

FairWest is poised for significant growth as it embarks on a major drilling program focused on its oil resource plays.



FAIRWEST



Financial Report

for the three and nine months ended September 30, 2011

Q3

FairWest Energy Corporation

#800, 407 – 2 Street SW
Calgary, Alberta
T2P 2Y3

Telephone: 403-264-4949
Facsimile: 403-269-1761
Email: info@fairwestenergy.com



Financial Statements

Three and nine months ended September 30, 2011 with 2010 comparatives
(All figures expressed in thousands except per share amounts unless otherwise noted)

FairWest Energy Corporation

Condensed Statements of Financial Position

(Unaudited)

	Note	September 30, 2011	December 31, 2010	January 1, 2010
Assets		\$	\$	\$
Current assets				
Cash and cash equivalents		-	-	5
Accounts receivable	5	3,205	3,176	3,292
Notes receivable	18	516	516	2,656
Prepaid expenses		157	213	330
		3,878	3,905	6,283
Non-current assets				
Property plant and equipment	6	14,547	12,640	22,770
Exploration and evaluation assets	7	5,341	5,029	4,661
Investment in associates	8	227	229	56
Deferred tax assets		3,210	2,293	3,715
		23,325	20,191	31,202
Total assets		27,203	24,096	37,485
Equity and liabilities				
Current liabilities				
Accounts payable and accrued liabilities	5, 18	6,111	7,294	9,040
Bank loan payable	11	4,208	2,490	6,641
Financial contracts		-	-	133
Current portion of finance leases	13	56	187	203
Current portion of loans payable	14	34	43	41
Preferred shares	9	-	2,082	-
		10,409	12,096	16,058
Non-current liabilities				
Debentures payable	12	5,000	7,074	3,060
Finance leases	13	-	28	65
Loans payable	14	5	29	72
Decommissioning liabilities	15	5,796	5,772	5,142
Flow-through share premium liability	10	812	924	296
Preferred shares	9	-	-	2,019
		11,613	13,827	10,654
Total liabilities		22,022	25,923	26,712
Equity				
Share capital	10	63,476	55,604	52,081
Warrants	10	23	24	187
Contributed surplus		2,654	2,107	1,675
Deficit		(60,972)	(59,562)	(43,170)
Total equity		5,181	(1,827)	10,773
Total equity and liabilities		27,203	24,096	37,485

Going Concern (note 1)

Contingent liabilities (note 16)

Commitments (note 17)

Subsequent events (note 20)

The accompanying notes are an integral part of these financial statements.

Financial Statements

Three and nine months ended September 30, 2011 with 2010 comparatives

(All figures expressed in thousands except per share amounts unless otherwise noted)

FairWest Energy Corporation

Condensed Statements of Loss and Comprehensive Loss

(Unaudited)

	Note	Sept. 30, 2011 (3 months)	Sept. 30, 2010 (3 months)	Sept. 30, 2011 (9 months)	Sept. 30, 2010 (9 months)
		\$	\$	\$	\$
Revenue					
Petroleum and natural gas		1,042	1,105	3,208	3,760
Royalties		(189)	(78)	(390)	(173)
		853	1,027	2,818	3,587
Processing fee income		86	76	226	235
Royalty income		7	2	20	43
Gain (loss) on disposal of assets		(13)	(324)	1,036	(422)
Gain on flow-through share premium		108	132	527	365
Unrealized gain (loss) on financial contract		-	(35)	-	264
Gain on settlement of debt		-	-	-	173
		1,041	878	4,627	4,245
Expenses					
Operating		1,017	845	2,866	2,579
Depletion and depreciation	6	397	442	1,253	1,507
General and administration		512	847	1,687	1,910
Share-based payments	10	114	40	488	192
Part XII.6 tax		-	-	5	5
Impairment (reversal) of property, plant and equipment	6	(2,538)	2,409	(1,137)	5,823
Impairment of exploration and evaluation assets	7	5	-	59	-
(Equity) loss on investment	8	(1)	-	(2)	56
Total expenses		(494)	4,583	5,219	12,072
Operating (income) loss before finance and taxes		(1,535)	3,705	592	7,827
Finance income	19	(6)	(41)	(19)	(137)
Finance expenses	19	536	862	1,370	1,832
Loss (gain) on compound financial instrument	9, 12	(220)	-	353	-
Loss (income) before taxes		(1,225)	4,526	2,296	9,522
Income tax, prior period		(46)	-	(46)	-
Deferred tax (recovery)		(947)	352	(840)	1,456
Net (income) loss and comprehensive (income) loss		(2,218)	4,878	1,410	10,978
Basic (earnings) loss per share	10	(0.010)	0.033	0.006	0.080
Diluted (earnings) loss per share	10	(0.010)	0.033	0.006	0.080
Basic weighted average number of shares outstanding		232,895,491	149,329,936	218,214,426	137,504,559
Diluted weighted average number of shares outstanding		232,895,491	149,329,936	218,214,426	137,504,559

The accompanying notes are an integral part of these financial statements.

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FairWest Energy Corporation Condensed Statements of Changes in Equity (Unaudited)

	Note	Number of common Shares	Share capital	Convertible debentures equity component	Preferred shares	Total share capital	Warrants	Contributed surplus	Retained earnings/ deficit	Total equity
			(\$)	(\$)	(\$)	(\$)	(\$)	(\$)	(\$)	(\$)
Balance at January 1, 2011		192,301,620	54,802	645	157	55,604	24	2,107	(59,562)	(1,827)
Issuance of common shares	10	6,060,000	1,212	-	-	1,212	-	-	-	1,212
Issuance of flow-through shares	10	8,242,000	1,686	-	-	1,686	-	-	-	1,686
Preferred share modification	9	-	-	-	493	493	-	-	-	493
Share issue costs net of tax of \$36 thousand		-	(294)	-	-	(294)	-	-	-	(294)
Preferred shares converted to common shares	9	14,082,524	2,743	-	(650)	2,093	-	-	-	2,093
Debentures converted to common shares	12	13,893,340	2,225	(201)	-	2,024	-	-	-	2,024
Warrants exercised	10	6,273,147	629	-	-	629	(1)	-	-	628
Options exercised	10	200,000	29	-	-	29	-	-	-	29
Shares cancelled	10	(195,979)	-	-	-	-	-	-	-	-
Share-based payments	10	-	-	-	-	-	-	547	-	547
Net loss and comprehensive loss for the period		-	-	-	-	-	-	-	(1,410)	(1,410)
Balance at September 30, 2011		240,856,652	63,032	444	-	63,476	23	2,654	(60,972)	5,181
Balance at January 1, 2010		129,839,879	51,441	483	157	52,081	187	1,675	(43,170)	10,773
Issuance of common shares	10	12,930,000	1,293	-	-	1,293	-	-	-	1,293
Issuance of flow-through shares	10	4,600,000	184	-	-	184	-	-	-	184
Issuance of debentures	12	-	-	166	-	166	-	-	-	166
Transaction costs net of tax of \$11 thousand		-	(40)	(16)	-	(56)	-	-	-	(56)
Issuance costs reclassified from share capital to convertible debentures		-	113	-	-	113	-	-	-	113
Creditor settlements		6,510,057	456	-	-	456	-	-	-	456
Warrants issued	10	-	-	-	-	-	65	-	-	65
Warrants expired		-	-	-	-	-	(187)	187	-	-
Share-based payments	10	-	-	-	-	-	-	187	-	187
Net loss and comprehensive loss for the period		-	-	-	-	-	-	-	(10,978)	(10,978)
Balance at September 30, 2010		153,879,936	53,447	633	157	54,237	65	2,049	(54,148)	2,203

The accompanying notes are an integral part of these financial statements.

Financial Statements

Three and nine months ended September 30, 2011 with 2010 comparatives

(All figures expressed in thousands except per share amounts unless otherwise noted)

FairWest Energy Corporation

Condensed Statements of Cash Flows

(Unaudited)

	Sept. 30, 2011 (3 months)	Sept. 30, 2010 (3 months)	Sept. 30, 2011 (9 months)	Sept. 30, 2010 (9 months)
	\$	\$	\$	\$
Cash flows from operating activities				
Net income (loss)	2,218	(4,878)	(1,410)	(10,978)
Adjustments for:				
Depletion and depreciation	397	442	1,253	1,507
Impairment of property, plant and equipment	(2,538)	2,409	(1,137)	5,823
Impairment of exploration and evaluation assets	5	-	59	-
Accretion	67	130	248	379
Share-based payments	114	40	488	192
Unrealized gain on financial contracts	-	35	-	(264)
Gain (loss) on sale of assets	13	324	(1,036)	422
Deferred tax expense (recovery)	(947)	352	(840)	1,456
Gain on flow-through share premium	(108)	(132)	(527)	(365)
Equity loss on investment	-	-	-	56
Gain on settlement of debt	-	-	-	(173)
Loss (gain) on compound instrument	(220)	-	353	-
	(999)	(1,278)	(2,549)	(1,945)
Change in non-cash working capital	255	308	(518)	(1,214)
Abandonment costs incurred	-	-	-	(3)
	(744)	(970)	(3,067)	(3,162)
Cash flows from (used in) financing activities				
Issuance of share capital, net of share issuance costs	(5)	278	2,942	1,560
Proceeds from debentures, net of transaction costs	-	-	-	3,895
Change in bank loan payable	1,117	(2,298)	1,718	(3,978)
Change in loans payable	(11)	(11)	(33)	(31)
Change in finance leases	(55)	(49)	(159)	(3)
Change in note payable	(625)	1,250	-	1,650
Cash on option exercise	20	-	20	-
Cash on warrant exercise	625	-	628	-
Change in non-cash working capital	-	30	-	30
	1,066	(800)	5,116	3,123
Cash flows from (used in) investing activities				
Expenditures on exploration and evaluation assets	(126)	(117)	(411)	(527)
Additions to property plant and equipment	(550)	(567)	(2,118)	(951)
Proceeds on sale of property plant and equipment	(12)	1,712	1,115	1,971
Distributions from equity investments	1	-	1	-
Changes in non-cash working capital	365	781	(636)	(420)
	(322)	1,809	(2,049)	73
Change in cash and cash equivalents	-	39	-	34
Cash and cash equivalents, beginning of period	-	-	-	5
Cash and cash equivalents, end of period	-	39	-	39

The accompanying notes are an integral part of these financial statements.

Financial Statements

Three and nine months ended September 30, 2011 with 2010 comparatives
(All figures expressed in thousands except per share amounts unless otherwise noted)

1. Reporting Entity, Nature of Operations and Going Concern

Reporting entity and nature of operations

FairWest Energy Corporation (the "Company") is a company incorporated in Canada under the Canada Business Corporations Act. Its registered office is #800, 407 – 2nd Street SW, Calgary, Alberta, T2P 2Y3. The Company is engaged in the acquisition, exploration, development and production of petroleum and natural gas in western Canada. Its common shares trade on the TSX Venture Exchange under the symbol "FEC".

Going concern

These financial statements have been prepared on a going concern basis which assumes that the Company will be able to realize its assets and discharge its liabilities in the normal course of business for the foreseeable future. Wells drilled on the farmout lands have yielded promising results and have resulted in numerous potential additional locations and reserves. The Company expects to continue to improve its working capital position during the balance of 2011 and into 2012 by increasing production levels from the farmout drilled wells and from workovers on existing wells. As at September 30, 2011, the Company has a working capital deficiency of \$6,531 thousand, net loss of \$1,410 thousand and negative cash flow from operating activities of \$3,067 thousand. Included in the working capital deficiency is bank debt of \$4,208 thousand. The working capital deficiency at December 31, 2010 was \$8,191 thousand, including \$2,490 thousand of bank debt and \$2,082 thousand of preferred share debt. The decrease in the working capital deficiency was achieved by conversion of preferred shares to common equity, the sale of equity and the sale of undeveloped land.

Current production is approximately 400 boe/d and is expected to increase by December 31, 2011, when wells drilled under two farmout agreements (the "farmout wells") are expected to be on production. The current production is weighted approximately 25% oil, up from December 31, 2010 levels of approximately 15%. The Company is continuing to focus on oil production and expects that by year end the ratio of oil to gas production will be approximately 30/70. This will increase cash flows due to the relatively stronger oil price, as compared to gas, which the Company expects to continue into 2012. The Company is continuing to review its existing inventory of wells to identify incremental production opportunities that can be achieved with optimization and workover programs.

Holders of Series 1 and 2 debentures in the amount of \$2,084 thousand elected to convert to common shares to September 30, 2011, reducing the Company's long term debt. An additional \$487 thousand series 2 debentures were converted to common equity subsequent to September 30, 2011. Series 1 and 2 debentures pay 14% interest and conversion has eliminated the obligation to pay interest in the amount of \$360 thousand annually. The Company anticipates that more debenture holders may convert to common shares during 2011.

The Company has a credit facility with its lender in the amount of \$8,000 thousand. The credit facility is secured by a \$35,000 thousand debenture against the Company's assets and a \$5,000 thousand guarantee from a significant shareholder. The lender is presently conducting an interim credit review. The Company is not in breach of any covenants with regard to the credit facility.

The Company's ability to continue as a going concern and to fully exploit and carry out its planned exploration and development program is contingent upon positive cash flow from operating activities, favourable commodity prices, the maintenance of its existing reserve and production base, successful drilling activities, the availability of financing from its secured lender and the continued support of its creditors.

The information contained herein is current as of November 24, 2011.

2. Basis of Preparation

Statement of compliance

The September 30, 2011 interim financial statements are prepared in accordance with International Financial Reporting Standards ("IFRS"). As a result, the comparative figures for 2010 and the Company's financial position as at January 1, 2010 have been restated from Canadian Generally Accepted Accounting Principles ("Previous GAAP") to IFRS. The reconciliations to IFRS from Previous GAAP are summarized in note 21 and disclose the impact of the transition to IFRS on the Company's reported financial position and financial performance, including the nature and effect of significant changes in accounting policies from those used in the Company's financial statements for the year ended December 31, 2010. Subject to certain transition elections disclosed in note 21, the Company has consistently applied the same accounting policies in its opening IFRS statement of financial position at January 1, 2010 and throughout all periods presented, as if these policies had always been in effect.

The interim financial statements of the Company have been prepared by management in accordance with IAS 34 – Interim Financial Reporting and are in accordance with IFRS 1 – First-time Adoption of IFRS, as they are part of the year ending December 31, 2011, the fiscal period of the Company's first IFRS financial statements. The policies applied in these condensed interim financial statements are based on IFRS issued and outstanding as of November 24, 2011, the date the Board of Directors approved the statements. Any changes to IFRS that occur subsequent to November 24, 2011 will be reflected in the Company's future interim and annual financial statements and could result in restatement of these interim financial statements, including the transition adjustments recognized on change-over to IFRS.

The interim financial statements should be read in conjunction with the Company's Previous GAAP annual financial statements for the year ended December 31, 2010 and the interim financial statements dated March 31, 2011 and June 30, 2011. Note 21 discloses IFRS information and elections for the year ended December 31, 2010 that are material to an understanding of these interim financial statements.

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2. Basis of Preparation (continued)

Basis of measurement

The financial statements have been prepared on a historical cost basis, except for the following:

- Measurement of financial contracts
- Measurement of financial instruments at fair value through profit or loss
- Compound financial instruments
- Measurement of share-based payments
- Decommissioning liabilities

Functional and presentation currency

These financial statements are presented in Canadian dollars, which is the Company's functional currency.

BOE presentation

The term barrels of oil equivalent ("boe") may be misleading particularly if used in isolation. All boe conversions in this report are derived by converting gas to oil in the ratio of six thousand cubic feet of gas to one barrel of oil. A boe conversion ratio of 6 mcf : 1 bbl is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead. All amounts of boe/d, bbl/d, mcf/d, \$/boe, \$/bbl and \$/mcf are not expressed in thousands.

Use of estimates and judgments

The preparation of financial statements in conformity with IFRS requires management to make judgments, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the year in which the estimates are revised and in any future years affected.

Significant areas of estimation uncertainty and critical judgments in applying accounting policies that impact the amounts recognized in the financial statements include:

- Compound financial instruments – estimate of the fair value of the liability instruments without conversion features.
- Impairment testing – estimates of reserves, future commodity prices, future costs, production profiles and discount rates.
- Depletion and depreciation – oil and natural gas reserves including future prices, costs and reserve base to use on calculations of depletion.
- Decommissioning liabilities – estimates related to amounts, likelihood, timing, inflation and discount rates.
- Share-based payments – forfeiture rates and volatility.
- Deferred tax – estimates of reversal of temporary differences, tax rates substantially enacted, and likelihood of assets being realized.

3. Significant Accounting Policies

These interim financial statements should be read in conjunction with note 3 of the Company's interim financial statements dated March 31, 2011. The accounting policies applied by the Company in these financial statements are the same as those disclosed therein.

4. Determination of fair values

A number of the Company's accounting policies and disclosures require the determination of fair value, for both financial and non-financial assets and liabilities. Fair values have been determined for measurement and/or disclosure purposes based on the following methods. When applicable further information about the assumptions made in determining fair values is disclosed in the note specific to the asset or liability.

Property, Plant and Equipment assets and Exploration and Evaluation assets

The fair value of property, plant and equipment ("PP&E") assets and Exploration and Evaluation ("E&E") assets is estimated with reference to the discounted cash flows expected to be derived from oil and natural gas production based on externally prepared reserve reports. The market value of PP&E is the estimated amount for which PP&E could be exchanged on the date of valuation between a willing buyer and a willing seller in an arm's length transaction wherein the parties had each acted knowledgeably, prudently and willingly. The market value of oil and natural gas interests (included in PP&E) is estimated with reference to the discounted cash flows expected to be derived for oil and natural gas production based on externally prepared reserve reports. The risk adjusted discount rate is specific to the asset with reference to general market conditions. The fair value of items of plant, equipment, fixtures and fittings is based on market approach and cost approaches using quoted market prices for similar items when available and replacement cost when appropriate.

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4. Determination of fair values (continued)

Accounts receivable, notes receivable, accounts payable, accrued liabilities and bank loan payable

The fair value of accounts receivable, accounts payable, accrued liabilities and bank loan payable approximate their carrying amounts due to their short-term to maturity. The fair value of trade and other receivables with a maturity of more than one year is estimated as the present value of future cash flows, discounted at the market rate of interest at the reporting date.

Non-derivative financial liabilities and compound financial instruments

Fair value which is determined for disclosure purposes is calculated based on the present value of future principal and interest cash flows, discounted at the market rate of interest at the reporting date. In respect of the liability component of convertible debentures and preferred shares, the market rate of interest is determined by reference to similar liabilities that do not have a conversion option. For loans payable, the market rate of interest is determined by reference to similar agreements.

Share-based payments

The fair value of employee stock options is measured using the Black-Scholes model. Measurement inputs include share price on measurement date, exercise price of the instrument, expected volatility, weighted average expected life of the instruments, expected dividends, expected forfeiture rate and the risk-free interest rate. Service and non-market performance conditions attached to the transactions are not taken into account in determining fair value.

5. Financial risk management and capital management

Overview

The Board of Directors has overall responsibility for the establishment of the Company's risk management framework. The Company's activities expose it to a variety of financial risks that arise as a result of its exploration, development, production, and financing activities:

- Credit risk
- Liquidity risk
- Market risk

This note presents information about the Company's exposure to each of the above risks and the Company's objectives, policies and processes for measuring and managing risk. Further quantitative disclosures are included throughout these financial statements.

Credit risk

Credit risk is the risk of financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligations, and arises principally from the Company's receivables from joint venture partners and petroleum and natural gas marketers.

	September 30, 2011	December 31, 2010
	\$	\$
Oil and natural gas marketing companies	553	664
Joint venture partners and other trade receivables	2,652	2,512
Total	3,205	3,176

Trade and other receivables

Receivables from petroleum and natural gas marketers are normally collected on the 25th day of the month following production. The Company historically has not experienced any collection issues with its petroleum and natural gas marketers. Joint venture receivables are typically collected in one to three months of the joint venture bill being issued to the partner. The Company attempts to mitigate the risk from joint venture receivables by obtaining partner approval of significant capital expenditures prior to the expenditure. However, the receivables are from participants in the petroleum and natural gas sector, and collection of the outstanding balances is dependent on industry factors such as commodity price fluctuations, escalating costs and the risk of unsuccessful drilling. In addition, a further risk exists with joint venture partners, such as disagreements, that increase the potential for non-collection. There is a time lag, sometimes significant, from the receipt of joint venture invoices, through the billing process to partners and receipt of payment that can affect the Company's cash flows. The Company does not typically obtain collateral from petroleum and natural gas marketers or joint venture partners; however, the Company does have the ability to withhold production from joint venture partners in the event of non-payment where it is the operator.

The carrying amount of accounts receivable represents the maximum credit exposure. The Company does not have an allowance for doubtful accounts as at September 30, 2011 and December 31, 2010.

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5. Financial risk management (continued)

The Company's receivables are aged as follows:

	September 30, 2011	December 31, 2010
	\$	\$
Not past due (less than 90 days)	1,241	1,547
Past due (90 days and over)	1,964	1,629
Total	3,205	3,176

Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they fall due. The Company has several strategies to address this risk.

The Company prepares annual capital expenditure budgets, which are compared to actuals, regularly monitored and updated as considered necessary. The Company also utilizes authorizations for expenditures on both operated and non-operated projects to further manage capital expenditures. To facilitate the capital expenditures program, the Company has a revolving reserve based credit facility (note 11) that is reviewed annually by the lender at a minimum. The Company also attempts to match its payment cycle with collection of petroleum and natural gas revenues on the 25th of each month.

The following is a maturity analysis of the Company's financial obligations:

	Less than 1 month	1-3 months	3 months to 1 year	Beyond 1 year	Total
	\$	\$	\$	\$	\$
Accounts payable	1,704	925	1,658	1,824	6,111
Bank loan payable	-	4,208	-	-	4,208
Debentures payable	-	-	-	5,166	5,166
Finance leases	10	19	29	-	58
Loans payable	3	7	24	5	39
	1,717	5,159	1,711	6,995	15,582

Market risk

Market risk is the risk that changes in market prices, such as foreign exchange rates, commodity prices, and interest rates will affect the Company's income or the value of financial instruments. The objective of market risk management is to manage and control market risk exposures within acceptable limits, while maximizing returns. The Company may utilize financial contracts to manage market risks.

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 not only by the relationship between the Canadian and United States dollar, but also by world economic events that dictate the levels of supply and demand. Based on September 30, 2011 production levels, a \$1.00/mcf change in gas prices received would change gross revenue by 26% or approximately \$400 thousand and a \$10.00/bbl change in liquids prices received would change gross revenue by 12% or approximately \$200 thousand for the nine month period ended September 30, 2011.

At September 30, 2011 and December 31, 2010, the Company had no long-term forward averaging contracts. Subsequent to September 30, 2011, the Company entered into a long-term physical contract for approximately half of its oil production with a floor price of CDN \$90.00/bbl and a ceiling price of CDN \$94.00/bbl, based on West Texas Intermediate ("WTI"), which will be adjusted back to delivery point.

The Company enters into monthly gas physical contracts to help mitigate commodity price risk as a normal part of its operations.

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 fluctuations on its bank debt which bears a floating rate of interest. A change of 1.0% in the floating rate would have an \$11 thousand impact on income before income taxes in the year, based on the amount of the bank debt at September 30, 2011. The Company had no interest rate swap or financial contracts in place as at or during the periods ended September 30, 2011 and December 31, 2010.

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5. Financial risk management (continued)

Capital Management

The Company's objective is to attain a strong capital base so as to maintain investor, creditor and market confidence and to sustain future development of the business. The Company considers its capital structure to include shareholders' equity, bank debt and working capital.

	September 30, 2011 \$	December 31, 2010 \$
Shareholders equity	5,181	(1,827)
Bank loan payable	4,208	2,490
Working capital (deficiency)(excluding bank debt)	(2,323)	(5,701)
Total	7,066	(5,038)

The Company manages its capital structure and makes adjustments to it in light of changes in economic conditions and the risk characteristics of the underlying petroleum and natural gas assets. In order to maintain or adjust capital structure, the Company may from time to time issue shares, adjust its capital spending and sell assets to manage current and projected debt levels.

The Company monitors capital based on the ratio of net debt to quarterly annualized funds flow from operations. In this ratio, net debt is defined as all outstanding debt, excluding the liability component of preferred shares, plus or minus working capital, divided by funds flow from operations for the most recent calendar quarter, annualized (multiplied by four). Funds flow from operations is defined as cash flow from operating activities before changes in non-cash working capital. The Company's goal is to achieve a ratio of less than 2 to 1. This ratio may increase at certain times as a result of acquisitions. In order to facilitate the management of this ratio, the Company prepares annual capital expenditures budgets, which are updated as necessary depending on varying factors including current and forecast prices, successful capital deployment and general industry conditions. The annual budgets are approved by the Board of Directors.

For the period ended September 30, 2011, the Company's ratio of net debt to quarterly annualized funds flow from operations was negative (September 30, 2010 - negative). The September 30, 2011 ratio is not within the range set by management as a result of low natural gas prices, declining production and capital expenditures to increase production being delayed. Management's plan to lower this ratio in 2011, includes increasing production volumes and associated cash flow, conversion of debt to equity and raising additional equity. The Company entered into several farmout agreements whereby a minimum of seven wells will be drilled, completed and equipped at no cost to the Company. Successful results from this drilling will impact production and cash flow of the Company with minimum capital expenditure requirements. The Company will continue to look for farmout opportunities. During 2011, average production is approximately 318 boe/d (2010 average – 408 boe/d). This decrease is a result natural declines, the sale of interests in several areas and curtailed capital expenditures to accommodate restructuring efforts. Current production is approximately 400 boe/d and is expected to increase by year end. The increase in production is due to the results of drilling on the farmout lands.

The net debt to annual funds flow from operations has been calculated as follows:

	September 30, 2011 \$	December 31, 2010 \$
Working capital deficiency (excluding bank debt)	2,323	5,701
Bank loan payable	4,208	2,490
Debentures payable	5,000	7,074
Long term finance leases and loans payable	5	57
	11,536	15,322
Quarterly funds flow from operations	(999)	(277)
Annualizing factor	4	4
Annualized funds flow from operations	(3,996)	(1,108)
Ratio	-	-

The Company's share capital is not subject to external restrictions; however, the bank debt facility is based on petroleum and natural gas reserves and certain covenants imposed by the bank. The credit facility is secured by a \$35,000 thousand debenture against the Company's assets and a \$5,000 thousand guarantee from a significant shareholder which will expire December 31, 2011. The Company anticipates the guarantee will be continued into 2012. The Company is not in default of any covenants at September 30, 2011. Up to September 30, 2011, \$2,084 thousand of Series 1 and 2 debentures were converted to common equity. To date, an additional \$487 thousand of Series 2 debentures were converted to common equity in the fourth quarter of 2011. The effect of all these conversions will be to decrease annual interest payments in the amount of \$360 thousand.

There were no changes in the Company's approach to capital management during the period.

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6. Property, plant and equipment

	Petroleum and natural gas property, plant and equipment	Office & automotive equipment	Total
	\$	\$	\$
Cost or deemed cost			
Balance at January 1, 2010	22,412	358	22,770
Additions	3,532	13	3,545
Disposals	(2,945)	-	(2,945)
Balance at December 31, 2010	22,999	371	23,370
Additions	2,112	-	2,112
Disposals	(89)	-	(89)
Balance at September 30, 2011	25,022	371	25,393
Accumulated depletion, depreciation and impairment losses			
Balance at January 1, 2010	-	-	-
Depletion and depreciation for the period	2,110	87	2,197
Impairment loss	8,920	-	8,920
Disposals	(387)	-	(387)
Balance at December 31, 2010	10,643	87	10,730
Depletion and depreciation for the period	1,204	49	1,253
Impairment loss	(1,137)	-	(1,137)
Balance at September 30, 2011	10,710	136	10,846
Carrying amounts			
At January 1, 2010	22,412	358	22,770
At December 31, 2010	12,356	284	12,640
At September 30, 2011	14,312	235	14,547

During the period ended September 30, 2011, primarily due to increase in reserves from drilling on the farmout lands, the Company recognized an impairment recovery of \$1,137 thousand [December 31, 2010 – (\$8,920) thousand] with respect to property, plant and equipment (“PP&E”) assets. Included in the calculation of depletion are future development costs in the amount of \$2,935 thousand (December 31, 2010 - \$3,520 thousand). During the period ended September 30, 2011, the Company capitalized general and administrative expenditures directly related to development activity of \$105 thousand (December 31, 2010 - \$108 thousand).

Included in PP&E is equipment under capital lease with a net book value as shown in the table below:

	September 30, 2011	December 31, 2010
	\$	\$
Cost	1,035	1,035
Accumulated depletion	(521)	(591)
Net book value	514	444

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7. Intangible Exploration and Evaluation assets

Intangible exploration and evaluation (“E&E”) assets consist of the Company’s exploration projects which are pending the determination of proved and probable reserves. Additions represent the Company’s share of costs incurred on E&E assets during the period.

E&E Assets	\$
Cost or deemed cost:	
Balance at January 1, 2010	4,661
Expiries	-
Transferred to D&P	-
Disposals	(299)
Additions	667
Balance at December 31, 2010	5,029
Expiries	(59)
Transferred to D&P	-
Disposals	(81)
Additions	452
Balance at September 30, 2011	5,341

During the period ended September 30, 2011, the Company capitalized general and administrative expenditures directly related to E&E assets of \$408 thousand (December 31, 2010 - \$558 thousand)

8. Investments in associates

The Company’s share of profit in its equity accounted investees for the period ended September 30, 2011 was undetermined (December 31, 2010 - \$63 thousand), but is not expected to be material.

	September 30, 2011	December 31, 2010
	\$	\$
Petrovest Exploration & Production Corporation (“Petrovest”)	-	-
Royalty Investments Limited Partnership (“RILP”)	227	229
Total	227	229

Petrovest Exploration & Production Corporation

	September 30, 2011	December 31, 2010
	\$	\$
Balance beginning of period	-	56
Share of net loss for period	-	(56)
Balance end of period	-	-

The Company’s share of Petrovest’s cumulative net losses are estimated to be \$216 thousand. This exceeds the Company’s original investment which has been adjusted to \$nil (December 31, 2010 - \$nil).

Royalty Investments Limited Partnership

	September 30, 2011	December 31, 2010
	\$	\$
Balance beginning of period	229	-
Investment during period	-	522
Distributions	(2)	-
Share of net loss for period	-	(5)
Loss on disposal of units	-	(288)
Balance end of period	227	229

The Company’s share of RILP’s net loss was \$5 thousand for the period ended December 31, 2010 and the investment has been written down by that amount. The Company’s share of RILP’s results for the period ended September 30, 2011 has not been determined to date.

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9. Preferred shares

Issued Preferred shares	Number of shares	Amount (\$)
Balance Preferred shares January 1, 2010	211,259	2,019
Accretion	-	63
Balance Preferred shares December 31, 2010	211,259	2,082
Accretion	-	11
Converted to common shares	(211,259)	(2,093)
Balance Preferred shares September 30, 2011	-	-

On March 7, 2011, the Company converted the preferred shares to common equity and issued 14,082,524 common shares. Conversion of the preferred shares resulted in extinguishment of the liability component and equity component of the preferred shares in the amount of \$2,093 thousand and \$650 thousand respectively and an addition to share capital for common equity in the amount of \$2,743 thousand. Dividends in the amount of \$34 thousand were paid in 2011 prior to the conversion (December 31, 2010 - \$144 thousand).

10. Share capital

The Company is authorized to issue an unlimited number of common voting shares and an unlimited number of preferred shares. During the period ended September 30, 2011, the Company issued 6,060,000 common shares for gross proceeds of \$1,212 thousand and 8,242,000 flow-through shares for gross proceeds of \$2,061 thousand. Total gross proceeds for both issuances was \$3,273 thousand. A flow-through share premium liability was recorded of \$416 thousand and a deferred tax adjustment of \$41 thousand with an offset to share capital of \$375 thousand. These adjustments resulted in net addition to share capital of \$1,212 thousand for common equity and \$1,686 thousand for flow-through equity.

To September 30, 2011, \$2,084 thousand debentures were converted to 13,893,340 common shares. These conversions resulted in an increase in common share capital of \$2.225 million and a decrease of \$201 thousand in the equity component of share capital, for a net increase in share capital of \$2.024 million.

Warrants	September 30, 2011		December 31, 2010	
	Number of Warrants	Amount (\$)	Number of Warrants	Amount (\$)
Balance, beginning of period	600,104	24	5,000,000	187
Issued	-	-	2,600,238	65
Cancelled	-	-	(2,000,134)	(41)
Exercised	(23,147)	(1)	-	-
Expired	-	-	(5,000,000)	(187)
Balance, end of period	576,957	23	600,104	24

Up to September 30, 2011, 23,147 warrants with an exercise price of \$0.15 were converted and resulted in the Company issuing 23,147 common shares for proceeds of \$3 thousand. This warrant exercise increased share capital by \$4 thousand and decreased warrants issued value by \$1 thousand.

Flow-through Share Warrants	September 30, 2011		December 31, 2010	
	Number of Warrants	Amount (\$)	Number of Warrants	Amount (\$)
Balance, beginning of period	6,250,000	-	6,250,000	-
Exercised	(6,250,000)	-	-	-
Balance, end of period	-	-	6,250,000	-

Flow-through share warrants issued in 2009 with an original expiry date of December 18, 2010 were amended to change the expiry date to September 14, 2011. All other terms and conditions of the warrants remain unchanged. This modification did not result in a revaluation of the warrants. The warrants were exercised during the third quarter of 2011 resulting in a \$625 thousand increase in share capital and 6,250,000 common shares issued. The shares issued upon exercise of these warrants were not flow-through shares. When the warrants were modified and the exercise date extended, the flow-through provision of the agreement was not extended. Therefore, when these warrants were exercised, common shares were issued.

Stock options

The Stock Option Plan ("the Plan") was adopted in order to offer directors, officers and employees of the Company, its affiliates and persons and companies providing ongoing services to the Company and its affiliates, the opportunity, through share options, to acquire a proprietary interest in the Company, thereby providing an additional incentive to the persons and companies contemplated above to promote the best interests of the Company and to provide the means to the Company to attract qualified persons. Pursuant to TSX Venture Exchange Policy 4.4 ("the Option Policy") the Corporation is permitted to maintain a rolling stock option plan. The total number of shares that may be issued pursuant to the Plan shall not exceed 10% of the aggregate number of issued and outstanding shares of the Company. The maximum number of shares that may be reserved for issuance to any one person under the Plan is 5% of the shares outstanding at the time of the grant.

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10. Share capital (continued)

Changes in the number of options, with weighted average exercise prices are summarized as follows:

	September 30, 2011		December 31, 2010	
	Number of Options	Weighted Average Exercise Price (\$)	Number of Options	Weighted Average Exercise Price (\$)
Balance, beginning of period	12,875,000	0.119	6,725,000	0.212
Granted	7,700,000	0.197	7,950,000	0.100
Cancelled	(450,000)	(0.150)	(1,800,000)	0.385
Exercised	(200,000)	(0.100)	-	-
Balance, end of period	19,925,000	0.149	12,875,000	0.119
Exercisable	12,141,691	0.139	7,574,998	0.133

As at September 30, 2011, the following options are outstanding:

Number of common shares under option	Exercisable Options	Exercise price per option (\$)	Weighted average life remaining (years)
4,475,000	4,475,000	0.15	3.25
7,250,000	4,766,692	0.10	3.46
500,000	333,335	0.10	3.90
200,000	66,666	0.10	4.21
7,500,000	2,499,998	0.20	4.67
19,925,000	12,141,691	0.14	3.89

Share-based payments

During the period ended September 30, 2011, 7,700,000 stock options were granted and 450,000 were cancelled. Weighted average assumptions and resulting fair values for stock options granted during the periods ended September 30, 2011 and December 31, 2010 were as follows:

	September 30, 2011	December 31, 2010
Risk-free interest rate (%)	2.01	2.85
Expected dividend yield (years)	-	-
Expected stock price volatility (weighted average) (%)	129	113
Expected option life (weighted average) (years)	4	4
Weighted average exercise price (\$)	0.20	0.10
Weighted average grant date fair value (\$)	0.12	0.05

Option pricing models require the input of highly subjective assumptions including the expected price volatility. Changes in the subjective input assumptions can materially affect the fair value estimate and therefore, the existing models do not necessarily provide a reliable measure of the fair value of the Company's stock options.

Flow-through shares

The following table summarizes information about flow-through shares outstanding:

Qualifying Expenditures

Year Issued	Total flow-through proceeds (\$)	Cumulative amount incurred to December 31, 2010 (\$)	Cumulative amount incurred to September 30, 2011 (\$)	Expenditures remaining at December 31, 2011 (\$)
2010(1)	3,012	1,017	2,246	766
2011 (2)	2,061	-	-	2,061
	5,073	1,017	2,246	2,827

(1) The Company renounced proceeds to investors as at December 31, 2010 and has until December 31, 2011 to incur the qualifying expenditures.

(2) The Company has until December 31, 2012 to incur qualifying expenditures.

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10. Share capital (continued)

During 2008, the Canada Revenue Agency ("CRA") initiated an audit of the Company's (including a previous subsidiary) flow-through share offerings for the 2004, 2005 and 2006 taxation years. On February 26, 2009, the Company received a letter from CRA indicating they believed the Company had a shortfall of \$3,295 thousand of flow-through eligible expenditures. These findings were summarized in a subsequent letter dated March 20, 2009. CRA subsequently issued a notice of reassessment. The Company did not believe that the reassessment was valid and filed a notice of objection on July 29, 2009. The CRA acknowledged receipt of the objection in a letter dated December 20, 2009 and indicated that a review would be completed by the appeals division of the CRA. To date the Company has not received any correspondence from the appeal division of CRA, but has received verbal confirmation that CRA is reviewing the notice of objection. Management's assessment is that any amounts that may be payable by the Company to CRA and/or investors resulting from the above will not be material.

Flow-through share premium liability

	September 30, 2011 (\$)	December 31, 2010 (\$)
Balance beginning of period	924	296
Premium attributed to flow-through shares issued	416	1,290
Reduction of liability due to expenditures incurred	(528)	(662)
Balance end of period	812	924

Expenditures during the three month period ended September 30, 2011 resulted in a reduction of the flow-through share premium liability of \$108 thousand.

Earnings per share

The following sets forth the computed basic and diluted earnings per share:

	September 30, 2011 (9 months)	September 30, 2010 (9 months)
Numerator		
Net loss (\$)	1,410	10,978
Denominator		
Weighted average number of common shares	218,214,426	137,504,559
Effect of dilutive securities		
preferred shares	-	-
stock options	-	-
debentures	-	-
warrants	-	-
	218,214,426	137,504,559
Basic loss per share (\$)	0.006	0.080
Diluted loss per share (\$)	0.006	0.080

All of the above preferred shares, stock options and warrants and debentures are potentially dilutive but were not included in the calculation of diluted earnings per share for the periods ended September 30, 2011 and September 30, 2010 because to do so would be anti-dilutive.

11. Bank loan payable

At September 30, 2011, the Company had a revolving, operating demand loan facility of \$8,000 thousand that bears interest at the lender's prime lending rate plus 2.5% on the first \$3,000 thousand of advances and the lender's prime lending rate on the balance of advances. The loan facility is secured by a \$35,000 thousand debenture over the Company assets and a \$5,000 thousand guarantee from a significant shareholder. A guarantee fee of \$150 thousand was paid to the guarantor. The guarantee expires on December 31, 2011, and the Company expects the guarantee to be continued. At September 30, 2011, there was \$4,208 thousand (December 31, 2010 - \$2,490 thousand) drawn on the facility.

The Company is required to maintain a working capital ratio of 1:1. At September 30, 2011 the working capital ratio is 1.24:1. This ratio is calculated by excluding from working capital the bank loan and adding any unused balance on the line. Increased production from the wells drilled on the farmout lands are expected to help the Company continue to meet its working capital covenant. In addition, the Company plans to sell assets, curtail capital expenditures, negotiate the extension of the guarantee and sell equity.

At September 30, 2011, the bank prime rate was 3.0%.

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12. Debentures payable

Series 1

To September 30, 2011, debenture holders representing 580 debentures (\$580 thousand) converted to common shares as per the conversion feature and the Company issued 3,866,666 common shares.

Series 2

To September 30, 2011, Series 2 debenture holders representing 1,504 debentures (\$1,504 thousand) converted their debentures to 10,026,674 common shares. Approval was received during the second quarter from regulatory authorities to modify the terms of the Series 2 debentures by extending the maturity date to December 31, 2012. No other terms were changed. This modification resulted in a decrease to the Series 2 debentures of \$140 thousand and a corresponding gain on compound instrument for the three month period ended September 30, 2011.

The following table shows the liability and equity components of the debentures:

Series 1 Debentures	Number of debentures	Liability component (\$)	Equity component (\$)	Total (\$)
Balance January 1, 2010 and December 31, 2010	1,750	1,750	428	2,178
Converted	(580)	(580)	(142)	(722)
Balance September 30, 2011	1,170	1,170	286	1,456

Series 2 Debentures	Number of debentures	Liability component (\$)	Equity component (\$)	Total (\$)
Balance January 1, 2010	1,365	1,310	55	1,365
Issuance of convertible debentures	4,135	3,970	165	4,135
Issuance costs	-	(79)	(3)	(82)
Amortization of issuance costs	-	37	-	37
Accretion of liability	-	86	-	86
Balance December 31, 2010	5,500	5,324	217	5,541
Converted	(1,504)	(1,444)	(59)	(1,503)
Modification of terms	-	(140)	-	(140)
Amortization of issuance costs	-	22	-	22
Accretion of liability	-	68	-	68
Balance September 30, 2011	3,996	3,830	158	3,988

Total Series 1 and Series 2 Debentures	Number of debentures	Liability component (\$)	Equity component (\$)	Total (\$)
January 1, 2010	3,115	3,060	483	3,543
December 31, 2010	7,250	7,074	645	7,719
September 30, 2011	5,166	5,000	444	5,444

13. Finance leases

The Company has entered into two finance leases for the use of compression equipment. One lease expired on September 30, 2011 and bore interest at 12.9%. At the end of the lease, the Company exercised its option to purchase the asset for one dollar. The current portion of this lease at December 31, 2010 was \$83 thousand. The second lease expires on March 31, 2012 and bears interest at 12.9%. At the end of the lease, the Company has the option to purchase the asset for one dollar. The current portion of the lease is \$56 thousand (December 2010 - \$104 thousand).

The future obligations under the capital leases are:

	2011 \$	2012 \$	Total \$
Principal	28	28	56
Imputed interest	1	1	2
	29	29	58

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14. Loans payable

The Company entered into two financing arrangements for service field trucks. One arrangement expires April 30, 2012 and bears interest at 5.4%. The current portion of this debt is \$13 thousand (December 2010 - \$22 thousand). The second arrangement expires December 31, 2012 and bears interest at 1.99%. The current portion of this debt is \$21 thousand (December 2010 - \$21 thousand).

Payments required under the loans are:

	2011 \$	2012 \$	Total \$
Principal	10	29	39
Interest	-	-	-
	10	29	39

15. Decommissioning liabilities

	September 30, 2011 \$	December 31, 2010 \$
Balance, beginning of period	5,772	5,142
Change in estimates	(323)	715
Change in rate	109	259
Increase on acquisitions	183	41
Decrease on dispositions	(91)	(476)
Costs incurred	-	(93)
Accretion expense	146	184
Balance, end of period	5,796	5,772

The Company's decommissioning obligations result from its ownership interest in oil and natural gas assets including well sites and gathering systems. The total future decommissioning obligation is estimated based on the Company's net ownership interest in all wells and facilities, estimated costs to reclaim and abandon these wells and facilities and the estimated timing of the costs to be incurred in future years. The Company has estimated the net present value of its total decommissioning obligation to be \$5,796 thousand at September 30, 2011 (December 31, 2010 - \$5,772 thousand) based on an undiscounted total future liability of \$6,891 thousand. These payments are expected to be made over the next 25-30 years. The provision is the discounted present value of the estimated cost, using existing technology at current prices, of decommissioning the Company's oil and natural gas fields and production facilities. The discount factor, being the risk-free rate related to the liability, is 3.25% (December 31, 2010 - 3.42%).

16. Contingent liabilities

- In 2005, the Company received a statement of claim in the amount of \$136 thousand from Aero Drilling & Consulting Ltd., in respect of services provided to a subcontractor of Supreme Energy Inc. The Company has reviewed the claim and considers it without merit and no provision has been made with respect to the claim. The Company is defending the claim.
- In November 2006, the Company received a notice of reassessment from Revenu Quebec for the period ended February 28, 2003, in the amount of \$211 thousand including interest. This relates to Fairstar Explorations Inc. ("Fairstar"). Fairstar and Western Energy Corporation amalgamated August 18, 2005 to form the Company. The Company has filed a notice of objection, does not believe that the reassessment is valid and has made no provision with respect to the claim in the financial statements.

17. Commitments

The Company leases its corporate office. Non-cancellable operating lease rentals excluding operating costs, are payable as follows:

	September 30, 2011 (\$)	December 31, 2010 (\$)
2011	65	259
2012 - 2013	431	431
Beyond 2013	-	-
	496	690

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18. Related parties

Key management personnel compensation comprised

	September 30, 2011	December 31, 2010
	(\$)	(\$)
Salaries and bonuses	360	980
Short-term employee benefits	15	7
Termination benefits	57	114
Share-based payments	215	7
	647	1,108

Executive officers and directors also participate in the Company's stock option plan (note 10).

Other related party transactions

In the fourth quarter 2010, the net assets of AltaEast Production Limited Partnership ("AEPLP"), Battle River Production Limited Partnership ("BRPLP"), Garrington Limited Partnership ("GLP"), Neutral Creek Limited Partnership ("NCLP"), Strategic Production Limited partnership ("SPLP") and Petrovest, together (the "Parties"), were acquired by RILP (the "Transaction"). Subsequent to the Transaction, the Company negotiated, with the Parties and RILP, the cancellation of the Company's requirement to make an offer to purchase the Parties' oil and natural gas assets pursuant to an option agreement between the Company and the Parties. The total amount of this contractual obligation was, in aggregate, estimated by the Company to be approximately \$9,500 thousand. Amounts due to and from the Parties were consolidated under RILP and certain adjustments to the amounts due were agreed to between RILP and the Parties.

Trade and other receivables from related parties – included in accounts receivable	Note	September 30, 2011	December 31, 2010	January 1, 2010
		(\$)	(\$)	(\$)
AltaEast Production Limited Partnership	18	-	-	6
Battle River Production Limited Partnership	18	-	-	40
Garrington Limited Partnership	18	-	-	167
Neuberry Energy (2007) Ltd. ("Neuberry")	18	-	-	1
Petrovest Exploration & Production Corporation	18	-	-	388
Royalty Investments Limited Partnership	18	-	177	-
Strategic Production Limited Partnership	18	-	-	16
		-	177	618

The trade and other receivables from related parties in the above table are unsecured, are on terms similar to trade receivables, have no fixed terms of repayment and bear no interest.

Notes receivable from related parties – short term – included in note receivable	Note	September 30, 2011	December 31, 2010	January 1, 2010
		(\$)	(\$)	(\$)
AltaEast Production Limited Partnership	18	-	-	653
Garrington Limited Partnership	18	-	-	308
Royalty Investments Limited Partnership	18	500	500	-
Strategic Production Limited Partnership	18	-	-	1,595
Total		500	500	2,556

The notes receivable from AEPLP and SPLP at January 1, 2010 were collected during 2010. The note receivable from GLP was forgiven to facilitate the transfer of net assets of Petrovest, GLP, BRPLP, AEPLP, SPLP and NCLP into RILP and a net loss on settlement of debt in the amount of \$308 thousand was recorded in 2010. The note receivable from RILP bears interest at 5%, is unsecured and is due upon demand. The note receivable from RILP is expected to be collected during 2011.

Trade and other payables to related parties – included in accounts payable	Note	September 30, 2011	December 31, 2010	January 1, 2010
		(\$)	(\$)	(\$)
Espoir Capital Corporation	18	-	-	45
Fauth Financial Services	18	-	7	94
Lavery, de Billy, LLP	18	-	-	8
Neutral Creek Limited Partnership	18	-	-	105
Royalty Investments Limited Partnership	18	37	-	-
Western Royalty Holdings Corporation	18	5	18	21
Total		42	25	273

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18. Related parties (continued)

- The trade and other payables to related parties are unsecured and have no fixed terms of repayment.
- Petrovest Exploration & Production Corporation is controlled by the CEO of the Company.
- Garrington Production Corporation (“GPC”) is controlled by the Chief Executive Officer (“CEO”) of the Company and is the general partner of GLP.
- A key management personnel of the Company is a director of Western Royalty Holdings Corporation (“Western”).
- Neutral Creek Corporation (“NCC”) is controlled by the CEO of the Company and is the general partner of NCLP.
- Battle River Oil and Gas Inc. (“BRO&G”) is controlled by the CEO of the Company. BRO&G is the general partner of BRPLP.
- AltaEast Oil & Gas Inc. (“AEOG”) is controlled by the CEO of the Company. AEOG is the general partner of AEPLP.
- Strategic Oil & Gas Production Inc. (“SOGP”) is controlled by the CEO of the Company. SOGP is the general partner of SPLP.
- A director of the Company is a partner in Lavery, de Billy, LLP (“Lavery”).
- The CEO of the Company is a director of Espoir Capital Corporation (“Espoir”).
- The CEO of the Company is related to a controlling interest in Fauth Financial Services (“Fauth Financial”).
- Espoir Management Inc. (“EMI”) is controlled by the CEO of the Company. EMI is the general partner of RILP.

The following transactions were in the normal course of operations and have been recorded at the exchange amounts, which is the amount of consideration established and agreed to by the related parties and in managements opinion is approximate fair value:

- During 2010, the CEO provided security to a lender to secure a credit facility for the Company and billed the Company \$30 thousand as a guarantee fee.
- During 2011, the Company was billed \$nil (2010 - \$2 thousand) by Lavery for legal services.
- During 2011, the Company charged various related party limited partnerships that it administers \$56 thousand (2010 - \$127 thousand) in management fees at a rate of \$2.00 to \$2.50/boe of sales and interest of \$19 thousand (2010 - \$119 thousand).
- During 2011, Fauth Financial billed the Company \$nil (2010 - \$199 thousand) of commissions related to the Company’s issuance of flow-through shares and debentures. The Company paid \$7 thousand (2010 - \$286 thousand) to Fauth Financial in 2011. The amount is included in share issuance costs and transaction costs in the financial statements.
- During 2011, a significant shareholder and associated companies provided a guarantee to a lender to secure a credit facility for the Company. The Company was billed \$150 thousand for a guarantee fee related to this transaction.
- During 2009, the Company received a \$50 thousand loan from Espoir which was fully repaid on March 1, 2010. The loan bore interest at 12% and interest paid in 2010 was \$1 thousand.

The following transactions were not in the normal course of operations:

- The Company sold wellbores in the Provost and Berry areas to AEPLP for cash proceeds of \$50. The sale closed on September 30, 2010 and was recognized for accounting purposes at this date. A gain of \$65 thousand was recorded on the sale.
- The Company sold wellbores in the Provost and Berry areas to SPLP for cash proceeds of \$50. The sale closed on September 30, 2010 and was recognized for accounting purposes at this date. A gain of \$65 thousand was recorded on the sale.
- In two separate transactions in 2011, the Company sold properties in the Berry Creek area to a significant shareholder and associated companies for cash proceeds of \$100 thousand and \$31 thousand respectively. The Company recorded a gain of \$44 thousand on the first sale and \$33 thousand on the second sale. These sales both closed on May 31, 2011 and were recognized for accounting purposes on this date.

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Three and nine months ended September 30, 2011 with 2010 comparatives
(All figures expressed in thousands except per share amounts unless otherwise noted)

19. Finance income and costs

Recognized in profit or loss

	Note	September 30, 2011 (\$)	September 30, 2010 (\$)
Interest income		19	(137)
Finance income		19	(137)
Interest on bank indebtedness		267	503
Interest on convertible debentures	12	689	618
Accretion on convertible instruments	12	102	187
Accretion on decommissioning liability	15	146	145
Preferred share interest	9	34	111
Accretion on preferred shares	9	-	47
Other interest		132	221
Finance costs		1,370	1,832
Net finance costs recognized in profit or loss		1,351	1,695

20. Subsequent events

- \$487 thousand debentures were converted to common shares at an exercise price of \$0.15 and 3,246,668 shares were issued as a result of this conversion.

21. Transition to IFRS

The accounting policies set out in note 3 have been applied in preparing the interim financial statements for the three and nine months ended September 30, 2011, the comparative information presented in these interim financial statements for both the three and nine months ended September 30, 2010 and year ended December 31, 2010 and in the preparation of an opening IFRS statement of financial position at January 1, 2010.

In preparing its opening IFRS statement of financial position, the Company has adjusted amounts reported previously in financial statements prepared in accordance with Previous GAAP. An explanation of how the transition from Previous GAAP to IFRS has affected the Company's financial position, financial performance and cash flows is set out in the following tables and the notes that accompany the tables.

The Company has applied the following transition exemptions to full retrospective application of IFRS:

- Deemed cost exemption for full cost oil and gas entities as further described in note 21(a).
- Decommissioning obligation exemption that allows any changes in decommissioning liabilities on transition to IFRS to be adjusted through opening retained earnings as further described in note 21(e).
- Business combinations exemption that allows a company to not have to restate any business combinations that occurred prior to the date of transition.
- Share-based payments exemption that allows a company to only have to evaluate share-based payments awards that were unvested as of the date of transition and that were issued subsequent to November 7, 2002.

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Three and nine months ended September 30, 2011 with 2010 comparatives

(All figures expressed in thousands except per share amounts unless otherwise noted)

21. Transition to IFRS (continued)

Reconciliation of statement of financial position – September 30, 2010

	Note	Previous GAAP Sept. 30, 2010	Effect of transition to IFRS	IFRS Reclassification	IFRS Sept. 30, 2010
		\$	\$	\$	\$
Assets					
Current assets					
Cash		38	-	-	38
Accounts receivable	(l)	2,412	-	1,395	3,807
Notes receivable	(l)	16	-	1,527	1,543
Due from related parties	(l)	1,395	-	(1,395)	-
Notes receivable from related parties	(l)	1,527	-	(1,527)	-
Prepaid expenses		338	-	-	338
Financial contracts		130	-	-	130
		5,856	-	-	5,856
Non-current assets					
Property plant and equipment	(a)	29,948	(15,620)	-	14,328
Exploration and evaluation assets	(b)	-	4,902	-	4,902
Investment in associates		-	-	-	-
Deferred tax assets	(c)	2,273	-	-	2,273
		32,221	(10,718)	-	21,503
Total assets		38,077	(10,718)	-	27,359
Equity and liabilities					
Current liabilities					
Accounts payable and accrued liabilities	(l)	5,955	-	240	6,195
Bank loan payable		2,663	-	-	2,663
Due to related parties	(l)	240	-	(240)	-
Note payable		1,650	-	-	1,650
Current portion of finance leases		210	-	-	210
Current portion of loans payable		42	-	-	42
Preferred shares	(g)	2,056	10	-	2,066
		12,816	10	-	12,826
Non-current liabilities					
Debentures payable	(d)	6,835	-	-	6,835
Finance leases		56	-	-	56
Loans payable		40	-	-	40
Decommissioning liabilities	(e)	4,187	1,143	-	5,330
Flow-through share premium liability	(f)	-	69	-	69
		11,118	1,212	-	12,330
Total liabilities		23,934	1,222	-	25,156
Equity					
Share capital	(h)	52,089	2,148	-	54,237
Warrants		65	-	-	65
Contributed surplus	(i)	2,021	28	-	2,049
Deficit	(j)	(40,032)	(14,116)	-	(54,148)
Total equity		14,143	(11,940)	-	2,203
Total equity and liabilities		38,077	(10,718)	-	27,359

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Three and nine months ended September 30, 2011 with 2010 comparatives
(All figures expressed in thousands except per share amounts unless otherwise noted)

21. Transition to IFRS (continued)

Reconciliation of statement of comprehensive loss for the three months ended September 30, 2010

	Note	Previous GAAP Sept. 30, 2010	Effect of transition to IFRS	IFRS Reclassification	IFRS Sept. 30, 2010
		\$	\$	\$	\$
Revenue					
Petroleum and natural gas sales		1,105	-	-	1,105
Royalties		(78)	-	-	(78)
		1,027	-	-	1,027
Processing fee income		76	-	-	76
Other income		73	-	(73)	-
Royalty income	(l)	-	-	2	2
Gain (loss) on disposal of assets	(a)	-	(354)	30	(324)
Gain on flow-through share income	(f, l)	-	132	-	132
Unrealized gain on financial contract		(35)	-	-	(35)
Gain on settlement of debt		-	-	-	-
Total revenue		1,141	(222)	(41)	878
Expenses					
Operating		845	-	-	845
Depletion and depreciation	(a, o)	1,867	(1,961)	536	442
General and administration	(n)	641	206	-	847
Share-based payments	(p)	25	15	-	40
Part XII.6 tax		-	-	-	-
Share of loss – associates		-	-	-	-
Impairment of property, plant and equipment	(a)	-	2,945	(536)	2,409
Total expenses		3,378	1,205	-	4,583
Operating loss before finance and taxes		2,237	1,427	41	3,705
Finance income		-	-	(41)	(41)
Finance expenses	(g, o)	793	69	-	862
Loss before taxes		3,030	1,496	-	4,526
Deferred tax expense (recovery)		157	195	-	352
Net loss and comprehensive loss		3,187	1,691	-	4,878

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Three and nine months ended September 30, 2011 with 2010 comparatives

(All figures expressed in thousands except per share amounts unless otherwise noted)

21. Transition to IFRS (continued)

Reconciliation of statement of comprehensive loss for the nine months ended September 30, 2010

	Note	Previous GAAP Sept. 30, 2010	Effect of transition to IFRS	IFRS Reclassification	IFRS Sept. 30, 2010
		\$	\$	\$	\$
Revenue					
Petroleum and natural gas sales		3,760	-	-	3,760
Royalties		(173)	-	-	(173)
		<u>3,587</u>	<u>-</u>	<u>-</u>	<u>3,587</u>
Processing fee income		235	-	-	235
Other income	(l)	210	-	(210)	-
Royalty income	(l)	-	-	43	43
Gain on flow-through share income	(f, l)	-	365	-	365
Unrealized gain on financial contract		264	-	-	264
Gain on settlement of debt		173	-	-	173
Loss on disposal of assets	(a)	-	(452)	30	(422)
Total revenue		<u>4,469</u>	<u>(87)</u>	<u>(137)</u>	<u>4,245</u>
Expenses					
Operating		2,579	-	-	2,579
Depletion and depreciation	(a)	4,619	(3,648)	536	1,507
General and administration	(n)	1,362	548	-	1,910
Share-based payments	(p)	122	70	-	192
Part XII.6 tax		5	-	-	5
Share of loss – associates		56	-	-	56
Loss on settlement of debt		-	-	-	-
Impairment of property, plant and equipment		-	6,359	(536)	5,823
Total expenses		<u>8,743</u>	<u>3,329</u>	<u>-</u>	<u>12,072</u>
Operating loss before finance and taxes		<u>4,274</u>	<u>3,416</u>	<u>138</u>	<u>7,827</u>
Finance income	(k)	-	-	(137)	(137)
Finance expenses	(g, o)	1,619	213	-	1,832
Loss before taxes		<u>5,893</u>	<u>3,629</u>	<u>-</u>	<u>9,522</u>
Current income tax		-	-	-	-
Deferred tax expense (recovery)		(779)	2,235	-	1,456
Net loss and comprehensive loss		<u>5,114</u>	<u>5,864</u>	<u>-</u>	<u>10,978</u>

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Three and nine months ended September 30, 2011 with 2010 comparatives
(All figures expressed in thousands except per share amounts unless otherwise noted)

21. Transition to IFRS (continued)

a. IFRS 1 election for full cost oil and gas entities

	Note	January 1, 2010 (\$)	September 30, 2010 (\$)	December 31, 2010 (\$)
Balance as per Previous GAAP		34,729	29,948	23,204
Transfer to E&E assets on transition	(a)	(4,966)	(4,966)	(4,966)
Impairment on transition	(a)	(6,993)	(6,993)	(6,993)
Sale of assets	(a)	-	(484)	(473)
Capitalized G&A	(n)	-	(1,119)	(1,359)
Decommissioning liability adjustment		-	841	842
Impairment	(a)	-	(5,287)	(1,267)
Depletion	(a)	-	2,398	3,662
Reclassification to E&E		-	(10)	(10)
Balance as per IFRS		22,770	14,328	12,640

IFRS 1 election for full cost oil and gas entities

The Company elected an IFRS 1 exemption whereby the Previous GAAP full cost pool was measured upon transition to IFRS as follows:

- E&E assets were reclassified from the full cost pool to E&E assets at the amount that was recorded under Previous GAAP. On transition \$4,966 thousand was reclassified to intangible E&E assets and an impairment of \$305 thousand was recorded for a net of \$4,661 thousand.
- The remaining full cost pool was allocated to PP&E assets and the respective CGUs pro-rata using reserve values.

Depletion

Upon transition to IFRS, the Company adopted a policy of depleting oil and gas interests on an area by area basis on a unit of production basis over proved plus probable reserves. The depletion policy under Previous GAAP was based on units of production over proved reserves of the entire full cost pool. Overall the impact of this adoption was a decrease to depletion expense as a result of using proved and probable reserves and associated future capital in the IFRS depletion calculation compared to using only proved reserves and associated future capital under Previous GAAP. There was a decrease in depletion expense of \$2,398 thousand for the nine months ended September 30, 2010 and \$3,662 thousand for the year ended December 31, 2010.

Impairment

Under Previous GAAP, an impairment of oil and gas assets was recognized and measured on the entire full cost pool and was not reversed. Under IFRS, impairments of PP&E are recognized and measured at a CGU level and impairments are reversed. The Company recognized impairment at January 1, 2010 of \$6,993 thousand, a further net impairment of \$5,287 thousand for the nine months ended September 30, 2010 and a total change in impairment of \$1,267 thousand for the year ended December 31, 2010. The impairments are related to the Company's natural gas CGUs and arose primarily due to declining forward natural gas prices. The impairments were based on the difference between each period's respective PP&E net book values and their recoverable amounts. The recoverable amounts were determined using fair value less costs to sell based on discounted future cash flows of proved and probable reserves using forecast prices and costs discounted at 10% for reserves that were primarily oil and 15% for reserves that were primarily natural gas.

Loss on disposal of assets

During the nine months ended September 30, 2010 the Company sold oil and gas assets which resulted in a loss of \$484 thousand which was not recorded under Previous GAAP because under the full cost method of accounting for oil and gas properties, a loss is not recognized on disposal of assets if the loss did not result in a change to the depletion rate of more than 20% for the cost centre.

During the year ended December 31, 2010 the Company sold oil and gas assets which resulted in a loss of \$473 thousand from that recorded under Previous GAAP due to changes to the carrying amounts of PP&E and decommissioning liabilities under IFRS.

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Three and nine months ended September 30, 2011 with 2010 comparatives
(All figures expressed in thousands except per share amounts unless otherwise noted)

21. Transition to IFRS (continued)

b. Exploration & evaluation assets

	Note	January 1, 2010 (\$)	September 30, 2010 (\$)	December 31, 2010 (\$)
Balance as per Previous GAAP		-	-	-
Transfer from PP&E on transition	(a)	4,966	4,966	4,966
Impairment on transition	(b)	(305)	(305)	(305)
Sale of assets		-	(300)	(300)
Reclassification from PP&E		-	10	10
Capitalized G&A	(n)	-	531	658
Balance as per IFRS		4,661	4,902	5,029

Impairment

Reclassified E&E assets were reviewed for impairment. Impairment of E&E assets of \$305 thousand was recognized on transition at January 1, 2010.

c. Deferred tax assets

	Note	January 1, 2010 (\$)	September 30, 2010 (\$)	December 31, 2010 (\$)
Balance as per Previous GAAP		1,442	2,273	2,293
Adjustment for flow-through shares issued in 2009	(f)	246	-	-
Deferred tax on IFRS adjustments on transition		2,027	2,027	2,027
Deferred tax on IFRS adjustments (valuation allowance)		-	(2,027)	(2,027)
Balance as per IFRS		3,715	2,273	2,293

d. Debentures payable

	Note	January 1, 2010 (\$)	September 30, 2010 (\$)	December 31, 2010 (\$)
Balance as per Previous GAAP and IFRS		3,060	6,835	7,074

In October 2009, the Company modified the terms of conversion of the Series 1 debentures payable. Under IFRS, this modification required recognition of costs of modifying the conversion ratio resulting in a charge to deficit of \$428 thousand and a corresponding increase to the equity component.

e. Decommissioning liabilities

	Note	January 1, 2010 (\$)	September 30, 2010 (\$)	December 31, 2010 (\$)
Balance as per Previous GAAP		4,326	4,187	4,613
Adjustment on transition	(e)	816	816	816
Adjustment of obligations on acquisitions/ dispositions	(e)	-	(162)	(156)
Change in estimate and rates		-	522	564
Accretion adjustments	(m)	-	(33)	(65)
Balance as per IFRS		5,142	5,330	5,772

IFRS 1 provides an exception that the Company has elected which allows an entity to measure decommissioning liabilities as at the date of transition to IFRS in accordance with IAS-37 and recognize any differences between that amount and the carrying amount of the liabilities determined under Previous GAAP directly in retained earnings. Under Previous GAAP, asset retirement obligations were discounted at a credit adjusted risk free rate of 5.75%. Under IFRS the estimated cash flow to abandon and remediate the wells and facilities has been risk adjusted therefore the provision is discounted at risk free rates that coincide with the expected time frame of the abandonments which will vary over time.

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21. Transition to IFRS (continued)

e. Decommissioning liabilities

As at January 1, 2010, decommissioning liabilities increased by \$816 thousand with a corresponding increase in deficit.

Decommissioning liabilities increased by \$489 thousand for the period ended September 30, 2010 and increased by \$499 thousand for the year ended December 31, 2010 as a result of the effect of change in discount rates used under IFRS and changes in accretion expense.

f. Flow-through share premium liability

	Note	January 1, 2010 (\$)	September 30, 2010 (\$)	December 31, 2010 (\$)
Balance as per Previous GAAP		-	-	-
Adjustment on transition	(f)	296	296	296
Adjustment for issuances of flow-through shares	(f)	-	138	1,290
Transfer to profit or loss	(f)	-	(365)	(662)
Balance as per IFRS		296	69	924

Under Previous GAAP, proceeds received from flow-through shares were included in their entirety in share capital and the estimated tax cost of issuing flow-through shares was reflected in share capital and deferred taxes when the expenditures were renounced. Under IFRS, the premium received on the flow-through shares, being the difference in price over a common share with no tax attributes, is not included in share capital, but rather is included on the balance sheet as a flow-through share premium liability. In addition, as the flow-through expenditures are incurred the deferred tax liability associated with the renounced tax deductions are recognized through profit or loss along with a pro-rata portion of the deferred premium.

On transition, the Company increased share capital by \$1,900 thousand reflecting the impact of eliminating the deferred income tax and the premiums on flow-through shares issued between 2005 and 2008 with a corresponding increase in deficit.

On transition, the Company also increased share capital by \$142 thousand reflecting the net impact of eliminating the premiums on flow-through shares issued in 2009 and the related deferred income tax in 2009. The corresponding effect was to increase deferred tax asset by \$246 thousand, deficit by \$92 thousand and increased flow-through share premium liability by \$296 thousand on January 1, 2010.

For the periods ended September 30, 2010 and December 31, 2010, the Company reclassified the premium for flow-through shares issued of \$138 thousand and \$1,290 thousand respectively from share capital. As the expenditures were incurred the premium was reclassified to profit or loss.

g. Preferred shares

	Note	January 1, 2010 \$	September 30, 2010 \$	December 31, 2010 \$
Balance as per Previous GAAP		2,056	2,056	2,056
Adjustment for equity component	(g)	(37)	(37)	(37)
Accretion on liability component	(g)	-	47	63
Balance as per IFRS		2,019	2,066	2,082

Under Previous GAAP, the Company valued the equity component of the preferred shares and used the residual method to value the debt component of the preferred shares. Under IFRS, the Company is required to initially value the liability component of the preferred shares and value the equity component as the difference between the fair value of the preferred shares and the fair value of the liability component. As at January 1, 2010, the liability component of the preferred shares decreased by \$37 thousand with a corresponding increase in the equity component of preferred shares of \$100 thousand and an increase in deficit of \$63 thousand.

The liability component of preferred shares increased by \$47 thousand as at September 30, 2010 and \$63 thousand as at December 31, 2010 as a result of changes in accretion with a corresponding increase in finance expenses.

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21. Transition to IFRS (continued)

h. Share capital

	Note	January 1, 2010 \$	September 30, 2010 \$	December 31, 2010 \$
Balance as per Previous GAAP		49,795	52,089	54,190
Adjustment for flow-through shares issued between 2005 and 2008	(f)	1,900	1,900	1,900
Adjustment for flow-through shares issued in 2009	(f)	(142)	(142)	(142)
Debenture series 1 modification	(d)	428	428	428
Preferred shares equity component	(g)	100	100	100
Flow-through share premium liability	(f)	-	(138)	(872)
Balance as per IFRS		52,081	54,237	55,604

i. Contributed surplus

	Note	January 1, 2010 \$	September 30, 2010 \$	December 31, 2010 \$
Balance as per Previous GAAP		1,675	2,021	2,053
Share-based payment adjustments	(p)	-	28	54
Balance as per IFRS		1,675	2,049	2,107

j. Deficit

	Note	January 1, 2010 \$	September 30, 2010 \$	December 31, 2010 \$
Balance as per Previous GAAP		(34,785)	(40,032)	(50,450)
Exploration and evaluation impairment		(305)	(305)	(305)
Property, plant & equipment impairment		(6,993)	(12,816)	(8,796)
Depletion and depreciation		-	2,934	4,198
Deferred tax		2,026	(209)	(627)
Decommissioning liabilities		(816)	(783)	(798)
Sale of assets		-	(339)	(329)
Flow-through shares		(1,806)	(1,442)	(1,145)
Preferred shares		(491)	(538)	(554)
Share-based payments		-	(70)	(100)
General and administrative expense		-	(548)	(656)
Balance as per IFRS		(43,170)	(54,148)	(59,562)

k. Provisions

Amounts disclosed as contingent liabilities under Previous GAAP were examined to determine the extent to which the contingent liabilities should be recognized as provisions. No additional provisions were considered necessary for such items.

l. Reclassifications

Certain amounts have been reclassified to conform with IFRS presentation.

m. Cash flow statements

Upon transition to IFRS, the only significant changes to operating and investing cash flows for the three and nine months ended September 30, 2010 and December 31, 2010 were related to the changes in capitalization of G&A expenses. There were no significant changes to financing cash flows for the three and nine months ended September 30, 2010 and year ended December 31, 2010.

n. Directly attributable general and administration expenses

Certain general and administration (G&A) expenses were capitalized under Previous GAAP which are not directly attributable to PP&E and therefore cannot be capitalized under IFRS. G&A expenses increased by \$548 thousand for the nine months ended September 30, 2010 and \$656 thousand for the year ended December 31, 2010. G&A expenses of \$530 thousand for the nine months ended September 30, 2010 and \$657 thousand for the year ended December 31, 2010 were allocated to E&E assets.

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21. Transition to IFRS (continued)

o. Finance expenses

Under Previous GAAP, accretion expense was included as part of depletion, depreciation and accretion in the statement of comprehensive loss. This item is presented as finance expenses under IFRS. The Company reclassified accretion expense of \$138 thousand for the nine months ended September 30, 2010 and \$231 thousand for the year ended December 31, 2010 to finance expenses. The Company increased finance expense by an amount of \$20 thousand and \$29 thousand relating to amounts reported as dividend payments under Previous GAAP for the nine month period ended September 30, 2010 and year ended December 31, 2010 respectively.

p. Share-based payments

Under Previous GAAP, share-based payments calculations did not consider each tranche in a stock option granted with graded vesting as a separate grant with a different vesting date and fair value. For stock options granted in 2010 additional share-based payments of \$70 thousand for the nine months ended September 30, 2010 and \$100 thousand for the year ended December 31, 2010 has been recognized with a corresponding increase in contributed surplus.

22. Future Accounting Changes

The following standards and interpretations have not been illustrated as they will only be applied for the first time in future periods. They may result in consequential changes to the accounting policies and other note disclosures. The Company is currently evaluating the impact of adopting these standards on its financial statements.

IFRS 9 Financial Instruments

As at January 1, 2015, the Company will be required to adopt IFRS 9 Financial Instruments, which is the result of the first phase of the International Accounting Standards Board's ("IASB") project to release IAS 19 Financial Instruments: Recognition and Measurement. The new standard was issued in November 2009 and replaces the current multiple classification and measurement models for financial assets and liabilities with a single model that has only two classification categories: amortized cost and fair value. IFRS 9 also replaces the models for measuring equity instruments, and such instruments are either recognized at fair value through net profit (loss) or at fair value through other comprehensive income (loss).

IFRS 10 Consolidated Financial Statements

IFRS 10 Consolidated Financial Statements is the result of the IASB's project to replace Standing Interpretations Committee 12, "Consolidation – Special Purpose Entities" and the consolidation requirements of IAS 27, "Consolidated and Separate Financial Statements". The new standard eliminates the current risk and rewards approach and establishes control as the single basis for determining the consolidation of an entity. IFRS 10 provides guidance on participating and protective rights and also addresses the notion of "de facto" control. It also includes guidance related to an investor with decision making rights to determine if it is acting as a principal or agent.

IFRS 11 Joint Arrangements

IFRS 11 Joint Arrangements is the result of the IASB's project to replace IAS 31, "Interests in Joint Ventures". The new standard redefines "joint operations" and "joint ventures" and requires joint operations to be proportionately consolidated and joint ventures to be equity accounted. Under IAS 31, joint ventures could be proportionately accounted. The Company expects its joint venture arrangements will continue to meet the definition of "joint operations" and that proportionate consolidation of such arrangements will continue under the new standard.

IFRS 12 Disclosure of Interests in Other Entities I

IFRS 12 Disclosure of Interests in Other Entities outlines the required disclosures for interests in subsidiaries and joint arrangements. The new standard requires disclosure of additional information that will assist financial statement users to evaluate the nature, risks and financial effects associated with an entity's interests in subsidiaries and joint arrangements.

IFRS 13 Fair Value Measurement

IFRS 13 is a comprehensive standard for fair value measurement and disclosure requirements for use across all IFRS standards. The new standard clarifies that fair value is the price that would be received to sell an asset, or paid to transfer a liability in an orderly transaction between market participants, at the measurement date. It also establishes disclosures about fair value measurement. Under existing IFRS, guidance on measuring and disclosing fair value is dispersed among the specific standards requiring fair value measurements and in many cases does not reflect a clear measurement basis or consistent disclosures.

IAS 1 Presentation of Financial Statements

In June 2011, the IASB issued an amendment to IAS 1 Presentation of Financial Statements requiring companies to group items presented within other comprehensive income (loss) based on whether they may be subsequently reclassified to net profit (loss). This amendment to IAS 1 is effective for annual periods beginning on or after July 1, 2012 with full retrospective application. Early adoption is permitted.

Management's Discussion & Analysis

The following Management's Discussion and Analysis ("MD&A") of FairWest Energy Corporation (the "Company") is Management's explanation of the operating and financial results for the quarter ended September 30, 2011, as well as estimates of future operating and financial performance based on information currently available. It should be read in conjunction with the annual MD&A and audited financial statements of the Company for the year ended December 31, 2010, together with the accompanying notes and the interim MD&A and unaudited financial statements for the periods ended March 31, 2011 and June 30, 2011.

Basis of presentation

The financial statements, MD&A and comparative information have been prepared in Canadian dollars unless otherwise indicated and in accordance with International Financial Reporting Standards ("IFRS") representing generally accepted accounting principles ("GAAP") for publically accountable enterprises in Canada. The transition date to IFRS was January 1, 2010 and comparative figures for 2010 and the Company's financial position as at January 1, 2010 have been restated to IFRS from the previous Canadian generally accepted accounting principles ("Previous GAAP"). Reconciliations to IFRS from Previous GAAP financial statements including the impact of the transition on the Company's reported financial position and financial performance, and the nature and effect of significant changes in accounting policies from those used in the Company's financial statements for the year ended December 31, 2010 are summarized in note 21 of the March 31, 2011 and June 30, 2011 unaudited financial statements.

The term barrels of oil equivalent ("boe") may be misleading particularly if used in isolation. All boe conversions in this report are derived by converting gas to oil in the ratio of six thousand cubic feet of gas to one barrel of oil. A boe conversion ratio of 6 mcf : 1 bbl is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead. All amounts of boe/d, bbl/d, mcf/d, \$/boe, \$/bbl and \$/mcf are not expressed in thousands.

Unless otherwise stated and other than per unit items, all figures are presented in thousands.

Core businesses overview and strategy

These financial statements have been prepared on a going concern basis which assumes that the Company will be able to realize its assets and discharge its liabilities in the normal course of business for the foreseeable future. Wells drilled on the farmout lands have yielded promising results and have indicated numerous potential additional locations and reserves. The Company expects to continue to improve its working capital position during the balance of 2011 and into 2012 by increasing production levels from the farmout drilled wells and from workovers on existing wells. As at September 30, 2011, the Company has a working capital deficiency of \$6,531 thousand, net loss of \$1,410 thousand and negative cash flow from operating activities of \$3,067 thousand. Included in the working capital deficiency is bank debt of \$4,208 thousand. The working capital deficiency at December 31, 2010 was \$8,191 thousand, including \$2,490 thousand of bank debt and \$2,082 thousand of preferred share debt. The decrease in the working capital deficiency was achieved by conversion of preferred shares to common equity, the sale of equity and the sale of undeveloped land.

Current production is approximately 380 boe/d and is expected to increase by December 31, 2011, when wells drilled under two farmout agreements (the "farmout wells") are expected to be on production. The current production is weighted approximately 25% oil, up from December 31, 2010 levels of approximately 15%. The Company is continuing to focus on oil production and expects that by year end the ratio of oil to gas production will be approximately 30/70. This will increase cash flows due to the relatively stronger oil price, as compared to gas, which the Company expects to continue into 2012. The Company is continuing to review its existing inventory of wells to identify incremental production opportunities that can be achieved with optimization and workover programs.

Holders of Series 1 and 2 debentures in the amount of \$2,084 thousand elected to convert to common shares to September 30, 2011, reducing the Company's long term debt. An additional \$487 thousand series 2 debentures were converted to common equity, subsequent to September 30, 2011. Series 1 and 2 debentures pay 14% interest and conversion has eliminated the obligation to pay interest in the amount of \$360 thousand annually. The Company anticipates that more debenture holders may convert to common shares during 2011.

The Company has a credit facility with its lender in the amount of \$8,000 thousand. The credit facility is secured by a \$35,000 thousand debenture against the Company's assets and a \$5,000 thousand guarantee from a significant shareholder. The lender is presently conducting an interim credit review. The Company is not in breach of any covenants with regard to the credit facility.

The Company's ability to continue as a going concern and to fully exploit and carry out its planned exploration and development program is contingent upon positive cash flow from operating activities, favourable commodity prices, the maintenance of its existing reserve and production base, successful drilling activities, the availability of financing from its secured lender and the continued support of its creditors.

The information contained herein is current as of November 24, 2011.

Management's Discussion and Analysis

Non-GAAP Measurements - This MD&A contains the terms funds flow from operations and operating netback. These terms should not be considered an alternative to, or more meaningful than cash flow from operating activities or net income as determined in accordance with Canadian GAAP as an indicator of the Company's performance. The Company's determination of funds flow from operations may not be comparable to that reported by other companies, especially those in other industries. Funds flow from operations represents net earnings adjusted for non-cash items including, but not limited to, depletion and depreciation, accretion, stock-based compensation, future income taxes, unrealized gain or loss on financial contracts, loss on compound instrument, impairment and gain on flow-through share premium liability. The Company evaluates its performance based on earnings and funds flow from operations. Operating netback is a non-GAAP measurement that represents profit margins realized by the production and sale of petroleum and natural gas. The Company considers funds flow from operations and operating netbacks key measures that demonstrate the Company's ability to generate the funds flow necessary to fund future growth through capital investment and to repay debt.

	September 30, 2011 (3 Months)	September 30, 2010 (3 Months)	September 30, 2011 (9 Months)	September 30, 2010 (9 Months)
Cash flow from operating activities (\$)	(744)	(970)	(3,067)	(3,162)
Changes in non-cash working capital (\$)	(255)	(308)	518	1,214
Decommissioning liability expenditures (\$)	-	-	-	3
Funds flow from operations (\$)	(999)	(1,278)	(2,549)	(1,945)

Forward-Looking Statements

Certain statements contained in this MD&A and in certain documents incorporated by reference into this MD&A, constitute forward-looking statements. These statements relate to future events or future performance. All statements other than statements of historical fact may be forward-looking statements. Forward-looking statements are often, but not always, identified by the use of words such as "seek", "anticipate", "budget", "plan", "continue", "estimate", "expect", "forecast", "may", "will", "project", "predict", "potential", "targeting", "intend", "could", "might", "should", "believe" and similar expressions. These statements involve known and unknown risks, uncertainties and other factors that may cause actual results or events to differ materially from those anticipated in such forward-looking statements. Management believes the expectations reflected in those forward-looking statements are reasonable but no assurance can be given that these expectations will prove to be correct and such forward-looking statements included in, or incorporated by reference into, this MD&A or as of the date specified in the documents incorporated by reference into this MD&A, as the case may be.

In particular, this MD&A and the documents incorporated by reference, contain forward-looking statements pertaining to the following:

- the performance characteristics of the Company's oil and natural gas properties;
- the Company's oil and natural gas production levels;
- the size of the Company's oil and natural gas reserves;
- projections of market prices and costs;
- supply and demand for oil and natural gas;
- expectations regarding the ability to raise capital and to continually add to reserves through acquisitions and development;
- treatment under governmental regulatory regimes and tax laws; and
- capital expenditures programs.

The actual results could differ materially from those anticipated in these forward-looking statements as a result of risk factors set forth below and elsewhere in this MD&A:

- volatility in market prices for oil and natural gas;
- liabilities inherent in oil and natural gas operations;
- uncertainties associated with estimating oil and natural gas reserves;
- competition for, among other things, capital, acquisitions of reserves, undeveloped lands and skilled personnel;
- incorrect assessments of the value of acquisitions;
- geological, technical, drilling and processing problems; and
- changes in income tax laws or changes in tax laws and incentive programs relating to the oil and gas industry and income trusts.

Statements relating to "reserves" or "resources" are deemed to be forward-looking statements, as they involve the implied assessment, based on certain estimates and assumptions, that the resources and reserves described can be profitably produced in the future. Readers are cautioned that the foregoing lists of factors are not exhaustive. The forward-looking statements contained in this MD&A and the documents incorporated by reference herein are expressly qualified by this cautionary statement. Except as required by applicable securities law, the Company does not undertake any obligation to publicly update or revise any forward-looking statements.

Management's Discussion and Analysis

Financial Strategy in Current Economic Environment

The economic environment in Canada is holding steady and perhaps improving slightly, although the future outlook is uncertain due to the economic crisis in Europe and continued depressed economic outlook in the United States. Decreased demand for goods and services in these parts of the world affects the commodity prices and the value of the Canadian dollar. The price of natural gas remains depressed and it is not expected to increase significantly over the next year. Pipeline capacity in the United States is affecting the price of oil to the downside at the southern refineries. Oil prices are at a relatively good level, but fluctuate as economic outlooks change in other parts of the world. The firmer oil prices are positive for the Company as the ratio of oil production to natural gas production has increased to 25% at September 30, 2011, from 15% at December 30, 2010. The Company continues to focus on oil production to improve financial strength, including generating free cash flow.

Quarterly Performance

The Company is engaged in the exploration for and the acquisition, development and production of, oil and natural gas reserves in the provinces of Alberta and Saskatchewan. Quarterly performance is as follows:

Financial Highlights ⁽¹⁾	2010-2011 IFRS				2010			2009 Previous GAAP
	Sept. 30, 2011 (3 Months) (\$)	June 30, 2011 (3 Months) (\$)	Mar. 31, 2011 (3 Months) (\$)	Dec. 31, 2010 (3 Months) (\$)	Sept. 30, 2010 (3 Months) (\$)	June 30, 2010 (3 Months) (\$)	Mar. 31, 2010 (3 Months) (\$)	Dec. 31, 2009 (3 Months) (\$)
Revenue								
Petroleum and natural gas sales, net of royalties	853	1,007	958	1,121	1,027	1,191	1,369	1,334
Net (income) loss	(2,218)	2,287	1,340	5,413	4,878	3,488	2,612	2,434
Funds flow from operations	(999)	(827)	(721)	(861)	(1,278)	(390)	(277)	(887)
Basic (earnings) loss per share	(0.010)	0.010	0.006	0.033	0.033	0.027	0.020	0.019
Diluted (earnings) loss per share	(0.010)	0.010	0.006	0.033	0.033	0.027	0.020	0.019
Share Data:								
Common shares outstanding	240,856,652	225,669,291	222,701,144	192,301,620	153,879,936	149,279,936	129,839,879	129,839,879
Weighted shares outstanding	232,895,491	224,760,592	196,588,214	145,415,353	149,329,936	133,129,687	129,839,879	129,839,879
Preferred shares	-	-	-	211,259	211,259	211,259	211,259	211,259
Common share warrants	576,957	576,957	600,104	600,104	2,600,238	7,600,238	6,233,400	5,000,000
Flow-through share warrants	-	6,250,000	6,250,000	6,250,000	6,250,000	6,250,000	6,250,000	6,250,000
Options	19,925,000	20,275,000	12,775,000	12,875,000	12,875,000	12,375,000	12,325,000	6,725,000
Highlights of Operations								
Natural gas								
Volume – mcf/d	1,401	1,446	1,554	2,141	1,966	1,949	2,371	2,540
\$/mcf	3.38	4.32	3.83	4.18	4.35	4.35	5.28	4.66
Oil and NGLs								
Volume – bbl/d	76	71	73	55	52	62	58	57
\$/bbl	86.17	84.28	78.32	72.10	66.83	66.49	73.13	71.40
Barrel of oil equivalent								
Volume – boe/d	310	312	332	412	380	387	453	480

(1) The Company's IFRS transition date was January 1, 2010. Comparative information for 2009 has not been restated.

Management's Discussion and Analysis

Petroleum and Natural Gas Sales

The following table represents revenue, sales volumes and average prices received from the sale of petroleum and natural gas for the periods indicated:

	September 30, 2011 (3 Months)	September 30, 2010 (3 Months)	September 30, 2011 (9 Months)	September 30, 2010 (9 Months)
Revenue				
Natural gas revenue (\$)	436	786	1,541	2,685
Oil and natural gas liquids revenue (\$)	606	319	1,667	1,075
Petroleum and natural gas sales (\$)	1,042	1,105	3,208	3,760
Royalty (\$)	(189)	(78)	(390)	(173)
Petroleum and natural gas sales, net of royalty expense (\$)	853	1,027	2,818	3,587
Petroleum and natural gas sales (\$/boe)	36.55	31.68	36.96	33.90
Sales Volumes				
Natural gas (mmcf)	129	181	400	572
Oil and natural gas liquids (mmbbls)	7	5	20	16
MBoe	29	35	87	111
Boe/d	310	380	318	406
Average Sales Price				
Natural gas (\$/mcf)	3.38	4.35	3.85	4.70
Oil and natural gas liquids (\$/bbl)	86.17	66.83	83.01	68.78

Production declined to an average of 318 boe/d during the nine month period ended September 30, 2011 compared to 406 boe/d during the same period in 2010. This is a result of natural declines, the sale of interests in several areas and curtailed capital expenditures to accommodate restructuring efforts. Due to the unusually cold and wet spring, the Company experienced more than the usual weather related shut-in production in the first half of 2011. Sale of properties accounts for approximately 30 boe/d of decline in sales volume with severe weather and natural declines accounting for the balance. Current production has increased to approximately 380 boe/d and is expected to increase by December 31, 2011. Results from drilling activity on the Company's farmouts at Provost and Kirkpatrick Lake have produced encouraging results in the third quarter and the Company expects additional production to come on stream in December 2011 from these wells, which accounts for the majority of the increased production.

Natural gas prices averaged \$3.38/mcf during the third quarter of 2011 compared to \$4.35/mcf during the corresponding period in 2010. Natural gas prices have remained soft in the second half of 2011 and the Company expects this to continue into 2012. The Company had 1,000 GJ/d of natural gas under fixed price contracts for 2010 at an average price of \$4.86/GJ. The contracts expired December 31, 2010. For 2011, the Company has entered into monthly fixed physical contracts and will continue to do so. These contracts are at substantially lower prices than the 2010 longer term contracts.

Oil and natural gas liquids prices increased during the third quarter of 2011 to \$86.17/bbl versus \$66.83/bbl during the same period of 2010. On a relative basis oil and natural gas liquids still commands a higher price over natural gas and this has continued in 2011 with oil prices continuing to increase further. The Company is focusing on oil projects in 2011 to capture the higher netbacks from oil. At September 30, 2011, the Company was approximately 75% weighted in gas production, but anticipates being closer to 70% gas, 30% oil by year end as new oil production comes on stream. The Company recently entered into a six month physical contract for approximately half its oil production, with a floor price of CDN \$90.00/bbl and a ceiling price of CDN \$94.00/bbl, based on West Texas Intermediate ("WTI") pricing. The price will be adjusted for transportation to an Alberta price. For the three months ended September 30, 2011, revenue from oil and natural gas liquids represented 58% of total petroleum and natural gas revenue even though it only accounted for 25% of total volumes.

Royalties

The following table shows royalty expense for the periods indicated:

	September 30, 2011 (3 Months)	September 30, 2010 (3 Months)	September 30, 2011 (9 Months)	September 30, 2010 (9 Months)
Royalties (\$)	189	78	390	173
% of sales	18.1	7.1	12.2	4.6
\$/boe	6.63	2.23	4.49	1.56

Royalties as a percentage of sales increased to 12.2% in the nine month period ended September 30, 2011, from 4.6% in 2010. Royalties increased in the third quarter of 2011 due to an adjustment for the years 2006 to 2009 on the Jumpbush property. This adjustment accounts for approximately \$100 thousand or 53.0% of the total royalty in the third quarter and 26.0% of the royalty for the year to date. Royalties are expected to increase as the Company brings on more production.

Management's Discussion and Analysis

Royalty Income

The following table shows royalty income for the periods indicated:

	September 30, 2011 (3 Months)	September 30, 2010 (3 Months)	September 30, 2011 (9 Months)	September 30, 2010 (9 Months)
Royalty income (\$)	7	2	20	43
\$/boe	0.25	0.06	0.23	0.39

Operating

The following table shows operating costs for the periods indicated:

	September 30, 2011 (3 Months)	September 30, 2010 (3 Months)	September 30, 2011 (9 Months)	September 30, 2010 (9 Months)
Operating (\$)	1,017	845	2,866	2,579
Processing fee income (\$)	(86)	(76)	(226)	(235)
Total (\$)	931	769	2,640	2,344
\$/boe	32.65	22.02	30.42	21.14

For the nine month period ended September 30, 2011, per unit operating costs were \$30.42/boe as compared to \$21.14/boe during the same period in 2010. This is attributed to lower production volumes. Some production costs such as surface lease rentals and municipal taxes are fixed and do not decrease with production. Also included in operating costs for the three and nine months ended September 30, 2011 is approximately \$168 thousand for a processing fee equalization adjustment on a property that was sold during 2010. This adjustment increases operating costs by \$5.89/boe and \$1.94/boe respectively for the three and nine month period in 2011. The Company expects to lower per unit operating costs in 2011, through continued overall cost reductions and increased production volumes.

Extremely cold and wet weather in the first half of 2011 were a major factor contributing to the increased operating costs. Due to extreme conditions, there was more than the usual shut-in production as wells could not be maintained. In addition, operating costs for snow removal and other weather related expenditures were significantly increased. Shut-in production was not fully restored until the third quarter of 2011. Operating costs should decrease on a per boe basis as production increases in the fourth quarter.

Operating expenses are analyzed by the Company net of processing income which represents the recovery of processing costs incurred by third parties at the Company's facilities. The amount of processing income is completely variable with the volume of third-party gas being flowed through the Company's facilities. There are no long term fixed contracts with respect to this throughput.

Netbacks

The following table shows operating netbacks for the periods indicated:

	September 30, 2011 (3 Months)	September 30, 2010 (3 Months)	September 30, 2011 (9 Months)	September 30, 2010 (9 Months)
Petroleum and natural gas sales (\$)	1,042	1,105	3,208	3,760
Processing fee income (\$)	86	76	226	235
Royalties (\$) ⁽¹⁾	(189)	(78)	(390)	(173)
Operating expense (\$) ⁽²⁾	(1,017)	(845)	(2,866)	(2,579)
Operating netback (\$)	(78)	258	178	1,243
Petroleum and natural gas sales (\$/boe)	36.55	31.68	36.96	33.90
Processing fee income (\$/boe)	3.02	2.18	2.60	2.12
Royalties (\$/boe) ⁽³⁾	(6.63)	(2.23)	(4.49)	(1.56)
Operating (\$/boe) ⁽⁴⁾	(35.67)	(24.20)	(33.02)	(23.26)
Operating netback (\$/boe)	(2.73)	7.43	2.05	11.20

(1) Three and nine month periods in 2011, include a \$100 thousand adjustment that relates to a prior period.

(2) Three and nine month periods in 2011, include a \$168 thousand adjustment that relates to a prior period.

(3) Three and nine month periods in 2011, include an adjustment for a prior period of \$3.51/boe and \$1.15/boe respectively.

(4) Three and nine month periods in 2011, include an adjustment for a prior period of \$5.89/boe and \$1.94/boe respectively.

Management's Discussion and Analysis

General and Administrative

The following table shows general and administrative expense for the periods indicated:

	September 30, 2011 (3 Months)	September 30, 2010 (3 Months)	September 30, 2011 (9 Months)	September 30, 2010 (9 Months)
Gross general and administrative (\$)	644	999	2,133	2,488
Capitalized general and administrative (\$)	(132)	(152)	(446)	(578)
Net general and administrative (\$)	512	847	1,687	1,910
Gross general and administrative (\$/boe)	22.59	28.61	24.57	22.43
Capitalized general and administrative (\$/boe)	(4.63)	(4.35)	(5.13)	(5.21)
Net general and administrative (\$/boe)	17.96	24.26	19.44	17.22

For the nine month period ended September 30, 2011 the Company capitalized \$446 thousand (2010 - \$578 thousand) of overhead expenses. The Company expects general and administrative ("G&A") expenses to decrease in 2011 on a per boe basis as production increases and it continues to emphasize cost reduction. For the nine month period ended September 30, 2011, gross G&A expense has decreased by \$355 thousand or 14.0% despite the cost of conversion to IFRS which attributes to approximately \$200 thousand of G&A costs incurred to date in 2011.

Funds Flow from Operations

The following table shows funds flow from operations for the periods indicated:

	September 30, 2011 (3 Months)	September 30, 2010 (3 Months)	September 30, 2011 (9 Months)	September 30, 2010 (9 Months)
Funds flow from operations (\$)	(999)	(1,278)	(2,549)	(1,945)
\$/boe	(35.04)	(36.51)	(29.36)	(17.52)

Lower production is a significant factor affecting funds flow from operations. Production for the nine month period ended September 30, 2011 was 318 boe/d compared to 406 boe/d for the same period in 2010. Current production is approximately 380 boe/d and is expected to increase by December 31, 2011. This increase has been achieved from drilling results on the farmout lands and workover and optimization projects. During 2011, the Company also had negative adjustments of \$100 thousand to royalty expense and \$168 thousand to operating costs. Both of these adjustments relate to prior periods and resulted in a \$9.40/boe decrease in per unit funds flow from operations.

Low natural gas prices are another large factor in negative funds flow from operations. The price for gas was \$3.85/mcf for the nine month period ended September 30, 2011, compared to \$4.70/mcf for the same period in 2010. The price for oil and natural gas liquids was \$83.01/bbl for the nine month period ended September 30, 2011, compared to \$68.78/bbl for the same period in 2010. At September 30, 2011, the Company was weighted 75% gas and 25% oil production.

Share-based Compensation

The following table shows the share-based compensation expense for the periods indicated:

	September 30, 2011 (3 Months)	September 30, 2010 (3 Months)	September 30, 2011 (9 Months)	September 30, 2010 (9 Months)
Share-based compensation (\$)	114	40	488	192
\$/boe	4.00	1.15	5.62	1.73

The share-based compensation for the nine month period ended September 30, 2011 was \$555 thousand (2010 - \$211 thousand). Of this total, \$488 thousand (2010 - \$192 thousand) was expensed and \$67 thousand (2010 - \$19 thousand) was capitalized. The increase in share-based expense is due to an additional 7,700,000 options granted in the second quarter of 2011. Share-based payments are used to provide incentive to employees, officers and directors on a cost effective basis to the Company as they are not cash based. The Company uses the Black-Scholes option pricing model to calculate share-based compensation.

Management's Discussion and Analysis

Depletion, Depreciation and Impairment

The following table shows depletion, depreciation and impairment expense for the periods indicated:

	September 30, 2011 (3 Months)	September 30, 2010 (3 Months)	September 30, 2011 (9 Months)	September 30, 2010 (9 Months)
Depletion and depreciation (\$)	397	442	1,253	1,507
Exploration and Evaluation Impairment (\$)	5	-	59	-
Property, Plant and Equipment Impairment (Reversal) (\$)	(2,538)	2,409	(1,137)	5,823
Total (\$)	(2,136)	2,851	175	7,330
\$/boe	(74.93)	81.66	2.02	66.10

Future development costs on proved reserves of \$2,934 thousand are included in the calculation of depletion and depreciation (2010 - \$2,194 thousand).

There was a net \$2,538 thousand impairment reversal for the nine month period ended September 30, 2011 (2010 - \$5,823 thousand impairment). The 2011 reversal is a result of additional oil reserves added by the farmout wells completed in the third quarter. Natural gas price declines are the largest factor contributing to the 2010 impairment and this trend has continued into 2011 to a lesser extent. Impairments are based on the Company's independent reserve evaluation's discounted cash flows, updated by management. The cost of unproved properties and decommissioning liability that are not included in the independent reserve evaluation are added to the cash flows. The resulting value is compared to the net book value ("NBV") of the Company's property and equipment assets. If the NBV is greater than the adjusted cash flows, the NBV is written down to that amount. If the NBV is less than the adjusted cash flows, the NBV is written up to that amount, but not greater than the depleted amount prior to any impairment.

Net (Income) Loss

The net loss for the nine month period ended September 30, 2011 is \$1,410 thousand (2010 - \$10,978 thousand). Depletion, depreciation and impairment in the amount of \$7,330 thousand was the most significant factor in 2010. During 2011, due to impairment reversals, these items are not as significant.

	September 30, 2011 (3 Months)	September 30, 2010 (3 Months)	September 30, 2011 (9 Months)	September 30, 2010 (9 Months)
Net (income) loss (\$)	(2,218)	4,878	1,410	10,978
\$/boe	(77.80)	139.71	16.24	98.99

Unrealized Gain (Loss) on Financial Contracts

The following table shows unrealized gain (loss) on financial contracts for the periods indicated:

	September 30, 2011 (3 Months)	September 30, 2010 (3 Months)	September 30, 2011 (9 Months)	September 30, 2010 (9 Months)
Unrealized gain (loss) (\$)	-	(35)	-	264
\$/boe	-	(1.00)	-	2.38

At September 30, 2010, the Company had two long-term forward averaging contracts as described below:

- A fixed price physical contract to sell 500 GJ/d at a price of \$4.86/GJ for calendar 2010. The fair value at September 30, 2010 was \$62 thousand.
- A physical contract to sell 500 GJ/d for the period February 2010 to December 2010 with a floor price of \$5.00/GJ and a ceiling price of \$6.35/GJ. The fair value at September 30, 2010 was \$68 thousand.

For 2011, the Company is entering into monthly physical contracts to help mitigate commodity price risk. These contracts are at substantially lower prices than the 2010 longer term contracts. Due to the short duration of these contracts there is no gain or loss recorded. The Company will continue to monitor natural gas prices and may enter into longer term contracts if forward prices fall significantly from the current spot prices. The Company has entered into a six month physical contract for approximately half of its oil production with a floor price of CDN \$90.00/bbl and a ceiling price of CDN \$94.00/bbl, based on WTI pricing. The price will be adjusted for transportation to an Alberta price.

Gain on Settlement of Debt

The following table shows gain on settlement of debt for the periods indicated:

	September 30, 2011 (3 Months)	September 30, 2010 (3 Months)	September 30, 2011 (9 Months)	September 30, 2010 (9 Months)
Gain on settlement of debt (\$)	-	-	-	173
\$/boe	-	-	-	1.56

Management's Discussion and Analysis

In 2010, the Company settled \$831 thousand of unsecured trade debt with \$180 thousand cash, 6,510,057 common shares and 551,571 common share purchase warrants. The deemed price of the common shares issued was \$0.10 per share and the warrants are exercisable into common shares at a price of \$0.15 per share until September 30, 2012. This transaction resulted in a gain of \$173 thousand.

Gain on Flow-through Share Premium

The following table shows gain on flow-through share premium for the periods indicated:

	September 30, 2011 (3 Months)	September 30, 2010 (3 Months)	September 30, 2011 (9 Months)	September 30, 2010 (9 Months)
Gain on flow-through share premium (\$)	108	132	527	365
\$/boe	3.79	3.78	6.07	3.29

Eligible expenditures incurred that result in tax pools that can be flowed-through to investors in flow-through equity result in a decrease to the flow-through share premium liability and an offsetting gain to income.

Gain (Loss) on Compound Financial Instrument

The following table shows loss on compound financial instrument for the periods indicated:

	September 30, 2011 (3 Months)	September 30, 2010 (3 Months)	September 30, 2011 (9 Months)	September 30, 2010 (9 Months)
Gain (Loss) on compound financial instrument (\$)	220	-	(353)	-
\$/boe	7.72	-	(4.07)	-

Modification of the terms of the preferred shares as discussed under liquidity and capital resources has resulted in an addition to preferred share equity and an offsetting loss to income in the amount of \$493 thousand. Modifications of the Series 2 debentures has resulted in a decrease in the debentures payable and a corresponding net gain to income in the amount of \$140 thousand. Combined, these modifications resulted in a net loss of \$353 thousand.

Gain (loss) on Disposal of Assets

The following table shows gain (loss) on disposal of assets for the periods indicated:

	September 30, 2011 (3 Months)	September 30, 2010 (3 Months)	September 30, 2011 (9 Months)	September 30, 2010 (9 Months)
Gain (loss) on disposal of assets (\$)	(13)	(324)	1,036	(422)
\$/boe	(0.46)	(9.28)	11.93	(3.81)

During the third quarter of 2011, the Company realized a \$4 thousand gain on the sale of seismic and a loss of \$17 thousand relating to a former subsidiary of the Company. During the nine months ended September 30, 2011, the most significant gain on disposal of assets was the sale of a 20.0% interest in undeveloped land which resulted in a gain of \$972 thousand.

During the first quarter of 2010, the Company sold a gas well in the Provost area and realized a \$212 thousand loss on the sale. During the second quarter of 2010, the Company sold assets in the Provost area and realized a gain of \$14 thousand. The Company also realized a gain of \$100 thousand relating to a former subsidiary of the Company during the second quarter of 2010. The Company realized a net loss of \$324 thousand on the sale of oil and gas assets during the third quarter of 2010, in the Provost and Berry areas.

Finance Income

The following table shows finance income for the periods indicated:

	September 30, 2011 (3 Months)	September 30, 2010 (3 Months)	September 30, 2011 (9 Months)	September 30, 2010 (9 Months)
Finance income (\$)	6	41	19	137
\$/boe	0.21	1.17	0.22	1.24

The interest charged in 2010 relates to interest charged on notes receivable from related parties. The amount of notes receivable decreased during 2010 from \$2,700 thousand at the beginning of the year to \$500 thousand at the end of the year. The Company expects the note to be repaid by the end of 2011 and interest income to continue to decrease throughout the remainder of the year.

Management's Discussion and Analysis

Finance Expenses

The following table shows finance expenses for the periods indicated:

	September 30, 2011 (3 Months)	September 30, 2010 (3 Months)	September 30, 2011 (9 Months)	September 30, 2010 (9 Months)
Finance expense (\$)	468	732	1,122	1,453
Accretion (\$)	67	130	248	379
Total (\$)	535	862	1,370	1,832
\$/boe	18.80	24.69	15.79	16.52

Interest on the credit facility is the bank's prime rate plus 2.5% on the first \$3.0 million drawn on the line and the bank's prime rate on the balance of the amount drawn. The bank's prime rate at September 30, 2011 was 3.0%. Included in finance expense for the nine month period ended September 30, 2011 is a \$25 thousand bank fee charged for the breach of the working capital covenant with the Company's lender and a guarantee fee of \$150 thousand paid to a significant shareholder. For the nine month period ended September 30, 2010, a bank fee of \$50 thousand is included in interest expense. The \$50 thousand fee relates to an agreement with the Company's previous lender.

At December 31, 2010, the Company had total debenture financing of \$7,250 thousand. The interest paid on these debentures is 14.0%. During the nine months ended September 30, 2011, Series 1 and 2 debenture holders in the amount of \$2,084 thousand elected to convert their debentures to 13,893,340 common shares at an exercise price of \$0.15. Subsequent to the third quarter of 2011, an additional \$487 thousand Series 2 debenture holders elected to convert to common equity. The Company expects that more debenture holders may elect to convert to common shares during the balance of 2011. As debenture holders convert to common shares, interest expense will be reduced.

Included in finance expenses is accretion relating to the liability component of debentures, preferred shares and decommissioning liability.

Part XII.6 Tax

Part XII.6 tax is levied when a company allocates income tax expenditures to a flow-through shareholder prior to the date the actual expenditures are incurred. A total of \$1,229 thousand of qualified expenditures were incurred during the nine month period ended September 30, 2011 (2010 - \$985 thousand). Proceeds from sales of flow-through shares sold by the Company in 2010 require that a further \$766 thousand of qualified expenditures be spent by December 31, 2011. The Company expects to incur these expenses within the prescribed time period.

During 2008, the Canada Revenue Agency ("CRA") initiated an audit of the Company's (including a previous subsidiary) flow-through share offerings for the 2004, 2005 and 2006 taxation years. On February 26, 2009, the Company received a letter from CRA indicating they believed the Company had a shortfall of \$3,295 thousand of flow-through eligible expenditures. These findings were summarized in a subsequent letter dated March 20, 2009. CRA subsequently issued a notice of reassessment. The Company does not believe the reassessment is valid and filed a notice of objection on July 29, 2009. The CRA acknowledged receipt of the objection in a letter dated December 20, 2009. To date, the Company has not received any correspondence from the appeal division of the CRA, but has received verbal confirmation that the CRA is reviewing the notice of objection. Management's assessment is that any amounts that may be payable by the Company to CRA and/or investors resulting from the above will not be material.

The following table shows part XII.6 tax for the periods indicated:

	September 30, 2011 (3 Months)	September 30, 2010 (3 Months)	September 30, 2011 (9 Months)	September 30, 2010 (9 Months)
Part XII.6 tax (recovery) (\$)	-	-	5	-
\$/boe	-	-	0.06	-

Capital Expenditures

The following table sets out capital expenditures of the Company:

	September 30, 2011 (9 Months)		September 30, 2010 (9 Months)	
	PP&E (\$)	E&E (\$)	PP&E (\$)	E&E (\$)
Lease rental	173	-	197	-
Seismic	-	-	-	-
Drilling, completions and workovers	788	-	98	-
Decommissioning liabilities	(122)	-	598	-
Equipping and tie-in	819	-	473	-
Property dispositions and adjustments	(89)	(81)	(2,944)	(300)
Property acquisitions and adjustments	350	-	-	-
Undeveloped land acquisition	-	44	-	11
Other	-	-	12	-
Capitalized expenditures	105	408	67	530
Total	2,024	371	(1,499)	241

Management's Discussion and Analysis

Liquidity and Capital Resources

The Company has capitalized on its extensive land base with a small capital investment during 2011. It did so by entering into farmout agreements with third parties, whereby a total of 8 horizontal wells have been drilled on the Company lands with minimal cash investment by the Company. The results from the wells that are currently on production have added approximately 45 boe/d (65% oil) production. The Company anticipates that when all wells are on production, they will add, in total, 100 boe/d of primarily oil production. The results of this drilling has opened up numerous potential drilling opportunities which can be pursued, depending on availability of capital and other farmout opportunities.

The Company converted \$2,084 thousand of Series 1 and 2 debentures into common equity at a conversion price of \$0.15, to September 30, 2011. These debentures paid interest at a rate of 14% annually, which corresponds to a \$292 thousand annual savings in interest expense. Subsequent to September 30, 2011, the Company to date, has converted an additional \$487 thousand of Series 2 debentures and expects to convert more prior to year end.

The Company has received an increase from its lender to the credit facility to \$8,000 thousand. This facility is secured by a \$35,000 thousand debenture on the Company's assets and a \$5,000 thousand guarantee by a significant shareholder. The lender is currently conducting an interim review of the credit facility. The Company anticipates continued support from both its lender and significant shareholder.

The Company is continuing to pursue sales of assets and reduction to G & A costs to improve its working capital position.

Changes in the number of options, with weighted average exercise prices are summarized as follows:

	September 30, 2011		December 31, 2010	
	Number of Options	Weighted Average Exercise Price (\$)	Number of Options	Weighted Average Exercise Price (\$)
Balance, beginning of period	12,875,000	0.119	6,725,000	0.212
Granted	7,700,000	0.197	7,950,000	0.100
Cancelled	(450,000)	(0.150)	(1,800,000)	0.385
Exercised	(200,000)	(0.100)	-	-
Balance, end of period	19,925,000	0.149	12,875,000	0.119
Exercisable	12,141,691	0.139	7,574,998	0.133

The options cancelled were to former employees and one director of the Company.

As at September 30, 2011, the following options are outstanding:

Number of common shares under option	Exercisable Options	Exercise price per option (\$)	Weighted average life remaining (years)
4,475,000	4,475,000	0.15	3.25
7,250,000	4,766,692	0.10	3.46
500,000	333,335	0.10	3.90
200,000	66,666	0.10	4.21
7,500,000	2,499,998	0.20	4.67
19,925,000	12,141,691	0.14	3.89

As at September 30, 2011, the following are outstanding:

Warrants	September 30, 2011		December 31, 2010	
	Number of Warrants	Amount (\$)	Number of Warrants	Amount (\$)
Balance, beginning of period	600,104	24	5,000,000	187
Issued	-	-	2,600,238	65
Cancelled	-	-	(2,000,134)	(41)
Exercised	(23,147)	(1)	-	-
Expired	-	-	(5,000,000)	(187)
Balance, end of period	576,957	23	600,104	24

During the second quarter of 2011, 23,147 warrants with an exercise price of \$0.15, issued as a result of a creditor settlement agreement, were converted and resulted in the Company issuing 23,147 common shares.

Management's Discussion and Analysis

Flow-through Share Warrants	September 30, 2011		December 31, 2010	
	Number of Warrants	Amount (\$)	Number of Warrants	Amount (\$)
Balance, beginning of period	6,250,000	-	6,250,000	-
Exercised	(6,250,000)	-	-	-
Balance, end of period	-	-	6,250,000	-

Flow-through share warrants issued in 2009, with an original expiry date of December 18, 2010, were amended to change the expiry date to September 14, 2011. All other terms and conditions of the warrants remain unchanged. During the third quarter of 2011, these warrants were exercised, resulting in a \$625 thousand increase in share capital and 6,250,000 common shares being issued. When the warrants were modified and the exercise date extended, the flow-through provision of the agreement was not extended.

Related Party Transactions

In the fourth quarter 2010, the net assets of AltaEast Production Limited Partnership ("AEPLP"), Battle River Production Limited Partnership ("BRPLP"), Garrington Limited Partnership ("GLP"), Neutral Creek Production Limited Partnership ("NCLP"), Petrovest Exploration & Production ("Petrovest") and Strategic Production Limited partnership ("SPLP"), together (the "Parties"), were acquired by Royalty Investments Limited Partnership ("RILP"), (the "Transaction"). Subsequent to the Transaction, the Company negotiated, with the Parties and RILP the cancellation of the Company's requirement to make an offer to purchase the Parties' oil and natural gas assets pursuant to an option agreement between the Company and the Parties. The total amount of this contractual obligation was, in aggregate, estimated by the Company to be approximately \$9,500 thousand. Amounts due to and from the Parties were consolidated under RILP and certain adjustments to the amounts due were agreed to between RILP and the Parties.

(a) Royalty Investments Limited Partnership

Esplor Management Inc. ("EMI") is the general partner of RILP. The CEO of the Company is a director of EMI. At September 30, 2011 there is \$500 thousand (December 2010 - \$500 thousand) outstanding in the form of a promissory note receivable from RILP. During 2011, the Company charged RILP \$19 thousand (September 2010 - \$nil) in interest and charged \$56 thousand (September 2010 - \$nil) in management fees at a rate of \$2.00/boe of sales.

(b) Petrovest Exploration & Production Corporation

The Chief Executive Officer of the Company is a director of Petrovest. At September 30, 2011, the Company charged Petrovest \$nil (September 2010 - \$13 thousand) in management fees at a rate of \$2.50/boe of sales and interest of \$nil (September 2010 - \$16 thousand).

(c) Garrington Limited Partnership

Garrington Production Corporation ("GPC") is the general partner of GLP. The CEO of the Company is a director of GPC. During 2011, the Company charged GLP \$nil (September 2010 - \$9 thousand) in management fees at a rate of \$2.50/boe of sales and interest of \$nil (September 2010 - \$18 thousand).

(d) Neutral Creek Limited Partnership

Neutral Creek Corporation ("NCC") is the general partner of NCLP. The CEO of the Company is a director of NCC. During 2011, the Company charged NCLP \$nil (September 2010 - \$18 thousand) in management fees at a rate of \$2.50/boe of sales.

(e) Battle River Production Limited Partnership

Battle River Oil & Gas Inc. ("BRO&G") is the general partner of BRPLP. The CEO of the Company is a director of BRO&G. During 2011, the Company charged BRPLP \$nil (September 2010 - \$33 thousand) in management fees at a rate of \$2.50/boe of sales.

(f) AltaEast Production Limited Partnership

AltaEast Oil & Gas Inc. ("AEOG") is the general partner of AEPLP. The CEO of the Company is a director of AEOG. During 2011, the Company charged AEPLP \$nil (September 2010 - \$27 thousand) in management fees at a rate of \$2.50/boe of sales and AEPLP paid interest on a note receivable of \$nil (September 2010 - \$23 thousand).

(g) Strategic Production Limited Partnership

Strategic Oil & Gas Production Inc. ("SOGP") is the general partner of SPLP. The CEO of the Company is a director of SOGP. During 2011, SPLP paid interest of \$nil (September 2010 - \$62 thousand). During 2011, the Company charged SPLP \$nil (September 2010 - \$27 thousand) in management fees at a rate of \$2.50/boe of sales.

(h) Lavery, de Billy, LLP

A director of the Company is a partner at Lavery de Billy, LLP ("Lavery"). In 2011, Lavery charged the Company \$nil (September 2010 - \$2 thousand) for services rendered.

Management's Discussion and Analysis

(i) Espoir Capital Corporation

The CEO of the Company is the controlling shareholder of Espoir Capital Corporation ("Espoir"). In 2010, the Company paid interest of \$1 thousand to Espoir on a short term loan.

(j) Fauth Financial Services

The CEO of the Company is related to the controlling interest in Fauth Financial Services ("Fauth Financial"). During 2011, Fauth Financial billed the Company \$nil (September 2010 - \$199 thousand) and the Company paid \$7 thousand (September 2010 - \$286 thousand).

(k) Vern Fauth

In 2010, the CEO of the Company provided a guarantee on behalf of the Company to its new lender to secure the New Credit Facility. The Company paid the CEO a guarantee fee of \$30 thousand.

(l) Significant Shareholder and Associated Companies

During 2011, a significant shareholder and associated companies provided a guarantee to a lender to secure a credit facility for the Company. The Company was billed \$150 thousand for a guarantee fee related to this transaction.

In two separate transactions in 2011, the Company sold properties in the Berry Creek area to a significant shareholder and associated companies for cash proceeds of \$100 thousand and \$31 thousand respectively. The Company recorded a gain of \$44 thousand on the first sale and \$33 thousand on the second sale. These sales both closed on May 31, 2011 and were recognized for accounting purposes on this date.

Financial instruments

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

- Credit risk
- Liquidity risk
- Market risk

This section presents information about the Company's exposure to each of the above risks and the Company's objectives, policies and processes for measuring and managing risk. Further quantitative disclosures are included throughout these financial statements. The Board of Directors has overall responsibility for the establishment of the Company's risk management framework. The Board has implemented and monitors compliance with risk management policies. The Company's risk management policies are established to identify and analyze the risks faced by the Company, to set appropriate risk limits and controls and to monitor risks and adherence to market conditions and the Company's activities.

Credit risk

Credit risk is the risk of financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligations, and arises principally from the Company's receivables from joint venture partners and petroleum and natural gas marketers.

	September 30, 2011	December 31, 2010
Oil and natural gas marketing companies (\$)	553	664
Joint venture partners and other trade receivables (\$)	2,652	2,512
Total (\$)	3,205	3,176

Trade and other receivables

Receivables from petroleum and natural gas marketers are normally collected on the 25th day of the month following production. The Company historically has not experienced any collection issues with its petroleum and natural gas marketers. Joint venture receivables are typically collected in one to three months of the joint venture bill being issued to the partner. The Company attempts to mitigate the risk from joint venture receivables by obtaining partner approval of significant capital expenditures prior to the expenditure. However, the receivables are from participants in the petroleum and natural gas sector, and collection of the outstanding balances is dependent on industry factors such as commodity price fluctuations, escalating costs and the risk of unsuccessful drilling. In addition, a further risk exists with joint venture partners, such as disagreements, that increase the potential for non-collection. There is a time lag, sometimes significant, from the receipt of joint venture invoices, through the billing process to partners and receipt of payment that can affect the Company's cash flows. The Company does not typically obtain collateral from petroleum and natural gas marketers or joint venture partners; however, the Company does have the ability to withhold production from joint venture partners in the event of non-payment.

The carrying amount of accounts receivable represents the maximum credit exposure. The Company does not have an allowance for doubtful accounts as at September 30, 2011 and December 31, 2010, and did not provide for any doubtful accounts.

Management's Discussion and Analysis

The Company's receivables are aged as follows:

Aging	September 30, 2011	December 31, 2010
Not past due (less than 90 days) (\$)	1,241	1,547
Past due (90 days and over) (\$)	1,964	1,629
Total (\$)	3,205	3,176

Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they fall due. The Company has several strategies to address this risk.

The Company prepares annual capital expenditure budgets, which are compared to actuals, regularly monitored and updated as considered necessary. The Company also utilizes authorizations for expenditures on both operated and non-operated projects to further manage capital expenditures. To facilitate the capital expenditures program, the Company has a revolving reserve based credit facility that is reviewed annually by the lender at a minimum. The Company is currently in default of its obligations regarding a covenant. The Company also attempts to match its payment cycle with collection of petroleum and natural gas revenues on the 25th of each month.

The following is a maturity analysis of the Company's financial obligations:

	Less than 1 month \$	1-3 months \$	3 months to 1 year \$	Beyond 1 year \$	Total \$
Accounts payable	1,704	925	1,658	1,824	6,111
Bank loan payable	-	4,208	-	-	4,208
Debentures payable	-	-	-	5,166	5,166
Finance leases	10	19	29	-	58
Loans payable	3	7	24	5	39
	1,717	5,159	1,711	6,995	15,582

Market risk

Market risk is the risk that changes in market prices, such as foreign exchange rates, commodity prices, and interest rates will affect the Company's income or the value of financial instruments. The objective of market risk management is to manage and control market risk exposures within acceptable limits, while maximizing returns. The Company may utilize financial contracts to manage market risks.

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 not only by the relationship between the Canadian and United States dollar, but also by world economic events that dictate the levels of supply and demand. Based on September 30, 2011 production levels, a \$1.00/mcf change in gas prices received would change gross revenue by 26% or approximately \$400 thousand and a \$10.00/bbl change in liquids prices received would change gross revenue by 12% or approximately \$200 thousand for the nine month period ended September 30, 2011.

At September 30, 2011 and December 31, 2010, the Company had no long-term forward averaging contracts. Subsequent to September 30, 2011, the Company entered into a long-term physical contract for approximately half of its oil production with a floor price of CDN \$90.00/bbl and a ceiling price of CDN \$94.00/bbl, based on WTI, which will be adjusted back to delivery point.

The Company enters into monthly gas physical contracts to help mitigate commodity price risk as a normal part of its operations.

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 fluctuations on its bank debt which bears a floating rate of interest. A change of 1.0% in the floating rate would have a \$11 thousand impact on income before income taxes in the year, based on the amount of the bank debt at September 30, 2011. The Company had no interest rate swap or financial contracts in place as at or during the periods ended September 30, 2011 and December 31, 2010.

Fair value of financial instruments

The Company's financial instruments include cash, accounts receivable, note receivable, financial contracts, accounts payable and accrued liabilities, bank loan payable, debentures payable, loans payable and preferred shares.

The fair value of accounts receivable, amounts due and from related parties and accounts payable and accrued liabilities approximate their carrying amounts due to their short-term maturity. The fair value of the financial contracts at September 30, 2011 are \$nil (September 30, 2010 – \$130 thousand).

Management's Discussion and Analysis

The bank loan payable bears interest at the banks prime rate plus 2.5% on the first \$3,000 thousand and prime on the balance of the amount drawn. Therefore, accordingly the fair market value approximates the carrying value.

The fair values of note receivable, debentures payable, note payable, loans payable and preferred shares are not materially different from carrying values.

Critical Accounting Estimates

The reader is advised that the critical accounting estimates, policies and practices as described in this MD&A continue to be critical in determining the Company's financial results.

The reader is further cautioned that the preparation of financial statements in accordance with GAAP requires management to make certain judgments and estimates that affect the reported amount of assets, liabilities, revenues and expenses. Estimating reserves is also critical to several accounting estimates and requires judgments and decisions based upon available geological, geophysical, engineering and economic data. These estimates may change, having either a negative or positive effect on net earnings as further information becomes available and as the economic environment changes. Changes in these judgments and estimates could have a material impact on the financial results and financial condition. The following discussion outlines accounting policies and practices that are critical to determining the Company's financial results.

Accounting for Petroleum and Natural Gas Operations

The Company follows the full cost method of accounting whereby all costs relating to the acquisition of, exploration for and development of oil and gas reserves are capitalized. Such costs include lease acquisition, lease rentals on undeveloped properties, geological and geophysical costs, drilling both productive and non-productive wells, production equipment and overhead charges directly related to acquisition, exploration and development activities.

The application of the full cost method of accounting requires management's judgment to determine the proper designation of a well as either developmental or exploratory, which will ultimately determine the proper income tax treatment of the costs incurred.

Reserve Estimates

Full cost accounting depends on the estimated proven and probable reserves that are believed to be recoverable from the Company's oil and gas properties. The process of estimating reserves is complex. It requires significant judgments and decisions based on available geological, geophysical, engineering and economic data. These estimates may change substantially as additional data from ongoing development activities and production performance becomes available and as economic conditions impacting oil and gas prices and costs change. The Company's reserve estimates are based on current production forecasts, prices and economic conditions. An independent engineering firm, Sproule Associates Limited, evaluates all of the Company's reserves.

Reserve estimates are critical to many of the accounting estimates, including:

- Calculating unit-of-production depletion rates. Proven reserve estimates are used to determine rates that are applied in calculating depletion expense.
- Assessing when necessary, oil and gas assets for possible impairment. Estimated future undiscounted cash flows are determined using proven reserves or discounted cash flows are determined using proven and probable reserves. The criteria used to assess impairment, including the impact of changes in reserve estimates, are discussed below.

As circumstances change and additional data becomes available, reserve estimates also change, possibly materially impacting net income. Estimates made are reviewed and revised, either upward or downward, as warranted by the new information. Revisions are often required due to changes in well performance, prices, economic conditions and governmental restrictions.

Although every reasonable effort is made to ensure that reserve estimates are accurate, reserve estimation is an inferential science. As a result, the subjective decisions, new geological or production information and a changing environment may impact these estimates. Revisions to the reserve estimates can arise from changes in oil and gas prices and reservoir performance. Such revisions can be either positive or negative.

Impairment of Petroleum and Natural Gas Properties

The Company is required to review its full cost pool for impairment at least annually. An impairment provision is recorded whenever events or circumstances indicate that the carrying value of the Company's properties may not be recoverable. The impairment provision is based on the excess of carrying value over fair value. Fair value is defined as the present value of the estimated future net revenues from production of total proved and probable petroleum and natural gas reserves, as estimated by the Company on the balance sheet date. Reserve estimates, as well as estimates for petroleum and natural gas prices and production costs may change and there can be no assurance that impairment provisions will not be required in the future.

Management's assessment of, among other things, the results of exploration activities, commodity price outlooks and planned future development and sales, impact the amount and timing of impairment provisions.

Decommissioning Liability

The decommissioning liability provision recorded in the financial statements is based on an estimate for total costs for future site restoration and abandonment of the Company's petroleum and natural gas properties and equipment. This estimate is based on management's analysis of production structure, reservoir characteristics and depth, market demand for equipment, currently available procedures and discussions with construction and engineering consultants. Estimating these future costs requires management to make estimates and judgments that are subject to future revisions based on numerous factors, including changing technology, political and regulatory environments.

Income Taxes

The Company records future tax assets and liabilities to account for the expected future tax consequences of events that have been recorded in the financial statements and tax returns. These amounts are estimates; the actual tax consequences may differ from the estimates due to changing tax rates and regimes, as well as changing estimates of cash flows and capital expenditures in current and future periods. The Company periodically assesses its ability to realize on its future tax assets. If the Company concludes that it is not more likely than not that some portion or all of the future tax assets will be realized under accounting standards, the tax asset will be adjusted by a valuation allowance.

Claims and Litigation

In 2005, the Company received a statement of claim in the amount of \$136 thousand from Aero Drilling & Consulting Ltd., in respect of services provided to a subcontractor of Supreme Energy Inc. The Company has reviewed the claim and considers it without merit and no provision has been made with respect to the claim in the financial statements. The Company is defending the claim.

In November 2006, the Company received notice of reassessment from Revenu Quebec for the period ended February 28, 2003, in the amount of \$211 thousand including interest. This relates to Fairstar Explorations Inc. ("Fairstar"). Fairstar and Western Energy Corporation amalgamated August 18, 2005 to form the Company. The Company has filed a notice of objection, does not believe that the reassessment is valid and has made no provision with respect to the claim in the financial statements.

Commitments

(a) The Company's total obligations, under a property lease agreement, exclusive of occupancy costs are as follows:

	Gross (\$)
2011	65
2012-2013	431
Beyond 2013	-
Total	496

(b) The future obligations under capital lease and loans payable are:

	2011 (\$)	2012 (\$)	Total (\$)
Capital Lease			
Principal	28	28	56
Imputed interest	1	1	2
	29	29	58
Loan Payable			
Principal	10	29	39
Imputed interest	-	-	-
	10	29	39
Total			
Principal	38	57	95
Imputed interest	1	1	2
	39	58	97

Management's Discussion and Analysis

Outlook

The fourth quarter of 2011 is expected to show improvement in the Company's operating performance as production increases. The Company's two major farmout agreements at Kirkpatrick Lake and Provost have yielded positive results in the Viking oil resource play. At Kirkpatrick Lake four horizontal wells have been drilled, completed and placed on production. The Farmee has experienced operational problems on two of the four wells completed. A workover is currently being conducted on one of the wells that to date has not been capable of production and the other well is producing at uneconomic rates. The remaining two wells are producing at a combined rate of 60 boe/d (60% gas) with the Company's share at 18 boe/d. A fifth horizontal well was drilled and cased and the completion of this well is pending.

At Provost, three horizontal Viking oil wells have been drilled, cased and completed. Two of the wells were on stream in September 2011 with the third expected to be tied in during December 2011. The first two wells are producing at a combined rate of 83 boe/d (55% oil) with the Company's share at 27 boe/d. Completion results for the third well were very encouraging with flowing rates of 60 bbl/d oil and 1 MMcf/d of natural gas (225 boe/d combined). The Farmee has indicated they would be interested in drilling three joint development wells by the end of the first quarter of 2012 (the Company will be a 32% participant).

The Company is still faced with significant challenges to generate profits from natural gas production as long as prices remain low. Already high fixed operating costs associated with taxes and surface rentals continue to increase. Operating costs for third party gas processing facilities continue to increase reflecting lower throughput by other industry companies. Other variable operating costs such as fuel (which is tied to the increase in oil prices) continue to experience upward pressure. We are optimistic that increased oil production from new resource oil plays at Provost, Kirkpatrick Lake and Antelope in the Viking and Berry Creek in the Mannville will rejuvenate the Company and create value for shareholders. The Company has identified numerous oil drilling locations within its land base including development locations to follow up on successful drilling at Provost and Kirkpatrick Lake.

Additional information can be found regarding FairWest at www.SEDAR.com.

Corporate Information

Management

Vern Fauth
Chief Executive Officer
Douglas O. McNichol
President and Chief Operating Officer
Marion D. Mackie
Chief Financial Officer
Michael Lambros
Vice President, Land
Darlene Zeck
Vice President, Administration
Philip Rodd
General Manager, Exploration

Directors

Vern Fauth ⁽⁴⁾
Calgary, Alberta
H. Allen Cameron ⁽¹⁾
Calgary, Alberta
Sean Fauth ^{(1) (2) (3)}
Calgary, Alberta
David Kelcher ⁽¹⁾
Calgary, Alberta
Douglas O. McNichol ⁽³⁾
Calgary, Alberta
Carl M. Ravinsky ⁽²⁾
Montreal, Quebec

- (1) Audit Committee
(2) Compensation and Governance Committee
(3) Environmental, Health and Safety Committee
(4) Executive Chairman

Stock Exchange Listing

TSX Venture Exchange
Trading Symbol: FEC

Auditors

Kenway Mack Slusarchuk Stewart LLP
Calgary, Alberta

Registrar and Transfer Agent

Olympia Trust Company
Suite 2300, 125 – 9 Avenue SE
Calgary, Alberta T2G 0P6
Telephone: (403) 261-0900

Contact

Vern Fauth
Chief Executive Officer
Douglas O. McNichol
President and Chief Operating Officer
Marion D. Mackie
Chief Financial Officer

FairWest Energy Corporation
#800, 407 – 2 Street S.W.
Calgary, Alberta T2P 2Y3
Telephone: 403.264.4949
Facsimile: 403.269.1761
Email: info@fairwestenergy.com