010:

	2011
Collars	
Volume (bbl per day)	500
Average floor (US\$ per bbl)	\$70.00
Average ceiling (US\$ per bbl)	\$101.25
Swaps	
Volume (bbl per day)	500
Average price (US\$ per bbl)	\$75.00
Total volume (bbl per day)	1,000
Average floor price (US\$ per bbl)	\$72.50

Sulphur

The Company's average realized sulphur price for 2010 was \$37.49 per tonne, down 50% from an average realized price of \$75.73 in 2009.

Petroleum and Natural Gas Revenue

(\$THOUSANDS EXCEPT AS NOTED)	2010	2009	CHANGE
Petroleum and natural gas sales:			
Natural gas	123,529	130,921	(6%)
Crude oil	84,117	80,531	4%
Natural gas liquids	15,422	6,766	128%
Sulphur	934	2,000	(53%)
Total	224,002	220,218	2%
Per BOE	\$40.30	\$41.74	(3%)
Other revenue items:			
Sulphur block	10,511	27,836	(62%)
Change in the fair value of derivatives	(1,008)	(8,382)	88%
Other income	1,132	885	28%
Total	10,635	20,339	(48%)
Total petroleum and natural gas revenue	234,637	240,557	(2%)
Per BOE	\$42.21	\$45.59	(7%)

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Petroleum and natural gas sales of \$224.0 million were reported in 2010, a 2% increase from \$220.2 million reported in 2009. The increase is a result of higher overall production and strengthened oil and NGL prices throughout 2010. These increases were partially offset by a drop in Fairborne's realized gas prices as the Company had fewer risk management contracts outstanding in 2010 compared to the prior year. In addition, lower sulphur prices realized in 2010 also contributed to lower petroleum and natural gas sales compared to the prior year.

Also impacting total revenue in 2010 was a decrease in sulphur block revenue from \$27.8 million in 2009 to \$10.5 million in 2010 as a result of the contract being satisfied in June 2010 with no further revenue to be recognized.

The change in fair value of derivatives represents the change in the mark-to-market value of derivatives during 2010. The \$1.0 million decrease in the fair value of derivatives recorded in 2010 (2009 – \$8.4 million decrease) reflects both the changes in the unrealized value of existing contracts as well as a reduction for contracts settled during the period. Fairborne's risk management program, including derivative contracts and physical sales contracts, increased the Company's realized revenue by an estimated \$20.8 million in 2010 (2009 – \$37.3 million).

Royalties

(\$THOUSANDS EXCEPT AS NOTED)	2010	2009	CHANGE
Crown	16,387	9,893	66%
Freehold and overriding	8,403	7,389	14%
Total	24,790	17,282	43%
Crown (% of P&NG sales)	7.3%	4.5%	62%
Freehold and overriding (% of P&NG sales)	3.8%	3.4%	12%
Total (% of P&NG sales)	11.1%	7.9%	41%
Per BOE	\$4.46	\$3.28	36%

Fairborne recorded \$24.8 million of royalties in 2010 representing a royalty rate of 11.1%, a 41% increase from 7.9% (\$17.3 million) recorded in 2009. Freehold and overriding royalties remain consistent averaging between 3% and 4%; however, crown royalty rates increased from 4.5% in 2009 to 7.3% in 2010. Included in 2010 crown royalties is a \$3.3 million adjustment resulting from the Crown's recalculation of allowable deductions and credits under the new royalty regime effective January 2009. The crown royalty rate is also impacted by Fairborne's risk management program which increases natural gas revenues resulting in higher realized prices than the prices utilized in calculating royalties. In 2009 revenues were increased by \$37.3 million, whereas in 2010 revenues were increased by \$20.8 million; as such, the program did not have as big an impact on realized prices in 2010 compared to 2009 and accordingly had less of an impact on realized crown royalty rates.

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Operating Costs

(\$THOUSANDS EXCEPT AS NOTED)	2010	2009	CHANGE
Operating costs			
Natural gas	38,484	38,859	(1%)
Oil and NGLs	13,952	15,232	(8%)
Total	52,436	54,091	(3%)
Per BOE	\$9.43	\$10.25	(8%)

Operating costs of \$52.4 million (\$9.43 per BOE) were recorded in 2010, representing an 8% decrease from the \$10.25 per BOE recorded in 2009. The decrease in operating expenses is a result of cost reduction initiatives implemented in 2009 in the Company's Wild River and Sinclair properties.

Transportation Expenses

	2010	2009	CHANGE
Transportation (<i>\$thousands</i>)	5,998	5,622	7%
Per BOE	\$1.08	\$1.07	1%

Transportations costs of \$6.0 million (\$1.08 per BOE) recorded in 2010 include clean oil trucking, trucking of natural gas liquids, certain third party fuel charges and transportation and fuel costs associated with the usage of natural gas pipelines. Transportation costs in 2010 have remained consistent with 2009.

Operating Netbacks

(\$ PER BOE)	2010	2009	CHANGE
Petroleum and natural gas sales ⁽¹⁾	40.30	41.74	(3%)
Sulphur block revenue	1.89	5.28	(64%)
Other income ⁽¹⁾	0.20	0.17	18%
Royalties	(4.46)	(3.28)	36%
Operating costs	(9.43)	(10.25)	(8%)
Transportation	(1.08)	(1.07)	1%
Operating netback	27.42	32.59	(16%)

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

Fairborne's operating netback of \$27.42 per BOE in 2010 decreased 16% compared to 2009 (\$32.59 per BOE) as a result of lower natural gas prices, lower sulphur block revenues, and higher royalties, partially offset by lower operating expenses.

General and Administrative ("G&A") Expenses

(\$THOUSANDS EXCEPT AS NOTED)	2010	2009	CHANGE
G&A expenses, net of recoveries	15,524	13,322	17%
Compensation costs	5,727	17,822	(68%)
Total G&A expenses	21,251	31,144	(32%)
G&A expenses, per BOE	\$2.79	\$2.52	11%
Compensation costs, per BOE	\$1.03	\$3.38	(70%)

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Fairborne recorded \$15.5 million (\$2.79 per BOE) of G&A expenses, net of recoveries, in 2010, an increase of 17% when compared to \$13.3 million (\$2.52 per BOE) recorded in 2009. The increase in 2010 relates to higher corporate compliance costs as well as higher employee compensation costs. Fairborne does not capitalize G&A expenses, other than recoveries permitted under joint operating agreements.

Non-cash compensation expense of \$5.7 million recorded in 2010 is 68% lower when compared to 2009. In 2009, non-cash compensation expense of \$17.8 million included \$12.6 million of accelerated compensation expense for the 6.6 million stock options that were surrendered on June 1, 2009.

Interest

(\$THOUSANDS EXCEPT AS NOTED)	2010	2009	CHANGE
Interest expense	13,796	14,661	(6%)
Accretion of convertible debentures	1,887	1,988	(5%)
Total interest	15,683	16,649	(6%)
Per BOE	\$2.82	\$3.16	(11%)

Fairborne recorded \$13.8 million in interest expense in 2010, a decrease of 6% from \$14.7 million in 2009. The decrease in interest expense in 2010 reflects the decrease in lending rates on the Company's credit facilities.

Also included in total interest is the amortization of financing charges associated with the issuance of the convertible debentures. The financing charges amortized in 2010 were consistent with the prior year. These costs will continue to be expensed over the term of the debentures.

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

	2010	2009	CHANGE
Depletion, depreciation and accretion (<i>\$thousands</i>)	136,325	139,558	(2%)
Per BOE	\$24.53	\$26.45	(7%)

Fairborne recorded \$136.3 million in depletion and depreciation of capital assets and accretion of asset retirement obligations during 2010. On a BOE basis, the DD&A rate of \$24.53 per BOE in 2010 was 7% lower than the prior year's rate of \$26.45 per BOE as a result of reserve additions associated with the Company's 2010 capital expenditure program, including the McLeod River property acquisition.

Taxes

	2010	2009	CHANGE
Future tax expense (reduction) (<i>\$thousands</i>)	(5,562)	1,856	(400%)
Per BOE	\$(1.00)	\$0.35	(386%)

Fairborne recorded a future tax reduction of \$5.6 million in 2010 compared to the future tax expense of \$1.9 million recorded in 2009, both of which reflect a provision for future tax at tax rates expected to apply when the related temporary differences reverse.

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Net Income (Loss) and Funds Generated from Operations

(\$THOUSANDS EXCEPT AS NOTED)	2010	2009	CHANGE
Funds generated from operations	122,677	143,811	(15%)
Per share – basic	\$1.20	\$1.59	(25%)
Per share – diluted	\$1.20	\$1.59	(25%)
Cash flow from operations (including changes in working capital)	119,805	141,233	(15%)
Per share – basic	\$1.17	\$1.56	(25%)
Per share – diluted	\$1.17	\$1.56	(25%)
Net loss	(16,284)	(25,645)	37%
Per share – basic	\$(0.16)	\$(0.28)	43%
Per share – diluted	\$(0.16)	\$(0.28)	43%

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

(\$THOUSANDS EXCEPT AS NOTED)	2010	2009
Cash flow from operating activities	119,805	141,233
Change in non-cash working capital	1,381	1,168
Asset retirement expenditures	1,491	1,410
Funds generated from operations	122,677	143,811

BOE ANALYSIS

	2010		2009	
	(\$THOUSANDS)	(\$ PER BOE)	(\$THOUSANDS)	(\$ PER BOE)
Petroleum and natural gas revenue ⁽¹⁾	234,637	42.21	240,557	45.59
Royalties	(24,790)	(4.46)	(17,282)	(3.28)
Operating expenses	(52,436)	(9.43)	(54,091)	(10.25)
Transportation costs	(5,998)	(1.08)	(5,622)	(1.07)
Change in fair value of derivatives	1,008	0.18	8,382	1.59
General and administrative ⁽²⁾	(15,524)	(2.79)	(13,322)	(2.52)
Compensation expense ⁽³⁾	(424)	(0.08)	(150)	(0.03)
Interest expense ⁽⁴⁾	(13,796)	(2.48)	(14,661)	(2.78)
Funds generated from operations	122,677	22.07	143,811	27.25
Change in fair value of derivatives	(1,008)	(0.18)	(8,382)	(1.59)
Compensation expense – non-cash	(5,303)	(0.95)	(17,672)	(3.34)
Accretion of convertible debentures	(1,887)	(0.34)	(1,988)	(0.38)
Depletion, depreciation and accretion	(136,325)	(24.53)	(139,558)	(26.45)
Future tax (expense) reduction	5,562	1.00	(1,856)	(0.35)
Net loss	(16,284)	(2.93)	(25,645)	(4.86)

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

(2) Net of compensation expense.

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

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

*2010 Management's Discussion & Analysis***LIQUIDITY AND CAPITAL RESOURCES****Capital Expenditures**

(\$THOUSANDS)	2010	2009
Exploration and development		
Land and lease acquisitions	20,832	10,138
Geological and geophysical	5,404	(45)
Drilling and completions	104,990	74,385
Well equipment and facilities	25,571	25,601
Corporate assets	293	310
	157,090	110,389
Property acquisitions, net of dispositions	77,572	(24,844)
Total	234,662	85,545

During 2010, Fairborne's exploration and development expenditures totaled \$157.1 million with capital expenditures financed through funds generated from operations and bank debt. The Company completed a number of property acquisitions throughout 2010, which included \$71.6 million for the McLeod River acquisition as well as \$5.0 million to purchase additional working interests at Marlboro.

Fairborne was active in provincial land sales during the year, spending \$20.8 million to increase undeveloped land holdings, primarily in the Marlboro, Harlech and Westerosé areas.

Fairborne spent \$105.0 million on drilling and completion activities in 2010 with a total of 40 (32.3 net) wells drilled, resulting in 28 (23.4 net) natural gas wells and 12 (8.9 net) oil wells. Drilling activities during 2010 were focused primarily on Fairborne's Marlboro, Harlech, Westerosé and Sinclair properties with 10 (8.2 net) wells drilled in Marlboro, six (5.0 net) wells drilled on the Company's Harlech property, three (3.0 net) wells drilled on Westerosé and seven (6.1 net) wells drilled on the Sinclair property in Manitoba.

In 2010 tangible capital expenditures of \$25.6 million included numerous well tie-ins in the Marlboro, Harlech, Westerosé and Sinclair areas as well as a significant gathering system expansion in the Marlboro area.

Working Capital and Bank Indebtedness

At December 31, 2010, Fairborne had drawn \$206.3 million (2009 – \$103.7 million) against its credit facilities and had a working capital deficit (excluding convertible debentures) of \$17.8 million (2009 – \$6.4 million) for a net debt position of \$224.1 million (2009 – \$110.1 million).

In 2010, the majority of Fairborne's capital expenditure program of \$157.1 million was financed by funds generated from operations of \$122.7 million, with the excess financed through bank debt. The property acquisition of \$71.6 million was financed entirely from bank debt.

Fairborne's credit facilities at December 31, 2010 included a \$310 million extendible revolving term credit facility and a \$15 million demand operating credit facility for a total available facility of \$325 million. The extendible revolving term facility is available on a revolving basis until May 27, 2011 (364 day facility) at which time it may be extended, at the lenders option. If the revolving period is not extended, the undrawn

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portion of the facility will be cancelled and the amount outstanding would convert to a 365 day non-revolving term facility. The amounts outstanding under the non-revolving term facility are required to be repaid at the end of the term facility being May 27, 2012. Interest payable on amounts drawn under the facilities is at the prevailing bankers' acceptance rates plus stamping fees, lenders' prime rate or LIBOR rates plus applicable margins, depending on the form of borrowing by the Company. The margins and stamping fees vary from 0.56% to 4.00% depending on financial statement ratios and the form of borrowing. The credit facilities are secured by a general security agreement and a first ranking floating charge on the assets of the Company. The facility is subject to a semi-annual valuation of Fairborne's petroleum and natural gas assets. The Company anticipates it will have adequate liquidity to fund its financial liabilities as they come due. Fairborne has no defaults or breaches on its bank debt or any of its financial liabilities.

Fairborne actively manages its capital structure especially during periods of extreme volatility in both commodity and capital markets, such as experienced in 2010. The Company's objective when managing capital is to maintain a flexible capital structure which will allow it to execute on its capital investment program, including investing in oil and gas activities which may or may not be successful. As well, through periods of extreme market fluctuations, the Company strives to maintain flexibility and liquidity in its capital structure. As a result, Fairborne continually works to balance the proportion of debt and equity in its capital structure to take into account the level of risk being incurred in its capital expenditures. With depressed market prices at the end of 2010 and continuing into 2011, the ability to issue additional shares may become very restricted. As such, the Company has limited its capital expenditure program to a level which it anticipates will be able to be funded substantially from cash flow from operations.

In order to maintain or adjust the capital structure, Fairborne considers various factors including: its forecasted debt to forecasted funds from operations ratio while attempting to finance an acceptable investment program including incremental investment and acquisition opportunities; the current level of bank credit available from the banking syndicate; the level of bank credit that may be obtainable from the banking syndicate as a result of reserve growth; the availability of other sources of debt with different characteristics than the existing bank debt; the sale of assets; limiting the size of the investment program; and new common equity if available on favorable terms. In the midst of financial uncertainty at the end of 2010 and moving into 2011, the Company will continually re-evaluate its capital expenditure program in light of projected cash flows.

Convertible Debentures

At December 31, 2010, Fairborne had 100,000 Convertible Unsecured Subordinated Debentures (the "Debentures") with a face value of \$100 million. The Debentures bear interest at a rate of 6.5% per annum, which is payable semi-annually in arrears on December 31 and June 30 of each year. The Debentures mature on December 31, 2011 and can be converted into common shares of Fairborne at any time at the option of the holders at a conversion price of \$13.50 per share. Prior to the maturity date, the debentures can be redeemed in whole or in part at the option of the Company at a redemption price of \$1,025 plus accrued and unpaid interest. If the Company does not choose to redeem the debentures prior to the maturity date, the debentures will be satisfied at their face of \$100 million on December 31, 2011.

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Fairborne has adequate liquidity to satisfy the convertible debenture obligation when it comes due in December 2011 or earlier if the Company chooses to do so. At current debt levels, the Company has sufficient credit available on its bank facilities to satisfy the payment of convertible debentures. With the property disposition of \$125 million expected to close in March 2011, the Company will initially use the proceeds to pay down bank debt resulting in significantly more credit available through banking facilities. In determining the appropriate method for satisfying the debenture obligation, Fairborne will consider a variety of options including: the availability of other sources of debt with different characteristics than the existing bank debt; the sale of assets; limiting the size of the investment program; and new common equity if available on favorable terms.

Shareholders' Equity

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

In October 2009 the Company closed a bought deal share financing which included the issuance of 3.8 million flow-through common shares for proceeds of \$20 million. As a result of the flow-through share issue, Fairborne had a commitment to spend \$20 million on qualifying Canadian exploration expenditures. As at December 31 2010, the commitment has been satisfied.

During 2010 15,183 common shares were issued on the exercise of 15,582 Restricted Units and Performance Units and 107,166 Restricted Units and Performance Units were settled for cash. In addition, 28,991 common shares were issued on the exercise of stock options.

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

(THOUSANDS)	MARCH 9, 2011	DECEMBER 31, 2010	DECEMBER 31, 2009
Common shares	102,506	102,506	102,462
Warrants ⁽¹⁾	—	—	4,406
Convertible debentures ⁽²⁾	\$100,000	\$100,000	\$100,000
Incentive plans			
Restricted units	—	—	30
Performance units	—	—	92
Stock options	7,030	7,024	5,235
Weighted average shares ⁽³⁾			
Basic	n/a	102,486	90,609
Diluted	n/a	102,486	90,609

(1) Each warrant entitled the holder to acquire 0.39 of a common share at an exercise price of \$8.13 per common share. All remaining warrants expired on June 1, 2010.

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

(3) Weighted average common shares are for the twelve months ended December 31, 2010 and 2009.

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CONTRACTUAL OBLIGATIONS & COMMITMENTS

Fairborne has certain lease commitments for its office premises through to June 2016. As at December 31, 2010 the payments due under these commitments are approximately \$1.1 million per annum until June 2011 and approximately \$2.1 million per annum from July 2011 until June 2016 as the Company increased its office space effective July 1, 2011.

OFF-BALANCE-SHEET ARRANGEMENTS

Fairborne has no off-balance-sheet arrangements.

BUSINESS ENVIRONMENT AND RISK

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

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

CRITICAL ACCOUNTING ESTIMATES

Depletion and depreciation expense

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

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

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Full cost accounting ceiling test

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

Asset retirement obligation (“ARO”)

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

Income taxes

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

CHANGE IN ACCOUNTING POLICIES

International Financial Reporting Standards (“IFRS”)

Effective January 1, 2011, Canadian public companies are required to adopt International Financial Reporting Standards (“IFRS”). Some Canadian standards have already changed to converge with IFRS. Fairborne's financial statements up to and including the December 31, 2010 financial statements have been reported in accordance with Canadian generally accepted accounting principles (“GAAP”) as it existed on each reporting date. Financial statements for the quarter ended March 31, 2011, including comparative amounts, will be prepared on an IFRS basis.

In order to transition to IFRS, management has formed an executive steering committee which oversees the project team. A transition plan is in place to convert the financial statements to IFRS. Training has been provided to key employees and the Company continues to assess the effect of the transition on information systems, internal controls over financial reporting and disclosure controls and procedures. Systems and controls are being updated as IFRS accounting processes are implemented. Significant system and control changes are not anticipated. Analysis and quantification of differences between IFRS and Fairborne's current accounting policies is continuing. Some accounting policies may change on adoption of IFRS even though Fairborne's current accounting policies are acceptable under IFRS. Changes in accounting policy may materially impact the financial statements.

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The Company has prepared a preliminary balance sheet as at January 1, 2010 as well as preliminary financial statements for the six months ended June 30, 2010 on an IFRS basis. Calculations of the impact of changes in accounting policy have been prepared by management and have been provided to the Company's Audit Committee. Quantitative information is provided herein to allow readers to assess the impact of applying IFRS at January 1, 2010 and for the six months ended June 30, 2010. However readers are cautioned that the calculations have not been audited by the Company's auditors, nor approved by the Audit Committee or the Board of Directors of the Company and may still be subject to change. Specifically, interpretation and analysis of IFRS standards applicable to the period when Fairborne was a trust is ongoing and may result in material adjustments to the Company's opening balance sheet under IFRS. The Company is also currently preparing the financial statements for the nine months ended September 30, 2010 and the year ended December 31, 2010 on an IFRS basis.

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

Petroleum and Natural Gas Assets

IFRS standards would generally require that a company report its petroleum and natural gas assets on the date of adoption of IFRS at the amount which would have been recorded had the company always followed IFRS standards. Alternatively, IFRS standards allow for a conversion exemption whereby companies can choose to record opening petroleum and natural gas assets at a deemed cost equal to historic cost as calculated under Canadian GAAP or at fair value on the date of adoption of IFRS. Fairborne intends to elect to record P&NG assets at historic cost as calculated under Canadian GAAP on January 1, 2010. As such, the reported value of petroleum and natural gas assets at January 1, 2010 will not change under IFRS.

Under Canadian GAAP, all petroleum and natural gas assets are accounted for under the full cost accounting guideline. Under IFRS, P&NG assets will be divided into exploration and evaluation properties ("E&E assets") and petroleum and natural gas properties and equipment ("development assets"). E&E assets will initially be capitalized and amounts accumulated pending determination of technical feasibility and economic viability. E&E assets will not be depreciated and will be carried at cost less any accumulated impairment losses. Development assets will be measured at cost less accumulated depletion and depreciation and any accumulated impairment losses. E&E assets will initially be recorded at January 1, 2010 based on the Canadian GAAP historic cost of those assets. IFRS permits the remaining deemed cost of P&NG assets at January 1, 2010 to be allocated to individual development assets on a pro rata basis using either reserve values or reserve volumes. Fairborne intends to allocate the deemed cost to development assets pro rata based on reserve values. Due to the nature of Fairborne's assets, which are primarily development in nature, management has estimated E&E assets to be \$5.4 million at January 1, 2010 with \$875.5 million in development assets. At June 30, 2010, management has estimated E&E assets to be \$14.2 million.

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E&E assets and development assets have been assessed to determine whether impairment losses exist under IFRS as at January 1, 2010. These impairment tests differed from the current Canadian GAAP full cost ceiling test in several significant ways. Assets (including goodwill) were allocated to Cash Generating Units ("CGU"s) and a separate impairment test was completed for each CGU identified. Fairborne has identified five CGUs, Northern Alberta, Southern Alberta, Deep Basin, West Pembina and Manitoba/Saskatchewan. Fairborne has completed an IFRS impairment test for each CGU as at January 1, 2010 and does not anticipate that any impairment will be recorded at January 1, 2010. At June 30, 2010 the Company determined that no indicators of impairment were identified which would cause an impairment test to be completed and accordingly does not anticipate that any impairment will be recorded at June 30, 2010.

Under current Canadian GAAP the ceiling test is a two step test. The carrying value of assets is first compared to the undiscounted future cash flows. If the carrying value of the assets exceeds the undiscounted future cash flows, then the second step of the test is completed whereby the assets are written down to the value of the discounted future cash flows. Under IFRS, the impairment test compares the carrying value of the assets to the greater of the fair value of the assets and the value-in-use of the assets, which is a discounted cash flow measure. As a result, impairments may be recorded more frequently under IFRS. Future impairment tests may be required when management determines that indicators of impairment exist. Should impairment losses be recorded in accordance with IFRS, certain of those losses can reverse in the future if facts and circumstances change.

Depreciation under Canadian GAAP is calculated using a unit-of-production method based on total proved reserves for all accumulated costs (excluding unproved properties). Under IFRS, the net carrying value of development assets will still be depleted using a unit of production method; however, significant components with different useful lives, will be accounted for as separate items and depreciated separately. Fairborne has determined the components which will be used for the purpose of depreciating development assets. In addition, IFRS allows depreciation to be calculated using either proved reserves or proved plus probable reserves. Fairborne intends to depreciate assets using proved plus probable reserves. As a result, depreciation calculated on an IFRS basis for the six months ended June 30, 2010 is approximately \$17.2 million lower than that recorded under Canadian GAAP.

Under the full cost accounting guideline, gains or losses are not recognized upon the disposition of P&NG assets unless the disposition results in a significant change in the depletion rate. Under IFRS, gains and losses are recognized in net income on the disposal of an item of P&NG assets. The amount of the gain or loss is determined by comparing the proceeds from disposal with the carrying amount of the item. This will include transactions such as sales of assets, farm-outs, asset swaps and other non-monetary transactions which typically did not result in gains or losses being recorded under Canadian GAAP. Fairborne has reviewed asset sales and non-monetary transactions which occurred in the six months ended June 30, 2010 and has estimated the impact on net income of recording gains or losses on these transactions to be a \$1.2 million gain.

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Under Canadian GAAP, Fairborne did not capitalize general and administrative expenses to P&NG assets other than recoveries permitted under joint operating agreements. IFRS offers more guidance on amounts which should be capitalized. There is no impact of this change on P&NG assets recorded at January 1, 2010 due to the conversion exemption which Fairborne intends to elect. Fairborne has estimated the amount which will be capitalized under IFRS for the six months ended June 30, 2010 and expects that the amount of general and administrative costs capitalized will be approximately \$2.0 million higher than that which was recorded under Canadian GAAP. This will result in an increase in profit, net of tax and an increase in P&NG assets for the six months ended June 30, 2010.

Business Combinations

Accounting for business combinations also differs under IFRS. Fairborne has elected not to restate business combinations recorded prior to January 1, 2010 in accordance with IFRS standards. As a result, in respect of acquisitions prior to January 1, 2010, goodwill continues to represent the amount recognized under Canadian GAAP. However, goodwill recognized in business combinations after January 1, 2010 recorded under IFRS will represent the excess of the cost of the acquisition over the net fair value of the identifiable assets, liabilities and recognized contingent liabilities of the acquired entity. When the excess is negative, it will be recognized immediately in profit and loss. In addition, transaction costs which are included in the cost of the acquisition under Canadian GAAP will be expensed under IFRS. Fairborne did not enter into any business combinations in the first six months of 2010. The business combination entered into during the nine months ended September 30, 2010 has been accounted for under Canadian GAAP. The effect of applying IFRS standards to this business combination has not yet been analyzed, however, the \$230,000 of transaction costs that were capitalized under Canadian GAAP will be expensed under IFRS.

Deferred Income Taxes

Deferred income taxes are calculated under IFRS using a liability approach which is conceptually similar to Canadian GAAP however there are differences in the manner in which deferred income taxes are calculated. In addition, each other adjustment recorded on adoption of IFRS was assessed to determine if there was a related income tax impact, resulting in a decrease in deferred tax liability of \$3.3 million with a corresponding increase in retained earnings.

In addition to these changes, Fairborne calculated the tax effects of accounting for share issue costs and flow-through shares using IFRS standards. Under Canadian GAAP, when shares are issued the related costs are recorded on an after tax basis as an offset to the proceeds of the share issue. As the tax effect of the share issue costs reverses, the change in deferred income tax is recorded through profit and loss. Under IFRS, subsequent changes in tax rates related to these tax amounts are recorded to share capital, where the original tax benefit was recognized. This adjustment did not affect the tax liability account at January 1, 2010 however, it resulted in a decrease in share capital of \$0.3 million with a corresponding adjustment to retained earnings at January 1, 2010. No adjustment was required for the six months ended June 30, 2010. As well, the treatment of the tax effect of flow-through shares differs under Canadian GAAP and IFRS. Under Canadian GAAP, share capital is recorded at net proceeds less the deferred tax liability related to the renounced expenditures. Under IFRS, the increase to share capital when flow-through shares are issued is measured based on the current market price of common shares. The incremental

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proceeds, or “premium”, are recorded as a deferred charge. When expenditures are renounced, a deferred tax liability is recognized and the deferred charge is reversed. The net amount is recognized as deferred tax expense. At January 1 2010, this resulted in an increase in flow-through share premium of \$4.0 million representing the tax effect of proceeds of a flow-through share issuance completed in 2009 for which the related expenditures had not yet been renounced, with a corresponding decrease to retained earnings and an insignificant adjustment to share capital. For the six months ended June 30, 2010 when expenditures from this 2009 flow-through share issue were renounced it resulted in the reversal of the \$4.0 million deferred charge recorded on January 1, 2010, an increase in share capital of \$5.0 million and an increase in deferred tax expense of \$1.0 million.

Other Items

There are other accounting policy changes with potentially material impacts, including accounting for convertible debentures, warrants, exchangeable shares and stock based compensation.

Retention Awards are cash settled stock based payments which are recorded as a liability under both Canadian GAAP and IFRS. Under Canadian GAAP, the Retention Awards are measured at their intrinsic value while under IFRS they are measured at fair value. The impact of accounting for Retention Awards under IFRS was an increase of \$1.4 million in compensation liability at January 1, 2010 with a corresponding adjustment to retained earnings. For the six months ended June 30, 2010, the impact was a decrease in the current portion of the compensation liability and a decrease in general and administrative expenses of \$1.2 million.

Under IFRS, accounting for equity items such as trust units, warrants, convertible debentures and exchangeable shares held within a trust structure can be materially different than under Canadian GAAP. Given that Fairborne was a trust from June 2005 until December 2007, certain of these items may result in a material adjustment to the Company's statements under IFRS. Fairborne is in the process of assessing and quantifying the impact of these differences on the Company's IFRS statements.

CONTROLS AND PROCEDURES

Disclosure controls and procedures

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

2010 Management's Discussion & Analysis

Internal controls over financial reporting

Fairborne's Chief Executive Officer and Chief Financial Officer have designed or caused to be designed under their supervision, internal controls over financial reporting to provide reasonable assurance regarding the reliability of the Company's financial reporting and the preparation of financial statements for external purposes in accordance with Canadian GAAP. Such officers have evaluated, or caused to be evaluated under their supervision, the effectiveness of Fairborne's internal controls over financial reporting at the financial year end of the Company and have concluded that Fairborne's internal controls over financial reporting are effective at the financial year end of the Company for the foregoing purposes. During 2009 and 2010 Fairborne engaged external consultants to assist in documenting and assessing the Company's internal controls over financial reporting.

Fairborne is required to disclose herein any change in the Company's internal controls over financial reporting that occurred during the period beginning on October 1, 2010 and ended on December 31, 2010 that has materially affected, or is reasonably likely to materially affect, the Company's internal controls over financial reporting. No material changes in Fairborne's internal controls over financial reporting were identified during such period that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

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

*2010 Financial Reports***MANAGEMENT'S REPORT****To the Shareholders of Fairborne Energy Ltd.**

The accompanying consolidated financial statements of Fairborne Energy Ltd. and all the information in this Annual Report are the responsibility of management and have been approved by the Board of Directors.

The consolidated financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles. When alternative accounting methods exist, management has chosen those it deems most appropriate in the circumstances. Financial statements are not precise since they include certain amounts based on estimates and judgments. Management has determined such amounts on a reasonable basis in order to ensure that the consolidated financial statements are presented fairly, in all material respects. The financial information contained elsewhere in this report has been reviewed to ensure consistency with the consolidated financial statements.

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

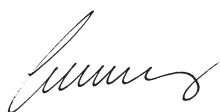
The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal controls. It exercises its responsibilities primarily through the Audit Committee, which is comprised of independent, non-management directors. The Audit Committee has reviewed the consolidated financial statements with management and the auditors and has reported to the Board of Directors which have approved the consolidated financial statements.

The consolidated financial statements have been audited by KPMG LLP, the external auditors, in accordance with auditing standards generally accepted in Canada on behalf of the shareholders.



STEVEN R. VANSICKLE

President and Chief Executive Officer



AARON G. GRANDBERG

Chief Financial Officer

Calgary, Canada

March 9, 2011

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

We have audited the accompanying consolidated financial statements of Fairborne Energy Ltd. ("the Company"), which comprise the consolidated balance sheets as at December 31, 2010 and 2009, the consolidated statements of operations and retained earnings and cash flows for the years then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with Canadian generally accepted accounting principles, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, we consider internal controls relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the consolidated financial position of the Company as at December 31, 2010 and 2009, and of its consolidated operations and its consolidated cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

KPMG LLP

KPMG

CHARTERED ACCOUNTANTS

Calgary, Canada

March 9, 2011

2010 Consolidated Financial Statements

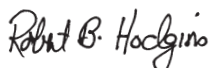
CONSOLIDATED BALANCE SHEETS

As at December 31,

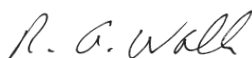
(\$THOUSANDS)	2010	2009
Assets		
Current assets		
Cash and cash equivalents	\$ 319	\$ 147
Accounts receivable	31,825	35,155
Prepaid expenses and deposits	5,813	8,079
	37,957	43,381
Petroleum and natural gas properties and equipment (Note 3)	982,250	880,892
Goodwill	16,170	16,170
	\$ 1,036,377	\$ 940,443
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	\$ 54,333	\$ 44,602
Derivative liability (Note 10)	1,367	359
Current portion of compensation plan (Note 8)	—	505
Deferred revenue	—	4,285
Convertible debentures (Note 5)	98,397	—
	154,097	49,751
Bank indebtedness (Note 4)	206,331	103,738
Convertible debentures (Note 5)	—	96,510
Asset retirement obligation (Note 6)	12,730	11,200
Future income taxes (Note 7)	89,405	89,919
Shareholders' equity		
Common shares (Note 8)	532,021	536,789
Warrants (Note 8)	—	2,721
Equity component of convertible debentures (Note 5)	5,581	5,581
Contributed surplus (Note 8)	33,089	24,827
Retained earnings	3,123	19,407
	573,814	589,325
Commitments (Note 11)		
Subsequent event (Note 12)		
	\$ 1,036,377	\$ 940,443

See accompanying notes to the consolidated financial statements.

Approved on behalf of the Board:


ROBERT B. HODGINS

Director


RICHARD A. WALLS

Director

2010 Consolidated Financial Statements

CONSOLIDATED STATEMENTS OF OPERATIONS AND RETAINED EARNINGS

For the years ended December 31,

(\$THOUSANDS EXCEPT PER SHARE AMOUNTS)

	2010	2009
Revenue		
Petroleum and natural gas	\$ 234,637	\$ 240,557
Royalties	(24,790)	(17,282)
	209,847	223,275
Expenses		
Operating	52,436	54,091
Transportation	5,998	5,622
General and administrative	21,251	31,144
Interest	15,683	16,649
Depletion, depreciation and accretion	136,325	139,558
	231,693	247,064
Loss before taxes	(21,846)	(23,789)
Future taxes (reduction) (Note 7)	(5,562)	1,856
Net loss and comprehensive loss	(16,284)	(25,645)
Retained earnings, beginning of year	19,407	45,052
Retained earnings, end of year	\$ 3,123	\$ 19,407
Net loss per share (Note 8)		
Basic	\$ (0.16)	\$ (0.28)
Diluted	\$ (0.16)	\$ (0.28)

See accompanying notes to the consolidated financial statements.

2010 Consolidated Financial Statements

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the years ended December 31,

(\$THOUSANDS)	2010	2009
Cash provided by (used in):		
Operating activities		
Net loss	\$ (16,284)	\$ (25,645)
Items not involving cash:		
Depletion, depreciation and accretion	136,325	139,558
Compensation expense	5,303	17,672
Future taxes (reduction)	(5,562)	1,856
Accretion of convertible debentures	1,887	1,988
Change in fair value of derivatives	1,008	8,382
Asset retirement expenditures	(1,491)	(1,410)
	121,186	142,401
Change in non-cash working capital	(1,381)	(1,168)
	119,805	141,233
Financing activities		
Bank indebtedness	102,593	(92,544)
Issuance of common shares, net of costs	13	65,724
	102,606	(26,820)
Investing activities		
Expenditures on petroleum and natural gas properties	(157,090)	(110,389)
Acquisition of petroleum and natural gas properties	(81,580)	(5,196)
Disposition of petroleum and natural gas properties	4,008	30,040
Change in non-cash working capital	12,423	(28,847)
	(222,239)	(114,392)
Change in cash and cash equivalents	172	21
Cash and cash equivalents, beginning of year	147	126
Cash and cash equivalents, end of year	\$ 319	\$ 147
Interest paid	\$ 13,869	\$ 15,485

See accompanying notes to the consolidated financial statements.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

For the Years Ended December 31, 2010 and 2009

(TABULAR AMOUNTS ARE STATED IN THOUSANDS AND THOUSANDS OF DOLLARS EXCEPT PER SHARE AMOUNTS)

NATURE OF OPERATIONS

Fairborne Energy Ltd. (the “Company” or “Fairborne”) is incorporated under the Business Corporations Act (Alberta) and is a public company listed on the Toronto Stock Exchange. Fairborne is a resource based company engaged in the exploration for, and the development and production of natural gas, natural gas liquids and crude oil in Western Canada.

1. SIGNIFICANT ACCOUNTING POLICIES**a) Basis of presentation**

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

b) Petroleum and natural gas operations

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

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

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

The Company places a limit on the carrying value of petroleum and natural gas properties and equipment, which may be depleted against revenues of future periods (the “ceiling test”). The carrying value is assessed to be recoverable when the sum of the undiscounted cash flows expected from the production of proved reserves, the lower of cost and market of unproved properties and the cost of major development projects exceeds the carrying value. When the carrying value is not assessed to be recoverable, an impairment loss is recognized to the extent that the carrying value of assets exceeds the sum of the discounted cash flows expected from the production of proved and probable reserves, the lower of cost and market of unproved properties and the cost of major development projects. The cash flows are estimated using expected future product prices and costs and are discounted using a risk-free interest rate.

2010 Consolidated Financial Statements

Repairs and maintenance are expensed as operating costs as incurred.

c) Asset retirement obligation (“ARO”)

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

d) Joint arrangements

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

e) Goodwill

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

f) Financial instruments

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

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

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

Fairborne manages its exposure to commodity price fluctuations by using physical delivery contracts with fixed prices, collars, puts or participating swaps. The majority of these contracts have been designated as “normal sale” contracts; therefore, these commodity contracts are not recorded on the balance sheet at fair value. Amounts received on the settlement of the commodity contracts are included in petroleum

2010 Consolidated Financial Statements

and natural gas revenue as the contracts settle. Certain of these contracts do not qualify as “normal sale” contracts and, as such, are accounted for as derivative contracts and recorded on the balance sheet at fair value. Changes in the fair value of derivative contracts are included in petroleum and natural gas revenue for the corresponding period.

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

g) Equity based compensation

Prior to the reorganization of Fairborne Energy Ltd. on December 19, 2007, Fairborne Energy Trust (the “Trust”) had a Trust Incentive Plan which included granting of restricted trust units (“Restricted Units”) and performance trust units (“Performance Units”) to directors, officers, employees and consultants and other service providers to the Trust and its subsidiaries. The plan could be settled in cash, common shares, or some combination thereof at the discretion of the Board of Directors. Prior to 2009, all settlements were in the form of equity. As such, the plan was accounted for as an equity settled award, whereby compensation cost was estimated on the grant date and recognized in earnings over the vesting period with the offset included in contributed surplus. In 2009, certain Restricted and Performance Units were settled for cash. As a result of these cash settlements, the incentive plan was then accounted for as a liability based plan rather than an equity based plan. Accordingly, as awards vested, a liability was recorded equal to the number of awards vested multiplied by the Company’s share price at the balance sheet date. All Restricted Units and Performance Units have been exercised as at December 31, 2010. No further awards will be granted under this plan.

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

In July 2008, Fairborne instituted a stock option plan which provides for the granting of stock options to directors, officers, employees, consultants and other service providers to the Company and its subsidiaries. Compensation expense associated with the stock option plan is recognized in income over the vesting period of the plan with a corresponding increase in contributed surplus. Compensation expense is based on the fair value of the equity based compensation on the grant date and is determined using the Black Scholes option pricing model. Fairborne estimates the number of options that are anticipated to be forfeited over the life of the options and incorporates this estimate into the compensation expense on the grant date. The amount of non-cash compensation expense for equity based plans is recognized in contributed surplus and is recorded as an increase in shareholders’ equity when equity based compensation plans are exercised.

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h) Income taxes

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

i) Corporate assets

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

j) Cash and cash equivalents

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

k) Measurement uncertainty

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

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

l) Per share information

Basic per share amounts are calculated using the weighted average number of shares outstanding during the year. Diluted per share amounts are calculated using the treasury stock method which is based on shares that would be issued under the Company’s incentive plans. The dilutive effect of convertible debentures is calculated using the if-converted method which is based on the number of shares issuable on conversion of outstanding convertible debentures. In addition, in calculating diluted net income per share, net income is increased by the interest on the convertible debentures and accretion of the convertible debenture discount.

m) Revenue recognition

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

2. PROPERTY ACQUISITION

On September 9, 2010, the Company acquired certain petroleum and natural gas assets which included undeveloped land, facilities interests and producing properties in the McLeod River area. The acquired properties expand the Company's existing interests in the Marlboro/Pine Creek area of North 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 September 9, 2010.

Details of the acquisition are as follows, subject to closing adjustments:

Net assets acquired:	
Petroleum and natural gas properties and equipment	\$ 72,907
Asset retirement obligations	(1,262)
	\$ 71,645
Consideration:	
Cash	\$ 71,415
Transaction costs	230
	\$ 71,645

3. PETROLEUM AND NATURAL GAS PROPERTIES AND EQUIPMENT

	2010	2009
Petroleum and natural gas properties and equipment	\$ 1,671,543	\$ 1,435,282
Accumulated depletion and depreciation	(691,099)	(556,289)
Corporate assets	4,600	4,307
Accumulated depreciation	(2,794)	(2,408)
	\$ 982,250	\$ 880,892

At December 31, 2010, future development costs of \$257.7 million (2009 – \$193.8 million) were included in the depletion calculation and costs of acquiring unproved properties in the amount of \$69.8 million (2009 – \$48.2 million) were excluded from the depletion calculation.

Fairborne performed a ceiling test calculation at December 31, 2010 and 2009 to assess the recoverable value of petroleum and natural gas properties and equipment. The oil and gas future prices for the December 31, 2010 ceiling test are based on the January 1, 2011 commodity price forecast of our independent reserve evaluators. The following table summarizes the benchmark prices used in the ceiling test calculation. Based on these assumptions, the undiscounted value of future net revenues from Fairborne's proved reserves exceeded the carrying value of petroleum and natural gas properties and equipment at December 31, 2010.

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YEAR	WTI OIL	FOREIGN	EDMONTON LIGHT	
	(US\$/BBL)	EXCHANGE	CRUDE OIL	AECO GAS
		RATE	(CDN\$/BBL)	(\$CDN/MMBTU)
2011	88.00	0.98	86.22	4.16
2012	89.00	0.98	89.29	4.74
2013	90.00	0.98	90.92	5.31
2014	92.00	0.98	92.96	5.77
2015	95.17	0.98	96.19	6.22
2016	97.55	0.98	98.62	6.53
2017	100.26	0.98	101.39	6.76
2018	102.74	0.98	103.92	6.90
2019	105.45	0.98	106.68	7.06
2020	107.56	0.98	108.84	7.21

Escalate thereafter 2.0% per year

4. BANK INDEBTEDNESS

At December 31, 2010 the Company had a \$310 million extendible revolving term credit facility and a \$15 million demand operating credit facility available from a syndicate of Canadian chartered banks, subject to the banks' semi-annual valuation of Fairborne's petroleum and natural gas properties. The extendible revolving term facility is available on a revolving basis until May 27, 2011 (364 day facility) at which time it may be extended, at the lenders option. If the revolving period is not extended, the undrawn portion of the facility will be cancelled and the amount outstanding will convert to a 365 day non-revolving term facility. The amounts outstanding under the non-revolving term facility are required to be repaid at the end of the term facility being May 27, 2012. Interest payable on amounts drawn under the facilities is at the prevailing bankers' acceptance rates plus stamping fees, lenders' prime rate or LIBOR rates plus applicable margins, depending on the form of borrowing by the Company. The margins and stamping fees vary from 0.56% to 4.00% depending on financial statement ratios and the form of borrowing. The credit facilities are secured by a general security agreement and a first ranking floating charge on the assets of the Company. At December 31, 2010 letters of credit totaling \$2.1 million were outstanding.

5. CONVERTIBLE DEBENTURES

The following tables set forth a reconciliation of the convertible debentures for the years ended December 31, 2010 and 2009:

	NUMBER OF	DEBT	EQUITY
	DEBENTURES	COMPONENT	COMPONENT
Balance, December 31, 2008	100,000	\$ 94,522	\$ 5,581
Accretion	—	1,988	—
Balance, December 31, 2009	100,000	96,510	5,581
Accretion	—	1,887	—
Balance, December 31, 2010	100,000	\$ 98,397	\$ 5,581

2010 Consolidated Financial Statements

At December 31, 2010, the Company had 100,000 convertible unsecured subordinated debentures outstanding with a face value of \$100 million that mature on December 31, 2011. The debentures bear interest at a rate of 6.5% per annum, which is payable semi-annually in arrears on December 31 and June 30 of each year. The debentures can be converted into common shares of Fairborne at any time at the option of the holders at a conversion price of \$13.50 per share. After December 31, 2009 and prior to December 31, 2010, the Company had the right to redeem all or a portion of the debentures at a price of \$1,050 plus accrued and unpaid interest. After December 31, 2010 and prior to the maturity date, the debentures will be redeemable in whole or in part at the option of the Company at a redemption price of \$1,025 plus accrued and unpaid interest.

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

6. ASSET RETIREMENT OBLIGATION

The Company's asset retirement obligation results from ownership interests in petroleum and natural gas assets including well site, gathering systems and processing facilities. The Company estimated the total undiscounted amount required to settle its asset retirement obligation to be approximately \$46.0 million (2009 – \$39.7 million). The majority of the costs are scheduled to be incurred between 2019 and 2023. A credit-adjusted risk-free interest rate of 8.5 percent and an inflation rate of 2 percent were used to calculate the asset retirement obligation.

A reconciliation of the asset retirement obligation is provided below:

	2010	2009
Balance, beginning of year	\$ 11,200	\$ 11,904
Property acquisition (Note 2)	1,262	–
Liabilities incurred	461	498
Liabilities acquired	250	–
Liabilities settled	(1,491)	(1,410)
Liabilities disposed	(81)	(854)
Accretion expense	1,129	1,011
Revision of estimates	–	51
Balance, end of year	\$ 12,730	\$ 11,200

2010 Consolidated Financial Statements

7. FUTURE INCOME TAXES

The provision for income taxes in the financial statements differs from the result which would have been obtained in applying the combined federal and provincial tax rate to the Company's loss before income taxes. The difference results from the following items:

	2010	2009
Loss before taxes	\$ (21,846)	\$ (23,789)
Combined federal and provincial tax rate	28.2%	29.2%
Computed "expected" income tax reduction	(6,161)	(6,946)
Increase (decrease) in income taxes resulting from:		
Non-deductible stock based compensation	1,615	5,352
Effect of change in tax rate	(91)	3,295
Other	(105)	155
Future taxes (reduction)	\$ (5,562)	\$ 1,856

The components of the future income tax liability at December 31, 2010 and 2009 are as follows:

	2010	2009
Future income tax liabilities:		
Petroleum and natural gas properties and equipment	\$ 112,470	\$ 112,108
Future income tax assets:		
Asset retirement obligation	(3,205)	(2,820)
Share issue costs	(1,033)	(1,618)
Income tax losses (expire 2013 to 2030)	(18,827)	(17,751)
	(23,065)	(22,189)
Net future income tax liability	\$ 89,405	\$ 89,919

8. SHAREHOLDERS' EQUITY

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

a) Common shares

	2010		2009	
	NUMBER OF SHARES	AMOUNT	NUMBER OF SHARES	AMOUNT
Balance, beginning of year	102,462	\$ 536,789	86,933	\$ 475,908
Issued on vesting of Restricted Units and Performance Units	15	140	100	1,360
Issued on exercise of stock option	29	140	—	—
Flow through shares issued for cash	—	—	3,780	20,034
Common shares issued for cash	—	—	11,649	49,508
Share issue costs	—	—	—	(3,818)
Future tax benefit of share issue costs	—	—	—	955
Tax effect of flow-through shares issued	—	(5,048)	—	(7,158)
Balance, end of year	102,506	\$ 532,021	102,462	\$ 536,789

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b) Warrants

The following table sets forth a reconciliation of the warrants issued and outstanding for the years ended December 31, 2010 and 2009:

	2010		2009	
	NUMBER OF WARRANTS	AMOUNT	NUMBER OF WARRANTS	AMOUNT
Balance, beginning of year	4,406	\$ 2,721	4,406	\$ 2,721
Expired	(4,406)	(2,721)	-	-
Balance, end of year	-	\$ -	4,406	\$ 2,721

Each warrant entitled the holder to acquire 0.39 of a common share of the Company at an exercise price of \$8.13 per common share and was exercisable at any time prior to June 1, 2010.

c) Per share amounts

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

	2010	2009
Numerator		
Net loss – basic and diluted	\$ (16,284)	\$ (25,645)
Denominator		
Weighted average shares – basic and diluted	102,486	90,609
Net loss per share – basic and diluted	\$ (0.16)	\$ (0.28)

Excluded from the diluted number of shares for the year ended December 31, 2010 is the effect of convertible debentures (7.4 million shares) and 7.0 million stock options as they are anti-dilutive to the net loss per share for the period. Excluded from the diluted number of shares for the year ended December 31, 2009 is the effect of convertible debentures (7.4 million shares), warrants (1.7 million shares) and 5.2 million stock options.

d) Equity and liability based compensation plans

i) STOCK OPTION PLAN

Fairborne has a stock option plan which provides for the granting of stock options to directors, officers, employees, consultants and other service providers to the Company and its subsidiaries. Stock options vest over a three year period and expire five years from the date of grant. Under the terms of the plan, stock options must be issued with an exercise price of not less than the volume weighted average trading price of common shares for the five trading days prior to the date of grant. The maximum number of shares reserved for issuance under the stock option plan is 10.3 million (10% of the outstanding common shares at December 31, 2010) of which 7.0 million are outstanding.

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The following table sets forth a reconciliation of the stock option plan activity for the years ended December 31, 2010 and 2009:

	2010		2009	
	WEIGHTED AVERAGE NUMBER OF OPTIONS	EXERCISE PRICE	WEIGHTED AVERAGE NUMBER OF OPTIONS	EXERCISE PRICE
Balance, beginning of year	5,235	\$ 4.25	6,904	\$ 12.74
Granted	2,200	4.20	5,118	4.00
Exercised	(97)	3.49	—	—
Forfeited	(314)	4.31	(200)	9.43
Cancelled	—	—	(6,587)	12.79
Balance, end of year	7,024	\$ 4.24	5,235	\$ 4.25
Exercisable, end of year	1,713	\$ 4.59	94	\$ 11.29

The weighted average fair value of options granted in 2010 was \$1.66 (2009 – \$1.68) per option using the Black-Scholes option pricing model with the following assumptions: risk free interest rate of 1.6 percent (2009 – 1.5 percent), expected volatility of 64 percent (2009 – 59 percent), average expected life of three years and a dividend rate of nil. An estimated forfeiture rate of two percent has been applied to the compensation costs recognized.

During 2009, the Board of Directors approved a voluntary stock option surrender program. Under the program various employees, officers and directors surrendered previously issued stock options for cancellation. The options surrendered by holders were cancelled effective June 1, 2009 and had an average exercise price of \$12.79. The Company recognized the remaining unamortized stock based compensation costs associated with the cancelled options of \$12.6 million in the consolidated statement of operations for the year ended December 31, 2009.

The following table summarizes stock options outstanding at December 31, 2010:

EXERCISE PRICE	OPTIONS OUTSTANDING	REMAINING TERM (YEARS)
\$ 2.00 – \$ 4.99	6,836	3.8
\$ 5.00 – \$ 7.99	55	3.4
\$ 8.00 – \$ 10.99	58	2.7
\$ 11.00 – \$ 13.99	75	2.6
	7,024	3.8

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ii) INCENTIVE PLAN

The following tables set forth a reconciliation of the Restricted and Performance unit plan activity for the years ended December 31, 2010 and 2009:

	NUMBER OF RESTRICTED UNITS	2010 NUMBER OF PERFORMANCE UNITS	TOTAL
Balance, beginning of year	30	92	122
Exercised	(30)	(92)	(122)
Balance, end of year	-	-	-

	NUMBER OF RESTRICTED UNITS	2009 NUMBER OF PERFORMANCE UNITS	TOTAL
Balance, beginning of year	78	204	282
Exercised	(48)	(112)	(160)
Balance, end of year	30	92	122
Exercisable, end of year	-	-	-
Equivalent common shares, end of year ⁽¹⁾	35	85	120

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

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

Pursuant to the terms of the plans, settlements of Restricted and Performance units could be made in cash, common shares or some combination thereof at the discretion of the Board of Directors. Prior to January 1, 2009, all settlements were in the form of equity, either in trust units or common shares. During 2009, certain Restricted Units and Performance Units were settled for cash. As such, the incentive plan was then accounted for as a liability based plan rather than an equity based plan. During the year ended December 31, 2010, all remaining restricted and performance units vested and were settled with either cash or common shares. As such, no liability remains at December 31, 2010 (2009 – \$0.5 million).

iii) RETENTION AWARD PLAN

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

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

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

At December 31, 2010, the liability associated with the Retention Awards is \$nil (2009 – \$nil).

The following table sets forth a reconciliation of the retention award plan activity for the years ended December 31, 2010 and 2009:

	2010		2009	
	NUMBER OF AWARDS	WEIGHTED AVERAGE EXERCISE PRICE	WEIGHTED AVERAGE NUMBER OF AWARDS	EXERCISE PRICE
Balance, beginning of year	1,390	\$ 5.74	8,005	\$ 5.87
Exercised	–	–	(25)	5.75
Expired	(870)	5.75	–	–
Forfeited	(460)	5.75	(395)	5.72
Cancelled	–	–	(6,195)	5.93
Balance, end of year	60	\$ 5.52	1,390	\$ 5.74
Exercisable, end of year	40	\$ 5.52	907	\$ 5.74

e) Contributed surplus

The following table sets forth a reconciliation of the contributed surplus for the years ended December 31, 2010 and 2009:

	2010	2009
Balance, beginning of year	\$ 24,827	\$ 8,513
Equity based compensation	5,668	18,173
Warrants expired	2,721	–
Stock options exercised	(127)	–
Restricted and Performance Units exercised	–	(1,360)
Compensation plan forfeitures	–	(116)
Reclassification to compensation plan liability	–	(383)
Balance, end of year	\$ 33,089	\$ 24,827

f) Management of capital structure

Fairborne actively manages its capital structure which includes shareholders' equity, bank debt, convertible debentures, and working capital. Fairborne's objective in managing its capital structure is to maintain flexibility and liquidity through periods of market fluctuations. In order to maintain or adjust the capital structure, Fairborne considers the following: incremental investment and acquisition opportunities; the current level of bank credit available from the banking syndicate; the level of bank credit that may be obtainable from the banking syndicate as a result of reserve growth; the availability of other sources of debt with different characteristics than the existing bank debt; the sale of assets; limiting the size of the investment program; and new share issuances if available on favorable terms. The Company's objective is to maintain a flexible structure that will allow it to execute its investment program, including exploration and development of its oil and gas properties and acquisition and disposition transactions which all carry varying amounts of risk. Fairborne continually strives to balance the proportion of debt and equity in its capital structure to take into account the level of risk being incurred in its investment program. Fairborne may from time to time issue shares and adjust its capital spending to manage current and projected debt levels.

The Company monitors capital based on the ratio of net debt to annualized cash flow. This ratio is calculated as net debt, defined as outstanding bank debt plus or minus working capital, excluding convertible debentures, divided by annualized cash flow from operations before changes in non-cash working capital and asset retirement expenditures. Fairborne's current strategy continues to be to target a ratio of 1 to 1, excluding convertible debentures. However, this ratio may increase at certain times as a result of acquisitions or dramatic commodity price fluctuations. In order to facilitate the management of this ratio, the Company prepares annual capital expenditure budgets, which are updated as necessary depending on varying factors including current and forecast prices, successful capital deployment and general industry conditions. The annual and updated budgets are approved by the Board of Directors. As at December 31, 2010, as a result of depressed natural gas prices and a property acquisition completed in September 2010, Fairborne's ratio of net debt to annualized cash flow was 2.1 to 1 (2009 – 0.77 to 1).

9. FINANCIAL INSTRUMENTS

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

- ❖ Credit risk
- ❖ Liquidity risk
- ❖ Market risk

a) Credit risk:

Credit risk is the risk of a financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligation and arises principally from joint venture partners and natural gas marketers. Virtually all of Fairborne's accounts receivable are from counterparties in the oil and gas industry and are subject to normal industry credit risks. As at December 31, 2010, the Company's accounts receivable consisted of \$11.2 million from joint venture partners, \$20.3 million from petroleum and natural gas marketers and \$0.3 million of other trade receivables.

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The carrying amount of accounts receivable and cash and cash equivalents represents the maximum credit exposure. Fairborne does not have an allowance for doubtful accounts as at December 31, 2010 and 2009 and did not provide for any doubtful accounts nor was it required to write-off any receivables for the years ended December 31, 2010 and 2009. The amounts outstanding for more than 90 days are predominantly due from large well established joint venture partners.

As at December 31, 2010 and 2009, the Company's accounts receivable is aged as follows:

	2010	2009
Current (less than 90 days)	\$ 28,709	\$ 31,282
Past due (more than 90 days)	3,116	3,873
Total	\$ 31,825	\$ 35,155

b) Liquidity risk:

Liquidity risk relates to the risk that a company will not be able to meet its financial obligations as they become due. Fairborne's financial liabilities on the balance sheet consist of accounts payable, bank debt, convertible debentures and working capital. The Company expects to satisfy obligations under accounts payable in less than one year. Fairborne has a revolving reserve based credit facility and demand loan facility as outlined in Note 4. The \$325 million credit facility is available on a revolving basis which converts to a 365 day facility if not extended by the lenders and the convertible debentures mature on December 31, 2011. Fairborne anticipates it will have adequate liquidity to fund its financial liabilities as they come due and anticipates recoveries in both commodity prices and capital markets over the next two years. The Company has no defaults or breaches on its bank debt or any of its financial liabilities.

c) Market risk:

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

FOREIGN CURRENCY EXCHANGE RATE RISK

Foreign currency exchange rate risk is the risk that the fair value of future cash flows will fluctuate as a result of changes in foreign exchange rates. The underlying market prices in Canada for petroleum and natural gas are impacted by changes in the exchange rate between the Canadian and United States dollar. In general, while the underlying foreign exchange rate affects oil and natural gas prices, Fairborne does not sell a significant amount of oil or natural gas denominated in U.S. dollars. Settlement of fixed price physical sales contracts denominated in U.S. dollars that are not accounted for as normal sales contracts are directly impacted by changes in the foreign exchange rate. A \$0.10 change to the foreign exchange rate at December 31, 2010 would have a \$0.4 million impact on the derivative liability at December 31, 2010 (December 2009 – an immaterial impact).

COMMODITY PRICE RISK

Commodity price risk is the risk that the fair value of future cash flows will fluctuate as a result of changes in commodity prices. Commodity prices for petroleum and natural gas are impacted by not only the relationship between the Canadian dollar and United States dollar, as outlined above, but also world economic events that dictate the levels of supply and demand. Fairborne has attempted to mitigate commodity price risk through the use of various financial derivatives and physical delivery sales contracts as outlined in Note 10. The change in fair value of derivative contracts resulted in an

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unrealized loss of \$1.0 million (2009 – unrealized loss of \$ 8.4 million) for the year ended December 31, 2010 which has been included in petroleum and natural gas sales. In addition, fixed price physical delivery contracts for natural gas that settled during the year ended December 31, 2010 increased realized revenue by an estimated \$20.8 million (2009 – \$35.5 million). The fixed price physical delivery contracts for oil that settled during the year ended December 31, 2010 had an insignificant impact on realized revenue (2009 – increase of \$1.8 million). A one dollar change to the price per barrel of oil would have a \$0.4 million impact on the value of the derivative liability at December 31, 2010 (2009 – \$0.4 million). A \$0.25 change to the price per thousand cubic feet of natural gas would have a \$0.5 million impact on the value of the derivative liability at December 31, 2010 (2009 – insignificant).

INTEREST RATE RISK

Interest rate risk is the risk that future cash flows will fluctuate as a result of changes in market interest rates. The Company is exposed to interest rate risk on its bank debt which has a floating interest rate. The convertible debentures do not bear interest rate risk as they are at a fixed rate. An increase in interest rates of 1% would reduce after tax net earnings for the year ended December 31, 2010 by approximately \$1.1 million (2009 – \$1.5 million) based on the average amount of bank debt outstanding during the year. An opposite impact would have occurred to after tax net earnings had interest rates decreased 1%. The Company had no interest rate derivatives outstanding at December 31, 2010 and 2009.

d) Fair value of financial instruments:

The carrying value of Fairborne’s financial instruments, other than bank indebtedness and convertible debentures, approximate their fair value due to their short maturity. The fair value of the bank indebtedness approximates its carrying value as it bears interest at a floating rate and the margins charged by the lenders are indicative of current credit spreads. The fair value of the convertible debentures at December 31, 2010 was \$102.5 million (2009 – \$100.3 million), based on observable trading prices. The fair value of the Company’s financial instruments, excluding working capital, are attributable to the following fair value hierarchy levels as at December 31, 2010 and 2009:

	CARRYING VALUE	VALUE FAIR	2010		
			LEVEL 1	LEVEL 2	LEVEL 3
Derivative liability	1,367	1,367	–	1,367	–
Bank indebtedness	206,331	206,331	–	206,331	–
Convertible debentures	98,397	102,500	102,500	–	–

	CARRYING VALUE	VALUE FAIR	2009		
			LEVEL 1	LEVEL 2	LEVEL 3
Derivative liability	359	359	–	359	–
Bank indebtedness	103,738	103,738	–	103,738	–
Convertible debentures	96,510	100,250	100,250	–	–

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10. COMMODITY CONTRACTS

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

a) Commodity contracts recorded at fair value:

At December 31, 2010, certain contracts have been recorded on the balance sheet at their estimated fair value as a \$1.4 million liability (2009 – liability of \$0.4 million). The change in the fair value has been recorded in petroleum and natural gas sales.

OIL:

	VOLUME (bbls PER DAY)	PRICE (US\$ PER bbl)	SETTLEMENT INDEX
Collars			
Jan 1, 2011 – Dec 31, 2011	500	70.00 – 101.25	WTI
Swaps			
Jan 1, 2011 – Dec 31, 2011	500	75.00	WTI

NATURAL GAS:

	VOLUME (Gjs PER DAY)	PRICE (CDN\$ PER GJ)	SETTLEMENT INDEX
Swap			
Jan 1, 2011 – Dec 31, 2011	5,000	5.16	AECO C Monthly

b) Commodity contracts not recorded at fair value:

The following natural gas fixed price contracts outstanding at December 31, 2010 have been entered into for the purpose of physical delivery of a non-financial item; therefore, the physical delivery contracts are not fair valued. Settlements on these contracts are included in petroleum and natural gas revenue as they occur.

NATURAL GAS:

	VOLUME (Gjs PER DAY)	PRICE (CDN\$ PER GJ)	SETTLEMENT INDEX
Swaps			
Jan 1, 2011 – Dec 31, 2011	5,000	5.00	AECO C Monthly
Jan 1, 2011 – Dec 31, 2011	5,000	5.00	AECO C Monthly

11. COMMITMENTS

The Company has certain lease commitments for its office premises through to June 2016. As at December 31, 2010 the payments due under these commitments are approximately \$1.1 million per annum until June 2011 and approximately \$2.1 million per annum from July 2011 until June 2016 as the Company increased its office space effective July 1, 2011.

12. SUBSEQUENT EVENT

On February 17, 2011, Fairborne entered into a property disposition which included undeveloped land, facilities and producing properties in the Peace River Arch and Brazeau area of north and west central Alberta for \$125 million, subject to closing adjustments. The disposition is subject to customary closing conditions, including industry standard due diligence and regulatory approval, and is expected to close in March 2011. Proceeds from the disposition will be used initially to reduce bank indebtedness.

Corporate Information

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 Calgary, Alberta T2P 5H1
 Telephone [403] 290-7750
 Fax [403] 290-7724

AUDITORS

KPMG LLP

RESERVE EVALUATORS

GLJ Petroleum Consultants Ltd.

BANKERS

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

LEGAL COUNSEL

Burnet, Duckworth & Palmer LLP
McCarthy Tetrault LLP

STOCK EXCHANGE LISTING

The Toronto Stock Exchange

Trading Symbol: **FEL**
 Convertible Debentures: **FEL.DB**

CORPORATE GOVERNANCE

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

DIRECTORS

Greg Bay
 President and CEO
 Cypress Capital Management Ltd.

Robert B. Hodgins
 Investor and Corporate Director

Johannes J. Nieuwenburg
 General Partner
 KERN Partners Ltd.

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

Steven R. VanSickle
 President and CEO
 Fairborne Energy Ltd.

Richard A. Walls
 President and
 Chief Executive Officer
 C & C Energia Ltd.

Rodney D. Wimer
 President
 Mazama Capital Partners

GENERAL INFORMATION

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

OFFICERS

Steven R. VanSickle
 President
 and Chief Executive Officer

David L. Summers
 Chief Operating Officer

Aaron G. Grandberg
 Chief Financial Officer

Jackie M. Cugnet
 Vice President
 Finance

David S. Cymbalisky
 Vice President
 Engineering

Scott W. Hadley
 Vice President
 Exploration

F. Tom Park
 Vice President
 Marketing

Gary M. Poirier
 Vice President
 Production

David E.T. Pyke
 Vice President
 Land and Contracts

ANNUAL MEETING

The Annual and Special Meeting of the Shareholders of Fairborne Energy Ltd. will be held at 3:00 pm, on May 25th, 2011 in the Grand Lecture Room at the Metropolitan Conference Centre, 333 – 4th Avenue S.W. Calgary, Alberta.