

# Q4 QUARTERLY REPORT



**FORTRESS  
ENERGY INC.**

FOR THE TWELVE MONTHS ENDED DECEMBER 31, 2010

## FINANCIAL AND OPERATING SUMMARY

	Three months ended December 31,				Year ended December 31,			
	2010		2009		2010		2009	
	(\$000's)	\$/Mcf	(\$000's)	\$/Mcf	(\$000's)	\$/Mcf	(\$000's)	\$/Mcf
Petroleum and natural gas sales	210	4.68	4,798	6.20	16,656	6.53	18,589	6.65
Royalties	(209)	(4.66)	71	0.09	(473)	(0.19)	(714)	(0.25)
Operating costs	(78)	(1.73)	(1,995)	(2.58)	(5,924)	(2.32)	(7,422)	(2.66)
Transportation	(51)	(1.14)	(223)	(0.29)	(987)	(0.39)	(915)	(0.33)
Operating netback <sup>(1)</sup>	(128)	(2.85)	2,651	3.42	9,272	3.63	9,538	3.41
Environmental remediation	-	-	(134)	(0.17)	-	-	(134)	(0.05)
General and administrative expenses	(244)	(5.45)	(821)	(1.06)	(3,252)	(1.27)	(2,908)	(1.04)
Professional fees	(130)	(2.90)	(73)	(0.10)	(516)	(0.20)	(675)	(0.24)
Bad debts recovery (expense)	(67)	(1.49)	(132)	(0.17)	4	-	(294)	(0.10)
Interest expense	(311)	(6.92)	(277)	(0.36)	(1,318)	(0.52)	(917)	(0.33)
Indemnification of flow-through share subscribers	(1,314)	(29.28)	-	-	(1,314)	(0.51)	-	-
Current income tax expense	-	-	(42)	(0.05)	(106)	(0.04)	(96)	(0.04)
Funds from operations before transaction costs	(2,194)	(48.89)	1,172	1.51	2,770	1.09	4,514	1.61
Transaction costs	-	-	-	-	(564)	(0.22)	-	-
Funds from operations <sup>(1)</sup>	(2,194)	(48.89)	1,172	1.51	(2,206)	0.87	4,514	1.61
Unrealized loss on commodity contracts	-	-	(808)	(1.04)	(1,321)	(0.52)	(1,166)	(0.42)
Stock-based compensation expense	-	-	(153)	(0.20)	(767)	(0.30)	(388)	(0.14)
Depletion, depreciation and accretion	(65)	(1.45)	(2,720)	(3.51)	(7,629)	(2.99)	(13,170)	(4.70)
Ceiling test impairment	-	-	(4,820)	(6.22)	(47,476)	(18.61)	(19,096)	(6.83)
Loss on sale of oil and gas properties	301	6.71	(304)	(0.39)	(1,000)	(0.39)	(304)	(0.11)
Write down of temporary investment	(183)	(4.08)	-	-	(293)	(0.11)	-	-
Loss before future income taxes	(2,141)	(47.71)	(7,633)	(9.85)	(56,280)	(22.05)	(29,610)	(10.59)
Future income tax	(724)	(16.13)	276	0.36	26	0.01	3,868	1.38
Net loss	(2,865)	(63.84)	(7,357)	(9.49)	(56,254)	(22.04)	(25,742)	(9.21)
Sales volumes (Mcf/d)	488		8,418		6,991		7,668	

<sup>(1)</sup> Non-GAAP measure. See discussion in the following MD&A.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

April 29, 2011

Management's discussion and analysis (MD&A) should be read in conjunction with the consolidated financial statements of Fortress Energy Inc. ("Fortress" or the "Company") for the years ended December 31, 2010 and 2009. The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles (GAAP). All tabular amounts in the following discussion are in thousands of Canadian dollars unless otherwise noted. Additional information is available on the Company's web site at [www.fortressenergy.ca](http://www.fortressenergy.ca) or under the Company's profile at [www.sedar.com](http://www.sedar.com).

### Non-GAAP Measurements

The terms "funds from operations" and "operating netback" used in the MD&A are not recognized measures under GAAP. Management believes that in addition to net income, funds from operations and operating netback are useful supplemental measures as they provide an indication of the results generated by the Company's principal business activities before the consideration of how those activities are financed. Investors are cautioned, however, that these measures should not be construed as alternatives to net income determined in accordance with GAAP.

The Company's method of calculating funds from operations may differ from that of other companies, and, accordingly, it may not be comparable to measures used by other companies. The Company calculates funds from operations by taking cash flow from operating activities as determined under GAAP before changes in non-cash operating working capital and abandonment expenditures. The consolidated statements of cash flows included in the consolidated financial statements present the reconciliation between net income (loss) and funds from operations. A summary of this reconciliation is as follows:

(\$000s)	Three months ended		Year ended	
	December 31,		December 31,	
	2010	2009	2010	2009
Cash provided by (used in) operating activities	(3,670)	640	1,556	2,720
Change in non-cash operating working capital	1,476	530	650	1,621
Abandonment expenditures	-	1	-	173
Funds from (used in) operations	(2,194)	1,171	2,206	4,514

Operating netback is calculated on a per boe basis taking the sale price and deducting royalties, operating costs and transportation costs, as follows:

	Three months ended December 31,				Year ended December 31,			
	2010		2009		2010		2009	
	(\$000s)	(\$/Mcf)	(\$000s)	(\$/Mcf)	(\$000s)	(\$/Mcf)	(\$000s)	(\$/Mcf)
Petroleum and natural gas sales	210	4.68	4,798	6.20	16,656	6.53	18,589	6.65
Royalties	(209)	(4.66)	71	0.09	(473)	(0.19)	(714)	(0.25)
Operating expenses	(78)	(1.73)	(1,995)	(2.58)	(5,924)	(2.32)	(7,422)	(2.66)
Transportation expenses	(51)	(1.14)	(223)	(0.29)	(987)	(0.39)	(915)	(0.33)
Operating netback	(128)	(2.85)	2,651	3.42	9,272	3.63	9,538	3.41

### Natural Gas, Crude Oil and Natural Gas Liquids (NGL) Conversions

Certain crude oil and NGL volumes have been converted to million cubic feet equivalent (Mcf) on the basis of one barrel (bbl) to six thousand cubic feet (Mcf). Mcfe may be misleading, particularly if used in isolation. A conversion ratio of one bbl to six Mcf is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent value equivalency at the well head.

## Forward-Looking Statements

Certain statements in this MD&A may contain forward-looking information including expectations of future production, components of cash flow and earnings, expected future events and/or financial results that are forward-looking in nature and subject to substantial risks and uncertainties. Without limiting the generality of the foregoing, the Company has made materially forward-looking statements:

- (i) Under “Liquidity and Capital Resources” regarding the CCAA proceedings and the CRA reassessment;
- (ii) Under “Liquidity and Capital Resources” regarding the potential listing alternatives;
- (iii) Under “Liquidity and Capital Resources” regarding the ability to continue as a going concern;
- (iv) Under “Income Tax Refund” regarding potential refund;
- (v) Under “Income Tax Audit” regarding expected resolution of the matter; and

The reader is cautioned that assumptions used in the preparation of such information may prove to be incorrect. The Company cautions the reader that actual performance will be affected by a number of factors, including changes in economic and political circumstances throughout the world. Events or circumstances may cause actual results to differ materially from those predicted, a result of numerous known and unknown risks, uncertainties, and other factors, many of which are beyond the control of the Company. These risks include, but are not limited to: the risks associated with the oil and gas industry, commodity prices and exchange rate changes; industry related risks could include, but are not limited to, operational risks in exploration, development and production (applicable to the forward-looking statements (i) through (iii) above), delays or changes in plans (applicable to the forward-looking statements identified in (i) through (v) above); risks associated with the uncertainty of reserve estimates, health and safety risks and the uncertainty of estimates and projections of production, costs and expenses. These external factors beyond the Company’s control may affect the marketability of oil and natural gas produced, industry conditions including changes in laws and regulations, changes in income tax regulations, increased competition, fluctuations in commodity prices, interest rates, and variations in the Canadian/United States dollar exchange rate. The reader is cautioned not to place undue reliance on this forward-looking information.

Statements throughout this MD&A that are not historical facts may be considered “forward-looking statements.” These forward-looking statements sometimes include words to the effect that management believes or expects a stated condition or result. All estimates and statements that describe the Company’s objectives, goals or plans are forward-looking statements. Since forward-looking statements address future events and conditions, by their very nature they involve inherent risks and uncertainties. Actual results could differ materially from those currently anticipated due to any number of risks including, but not limited to:

- (i) Risks that the CRA reassessment will be upheld;
- (ii) Risks associated with the oil and natural gas industry and regulatory bodies (e.g. operational risks in exploration, development and production, or changes in royalty rates);
- (iii) Delays or changes in plans with respect to exploration or development projects or capital expenditures;
- (iv) Uncertainty of estimates and projections relating to recoverable reserves, costs and expenses;
- (v) Health, safety and environmental risks;
- (vi) Commodity price and exchange rate fluctuations; and
- (vii) Liquidity risk and working capital requirements (refer to “Liquidity and Capital Resources”).

Forward-looking statements contained herein are made as of the date hereof subject to the requirements of applicable securities legislation and except as otherwise required by law, the Company assumes no obligation to update any forward-looking statements, whether as a result of new information, future events and results, or otherwise. There can be no assurance that forward-looking statements will prove to be

accurate, as actual results and future events could differ materially from those anticipated in such statements. Accordingly, the reader is cautioned not to place undue reliance on forward-looking statements.

## DESCRIPTION OF THE BUSINESS

Fortress Energy Inc. ("Fortress" or the "Company") was incorporated on January 15, 2007 under the Business Corporations Act (Alberta). Fortress is a Calgary-based junior oil and natural gas exploration and development company. All activity is conducted in Western Canada and comprises a single operating segment.

On March 2, 2011, Fortress applied to the Court of Queen's Bench of Alberta for an Order under the *Companies' Creditors Arrangement Act* (Canada) ("CCAA") staying all claims and actions against the Company and its assets and allowing the Company to prepare a plan of arrangement for its creditors if necessary. The Order was granted and was in effect until March 31, 2011. The Order was subsequently extended to May 27, 2011, at which time the matter will be reviewed by the Court. While the Order is in effect the Company will work with a court-appointed monitor. For further details refer to the "Liquidity and Capital Resources" section of this MD&A.

## SALE OF OIL AND GAS ASSETS

Effective August 31, 2010, the Company sold substantially all of its oil and gas properties, tangible equipment and undeveloped land, other than its interests at Buick Creek and Pine Creek, to Terra Energy Corp. ("Terra") for proceeds of \$30,437,000, consisting of cash of \$25,600,000 and 3,664,444 common shares of Terra valued at \$1.32 per share. The transaction costs were \$454,000. The Company has recorded a loss on the sale of oil and gas properties of \$1,000,000. The cash proceeds were used to repay bank indebtedness of \$21,457,000. The Terra shares trade on the Toronto Stock Exchange ("TSX") under the symbol "TT" and were subject to a four month hold period that expired on December 29, 2010.

## DETAILED FINANCIAL ANALYSIS

### Production

	Three months ended December 31,		Year ended December 31,	
	2010	2009	2010	2009
Sales volume:				
Natural gas (Mcf/d)	433	8,288	6,882	7,574
Oil and NGL (bbls/d)	9	19	18	15
Total (Mcf/d)	488	8,418	6,991	7,668

Sales volumes for the three months ended December 31, 2010 were 488 Mcfe/d compared to 8,418 Mcfe/d for the three months ended December 31, 2009 – a decrease of 94 percent. This decrease is attributed to the sale of substantially all of the Company's oil and gas properties on August 31, 2010. The Company retained its Buick Creek and Pine Creek properties. Sales volumes for the three months ended December 31, 2010 are attributed entirely to the Buick Creek property (three months ended December 31, 2009 - 282 Mcf/d).

Sales volumes for the year ended December 31, 2010 were 6,991 Mcfe/d compared to 7,668 Mcfe/d for the prior year - a decrease of 9 percent. The Company's share of sales volumes from its former Square Creek property increased in the fourth quarter of 2009 reflecting the Company's acquisition of its partner's 50 percent working interest on October 23, 2009. This increase in sales volumes was reduced by the effect of the sale of oil and gas properties on August 31, 2010. The sales volumes attributed to these sold properties for the year ended December 31, 2010 were 6,481 Mcfe/d compared to 7,231 Mcfe/d for the year ended December 31, 2009.

## Revenue

	Three months ended December 31,		Year ended December 31,	
	2010	2009	2010	2009
Petroleum and natural gas sales (\$000s)	210	4,798	16,656	18,589
Average realized prices:				
Natural gas (\$/Mcf)	3.77	4.19	4.37	4.19
Realized gain on commodity contracts (\$/Mcf)	-	1.96	2.06	2.43
Realized natural gas price (\$/Mcf)	69.06	6.15	6.43	6.62
Oil and NGL (\$/bbl)	4.08	51.10	61.63	53.71
Total (\$/Mcf)		37.17	6.53	39.87
Benchmark prices:				
AECO average natural gas price (\$/Mcf)	3.61	4.55	3.99	3.97
Edmonton par crude oil (\$/bbl)	80.91	76.99	78.16	89.18

For the three months ended December 31, 2010, petroleum and natural gas sales were \$210,000 compared to \$4,798,000 (including realized gains on commodity contracts of \$1,498,000) for the three months ended December 31, 2009. This decrease is due to the sale of oil and gas properties on August 31, 2010, as previously noted. Also, with the then pending sale of the Company's oil and gas assets, on July 21, 2010, the Company sold its commodity contracts for all production periods beginning on or after September 1, 2010 for cash proceeds of \$2,009,000. The proceeds were used to reduce bank indebtedness.

For the year ended December 31, 2010 petroleum and natural gas sales were \$16,656,000 (including realized gains on commodity contracts of \$5,268,000) compared to \$18,589,000 (including realized gains on commodity contracts of \$6,722,000) for the year ended December 31, 2009 - a decrease of 10 percent. This decrease is consistent with the three months ended December 31, 2010, as previously noted.

The average realized natural gas price for the three months ended December 31, 2010 was \$3.77/Mcf compared to the average AECO natural gas price of \$3.61/Mcf. The average realized natural gas price in the three months ended December 31, 2009 was \$4.19 /Mcf and the average AECO natural gas price was \$4.55/mcf.

The average realized natural gas price for the year ended December 31, 2010 was \$4.37/Mcf compared to the average AECO natural gas price for the period of \$3.99/Mcf. This compares to the average realized natural gas price in the year ended December 31, 2009 of \$4.19/Mcf and an average AECO price of \$3.97/Mcf. The Company receives a slight premium to the AECO natural gas price of approximately 4 percent to 5 percent due to the higher heating value of its natural gas.

The Company sold its commodity contracts effective September 1, 2010 and accordingly did not record a gain or loss on commodity contracts in the three months ended December 31, 2010. For the three months ended December 31, 2009, the Company realized a gain on commodity contracts of \$1,498,000, or \$1.96/Mcf. For the three months ended December 31, 2009 the Company recognized an unrealized loss on commodity contracts of \$808,000.

For the year ended December 31, 2010, the Company realized a \$5,268,000 gain on commodity contracts, or \$2.06/Mcf, compared to a realized gain on commodity contracts of \$6,722,000 or \$2.43/Mcf for the year ended December 31, 2009. In addition, the unrealized loss on commodity contracts in the year ended December 31, 2010 was \$1,321,000 compared to \$1,166,000 for the year ended December 31, 2009.

## Royalties

	Three months ended December 31,		Year ended December 31,	
	2010	2009	2010	2009
Royalties (\$000s)	209	(71)	473	714
\$/Mcf	4.66	(0.09)	0.19	0.25
Percentage of petroleum and natural gas sales (1)	99%	(2.1)%	4.2%	6.0%

(1) Before realized gains and losses on commodity contracts.

For the three months ended December 31, 2010, the Company recorded royalties expense of \$209,000 compared to a recovery of royalties for the three months ended December 31, 2009 of \$71,000. This increase is mainly due to adjustments for prior production periods of \$197,000 which includes \$99,000 of Alberta Royalty Tax Credits ("ARTCs") that are repayable as the result of an audit of the 2004 and 2005 amounts received by a predecessor company.

For the year ended December 31, 2010, royalties were \$473,000 compared to \$714,000 for the year ended December 31, 2009. This decrease is attributed to a decrease in the average natural gas sales volume in 2010. Royalties are not calculated or payable on realized gains and losses on commodity contracts. The effective royalty rate for the year ended December 31, 2010 was 4.2 percent compared to 6.0 percent for the prior year.

### Operating Expenses

	Three months ended		Year ended	
	December 31,		December 31,	
	2010	2009	2010	2009
Operating expenses (\$000s)	78	1,995	5,924	7,422
\$/Mcf	1.73	2.58	2.32	2.66

For the three months ended December 31, 2010, operating expenses were \$78,000, or \$1.73/Mcfe, compared to \$1,995,000, or \$2.58/Mcfe, for the three months ended December 31, 2009. Operating expenses decreased in the three months ended December 31, 2010 as a result of the sale of oil and gas properties in August 2010.

For the year ended December 31, 2010, operating expenses were \$5,924,000 or \$2.32/Mcfe as compared to \$7,422,000 or \$2.66/Mcfe for the year ended December 31, 2009. Operating expenses on a per Mcfe basis are lower for the year ended December 31, 2010 due to the sale of higher cost properties.

### Transportation Expenses

	Three months ended		Year ended	
	December 31,		December 31,	
	2010	2009	2010	2009
Transportation expenses (\$000s)	51	223	987	915
\$/Mcf	1.14	0.29	0.39	0.33

Transportation expenses include transportation and fuel costs associated with the usage of natural gas pipelines. For the three months ended December 31, 2010, transportation expenses were \$51,000 (\$1.14/Mcfe) compared to \$223,000 (\$0.29/Mcfe) for the three months ended December 31, 2009. The increased per Mcfe rate is due to the higher tariffs at Buick Creek. Transportation expenses for the year ended December 31, 2010 were \$987,000 (\$0.39/Mcfe) compared to \$915,000 (\$0.33/Mcfe) for the year ended December 31, 2009.

### General and Administrative Expenses

	Three months ended December 31,				Year ended December 31,			
	2010		2009		2010		2009	
	(\$000s)	(\$/Mcf)	(\$000s)	(\$/Mcf)	(\$000s)	(\$/Mcf)	(\$000s)	(\$/Mcf)
General and administrative expenses, net of recoveries	244	5.45	821	1.06	3,252	1.27	2,908	1.04
Professional fees	130	2.90	73	(0.10)	516	0.20	675	0.24
Bad debts (recoveries)	67	1.49	132	0.17	(4)	-	294	0.10
Total	441	9.84	1,026	1.33	3,764	1.47	3,877	0.70

General and administrative expenses, net of recoveries, decreased to \$244,000 in the three months ended December 31, 2010 from \$821,000 in the three months ended December 31, 2009. This decrease is due to lower expenditures in the three months ended December 31, 2010 as a result of the downsizing of the Company's operations after the sale of oil and gas properties on August 31, 2010. For the year ended December 31, 2010, general and administrative expenses, net of recoveries, were \$3,252,000 compared to \$2,908,000 for the year ended December 31, 2009 and include severance and other costs relating to the asset sale.

Professional fees include fees for lawyers, auditors, income tax professionals, and independent reserves evaluators. Professional fees increased to \$130,000 in the three months ended December 31, 2010 from \$73,000 for the three months ended December 31, 2009. Professional fees for the year ended December 31, 2010 totaled \$516,000 compared to \$675,000 for the year ended December 31, 2009. This decrease is primarily due to a reduction in legal and advisory fees in 2010 from the prior year. The Company incurred additional costs in 2009 related to income tax compliance.

For the three months ended December 31, 2010 the Company recorded bad debts expense of \$67,000 compared to \$132,000 for the three months ended December 31, 2009. For the year ended December 31, 2010, the Company recorded a recovery of bad debts of \$4,000 compared to an expense of \$294,000 for the year ended December 31, 2009. Bad debts primarily reflect the accounts of former joint venture partners that are considered uncollectible; many of these accounts are related to companies that were acquired by the Company. With the closing of the sale of the majority of the Company's properties, recoveries of many accounts that had previously been written off were recognized.

### Stock-based Compensation Expense

	Three months ended		Year ended	
	December 31,		December 31,	
	2010	2009	2010	2009
Stock-based compensation expense (\$000s):				
Stock options	-	154	718	303
Restricted stock units	-	(1)	49	85
Total	-	153	767	388
\$/Mcf	-	0.20	0.30	0.14

Stock-based compensation expense for the three months ended December 31, 2010 was \$nil compared to \$153,000 for the three months ended December 31, 2009. Stock-based compensation expense for the year ended December 31, 2010 was \$767,000 compared to \$388,000 for the year ended December 31, 2009. As a result of the sale of oil and gas properties in August 2010 and the substantial reduction in the Company's asset base, all stock options and restricted stock units outstanding on August 31, 2010 were immediately vested. The increase in stock-based compensation expense for the year ended December 31, 2010 reflects this accelerated vesting. All stock options expired unexercised on November 29, 2010.

### Interest Expense

	Three months ended		Year ended	
	December 31,		December 31,	
	2010	2009	2010	2009
Interest expense (\$000s):	311	277	1,318	917
\$/Mcf	6.92	0.36	0.52	0.33

The Company recorded interest expense of \$311,000 for the three months ended December 31, 2010 compared to \$277,000 for the three months ended December 31, 2009. Interest expense for the three months ended December 31, 2010 reflects accrued interest on flow-through commitments. Interest expense for the three months ended December 31, 2009 reflects interest on bank indebtedness and accrued interest on flow-through commitments. Interest expense for the year ended December 31, 2010 was \$1,318,000 compared to \$917,000 for the year ended December 31, 2009. This increase is due to an increase in the interest rates that the Company was charged on its bank indebtedness, in addition to facility extension fees and interest on flow-through commitments. All of the Company's bank indebtedness was repaid on the closing of the sale of oil and gas assets on August 31, 2010.

## Depletion, Depreciation and Accretion Expense

	Three months ended December 31,		Year ended December 31,	
	2010	2009	2010	2009
Depletion and depreciation expense (\$000s)	57	2,659	7,398	12,937
Accretion of asset retirement obligations (\$000s)	8	61	231	233
Depletion, depreciation and accretion expense (\$000s)	65	2,720	7,629	13,170
Ceiling test impairment (\$000s)	-	4,820	47,476	19,096
Depletion and depreciation expense (\$/Mcf)	1.27	3.43	2.90	4.62
Accretion of asset retirement obligations (\$/Mcf)	0.18	0.08	0.09	0.08
Depletion, depreciation and accretion expense (\$/Mcf)	1.45	3.51	2.99	4.70
Ceiling test impairment (\$/Mcf)	-	6.22	18.61	6.83

Depletion and depreciation expense is calculated based on capital expenditures, production rates, and proved reserves. Depletion and depreciation expense was \$57,000 for the three months ended December 31, 2010 compared to \$2,659,000 for the three months ended December 31, 2009. This decrease is due to the sale of oil and gas assets on August 31, 2010. On a per boe basis, depletion and depreciation expense for the three months ended December 31, 2010 was \$1.27/Mcfe compared to \$3.43/Mcfe for the three months ended December 31, 2009.

Depletion and depreciation expense for the year ended December 31, 2010 totaled \$7,398,000 compared to \$12,937,000 for the year ended December 31, 2009. On a per Mcfe basis, depletion and depreciation expense decreased to \$2.99/Mcfe for the year ended December 31, 2010 from \$4.62/Mcfe for the year ended December 31, 2009. The Company recorded a ceiling test impairment charge of \$47,476,000 in 2010, as compared to \$19,096,000 in 2009. These ceiling test impairment charges were the result of a significant decrease in natural gas prices.

Estimated future development costs for proved undeveloped properties included in the calculation of depletion expense at December 31, 2010 were \$nil compared to \$7,456,000 at December 31, 2009. Undeveloped land costs at December 31, 2010 decreased to \$170,000 from \$7,518,000 at December 31, 2009 and were excluded from assets subject to depletion. Undeveloped land costs decreased in 2010 due to the sale of oil and gas properties on August 31, 2010.

Accretion expense for the three months ended December 31, 2010 was \$8,000 compared to \$61,000 for the three months ended December 31, 2009. The accretion expense for the three months ended December 31, 2010 reflects changes to the assumptions used to calculate the Company's asset retirement obligations and an adjustment in the fourth quarter for accretion expense of prior periods. For the year ended December 31, 2010, accretion costs amounted to \$231,000 compared to \$233,000 for the year ended December 31, 2009.

## Income Tax

(000's except \$/Mcf)	Three months ended December 31,		Year ended December 31,	
	2010	2009	2010	2009
Income tax expense	-	42	106	96
Future income tax expense (reduction)	724	(276)	(26)	(3,868)
Total, net	724	(234)	80	(3,772)
\$/Mcf	16.13	(0.36)	0.03	(1.38)

The Company recorded income tax expense for the three months ended December 31, 2010 of \$724,000 compared to a reduction of income tax expense of \$234,000 for the three months ended December 31, 2009. This expense was the result of the reversal of previous renunciations from the issuance of flow-through shares in September 2009 as the required capital expenditures were not made by the Company prior to December 31, 2010.

For the year ended December 31, 2010, the Company recorded income tax expense of \$80,000 compared to reduction of income tax expense of \$3,772,000 for the year ended December 31, 2009.

The estimated tax pools of the Company at December 31, 2010 are as follows:

	(\$000's)
Canadian Oil and Gas Property Expenses	39
Canadian Development Expenses	21,489
Canadian Exploration Expenses	12,585
Undepreciated Capital Cost	24,784
	<u>58,897</u>

### Net Loss

	Three months ended December 31,		Year ended December 31,	
	2010	2009	2010	2009
Net loss (\$000s)	(2,865)	(7,357)	(56,254)	(25,742)
Net loss per share				
- basic and diluted (\$)	(0.05)	(0.13)	(1.02)	(0.76)
Net loss per \$/Mcf	(63.84)	(9.49)	(22.04)	(9.21)

The Company recorded a net loss of \$2,865,000 for the three months ended December 31, 2010 compared to a net loss of \$7,357,000 for the three months ended December 31, 2009. This translates into a net loss per basic and diluted share of \$0.05 for the three months ended December 31, 2010 compared to a loss per basic and diluted share of \$0.13 for the three months ended December 31, 2009. The net loss for the three months ended December 31, 2010 is the result of reduced sales volumes, royalty adjustments, the reversal of previously booked tax renunciations, and expenses for the indemnification of flow-through share subscribers.

The net loss for the year ended December 31, 2010 was \$56,254,000 compared to \$25,742,000 for the year ended December 31, 2009. Both years recorded reductions in natural gas prices from prior periods and substantial ceiling test impairment charges attributing to these losses.

### Funds from Operations

	Three months ended December 31,		Year ended December 31,	
	2010	2009	2010	2009
Funds from (used in) operations (\$000s) <sup>(1)</sup>	(2,194)	1,172	2,206	4,514
Funds from operations (\$/Mcf)	(48.89)	1.51	0.87	1.61
Funds from (used in) operations per share				
- basic and diluted (\$)	(0.04)	0.02	0.04	0.13

<sup>(1)</sup> Non-GAAP measure as defined on page 2.

Funds used in operations for the three months ended December 31, 2010 were \$2,194,000 compared to funds from operations of \$1,172,000 for the three months December 31, 2009. This decrease is attributable to lower revenues recorded in the three months ended December 31, 2010 and the sale of the Company's commodity contracts effective September 1, 2010.

Funds from operations for the year ended December 31, 2010 were \$2,206,000 compared to \$2,731,000 for the year ended December 31, 2009. This increase is due to lower production levels, lower realized natural gas prices, higher general and administrative expenses and expenses for the indemnification of flow-through share subscribers.

## Capital Expenditures

(\$000s)	Three months ended		Year ended	
	December 31,		December 31,	
	2010	2009	2010	2009
Land and seismic	(10)	119	361	530
Drilling and completions	-	447	498	4,678
Equipment and facilities	27	769	646	3,592
Acquisition	-	6,986	-	6,986
Disposition	47	-	(25,146)	-
Capitalized overhead costs	-	321	239	1,022
Other	-	16	3	43
	64	8,658	(23,399)	16,851

In the year ended December 31, 2010, the Company completed a fuel gas conversion at its Square Creek camp to reduce its operating costs, completed workover operations on two wells at Buick Creek, replaced coil tubing for two wells at Velma, completed pipeline header repairs at Mearon North to restore lost production and completed pipeline repairs at Ladyfern North. The disposition reflects the cash portion of the proceeds on the sale of oil and gas assets of \$25,600,000 net of transaction costs of \$454,000. The Company recorded a loss on the sale of oil and gas assets of \$1,000,000 in the year ended December 31, 2010.

## Outstanding Securities

Outstanding securities	
Common shares	55,294,617
Warrants (exercise price \$2.00)	5,516,700
Warrants – A (exercise price \$0.55)	21,779,000
Stock options – expired on April 11, 2011	800
Total outstanding securities at December 31, 2010	82,591,117

On September 30, 2009, the Company closed a public offering of 21,779,000 units and 6,594,000 flow-through common shares for gross proceeds of \$11,385,185 (\$10,320,000 net of issuance costs). Each unit consists of one common share of the Company and one common share purchase warrant. The warrants are exercisable on or before December 31, 2011. Each warrant entitles the holder thereof to purchase one common share at an exercise price of \$0.55. The expenditure commitment resulting from the issuance of 6,594,000 flow-through common shares was \$3,000,270 and was renounced to subscribers effective December 31, 2009. Only a portion of these funds were expended and, accordingly, an additional liability for \$1,314,000 has been recorded representing the anticipated payments to investors required under indemnification agreements.

Options to purchase 800 (December 31, 2009 – 4,774,579) common shares and warrants to purchase 27,295,700 (December 31, 2009 – 27,295,700) common shares at December 31, 2010 were not included in the calculation of diluted common shares outstanding because they were anti-dilutive.

## Liquidity and Capital Resources

The Company fully repaid its bank indebtedness on the closing of the sale of oil and gas properties on August 31, 2010. The facility was subsequently cancelled by the bank and the Company no longer has a borrowing facility. The Company has a letter of guarantee of \$107,000 outstanding as at December 31, 2010 (December 31, 2009 - \$1,007,000) which is secured by a cash deposit.

As at December 31, 2010, the Company has cash on hand of \$2,433,000 and 3,664,444 common shares of Terra with a carrying value of \$4,544,000. The Company anticipates that in 2011 it will be required to sell a portion of the Terra shares to allow it to continue ongoing operations and to continue its challenge of the CRA reassessment.

Cash used in operating activities for the three months ended December 31, 2010 was \$3,670,000 compared to cash generated from operating activities for the three months ended December 31, 2009 of \$641,000. This decrease is due to lower petroleum and natural gas sales in the three months ended December 31, 2010 and the sale of the Company's commodity contracts effective September 1, 2010 leaving it more vulnerable to fluctuations in natural gas prices. In addition, the Company recorded an expense for the indemnification of flow-through share subscribers of \$1,314,000. Cash provided by operating activities for the year ended December 31, 2010 was \$1,556,000 compared to \$2,720,000 for the year ended December 31, 2009. This increase is due to lower non-cash working capital balances.

Cash provided by financing activities for the three months ended December 31, 2010 was \$1,314,000 compared to \$2,135,000 for the three months ended December 31, 2009. Cash used in financing activities for the year ended December 31, 2010 was \$21,730,000 compared to the \$12,831,000 provided by financing activities for the year ended December 31, 2009. Cash used in financing activities for the year ended December 31, 2010 reflects the repayment of the Company's bank indebtedness of \$23,044,000 offset by the change in the liability for the indemnification of flow-through share subscribers of \$1,314,000. Cash provided by financing activities for the year ended December 31, 2009 reflects the net proceeds of an equity financing of \$10,320,000 and an increase in the amount drawn on the operating loan facility.

Cash provided by investing activities for the three months ended December 31, 2010 was \$1,304,000 compared to cash used in investing activities of \$9,775,000 for the three months ended December 31, 2009. The Company's capital expenditures in the three months ended December 31, 2010 were \$67,000 compared to \$1,672,000 plus \$6,986,000 for the Square Creek acquisition in the three months ended December 31, 2009. Cash provided by investing activities for the year ended December 31, 2010 was \$22,543,000 compared to cash used in investing activities of \$15,667,000 for the year ended December 31, 2009. For the year ended December 31, 2010, the Company incurred capital expenditures of \$1,747,000 and proceeds of \$25,146,000 on the disposition of oil and gas properties. This compares to capital expenditures of \$9,865,000 and the acquisition of its partner's interest at Square Creek for \$6,986,000 for the year ended December 31, 2009.

#### CCAA proceedings

On March 2, 2011, Fortress applied to the Court of Queen's Bench of Alberta for an Order under the *Companies' Creditors Arrangement Act* (Canada) ("CCAA") staying all claims and actions against the Company and its assets and allowing the Company to prepare a plan of arrangement for its creditors if necessary. The Order was granted and was in effect until March 31, 2011. The Order was subsequently extended to May 27, 2011, at which time the matter will be reviewed by the Court. While the Order is in effect the Company will work with a court-appointed monitor.

Fortress has taken this step to enable it to challenge a reassessment issued by the Canada Revenue Agency (the "CRA"), which reassessment is in the amount of approximately \$18,000,000 (in addition, the Company expects provincial reassessments based on the CRA reassessments of approximately \$10,000,000). As a result of the reassessment, if the Company took no action, it would be compelled to immediately remit \$9,000,000 to the CRA and the Company does not have the necessary funds to remit. Fortress believes that the CRA's position is not sustainable and is vigorously disputing the CRA's claim.

The reassessment denies the deduction of certain tax pools in SignalEnergy Inc.'s ("Signal") 2004, 2005 and 2006 taxation years on the basis that (i) those pools arose from expenses incurred prior to November of 2003 and (ii) that there was an acquisition of control of Signal (previously named SignalGene Inc.) in November of 2003. Signal was subsequently wound-up into Fortress.

Following the transactions that occurred in November of 2003, Signal was developed into an oil and gas company with over \$140,000,000 of oil and gas assets. On February 1, 2006, Signal received an unsolicited offer to acquire a substantial portion of its oil and gas assets for \$100,000,000 which transaction subsequently closed on March 10, 2006. Fortress used its available tax pools to reduce its taxable income from the proceeds of the disposition.

Management believes that no acquisition of control has occurred. Through a series of communications, including detailed written correspondence with the CRA, Fortress attempted to correct certain apparent factual misunderstandings that had led the CRA to determine that an acquisition of control had occurred. Unfortunately, notwithstanding the explanations by Fortress, the CRA issued the reassessments.

In addition to potential remedies that may be available under the CCAA, the Tax Act provides for at least two more levels at which this dispute can be considered. The first is at the appeals level with the CRA and, as a resolution at this level would resolve this matter most expeditiously; this is the avenue Fortress is pursuing at this time. If that process does not result in a successful resolution of this matter, Fortress can, and if necessary will, file an appeal to the Tax Court of Canada. While there is no certainty in the case of a CRA challenge, Fortress strongly believes that pursuit of this matter to a higher level should result in this matter being resolved in its favour.

As Fortress was a large corporation for purposes of the Tax Act in the taxation years that have been reassessed, under the relevant legislation the CRA is empowered to take action to collect 50 percent of the tax owing at any time during this dispute process (notwithstanding the ability of Fortress to challenge the reassessment and that no final legal determination of the matter has occurred). Due to the vast powers afforded to the CRA to collect this amount, and the severe adverse impact it would have on Fortress and its creditors if the CRA took any collection action without providing Fortress with reasonable notice, Fortress has taken action to protect stakeholders by voluntarily applying to the court for protection under CCAA.

#### TSX listing requirements

The Company announced that it had been advised on October 17, 2010 by the TSX that the Company substantially discontinued its business or materially changed the nature of its business by virtue of the closing of the sale of its oil and gas assets announced on September 1, 2010 and the Company was required to meet original listing requirements by February 18, 2011.

On February 23, 2011, Fortress announced that that it did not meet the listing requirements of the TSX by virtue of the sale of substantially all of its oil and gas assets on September 1, 2010. Fortress was notified by the TSX that its formal listing committee determined on February 25, 2011, that Fortress would be delisted from the TSX on March 30, 2011. As a result, Fortress then commenced the application process for listing on the TSX Venture Exchange and both exchanges at that time indicated a willingness to ensure a seamless transition to ensure no disruption of trading. Although application to the TSX Venture Exchange has started, Fortress is uncertain it will be accepted for listing until the CCAA Order is removed. Fortress was delisted from the TSX on March 30, 2011.

Fortress is considering a listing on the Canadian National Stock Exchange ("CNSX"). The CNSX has indicated its willingness to allow Fortress shares to be listed for trading on such exchange notwithstanding the CCAA Order.

#### Going concern uncertainty

The Company's consolidated financial statements have been prepared on a going concern basis, which assumes the realization of assets and discharge of liabilities in the normal course of business for the foreseeable future. The Company has experienced consecutive losses and has an accumulated deficit of \$154,993,000 as at December 31, 2010.

There is significant uncertainty regarding the Company's ability to continue as a going concern, which is dependent upon achieving on-going cash flow from operating activities and receiving additional support from its creditors and investors.

The Company is experiencing negative cash flow from operating activities. There is no certainty as to when the Company will have positive cash flow. The Company will be solely dependent upon outside sources and third party financings to obtain the necessary capital to implement a plan to explore and develop its properties or acquire further properties or restructure the Company and continue as a going concern. While the Company has repaid its outstanding bank indebtedness, it does not have access to short term bank financing. If the Company is unable to secure sufficient financing, delays or postponement of future development or production of the Company's properties may result. There can be no assurance that the additional capital required or other types of financing will be available if needed or even if available, the terms of such financing will be acceptable to the Company.

Therefore, failure to obtain suitable financing would, in all likelihood, lead to the liquidation of the Company's assets.

Should the stay period in the CCAA proceedings and any subsequent extensions thereof, if granted, not be sufficient to develop and present a plan ("Plan") under the CCAA, or allow a successful resolution of the dispute with CRA regarding the reassessment, or should the Plan not be accepted by affected creditors or confirmed by the Court and, in any such case, the Company loses the protection of the stay of proceedings, creditors including CRA may immediately enforce their rights and remedies against the Company and its properties which would in all likelihood lead to the liquidation of the Company's assets. Failure to implement a Plan and obtain sufficient exit financing within the time granted by the Court would in all likelihood also lead to the liquidation of the Company's assets.

There can be no assurance that a Plan proposed by the Company will be supported by the Company's creditors or confirmed by the Court, or that any such Plan or Plans will be consummated or successful. Without limiting the foregoing there can be no assurance that the Company will be successful in its dispute with CRA regarding the reassessment.

Considering a timely resolution of the CRA reassessment has not occurred and the timeline for a conclusion remains uncertain, it is not possible for the Company to invest in any new initiatives at this time and third party sources of financing may not be available to the Company.

The Company's financial statements do not contain any adjustments to the amounts and classification of assets and liabilities that might be necessary should the Company be unable to continue in business.

### **Related-Party Transactions**

- a) In 2010 the Company was charged \$242,000 (2009 - \$321,000) by a law firm of which a director of the Company is a partner.
- b) In 2010, the Company was charged \$nil (2009 - \$125,000) by a director for consulting services of which \$nil is included in accounts payable and accrued liabilities at December 31, 2010 (\$9,000 – December 31, 2009).

All related party transactions are in the normal course of business and have been measured at the agreed to exchange amounts, which are the amounts of consideration established and agreed to by the related parties and which are similar to those negotiated with third parties.

### **Commitments and Contingencies**

Office equipment

As at December 31, 2010 the Company is committed to minimum annual lease payments under operating leases for office equipment of \$9,000 in 2011.

### **Income Tax Refund**

In September 2008, the Company re-filed its income tax returns for the 1997 to 1999 tax years to claim additional scientific research and experimental development (SR&ED) credits related to the bio-technology business of its predecessor company. These additional claims could result in a refund of approximately \$3,400,000 to the Company.

### **SUBSEQUENT EVENTS**

#### **(a) Income Tax Audit**

In February 2011, the Company received a series of Notice of Assessments for the taxation years ended 2004 to 2007 from the Canada Revenue Agency ("CRA") pertaining to the conversion of SignalEnergy Inc., predecessor to the Company and formerly known as SignalGene Inc., into an oil and natural gas enterprise.

In these assessments, the CRA denied the use of tax pools existing at the time of the conversion. As a result, CRA now claims that the Company owes \$18,000,000 in taxes, interest and penalties.

The Company believes that these assessments will be resolved in the Company's favour. Accordingly, no provision for this amount has been included in these financial statements.

**(b) Companies' Creditors Arrangement Act (the "CAA") filing**

On March 2, 2011, the Company made an application for protection under the Companies' Creditors Arrangement Act and an order (the "Initial Order") was granted by the Court of Queen's Bench of Alberta (the "Court"). Hardie & Kelly Inc. was appointed by the Court as monitor of the Company (the "Monitor"). The Initial Order provides certain relief including the imposition of a Stay of Proceedings (the "Stay") against the Company and its assets through to March 31, 2011. The Order was subsequently extended to May 27, 2011, at which time the matter will be reviewed by the Court. While the Order is in effect the Company will work with a court-appointed monitor.

**Income Tax Reassessment**

Based on the results of an audit concluded in March 2009 by the Canada Revenue Agency (CRA) on the 2004 flow-through expenditures of a business acquired by the Company in 2006, the Company was reassessed by CRA for interest and penalties of \$300,000 on expenditures not qualifying for renunciation under the flow-through share program in the amount of \$1,916,000. The Company filed a Notice of Objection with CRA on July 31, 2009 after consultation with its tax advisors and legal counsel and is appealing this reassessment. The Company has indemnified the subscribers of this flow-through share offering from income taxes related to the offering. The amount of the potential indemnification is approximately \$765,000. The amounts of the interest and penalties and potential indemnification have not been recorded as the Company's position is that the more likely than not criteria for recognition have not been met.

**SELECTED QUARTERLY INFORMATION**

	2010				2009			
	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
Production:								
Natural gas (Mcf/d)	433	7,084	9,903	10,212	8,288	8,733	8,690	7,391
Oil and NGL's (bbl/d)	9	17	20	27	19	23	15	33
Total (Mcf/d)	488	7,185	10,022	10,374	8,418	8,868	8,778	10,120
Average realized prices:								
Natural gas (\$/Mcf)	3.77	8.12	5.28	6.49	6.15	7.02	8.98	8.03
Oil and NGL (\$/bbl)	69.06	54.12	62.09	63.54	51.1	82.29	108.04	79.61
Combined average (\$/Mcf)	4.63	8.19	5.36	6.58	6.2	7.11	9.05	8.16
Benchmark prices:								
AECO average natural gas price (\$/Mcf)	3.61	3.53	3.89	4.94	4.55	7.76	9.82	7.9
Edmonton Par crude oil price (\$/bbl)	80.91	74.88	75.53	80.92	76.99	123.08	126.37	98.45
Financial (\$000's unless otherwise noted):								
Petroleum and natural gas sales	210	5,412	4,886	6,148	4,798	5,802	7,231	5,637
Net loss	(2,865)	(3,390)	(39,985)	(10,012)	(7,357)	1,070	(744)	(3,455)
Net loss per share – basic (\$)	(0.05)	(0.06)	(0.72)	(0.18)	(0.13)	0.04	(0.04)	(0.22)
Net loss per share – diluted (\$)	(0.05)	(0.06)	(0.72)	(0.18)	(0.13)	0.04	(0.04)	(0.22)
Funds from (used in) operations	(2,194)	2,199	997	1,205	1,172	1,193	2,627	2,025
Operating costs (\$/Mcf)	1.73	2.25	2.34	2.38	2.58	2.62	2.57	1.99
Weighted average shares outstanding – basic (000)	55,295	55,295	55,295	55,295	55,295	26,965	16,809	15,980
Weighted average shares outstanding – diluted (000)	55,295	55,295	55,295	55,295	55,295	27,004	16,809	15,980

## **Disclosure Controls and Procedures**

The Company has established disclosure controls and procedures to ensure timely and accurate preparation of financial and other reports. Disclosure controls and procedures are designed to provide reasonable assurance that material information required to be disclosed is recorded, processed, summarized and reported within the periods specified by securities regulations and that information required to be disclosed is accumulated and communicated to the appropriate members of management and properly reflected in the Company's filings. The Chief Executive Officer and the Chief Financial Officer oversee this evaluation process and have concluded that the design and operation of these disclosure controls and procedures are adequate and effective in ensuring that the information required to be disclosed by the Company in reports filed with the Canadian Securities Administrators is accurate and complete and filed within the periods required. The Chief Executive Officer and Chief Financial Officer have individually signed certifications to this effect.

## **Internal Controls over Financial Reporting**

Management has designed internal controls over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with Canadian GAAP. The Company's management, under the direction and supervision of the Chief Executive Officer and Chief Financial Officer, conducted an evaluation of the design and effectiveness of the internal controls over financial reporting as at December 31, 2010. Based on their assessment, management determined that the internal controls over financial reporting were effective as at December 31, 2010.

There was no change in the Company's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting. Management, including the Chief Executive Officer and the Chief Financial Officer, do not expect that the Company's disclosure controls or the Company's internal controls over financial reporting will prevent or detect all error or fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. The design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs.

Given the Company's limited staff level, certain duties within the accounting and finance department cannot be properly segregated. However, none of the segregation of duty deficiencies resulted in a misstatement to the financial statements as the Company relies on certain compensating controls, including substantive periodic review of the financial statements and other information by the Chief Executive Officer and Audit Committee. This weakness is considered to be a common area of deficiency for many smaller listed companies in Canada.

## **New Canadian Accounting Pronouncements**

In December 2008, the CICA issued Section 1582, *Business Combinations*, which replaces the previous business combinations standard. The standard requires assets and liabilities acquired in a business combination, contingent consideration and certain acquired contingencies to be measured at their fair values as of the date of acquisition. In addition, acquisition-related and restructuring costs are to be recognized separately in the statement of operations. The Company's adoption of this standard on January 1, 2010 resulted in the expensing of certain acquisition-related costs in the three months and year ended December 31, 2010. This standard has been applied on a prospective basis with no restatement of prior periods.

## International Financial Reporting Standards

The Canadian Accounting Standards Board (AcSB) has confirmed that the use of IFRS will be required in 2011 for publicly accountable profit-oriented enterprises. The official changeover date is for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. The adoption date of January 1, 2011 will require the restatement, for comparative purposes, of amounts reported by the Company for the year ended December 31, 2010, including the opening balance sheet as at January 1, 2010.

The Company has started the process to transition from current Canadian GAAP to IFRS. The Company's IFRS conversion project is made up of three phases:

- Scoping and diagnostic phase – this phase involves performing a high-level impact analysis to identify areas that may be affected by the transition to IFRS. The results of this analysis were priority ranked according to complexity and the amount of time required to assess the impact of changes in transitioning to IFRS.
- Impact analysis and evaluation phase – during this phase, items identified in the scoping and diagnostic phase are addressed according to the priority levels assigned to them. This phase involved analysis of policy choices allowed under IFRS and their impact on the financial statements. In addition, certain potential differences are further investigated to assess whether there may be a broader impact to the Company's debt agreements, compensation arrangements or management reporting systems. The conclusion of the impact analysis and evaluation phase will require the Board of Directors to review and approve all accounting policy choices as proposed by management.
- Implementation phase – involves implementation of all changes approved in the impact analysis and evaluation phase and will include changes to information systems, business processes, modification of agreements and training of all staff who are impacted by the conversion.

The Company has completed the scoping and diagnostic phase of the project and has commenced the analysis of various accounting policy choices available under IFRS. The Company has not yet completed its accounting policies and is unable to quantify the impact of adopting IFRS on the financial statements. Due to the impact of low natural gas prices experienced and the resulting reallocation of staff resources, the Company is behind on its conversion schedule. The Company has recently hired consultants to assist with the project and expects that it will be able to meet the conversion timeline.

### First-Time Adoption of IFRS

IFRS 1, "*First-Time Adoption of International Financial Reporting Standards*", provides entities adopting IFRS for the first time with a number of optional exemptions and mandatory exceptions in certain areas to the general requirement for full retrospective application of IFRS. The Company is analyzing the various accounting policy choices available and will implement those determined to be the most appropriate for the Company as summarized below:

- Business Combinations – IFRS 1 would allow the Company to use the IFRS rules for business combinations on a prospective basis rather than re-stating all business combinations. The IFRS business combination rules converge with the new CICA Handbook Section 1582 that is also effective for the Company on January 1, 2011; however, early adoption is permitted.
- Property, Plant and Equipment ("PP&E") – IFRS 1 provides the option to value the PP&E assets at their deemed cost being the Canadian GAAP net book value assigned to these assets as at the date of transition, January 1, 2010. This amendment is permissible for entities, such as Fortress, that currently follow the full cost accounting guideline under Canadian GAAP that accumulates all oil and gas assets into one cost centre. Under IFRS, the Company's PP&E assets must be divided into smaller cost centres. The net book value of the assets on the date of transition will be allocated to the new cost centres on the basis of reserve volumes or values at January 1, 2010.
- Share-Based Payments – IFRS 1 allows Fortress an exemption on IFRS 2, "*Share-Based Payments*" to equity instruments granted on or before November 2, 2002 or which are vested before the Company's transition date to IFRS.

The transition from Canadian GAAP to IFRS is a significant undertaking that may materially affect the Company's reported financial position and results of operations. At this time, the Company has identified key differences that will impact the financial statements as follows:

- Re-classification of Exploration and Evaluation (E&E) expenditures from PP&E – Upon transition to IFRS, Fortress will re-classify all E&E expenditures that are currently included in the PP&E balance on the Consolidated Balance Sheet. E&E assets will consist mainly of the book value for the Company's undeveloped land that relates to exploration properties. E&E assets will not be depleted and must be assessed for impairment when indicators suggest the possibility of impairment. In addition, IFRS requires that E&E expenditures incurred before the Company has acquired the legal right to explore an area be expensed. Under current Canadian GAAP these expenditures would be capitalized to PP&E. Once E&E assets have reached technical feasibility and commercial viability they are reclassified to production assets.
- Calculation of depletion expense for PP&E assets – Upon transition to IFRS, the Company has the option to calculate depletion using a reserve base of proved reserves or both proved and probable reserves, as compared to the Canadian GAAP method of calculating depletion using only proved reserves. The Company's policy will be to calculate depletion using a reserve base of proved and probable reserves.
- Impairment of PP&E assets – Under IFRS, impairment of PP&E must be calculated at a more granular level than what is currently required under Canadian GAAP. Impairment calculations will be performed at the cash-generating unit level using either total proved or proved plus probable reserves. IFRS requires an impairment test on the adoption of IFRS on January 1, 2010. The test for impairment under IFRS requires the use of a discounted cash flow model to determine fair value, whereas Canadian GAAP uses an undiscounted cash flow model and then discounted cash flow model to assess impairment. Market factors such as discount rates and the price of natural gas will affect the Company's assessment of impairment. Depending upon these factors, the Company may have an impairment loss on adoption of IFRS. Also, impairment charges may be more frequent under IFRS as individual E&E projects that do not reach technical feasibility or commercial viability will be written down to their recoverable amount, whereas under Canadian GAAP these projects may continue to remain part of the full cost pool subject only to a ceiling test.
- Decommissioning Liabilities (Asset Retirement Obligations) – Under Canadian GAAP the Company recognizes a liability for the estimated fair value of future retirement obligations related to PP&E. This liability is based on the estimated costs to abandon and reclaim the Company's net working interest in wells and facilities, including an estimate of when these costs will be incurred. These cash outflows are discounted using a credit-adjusted risk-free interest rate. Changes in net present value of the future retirement obligation are expensed through accretion expense. Under IFRS the liability is calculated at each reporting date using estimates of risk-adjusted cash outflows discounted using the risk-free rate. Changes in the net present value are expensed through accretion expense. As a result of the change in discount rate from a credit-adjusted risk-free rate to a risk-free rate, the Company expects that there may be an increase in the value of the decommissioning liability under IFRS compared to Canadian GAAP; however, the difference is not known at this time.
- Income Tax - In transitioning to IFRS, the carrying amount of the Company's tax balances will be directly impacted by the tax effects resulting from changes required by the above IFRS accounting policy differences. Therefore, at this time the income tax impacts of the differences are not reasonably determinable.

In addition to accounting policy differences, the Company's transition to IFRS will impact the internal controls over financial reporting, the disclosure controls and procedures, the Company's business activities and information technology systems as follows:

- Internal controls over financial reporting – As the review of the Company's accounting policies is completed, an assessment will be made to determine changes required for internal controls over financial reporting. As an example, additional controls will be implemented for the IFRS 1 changes such as the allocation of PP&E as well as the process for re-classifying E&E expenditures from PP&E. This will be an ongoing process to ensure that all changes in accounting policies include the appropriate additional controls and procedures for future IFRS reporting requirements.

- Disclosure controls and procedures – Throughout the transition process, the Company will be assessing stakeholders' information requirements and will ensure that adequate and timely information is provided so that all stakeholders are kept apprised.
- Business activities – The Company has been cognizant of the upcoming transition to IFRS and as such will work with counterparties and lenders to ensure that agreement references to Canadian GAAP statements are modified to allow for IFRS statements. Based on the expected changes to the Company's accounting policies, there are no foreseen issues with the existing wording of debt covenants and related agreements as a result of the conversion to IFRS.
- Information technology systems – The Company has identified several accounting system upgrades required for IFRS reporting and is working with its software provider to make the necessary changes. The modifications are not significant; however, they are critical in order to allow for reporting of both Canadian GAAP and IFRS statements in 2010 as well as the modifications required to track PP&E costs and E&E costs to a more granular level of detail for IFRS reporting. Additional system modifications may be required based on final policy choices.

### **CRITICAL ACCOUNTING ESTIMATES**

The reader is advised that the critical accounting estimates, policies, and practices as described here continue to be critical in determining Fortress' 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 amounts 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 natural gas reserves are capitalized in a single Canadian cost centre. Such costs include lease acquisition, lease rentals on undeveloped properties, geological and geophysical costs, drilling 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 wells as either developmental or exploratory, which will ultimately determine the proper income tax treatment of the costs incurred.

Full cost accounting depends on the estimated proved reserves that are believed to be recoverable from the Company's oil and natural 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 natural gas prices and costs change. The Company's reserve estimates are based on current production forecasts, prices and economic conditions. Fortress' reserves were evaluated by the independent engineering firm Sproule Associates Ltd.

Reserve estimates are critical to many of Fortress' accounting estimates, including:

- Calculating the Company's unit-of-production depletion and future site restoration rates. Proved reserve estimates are used to determine rates that are applied to each unit-of-production in calculating depletion expense; and
- Assessing when necessary, oil and natural gas assets for possible impairment. Estimated future undiscounted cash flows are determined using proved 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 Fortress makes every reasonable effort to ensure that its 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. Positive or negative revisions to the Company's reserve estimates can arise from changes in oil and natural gas prices, and reservoir performance.

### **Impairment of Petroleum and Natural Gas Properties**

The Company reviews its full cost pool for impairment 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 plus 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, planned future development and sales impacts the amount and timing of impairment provisions.

### **Asset Retirement Obligations**

The provision for asset retirement obligations recorded in the consolidated financial statements is based on an estimate of total costs for future site restoration and abandonment of the Company's petroleum and natural gas properties. 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 its consolidated financial statements and its 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 its future tax assets. If Fortress concluded that it is more likely than not that some portion or all of the deferred tax assets will not be realized under accounting standards, the tax asset would be reduced by a valuation allowance.

### **Claims and Litigation**

The Company is involved in various claims and litigation arising in the normal course of business. The outcome of these matters is uncertain and there can be no assurance that such matters will be resolved in the Company's favour. If the outcomes of these claims are unfavourable, there could be a materially adverse impact on the Company's financial position or results of operations.

With the above risks and uncertainties, the reader is cautioned that future events and results may vary significantly from those which Fortress currently foresees.

## **BUSINESS RISKS and UNCERTAINTIES**

### **Going Concern and CCAA Issues**

There is substantial risk on the Company's ability to continue as a going concern. As the Company is experiencing negative cash flow with no certainty as to when it will have positive cash flow, the Company is dependent on outside sources for funding future capital expenditures. Failure to obtain such funding would, in all likelihood, lead to a liquidation of the Company's assets.

Similarly, if the Company cannot successfully implement a Plan under the CCAA or if the Plan is not accepted by affected Creditors or if the Company loses its protection of the stay of proceedings such would in all likelihood lead to the liquidation of the Company's assets.

Please refer to the discussion in the "*Liquidity and Capital Resources – Going Concern Uncertainty*" section of this MD&A.

### **CRA Reassessment**

The Company obtained the Order under the CCAA staying all claims and actions against the Company and its assets. Fortress took such steps in order to enable it to challenge a reassessment by CRA. While the Company believes the reassessment is not sustainable, in the event the reassessment is upheld and the CRA enforces its rights such would, in all likelihood, lead to a liquidation of the Company's assets.

### **Delisting**

The Common Shares have been delisted from trading on the TSX as a result of the sale of substantially all the assets of the Company. While the Company has applied to list the shares on an alternative Exchange, there can be no assurance that a listing will be obtained. Failure or delay in obtaining a listing on another stock exchange will drastically reduce the liquidity of the Common Shares.

### **Substantial Capital Requirements**

The Company will be required to acquire additional assets in order to continue as a viable entity. In order to acquire additional assets the Company will need additional capital. There can be no assurance that debt or equity financing, or cash generated by operations, will be available or sufficient to meet these requirements or for other corporate purposes or, if debt or equity financing is available, that it will be on terms acceptable to the Company. The inability of the Company to access sufficient capital for its operations could have a material adverse effect on its business, financial condition, results of operations and prospects including its ability to continue in business.

There is no assurance that current cash on hand will be able to sustain the Company through the conclusion of the dispute with CRA. Should the dispute continue for an extended period, the Company will be required to identify alternative sources of financing. Given the reassessment and that the Company is under CCAA, it may be difficult to raise the required capital to fund ongoing operations.

### **General**

Fortress' production and exploration activities are concentrated in the Western Canada Sedimentary Basin, where activity is highly competitive and includes a variety of different-sized companies ranging from smaller junior producers to the much larger integrated petroleum companies. Fortress is subject to various types of business risks and uncertainties including:

- Finding and developing oil and natural gas reserves at economic costs;
- Production of oil and natural gas in commercial quantities; and
- Marketability of oil and natural gas produced;

In order to reduce exploration risk, the Company strives to employ highly qualified and motivated professional employees with a demonstrated ability to generate high-quality proprietary geological and geophysical prospects. To help maximize drilling success, Fortress combines exploration in areas that afford multi-zone prospect potential, targeting a range of low to moderate-risk prospects with some exposure to selected high-risk with high-reward opportunities.

The Company mitigates its risk related to producing hydrocarbons through the utilization of the most appropriate technology and information systems. In addition, the Company seeks to maintain operational control of its prospects.

Oil and natural gas exploration and production can involve environmental risks such as pollution of the environment and destruction of natural habitat, as well as safety risks such as personal injury. In order to mitigate such risks, Fortress conducts its operations at high standards and follows safety procedures intended to reduce the potential for personal injury to employees, contractors and the public at large. The Company maintains current insurance coverage for general and comprehensive liability as well as limited pollution liability. The amount and terms of this insurance are reviewed on an ongoing basis and adjusted as necessary to reflect changing corporate requirements, as well as industry standards and government regulations. Fortress may periodically use financial or physical delivery hedges to reduce its exposure against the potential adverse impact of commodity price volatility, as governed by formal policies approved by senior management subject to controls established by the Board of Directors.

### **Third-party Credit Risk**

The Company may be exposed to third-party credit risk through its contractual arrangements with its current or future joint venture partners, marketers of its petroleum and natural gas production and other parties. In the event such entities fail to meet their contractual obligations to the Company, such failures may have a material adverse effect on Fortress' business, financial condition, results of operations and prospects.

Additional risk factors can be found under "Risk Factors Relating to the Oil and Gas Business" in the Company's 2010 Annual Information Form which can be found on the Company's website [fortressenergy.ca](http://fortressenergy.ca) or under the Company's profile on [www.sedar.com](http://www.sedar.com). The risks should not be construed as exhaustive. There are numerous factors, both known and unknown, that could cause actual results or events to differ materially from forecast results.

## MANAGEMENT'S RESPONSIBILITY FOR THE FINANCIAL STATEMENTS

The accompanying consolidated financial statements and all information in this report are the responsibility of management. The consolidated financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles. Financial statements are not precise since they include certain amounts based upon estimates and judgments. When alternative accounting methods exist, management has chosen those it deems to be the most appropriate to ensure fair and consistent presentation. The financial information presented elsewhere in this report is consistent with that in the financial statements.

Management maintains financial and operating systems that include appropriate and effective internal controls. Such systems are designed to provide reasonable assurance that the financial information is reliable and relevant, and the Company's assets are appropriately accounted for and adequately safeguarded.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and is ultimately responsible for reviewing and approving the financial statements. The Board of Directors carries out this responsibility principally through its Audit Committee.

The Audit Committee is appointed by the Board of Directors and reviews the financial statements and Management's Discussion and Analysis; assesses the adequacy of the internal controls of the Company; considers the report of the external auditors; examines the fees and expenses for audit services; and recommends to the Board of Directors the independent auditors for appointment by the shareholders. The Audit Committee reports its findings to the Board of Directors for consideration when approving the annual financial statements for issuance to the shareholders.

The consolidated financial statements as at and for the year ended December 31, 2010 have been audited by KPMG LLP, the external auditors, in accordance with Canadian generally accepted auditing standards, on behalf of the shareholders. KPMG LLP has full and free access to, and meets periodically with, the Audit Committee.

*"signed"*  
*J. Cameron Bailey*  
*President & CEO*

*"signed"*  
*Jamie Jeffs, C.A.*  
*Chief Financial Officer*

Calgary, Canada  
April 29, 2011



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## **INDEPENDENT AUDITORS' REPORT**

### **To the Shareholders of Fortress Energy Inc.**

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

### **Management's Responsibility for the Consolidated Financial Statements**

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

### **Auditor's Responsibility**

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

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

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



## **Opinion**

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

## **Emphasis of matter – Going Concern**

Without qualifying our opinion, we draw attention to note 1 and 14 to the financial statements concerning the company's ability to continue as a going concern. The Company has a deficit of \$154,993,000 at December 31, 2010 and has obtained an order under the Companies' Creditors Arrangement Act (Canada) for protection from its creditors. These conditions, along with the other matters explained in note 1 and 14 to the financial statements, indicate the existence of a material uncertainty which may cast doubt about the Company's ability to continue as a going concern.

*Signed "KPMG LLP"*

Chartered Accountants  
April 29, 2011  
Calgary, Canada

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**FORTRESS ENERGY INC.**

## CONSOLIDATED BALANCE SHEETS

(Under Creditor Protection Proceedings as of March 2, 2011 – note 1)

As at December 31

(in thousands)

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	2010	2009
<b>ASSETS</b>		
Current Assets		
Cash and cash equivalents (note 6)	\$ 2,433	\$ 64
Accounts receivable	1,750	5,576
Prepaid expenses and deposits	338	470
Commodity contracts (note 10)	-	1,321
Investment (note 3)	4,544	-
	<u>9,065</u>	<u>7,431</u>
Property, plant and equipment (notes 4 and 5)	2,178	90,017
	<u>\$ 11,243</u>	<u>\$ 97,448</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current Liabilities		
Revolving operating loan (note 6)	\$ -	\$ 23,044
Accounts payable and accrued liabilities	3,570	7,712
Income taxes	164	172
	<u>3,734</u>	<u>30,928</u>
Asset retirement obligations (note 8)	789	4,324
	<u>4,523</u>	<u>35,252</u>
Shareholders' Equity		
Share capital (note 9)	140,068	140,094
Warrants (note 9)	5,406	5,406
Contributed surplus (note 9)	16,239	15,435
Deficit	(154,993)	(98,739)
	<u>6,720</u>	<u>62,196</u>
Going concern (note 1)		
Commitments and contingencies (note 11)		
Subsequent events (note 14)		
	<u>\$ 11,243</u>	<u>\$ 97,448</u>

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See accompanying notes to consolidated financial statements.

On behalf of the Board of Directors:

*"signed"*  
J. Cameron Bailey  
Director

*"signed"*  
George Watson  
Director

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**FORTRESS ENERGY INC.**

## CONSOLIDATED STATEMENTS OF OPERATIONS, COMPREHENSIVE LOSS AND DEFICIT

(Under Creditor Protection Proceedings as of March 2, 2011 – note 1)

For the years ended December 31

(in thousands, except per share amounts and number of shares)

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	2010	2009
<b>REVENUES</b>		
Petroleum and natural gas sales	\$ 16,656	\$ 18,589
Royalties	(473)	(714)
Unrealized loss on commodity contracts (note 10)	(1,321)	(1,166)
	<u>14,862</u>	<u>16,709</u>
<b>EXPENSES</b>		
Operating	5,924	7,422
Transportation	987	915
Environmental remediation	-	134
General and administrative (notes 5 and 13)	3,252	2,908
Professional fees (note 13)	516	675
Bad debts (recovery)	(4)	294
Transaction costs	564	-
Stock-based compensation (note 9)	767	388
Interest	1,318	917
Depletion, depreciation and accretion	7,629	13,170
Ceiling test impairment (note 5)	47,476	19,096
Loss on sale of oil and gas assets	1,000	304
Write down of temporary investment	293	-
Indemnification of flow-through share subscribers (note 9)	1,314	-
	<u>71,036</u>	<u>46,223</u>
Loss before income taxes	(56,174)	(29,514)
Income tax expense (reduction) (note 7)		
Current	106	96
Future	(26)	(3,868)
	<u>80</u>	<u>(3,772)</u>
Net loss and comprehensive loss for the year	(56,254)	(25,742)
Deficit, beginning of year	(98,739)	(72,997)
Deficit, end of year	<u>\$ (154,993)</u>	<u>\$ (98,739)</u>
Weighted average shares outstanding (note 9)	55,294,617	34,073,339
Net loss per share – basic and diluted (note 9)	\$ (1.02)	\$ (0.76)

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See accompanying notes to consolidated financial statements.

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**FORTRESS ENERGY INC.**

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(Under Creditor Protection Proceedings as of March 2, 2011 – note 1)

For the years ended December 31

(in thousands)

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	2010	2009
<b>CASH PROVIDED BY (USED IN):</b>		
<b>OPERATING ACTIVITIES</b>		
Net loss for the year	\$ (56,254)	\$ (25,742)
Items not affecting cash flows:		
Unrealized loss on commodity contracts	1,321	1,166
Stock-based compensation	767	388
Depletion, depreciation and accretion	7,629	13,170
Ceiling test impairment	47,476	19,096
Loss on sale of oil and gas assets	1,000	304
Write down of temporary investment	293	-
Future income tax reduction	(26)	(3,868)
Abandonment expenditures	-	(173)
	2,206	4,341
Change in non-cash operating working capital (note 12)	(650)	(1,621)
Cash provided by operating activities	1,556	2,720
<b>FINANCING ACTIVITIES</b>		
Change in revolving operating loan	(23,044)	2,511
Issuance of common shares and warrants (note 9)	-	11,385
Share issuance costs	-	(1,065)
Indemnification of flow-through share subscribers	1,314	-
Cash provided by (used in) financing activities	(21,730)	12,831
<b>INVESTING ACTIVITIES</b>		
Property, plant and equipment additions	(1,747)	(9,865)
Proceeds on sale of property, plant and equipment (note 5)	25,146	-
Acquisition of business, net of cash (note 4)	-	(6,989)
Change in non-cash investing working capital (note 12)	(856)	1,184
Cash provided by (used in) investing activities	22,543	(15,667)
Net change in cash	2,369	(116)
Cash and cash equivalents - beginning of year	64	180
Cash and cash equivalents - end of year	\$ 2,433	\$ 64
Supplemental cash flow information:		
Income taxes paid	3	60
Interest paid	976	1,015

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See accompanying notes to consolidated financial statements.

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# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

December 31, 2010 and 2009

(Tabular figures are in thousands of Canadian dollars unless otherwise indicated)

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### 1. CREDITOR PROTECTION

Fortress Energy Inc. ("Fortress" or the "Company") was incorporated on January 15, 2007 under the Business Corporations Act (Alberta). Fortress is a Calgary-based junior oil and natural gas exploration and development company. All activity is conducted in Western Canada and comprises a single operating segment.

#### a) CCAA proceedings

On March 2, 2011, Fortress applied to the Court of Queen's Bench of Alberta for an Order under the *Companies' Creditors Arrangement Act* (Canada) ("CCAA") staying all claims and actions against the Company and its assets and allowing the Company to prepare a plan of arrangement for its creditors if necessary. The Order was granted and was in effect until March 31, 2011. The Order was subsequently extended to May 27, 2011, at which time the matter will be reviewed by the Court. While the Order is in effect the Company will work with a court-appointed monitor.

Fortress has taken this step to enable it to challenge a reassessment issued by the Canada Revenue Agency (the "CRA"), which reassessment is in the amount of approximately \$18,000,000 (in addition, the Company expects provincial reassessments based on the CRA reassessments of approximately \$10,000,000). As a result of the reassessment, if the Company took no action, it would be compelled to immediately remit \$9,000,000 to the CRA and the Company does not have the necessary funds to remit. Fortress believes that the CRA's position is not sustainable and is vigorously disputing the CRA's claim.

The reassessment denies the deduction of certain tax pools in SignalEnergy Inc.'s ("Signal") 2004, 2005 and 2006 taxation years on the basis that (i) those pools arose from expenses incurred prior to November of 2003 and (ii) that there was an acquisition of control of Signal (previously named SignalGene Inc.) in November of 2003. Signal was subsequently wound-up into Fortress.

Following the transactions that occurred in November of 2003, Signal was developed into an oil and gas company with over \$140,000,000 of oil and gas assets. On February 1, 2006, Signal received an unsolicited offer to acquire a substantial portion of its oil and gas assets for \$100,000,000 which transaction subsequently closed on March 10, 2006. Fortress used its available tax pools to reduce its taxable income from the proceeds of the disposition.

Management believes that no acquisition of control has occurred. Through a series of communications, including detailed written correspondence with the CRA, Fortress attempted to correct certain apparent factual misunderstandings that had led the CRA to determine that an acquisition of control had occurred. Notwithstanding the explanations by Fortress, the CRA issued the reassessments.

In addition to potential remedies that may be available under the CCAA, the Tax Act provides for at least two more levels at which this dispute can be considered. The first is at the appeals level with the CRA and, as a resolution at this level would resolve this matter most expeditiously; this is the avenue Fortress is pursuing at this time. If that process does not result in a successful resolution of this matter, Fortress can, and if necessary will, file an appeal to the Tax Court of Canada. While there is no certainty in the case of a CRA challenge, Fortress strongly believes that pursuit of this matter to a higher level should result in this matter being resolved in its favour.

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# **FORTRESS ENERGY INC.**

## **Notes to Consolidated Financial Statements**

December 31, 2010 and 2009

(Tabular figures are in thousands of Canadian dollars unless otherwise indicated)

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As Fortress was a large corporation for purposes of the Tax Act in the taxation years that have been reassessed, under the relevant legislation the CRA is empowered to take action to collect 50 percent of the tax owing at any time during this dispute process (notwithstanding the ability of Fortress to challenge the reassessment and that no final legal determination of the matter has occurred). Due to the vast powers afforded to the CRA to collect this amount, and the severe adverse impact it would have on Fortress and its creditors if the CRA took any collection action without providing Fortress with reasonable notice, Fortress has taken action to protect stakeholders by voluntarily applying to the court for protection under CCAA.

b) TSX listing requirements

The Company announced that it had been advised on October 17, 2010 by the TSX that the Company substantially discontinued its business or materially changed the nature of its business by virtue of the closing of the sale of its oil and gas assets announced on September 1, 2010 and the Company was required to meet original listing requirements by February 18, 2011.

On February 23, 2011, Fortress announced that that it did not meet the listing requirements of the TSX by virtue of the sale of substantially all of its oil and gas assets on September 1, 2010. Fortress was notified by the TSX that its formal listing committee determined on February 25, 2011, that Fortress would be delisted from the TSX on March 30, 2011. As a result, Fortress then commenced the application process for listing on the TSX Venture Exchange and both exchanges at that time indicated a willingness to ensure a seamless transition to ensure no disruption of trading. Although application to the TSX Venture Exchange has started, Fortress is uncertain it will be accepted for listing until the CCAA Order is removed. Fortress was delisted from the TSX on March 30, 2011.

Fortress is considering a listing on the Canadian National Stock Exchange ("CNSX"). The CNSX has indicated its willingness to allow Fortress shares to be listed for trading on such exchange notwithstanding the CCAA Order.

c) Going concern uncertainty

The Company's consolidated financial statements have been prepared on a going concern basis, which assumes the realization of assets and discharge of liabilities in the normal course of business for the foreseeable future. The Company has experienced consecutive losses and has an accumulated deficit of \$154,933,000 as at December 31, 2010.

There is significant uncertainty regarding the Company's ability to continue as a going concern, which is dependent upon achieving on-going cash flow from operating activities and receiving additional support from its creditors and investors.

The Company is experiencing negative cash flow from operating activities. There is no certainty as to when the Company will have positive cash flow. The Company will be solely dependent upon outside sources and third party financings to obtain the necessary capital to implement a plan to explore and develop its properties or acquire further properties or restructure the Company and continue as a going concern. While the Company has repaid its outstanding bank indebtedness, it does not have access to short term bank financing. If the Company is unable to secure sufficient financing, delays or postponement of future development or production of the Company's properties may result.

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# **FORTRESS ENERGY INC.**

## **Notes to Consolidated Financial Statements**

December 31, 2010 and 2009

(Tabular figures are in thousands of Canadian dollars unless otherwise indicated)

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There can be no assurance that the additional capital required or other types of financing will be available if needed or even if available, the terms of such financing will be acceptable to the Company.

Therefore, failure to obtain suitable financing would, in all likelihood, lead to the liquidation of the Company's assets.

Should the stay period in the CCAA proceedings and any subsequent extensions thereof, if granted, not be sufficient to develop and present a plan ("Plan") under the CCAA, or allow a successful resolution of the dispute with CRA regarding the reassessment, or should the Plan not be accepted by affected creditors or confirmed by the Court and, in any such case, the Company loses the protection of the stay of proceedings, creditors including CRA may immediately enforce their rights and remedies against the Company and its properties which would in all likelihood lead to the liquidation of the Company's assets. Failure to implement a Plan and obtain sufficient exit financing within the time granted by the Court would in all likelihood also lead to the liquidation of the Company's assets.

There can be no assurance that a Plan proposed by the Company will be supported by the Company's creditors or confirmed by the Court, or that any such Plan or Plans will be consummated or successful. Without limiting the foregoing there can be no assurance that the Company will be successful in its dispute with CRA regarding the reassessment.

Considering a timely resolution of the CRA reassessment has not occurred and the timeline for a conclusion remains uncertain, it is not possible for the Company to invest in any new initiatives at this time and third party sources of financing may not be available to the Company.

These financial statements do not contain any adjustments to the amounts and classification of assets and liabilities that might be necessary should the Company be unable to continue in business.

## **2. SIGNIFICANT ACCOUNTING POLICIES**

### **Basis of presentation**

The consolidated financial statements of the Company have been prepared by management in accordance with Canadian generally accepted accounting principles (GAAP). The timely preparation of financial statements requires that management make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from estimates.

In the opinion of management, these consolidated financial statements have been properly prepared within reasonable limits of materiality and within the framework of the significant accounting policies summarized below.

#### **a) Consolidation**

The consolidated financial statements of the Company include the accounts of the Company and its wholly-owned subsidiary. All inter-company transactions and balances have been eliminated. The financial statements include the accounts of Fortress and its wholly owned subsidiary, 1310639 Alberta Ltd., on a consolidated basis.

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# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

December 31, 2010 and 2009

(Tabular figures are in thousands of Canadian dollars unless otherwise indicated)

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b) Joint operations

A portion of the Company's exploration, development and production activities is conducted jointly with others and, accordingly, these consolidated financial statements reflect only the Company's proportionate interest in such activities.

c) Cash and cash equivalents

Cash and cash equivalents include short-term investments with an original maturity of three months or less from the date of purchase. Cash and cash equivalents are recorded at fair value.

d) Property, plant and equipment

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

Proceeds from the disposition of oil and natural gas properties are accounted for as a reduction of capitalized costs, with no gain or loss recognized unless such disposition would alter the depletion and depreciation rate by 20 percent or more.

Other capital assets include furniture and fixtures and are recorded at cost.

e) Depletion and depreciation

All costs of acquisition, exploration and development of oil and natural gas reserves, associated plant and equipment costs (net of salvage value), and estimated costs of future development of proved undeveloped reserves are depleted using the unit-of-production method based on estimated gross proved reserves as determined by the Company's independent reserve engineers.

Costs of unproved properties and seismic costs on undeveloped land are initially excluded from oil and natural gas properties for the purpose of calculating depletion. When proved reserves are assigned or the property or seismic costs are considered impaired, the cost of the property or the amount of the impairment is added to costs subject to depletion.

The relative volumes of oil and natural gas reserves and production are converted to equivalent barrels of oil based on the relative energy content of one barrel of oil being equal to six thousand cubic feet of natural gas.

Capital assets not related to oil and natural gas properties are depreciated over their estimated useful lives using the straight-line method at an annual rate of 20 percent.

f) Impairment of property, plant and equipment

A ceiling test is performed to recognize and measure impairment, if any, of the carrying amount of oil and natural gas properties and equipment by comparing the carrying amount of property and equipment to the sum of undiscounted cash flows expected to result from the future production of proved reserves and the cost of unproved properties less any impairment. Cash flows are based on a forecast of prices and costs, adjusted for transportation and quality, as provided by the Company's independent reserve engineers.

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# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

December 31, 2010 and 2009

(Tabular figures are in thousands of Canadian dollars unless otherwise indicated)

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Should this result in an excess of carrying value, the Company would then measure the amount of impairment by comparing the carrying amounts of property and equipment to the sum of the estimated net present value of future cash flows from proved plus probable reserves and the cost of unproved properties less any impairment. A risk-free interest rate is used to arrive at the net present value of the future cash flows. Any excess is recorded as additional depletion in the period the impairment is identified.

The carrying value of undeveloped properties (land and seismic data) is reviewed periodically and written down to net realizable value if impairment is determined.

g) Asset retirement obligations

Asset retirement obligations include the costs of abandonment of oil and natural gas wells, dismantling and removing tangible equipment, and returning land to its original condition.

The fair value of estimated asset retirement obligations is recognized in the consolidated financial statements in the period in which they are identified and when a reasonable estimate of the fair value can be made. The fair value is determined through a review of engineering studies, industry guidelines, and management's estimate on a site-by-site basis. The asset retirement cost, equal to the estimated fair value of the asset retirement obligation, is capitalized as part of the cost of the related long-lived asset.

The liability is subsequently adjusted for the passage of time, which is recognized as accretion expense in the consolidated statement of operations. The liability is also adjusted due to revisions in either the timing or the amount of the original estimated cash flows associated with the liability. The increase in the carrying value of the asset is amortized using the unit of production method based on estimated gross proven reserves, as determined by independent engineers. Actual costs incurred upon settlement of the asset retirement obligations are charged against the asset retirement obligation to the extent of the liability recorded. Any difference between the actual costs incurred upon settlement of the asset retirement obligation and the recorded liability is charged to property, plant and equipment in the period in which the settlement occurs unless the settlement represents abandonment of the last well in the cost centre, in which case the difference is charged to the consolidated statement of operations.

h) Flow-through shares

A portion of the Company's exploration and development activities is financed through proceeds received from the issuance of flow-through shares. Under the terms of the flow-through share issues, the tax attributes of the related expenditures are renounced to the share subscribers. To recognize the foregone tax benefits to the Company, the carrying value of the shares issued is reduced by the tax effect of the tax benefits renounced to the subscribers. The tax effect of the renunciation is recorded when the required documents are filed with the tax authorities and the corresponding exploration and development expenditures are incurred or there is reasonable certainty they will be incurred within the permitted time-frame.

i) Stock-based compensation

The Company accounts for stock options using the fair value method whereby compensation expense is recognized over the vesting period based on the fair value of stock options at the date of grant. The fair value of stock options granted is determined using the Black-Scholes option-pricing model and is recorded as compensation expense and contributed surplus. Contributed surplus is reduced as stock options are exercised and credited to share capital.

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# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

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(Tabular figures are in thousands of Canadian dollars unless otherwise indicated)

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j) Restricted stock unit plan

Restricted stock units vest over a three-year period and are settled in cash. Holders of each restricted stock unit are entitled to receive in cash at maturity the value equivalent to the weighted average share price on the Toronto Stock Exchange, for the last 20 trading days immediately prior to maturity. A liability and expense are recorded at each reporting date, determined by multiplying the number of vested units by the volume-weighted average closing price of the Company's common shares for the 20 day period immediately prior to the reporting date.

k) Revenue recognition

Petroleum and natural gas sales are recognized as revenue when the commodities are delivered to purchasers. The costs associated with the delivery, including operating and transportation, are recognized in the same period in which the related revenue is earned and recorded.

l) Future income taxes

The Company follows the asset and liability method of accounting for income taxes. Under this method, future tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using substantively enacted tax rates and laws that will be in effect when the differences are expected to reverse. The effect on future income tax assets and liabilities of a change in tax rates is recognized in net income in the period in which the change is substantively enacted. Income tax expense for the period is the tax payable for the period and any change during the period in future income tax assets and liabilities. A valuation allowance is recorded to the extent that it is not more likely than not the future income tax asset will be realized. The Company recognizes an income tax uncertainty when it is more likely than not that the uncertainty will be realized. Conversely, the Company derecognizes a previously recognized income tax uncertainty in the period in which it is no longer more likely than not that the uncertainty will be realized. An income tax uncertainty that meets the more likely than not threshold will initially and subsequently be measured using the Company's best estimate of the amount that will be ultimately realized.

m) Measurement uncertainty

The operations of the Company are complex, and regulations and legislation affecting the Company are continually changing. Although the ultimate impact of these matters on the net income or loss cannot be determined at this time, it could be material for any quarter or year. Management makes estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements, and revenues and expenses during the reporting year. Actual results can differ from those estimates.

The measurement of future income tax balances is subject to uncertainty relating to the outcome of the CRA reassessment (see note 1) and the reversal of temporary differences which are based on estimates of recoverability of oil and gas reserves, commodity prices, the timing of future cash flows and changes in legislation and tax rates. By their nature, these estimates are subject to measurement uncertainty and the effect on the financial statements of changes of estimates in future periods could be significant.

Recorded amounts for depletion and depreciation of petroleum and natural gas properties and equipment are based on estimates. The ceiling test and impairment calculations are based on estimates of oil and natural gas reserves, future costs required to develop those reserves and the fair value of unproved properties.

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# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

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By their nature, these estimates of reserves and the related future cash flows are subject to measurement uncertainty, and the effect on the consolidated financial statements of future years could be significant.

The capital expenditures classification made with respect to the renunciation of flow-through shares is based on estimates from geological and geophysical information obtained and the classification of the expenditures may be challenged by the taxation authorities and their assessments may be different from that of management. By their nature, these estimates are subject to measurement uncertainty and the effect on the consolidated financial statements of changes to estimates in future years could be significant.

The consolidated financial statements include accruals based on the terms of existing joint venture agreements. Due to varying interpretations of the definition of terms in these agreements the accruals made by management in this regard may be significantly different from those determined by the Company's joint venture partners. The effect on the consolidated financial statements resulting from such adjustments, if any, will be reflected prospectively.

Option pricing models require the input of highly subjective assumptions including the expected stock price volatility. By their nature, these estimates are subject to measurement uncertainty and the effect on the consolidated financial statements of changes of estimates in future years could be significant.

n) Derivative financial instruments and hedging activities

(i) Comprehensive income

Comprehensive income is comprised of net earnings or loss and other comprehensive income (OCI). OCI represents the change in equity for a period that arises from unrealized gains and losses on available-for-sale securities and changes in the fair market value of derivative instruments designated as cash flow hedges. Fortress does not currently have any transactions that give rise to OCI; therefore there is no difference between Fortress' net income or loss and comprehensive income or loss.

(ii) Financial instruments

All financial instruments are initially recorded at fair-value and are subsequently accounted for based on one of five classifications: held for trading, held-to-maturity, other financial liabilities, loans and receivables or available-for-sale. The classification of a financial instrument depends on its characteristics and the purpose for which it was acquired.

Held-for-trading

Held-for-trading financial instruments are financial assets or financial liabilities that are purchased with the intention of selling or repurchasing in the near term. A derivative is classified as held-for-trading unless designated as an effective hedge. Held-for-trading instruments are recorded at fair value with any subsequent changes in the fair value recognized as realized or unrealized gains or losses for the year.

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# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

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### Held-to-maturity

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and a fixed maturity that Fortress has the intention and ability to hold to maturity. These financial assets are measured at amortized cost using the effective interest method. Any gains or losses arising from the sale of a held-to-maturity investment are included in earnings.

Currently, there are no items accounted for under this category.

### Other financial liabilities

Items classified as other financial liabilities are accounted for at amortized cost using the effective interest method. Any gains or losses in the realization of other financial liabilities are included in earnings.

Fortress has classified its accounts payable and accrued liabilities as other financial liabilities. The fair values of accounts payable and accrued liabilities approximate their carrying values due to their short-term nature.

### Loans and receivables

Items classified as loans and receivables are accounted for at amortized cost using the effective interest method. Any gains or losses on the realization of loans and receivables are included in earnings. The fair value of accounts receivable approximates its carrying value due to the short-term nature of these instruments and is accounted for under this category.

### Available-for-sale

Available-for-sale assets are those financial assets that are not classified as held for trading, held-to-maturity or loans and receivables. Available-for-sale instruments are recorded at fair value. Any gains or losses arising from the change in fair value is recorded in OCI and upon the sale of the instrument or other-than-temporary impairment, the cumulative gain or loss is included in earnings.

Fortress has not designated any financial instruments as available-for-sale assets.

### o) Per share amounts

The treasury stock method is used in the determination of diluted earnings per share. Under this method, the diluted weighted average number of shares is calculated assuming the proceeds that arise from the exercise of outstanding in-the-money options are used to purchase common shares of the Company at their average market price for the applicable period.

### p) Comparative figures

Certain comparative figures have been reclassified to conform to the presentation adopted in the current year.

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# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

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(Tabular figures are in thousands of Canadian dollars unless otherwise indicated)

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q) Changes in accounting policies

The Canadian Institute of Chartered Accountants (CICA) Handbook Section 3064, *Goodwill and Intangible Assets*, replaced Section 3062, *Goodwill and Other Intangible Assets*, and resulted in the withdrawal of Section 3450, *Research and Development Costs*, and amendments to Accounting Guideline (AcG) 11, *Enterprises in the Development Stage* and Section 1000, *Financial Statement Concepts*. This standard reduces the differences with International Financial Reporting Standards (IFRS) in the accounting for intangible assets and results in closer alignment with U.S. GAAP.

The objectives of Section 3064 are to reinforce the principle-based approach to the recognition of assets only in accordance with the definition of an asset and the criteria for asset recognition and to clarify the application of the concept of matching revenues and expenses such that the current practice of recognizing as assets items that do not meet the definition and recognition criteria is eliminated. The standard also provides guidance for the recognition of internally developed intangible assets (including research and development activities), ensuring consistent treatment of all intangible assets, whether separately acquired or internally developed. The adoption of this standard by Fortress on January 1, 2009 did not have an impact on the Company's financial statements.

On January 20, 2009 the CICA's Emerging Issues Committee (EIC) issued EIC-173 *Credit Risk and the Fair Value of Financial Assets and Financial Liabilities*. Under EIC-173, an entity's own credit risk and the credit risk of the counterparty with which it conducts transactions should be taken into account in determining the fair value of financial assets and liabilities, including derivative instruments.

Fortress adopted the requirements of EIC-173 effective January 1, 2009. The adoption of this standard did not have an impact on the Company's financial statements.

In June 2009, the AcSB amended Section 3862, *Financial Instruments – Disclosures*, to converge with *Improving Disclosures about Financial Instruments* (Amendments to IFRS 7). The amendments expand the disclosures required in respect of recognized fair value measurements and clarify existing principles for disclosures about the liquidity risk associated with financial instruments. This standard is effective for the annual period ending December 31, 2009 (refer to note 10).

In December 2008, the CICA issued Section 1582, *Business Combinations*, which replaces the previous business combinations standard. The standard requires assets and liabilities acquired in a business combination, contingent consideration and certain acquired contingencies to be measured at their fair values as of the date of acquisition. In addition, acquisition-related and restructuring costs are to be recognized separately in the statement of operations. The Company's adoption of this standard on January 1, 2010 resulted in the expensing of certain acquisition-related costs in 2010. This standard has been applied on a prospective basis with no restatement of prior periods

r) Future accounting changes

The Canadian Accounting Standards Board (AcSB) has confirmed that the use of IFRS will be required in 2011 for publicly accountable profit-oriented enterprises. IFRS will replace Canada's current GAAP for those enterprises. These include stock exchange-listed companies and other profit-oriented enterprises that are responsible to large or diverse groups of stakeholders. The official changeover date is for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. Companies will be required to provide comparative IFRS information for the previous fiscal year.

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# FORTRESS ENERGY INC.

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### 3. TEMPORARY INVESTMENT

Temporary investment reflects the Company's investment in 3,664,444 common shares of Terra Energy Corp. ("Terra") which had a quoted market value on December 31, 2010 of \$1.24 per share. The Terra shares trade on the Toronto Stock Exchange ("TSX") under the symbol "TT" and were subject to a four month hold period that expired on December 29, 2010.

### 4. BUSINESS ACQUISITION

Effective October 23, 2009 the Company acquired its partner's working interests in the Square Creek area for \$6,986,000 including transaction costs of \$50,000 and the assumption of asset retirement obligations of \$251,000.

The acquisition has been accounted for using the purchase method and the results of operations are included in the consolidated statement of operations from the closing date of October 23, 2009.

### 5. PROPERTY, PLANT AND EQUIPMENT

On August 31, 2010, the Company sold substantially all of its oil and gas properties, tangible equipment and undeveloped land, other than its interests at Buick Creek and Pine Creek, to Terra Energy Corp. for proceeds of \$30,437,000, consisting of cash of \$25,600,000 and 3,664,444 common shares of Terra valued at \$1.32 per share. The Terra shares were subject to a four month hold period that expired on December 29, 2010. The transaction costs associated with this transaction were \$454,000. The cash proceeds were used to repay bank indebtedness of \$21,457,000. The Company realized a loss on the sale of oil and gas properties of \$1,000,000.

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	Cost	Accumulated Depletion and Depreciation	Net Book Value
December 31, 2010	\$	\$	\$
Oil and natural gas properties	7,746	5,701	2,045
Other	423	290	133
	8,169	5,991	2,178

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	Cost	Accumulated Depletion and Depreciation	Net Book Value
December 31, 2009	\$	\$	\$
Oil and natural gas properties	153,662	63,809	89,853
Other	420	256	164
	154,082	64,065	90,017

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In the year ended December 31, 2010, the Company capitalized general and administrative and stock-based compensation expenses of \$292,000 (year ended December 31, 2009 - \$1,022,000) directly attributable to exploration and development activities.

Estimated future development costs of \$nil (December 31, 2009 - \$7,456,000) were included in the calculation of depletion expense for the year ended December 31, 2010. As at December 31, 2010, undeveloped land costs of \$170,000 (December 31, 2009 - \$7,519,000) were excluded from assets subject to depletion.

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# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

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(Tabular figures are in thousands of Canadian dollars unless otherwise indicated)

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In 2010, the Company recorded a ceiling test impairment charge of \$47,476,000 (2009 - \$14,276,000), consisting of a charge of \$10,715,000 recorded in the first quarter and an additional charge of \$36,761,000 recorded in the second quarter of 2010 related to the Terra transaction.

The Company performed a ceiling test calculation at December 31, 2010 which resulted in the carrying amount of the Company's oil and natural gas properties not exceeding the estimated undiscounted future cash flows associated with the Company's proved reserves.

The oil and natural gas prices used in the ceiling test calculation are based on the December 31, 2010 commodity price forecast of our independent reserve evaluators and are as follows:

Year	AECO natural gas (Cdn\$/MMbtu)
2011	\$4.04
2012	\$4.66
2013	\$4.99
2014	\$6.58
2015	\$6.69

Prices are assumed to increase at a rate of 2.0 percent per year after 2015. The benchmark prices were adjusted for quality and transportation.

### 6. CREDIT FACILITIES

The Company fully repaid its bank indebtedness on the closing of the sale of oil and gas properties on August 31, 2010. The facility was subsequently cancelled by the bank and the Company no longer has a borrowing facility.

At December 31, 2009, the Company had a \$24,000,000 demand operating loan facility with its bank, bearing interest at the bank's prime lending rate plus 1.0 percent (effective interest rate for 2009 of 3.44 percent and for 2008 of 5.05 percent). At December 31, 2009, a total of \$23,044,000 was drawn on this facility. Effective January 18, 2010, the authorized borrowing amount of the Company's demand operating loan facility was reduced to \$17,000,000 as a result of a reduction in the Company's borrowing base due to low natural gas prices. The demand operating loan bears interest at the bank's prime lending rate plus 2.0 percent. In addition, a \$7,000,000 demand non-revolving loan facility was established with interest on this facility being charged at the bank's prime lending rate plus 5.0 percent. These facilities were collateralized by an interest over all present and after acquired property of the Company.

The Company has a letter of guarantee of \$107,000 outstanding as at December 31, 2010 (\$900,000 as at December 31, 2009) which is secured by a cash deposit.

### 7. INCOME TAXES

The provision for income tax reduction is summarized as follows:

	Year ended December 31,	
	2010	2009
	\$	\$
Current income tax expense	106	96
Future income tax reduction	(26)	(3,868)
Income tax reduction	80	(3,772)

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# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

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The provision for income tax reduction recorded in the consolidated statement of operations differs from the amount that would be obtained by applying the statutory income tax rate to the loss before tax as follows:

	Year ended December 31,	
	2010	2009
	\$	\$
Loss before tax	(56,174)	(29,514)
Expected tax recovery at 28.25% (2009 – 29.50%)	(15,869)	(8,707)
Add (deduct) income tax effect of:		
Stock-based compensation	216	114
Non-deductible interest and penalties	106	96
Indemnification of flow-through share subscribers	371	-
Rate adjustments and other	1,652	2,758
Valuation allowance	13,604	1,967
Income tax expense (reduction)	80	(3,772)

The Company has federal and provincial non-capital losses for income tax purposes of approximately \$2,234,000 as at December 31, 2010 which are available for application against future taxable income and which begin to expire in 2026.

At December 31, 2010, the Company has approximately \$58,897,000 of available resource pools and undepreciated capital cost pools. Also refer to notes 1, 11 and 14.

Future tax assets and liabilities are comprised of:

	As at December 31,	
	2010	2009
	\$	\$
Property, plant and equipment	(14,417)	(160)
Commodity contracts	-	373
Non-capital losses carried forward	(653)	(635)
Capital losses	(100)	(26)
Asset retirement obligations	(197)	(1,081)
Share issue costs	(390)	(624)
Valuation allowance	15,757	2,153
Net future income tax liability	-	-

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# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

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### 8. ASSET RETIREMENT OBLIGATIONS

The Company's asset retirement obligations result from net ownership interests in oil and natural gas assets including well sites, gathering systems and processing facilities. The Company estimates the net present value of its total asset retirement obligations at December 31, 2010 to be \$789,000 (December 31, 2009 - \$4,324,000) based on a total undiscounted future liability at December 31, 2010 of \$2,970,000 (December 31, 2009 - \$6,810,000) which will be primarily incurred between 2012 and 2029. An inflation rate of 2.0 percent (2009 - 2.0 percent) and a credit-adjusted risk-free interest rate of 9.0 percent (2009 - 7.5 percent) were used in 2010 to calculate the fair value of the asset retirement obligations.

Asset Retirement Obligations	\$
Balance, December 31, 2008	3,395
Adjustments to assumptions	489
Liabilities incurred and acquired	392
Accretion expense	233
Disposition of abandonment liability	(12)
Abandonment expenditures	(173)
Balance, December 31, 2009	4,324
Adjustments to assumptions	87
Liabilities incurred and acquired	17
Accretion expense	217
Disposition of abandonment liability	(3,856)
Abandonment expenditures	-
Balance, December 31, 2010	789

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# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

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### 9. SHARE CAPITAL

- (a) Authorized:
- Unlimited number of voting common shares.  
Unlimited number of preferred shares.

- (b) Common shares issued and outstanding:

- (i) Fortress Energy Inc.

	Number of Common Shares	\$
Balance, December 31, 2008	26,921,617	133,346
Public offering (ii)	28,373,000	7,443
Issuance costs (ii)	-	(695)
Balance, December 31, 2009	55,294,617	140,094
Tax effect of renunciation of resource expenditures	-	(26)
Balance, December 31, 2010	55,294,617	140,068

- (ii) On September 30, 2009 the Company closed a public offering of 21,779,000 units and 6,594,000 flow-through common shares (total common shares issued of 28,373,000) for gross proceeds of \$11,385,185 (\$10,320,000 net of issuance costs). Each unit consists of one common share of the Company and one common share purchase warrant. The warrants are exercisable on or before September 30, 2011. Each warrant entitles the holder thereof to purchase one common share at an exercise price of \$0.55.

The fair value of the warrants was \$3,942,000 as determined using the Black-Scholes option pricing model with a risk-free interest rate of 1.2 percent, an expected weighted average life of 1.5 years, an expected volatility of 152.75 percent and an expected dividend yield of nil. Accordingly, the fair value assigned to the common shares was \$7,443,000.

The expenditure commitment resulting from the issuance of 6,594,000 flow-through common shares is \$3,000,270 and will be renounced to subscribers effective December 31, 2009 with all expenditures to be incurred by December 31, 2010. This resulted in a provision of \$341,639 in Part XII.6 tax that was paid February 28, 2011. As of December 31, 2010, the Company had incurred \$104,000 (December 31, 2009 - \$nil) of eligible expenditures.

As the Company did not incur sufficient eligible flow-through expenditures, a liability for \$1,314,000 has been recorded which represents the anticipated payments to investors required under indemnification agreements.

# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

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(c) Warrants issued and outstanding:

	Number of Warrants	\$
Balance December 31, 2008	5,516,700	1,834
Public offering (note 9 (b)(ii))	21,779,000	3,942
Issuance costs	-	(370)
Balance, December 31, 2010 and 2009	27,295,700	5,406

A total of 5,516,700 warrants are exercisable on or before June 20, 2011 at an exercise price of \$2.00 per share. The remaining 21,779,000 warrants are exercisable on or before September 30, 2011 at an exercise price of \$0.55 per share.

(d) Contributed surplus:

	\$
Balance, December 31, 2008	15,062
Stock-based compensation expense	373
Balance, December 31, 2009	15,435
Stock-based compensation expense	804
Balance, December 31, 2010	16,239

(e) Stock option plan:

The Company grants stock options to employees, officers, directors and consultants of the Company pursuant to an incentive plan. Under this plan, the exercise price of options granted cannot be less than the closing market price for the Company's common shares on the date of grant. Options vest over a three-year period and expire five years from the date of grant.

The following table summarizes stock option transactions:

	2010		2009	
	Number	Weighted average exercise price \$	Number	Weighted average exercise price \$
Outstanding, beginning of year	4,774,579	0.50	1,805,873	1.56
Granted	-	-	3,680,000	0.25
Cancelled or expired	(4,773,779)	0.50	(180,400)	3.41
Forfeited	-	-	(530,894)	1.33
Outstanding, end of year	800	50.00	4,774,579	0.50
Exercisable, end of year	800	50.00	1,527,593	0.58

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The Company has the following stock options outstanding:

Outstanding at December 31, 2010			Exercisable at December 31, 2010		
Exercise Price	Number	Weighted average years to expiry	Weighted Average Exercise Price	Number	Weighted Average Exercise Price
\$			\$		\$
50.00	800	0.3	50.00	800	50.00

The Company records compensation costs on the granting of stock options using the fair value method. Compensation expense is calculated using the Black-Scholes option pricing model. The Company has not incorporated an estimated forfeiture rate for stock options that will not vest but accounts for the actual forfeitures as they occur.

As a result of the sale of oil and gas properties on August 31, 2010 and the substantial reduction on the Company's asset base, all stock options that were outstanding on August 31, 2010 were immediately vested. The increase in stock-based compensation expense for the year ended December 31, 2010 reflects this accelerated vesting. All stock options outstanding except for those priced at \$50.00 expired unexercised on November 29, 2010. The remaining 800 outstanding at December 31, 2010 expired on April 11, 2011.

In 2010, the Company recorded compensation expense of \$741,000 related to stock options (2009 – \$303,000) and capitalized stock-based compensation expense related to stock options of \$63,000 (2009 - \$70,000).

(f) Per share amounts:

The weighted average number of common shares outstanding for the years ended December 31, 2010 and 2009 are as follows:

	2010	2009
Weighted average – basic and diluted	55,294,788	34,073,339

Options to purchase 800 (December 31, 2009 – 4,774,579) common shares and warrants to purchase 27,295,700 (December 31, 2009 – 27,295,700) common shares at December 31, 2009 were not included in the calculation of diluted common shares outstanding because they were anti-dilutive.

(g) Restricted stock unit plan:

In June 2008, the Company approved a restricted stock unit plan. The Board of Directors, in its sole discretion may determine the period in which units credited under this plan shall vest; however, such period shall not exceed three years. Holders are credited with additional units as dividends are declared on the common shares. The value of vested units is determined by the weighted average of the board lot trading prices of the Company's common shares traded on the TSX for the last 20 trading days immediately prior to the day such units mature. Such amount is paid in cash within 30 days.

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# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

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As at December 31, 2010, there were nil (December 31, 2009 – 1,275,000) restricted stock units outstanding. The Company recorded a liability and expense based on the intrinsic value of the units. For the year ended December 31, 2009, the Company recorded compensation expense related to the restricted stock unit plan of \$26,000. A recovery of previously capitalized stock-based compensation related to the restricted stock units of \$11,000 was recorded in 2010 (December 31, 2009 - an expense of \$17,000).

As a result of the sale of oil and gas properties on August 31, 2010 and the substantial reduction in the Company's asset base, all restricted stock units outstanding on August 31, 2010 were immediately vested and were settled in cash.

The following table summarizes restricted stock unit transactions:

	Number
Outstanding, December 31, 2008	1,175,000
Granted	400,000
Forfeited	(300,000)
Outstanding, December 31, 2009	1,275,000
Vested	(1,275,000)
Outstanding, December 31, 2010	-

10.

## FINANCIAL INSTRUMENTS

### Overview

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

- Credit risk;
- Liquidity risk;
- Market risk;
- Foreign currency exchange risk;
- Commodity price risk; and
- Interest rate risk.

The Company's Board of Directors has overall responsibility for the establishment and oversight of the Company's risk management framework and establishes and monitors risk management policies to: identify and analyze the risks faced by the Company, set appropriate limits and controls, and monitor risks and adherence to market conditions and the Company's activities.

### Credit Risk

Credit risk is primarily related to the Company's receivables from joint venture partners and petroleum and natural gas marketers and the risk of financial loss if a customer, partner or counterparty to a financial instrument fails to meet its contractual obligations. A substantial portion of the Company's accounts receivable is with partners in the energy industry and is subject to normal industry credit risk. The Company generally grants unsecured credit but routinely assesses the financial strength of its partners.

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# **FORTRESS ENERGY INC.**

## **Notes to Consolidated Financial Statements**

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Receivables from petroleum and natural gas marketers are normally collected on the 25<sup>th</sup> day of the month following production. The Company sells the majority of its production to a single petroleum and natural gas marketers and, therefore, is subject to concentration risk which is mitigated by management's policies and practices related to credit risk, as discussed above. The Company historically has not experienced any collection issues with its petroleum and natural gas marketers. 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, the risk of unsuccessful drilling and occasional disagreements between parties. The Company attempts to mitigate the risk from joint venture receivables by obtaining partner approval of significant capital expenditures prior to expenditure. The Company does not typically obtain collateral from petroleum and natural gas marketers or joint venture partners; however in certain circumstances, it may cash call a partner in advance of the work. As well, the Company does have the ability to withhold production from joint venture partners in the event of non-payment.

The Company establishes an allowance for doubtful accounts as determined by management based on their assessment of collection and, therefore the carrying amount of accounts receivable generally represents the maximum credit exposure.

### **Liquidity Risk**

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they are due (see note 1). The Company's approach to managing liquidity is to ensure, as far as possible, that it will have sufficient liquidity to meet its liabilities when due without incurring unacceptable losses or risking harm to the Company's reputation.

The Company prepares capital expenditures budgets which are regularly monitored and updated as considered necessary. As well, the Company utilizes authorizations for expenditures on operated and non-operated projects to further manage capital expenditures. To facilitate the capital expenditure program, the Company relies on working capital and cash flows from operations. (See note 1).

### **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 net earnings or the value of financial instruments. The objective of market risk management is to mitigate exposures within acceptable limits, while maximizing returns.

The Company utilizes commodity price contracts to manage market risks relevant to commodity prices. All such transactions are conducted in accordance with the risk management policy that has been approved by the Board of Directors.

### **Foreign Currency Exchange Risk**

Foreign currency exchange rate risk is the risk that the fair value of financial instruments or future cash flows will fluctuate as a result of changes in foreign exchange rates. Although all of the Company's petroleum and natural gas sales are denominated in Canadian dollars, the underlying market prices in Canada for petroleum and natural gas are impacted by changes in the exchange rate between the Canadian and United States dollar. The Company had no forward exchange rate contracts in place as at December 31, 2010 or 2009.

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# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

December 31, 2010 and 2009

(Tabular figures are in thousands of Canadian dollars unless otherwise indicated)

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### Commodity Price Risk

Commodity price risk is the risk that the fair value of financial instruments or future cash flows will fluctuate as a result of changes in commodity prices. Commodity prices for petroleum and natural gas are impacted by world economic events that dictate the levels of supply and demand. With the then pending sale of the Company's oil and gas assets, on July 21, 2010, the Company sold its commodity contracts for all production periods beginning on or after September 1, 2010 for cash proceeds of \$2,009,000. The proceeds were used to reduce bank indebtedness.

For the year ended December 31, 2010, the Company realized a gain related to commodity contracts of \$5,268,000 (2009 - \$6,722,000 gain) which has been included in petroleum and natural gas sales. For the year ended December 31, 2010 the Company recorded an unrealized loss on commodity contracts of \$1,321,000 year ended December 31, 2009 unrealized loss of \$1,166,000.

### Capital Management

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. The Company considers its capital structure to include shareholders' equity and working capital. In order to maintain or adjust the capital structure, the Company may from time to time issue shares and adjust its capital spending to manage current and projected debt levels.

To assess capital and operating efficiency and financial strength, the Company continually monitors its working capital deficiency which is a non-GAAP measure and is calculated as follows:

	December 31, 2010	December 31, 2009
	\$	\$
Current assets	9,065	7,431
Current liabilities	(3,734)	(30,928)
Working capital (deficiency)	5,331	(23,497)

The Company has not paid or declared any dividends since the date of incorporation.

### Fair Value of Financial Instruments

The Company's financial instruments as at December 31, 2010 include cash, accounts receivable, temporary investment, and accounts payable. The fair values of accounts receivable and accounts payable approximate their carrying amounts due to their short terms to maturity. The fair value of commodity contracts is determined by calculating the difference between the contracted price and published forward price curves as at the balance sheet date, using the remaining contracted natural gas volumes. The Company's revolving operating loan bears interest at a floating market rate and accordingly the fair market value approximates the carrying value.

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# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

December 31, 2010 and 2009

(Tabular figures are in thousands of Canadian dollars unless otherwise indicated)

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The carrying and fair values of the Company's financial instruments as at December 31, 2010 are as follows:

Classification	Carrying Value \$	Fair Value \$
Held-for-trading (cash and cash equivalents and investment)	6,977	6,977
Loans and receivables (accounts receivable)	1,750	1,750
Other liabilities (accounts payable)	(3,734)	(3,734)
Total	4,993	4,993

The Company is required to present information about financial instruments measured at fair value in accordance with a three-level hierarchy. The hierarchy groups financial assets and liabilities into three levels based on the significance of inputs used in measuring the fair value of the financial assets and liabilities. The fair value hierarchy has the following levels:

- Level 1: quoted prices (unadjusted) in active markets for identical assets or liabilities;
- Level 2: inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices); and
- Level 3: inputs for the asset or liability that are not based on observable market data (unobservable inputs). The Company does not have any level 3 financial instruments.

The level within which the financial asset or liability is classified is determined based on the lowest level of significant input to the fair value measurement. As at December 31, 2009 the Company had a commodity contracts asset that was a derivative financial instrument and was recorded at fair value using quoted market prices and classified as a level 2 asset in the fair value hierarchy. The Company sold its commodity contracts asset effective September 1, 2010.

## 11. COMMITMENTS AND CONTINGENCIES

### Office equipment

As at December 31, 2010 the Company is committed to minimum annual lease payments under operating leases for office equipment of \$9,000 in 2011.

### Claims and Litigation

The Company is involved in various claims and litigation arising in the normal course of business. The outcome of these matters is uncertain and there can be no assurance that such matters will be resolved in the Company's favour. If the outcome is unfavourable, it could have a materially adverse impact on the Company's financial position or results of operations.

### Income Tax Refund

In September 2008, the Company re-filed its income tax returns for the 1997 to 1999 tax years to claim additional scientific research and experimental development credits related to the bio-technology business of its predecessor company. These additional claims could result in a refund of approximately \$3,400,000 to the Company.

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# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

December 31, 2010 and 2009

(Tabular figures are in thousands of Canadian dollars unless otherwise indicated)

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### Income Tax Reassessment

Based on the results of an audit concluded in March 2009 by the Canada Revenue Agency (CRA) on the 2004 flow-through expenditures of a business acquired by the Company in 2006, the Company was reassessed by the CRA for interest and penalties of \$300,000 on expenditures not qualifying for renunciation under the flow-through share program in the amount of \$1,916,000. The Company filed a Notice of Objection with the CRA on July 31, 2009 after consultation with its tax advisors and legal counsel and is appealing this reassessment. The Company has indemnified the subscribers of this flow-through share offering from income taxes related to the offering. The amount of the potential indemnification is approximately \$765,000. The amounts of the interest and penalties and potential indemnification have not been recorded as the Company's position is that the more likely than not criteria for recognition have not been met.

### Income Tax Audit

In January 2010, the Company received an audit letter from the CRA pertaining to the conversion of SignalEnergy Inc., predecessor to the Company and formerly known as SignalGene Inc., into an oil and natural gas enterprise. Also refer to notes 1 and 14.

## 12. CHANGE IN NON-CASH WORKING CAPITAL

Changes in non-cash working capital balances are comprised of the following:

	As at December 31,	
	2010	2009
	\$	\$
Accounts receivable	3,826	1,421
Prepaid expenses and deposits	132	384
Accounts payable and accrued liabilities	(4,142)	(2,278)
Income taxes payable	(8)	36
	(192)	(437)
Indemnification of flow-through shares subscribers included in accounts payable	(1,314)	-
	(1,506)	(437)
Attributable to investing activities	(856)	1,184
Attributable to operating activities	(650)	(1,621)

## 13. RELATED PARTY TRANSACTIONS

- (a) In 2010 the Company was charged \$242,000 (2009 - \$321,000) by a law firm of which a director of the Company is a partner.
- (b) In 2010, the Company was charged \$nil (2009 - \$125,000) by a former director for consulting services of which \$nil is included in accounts payable and accrued liabilities at December 31, 2010 (\$9,000 – December 31, 2009).

All related party transactions are in the normal course of business and have been measured at the agreed to exchange amounts, which are the amounts of consideration established and agreed to by the related parties and which are similar to those negotiated with third parties.

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# **FORTRESS ENERGY INC.**

## **Notes to Consolidated Financial Statements**

December 31, 2010 and 2009

(Tabular figures are in thousands of Canadian dollars unless otherwise indicated)

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### **14. SUBSEQUENT EVENTS**

#### **(a) Income Tax Audit**

In February 2011, the Company received a series of Notice of Assessments for the taxation years ended 2004 to 2007 from the Canada Revenue Agency ("CRA") pertaining to the conversion of SignalEnergy Inc., predecessor to the Company and formerly known as SignalGene Inc., into an oil and natural gas enterprise.

In these assessments, the CRA denied the use of tax pools existing at the time of the conversion. As a result, CRA now claims that the Company owes approximately \$18,000,000 in taxes, interest and penalties. The Company believes that these assessments will be resolved in the Company's favour. As such, no provision for this amount has been included in these financial statements (refer to note 1).

#### **(b) Companies' Creditors Arrangement Act**

On March 2, 2011, the Company made an application for protection under the Companies' Creditors Arrangement Act and an order was granted by the Court of Queen's Bench of Alberta. Hardie & Kelly Inc. was appointed by the Court as monitor of the Company. The Order provides certain relief including the imposition of a Stay of Proceedings against the Company and its assets through to March 31, 2011. The Order was subsequently extended to May 27, 2011 at which time the matter will be reviewed by the Court.