



# Q3/09 REPORT

FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2009



**FORTRESS  
ENERGY INC.**

## FINANCIAL AND OPERATING SUMMARY

	Three months ended September 30,				Nine months ended September 30,			
	2009		2008		2009		2008	
	(\$000s)	\$/boe	(\$000s)	\$/boe	(\$000s)	\$/boe	(\$000s)	\$/boe
Petroleum and natural gas sales	4,240	40.53	5,802	42.64	13,791	40.90	18,670	48.58
Royalties	135	1.29	(1,158)	(8.51)	(785)	(2.33)	(3,421)	(8.90)
Operating costs	(1,757)	(16.81)	(2,139)	(15.72)	(5,427)	(16.10)	(5,565)	(14.48)
Transportation	(197)	(1.88)	(258)	(1.90)	(692)	(2.05)	(707)	(1.84)
Operating netback <sup>(1)</sup>	2,421	23.13	2,247	16.51	6,887	20.42	8,977	23.36
General and administrative expenses	(726)	(6.94)	(652)	(4.79)	(2,087)	(6.19)	(1,706)	(4.44)
Professional fees	(114)	(1.09)	(122)	(0.90)	(602)	(1.79)	(459)	(1.19)
Bad debts	17	0.16	28	0.21	(162)	(0.48)	81	0.21
Interest expense	(187)	(1.79)	(308)	(2.26)	(640)	(1.90)	(1,049)	(2.73)
Current income tax expense	(18)	(0.17)	-	-	(54)	(0.16)	-	-
Funds from operations <sup>(1)</sup>	1,393	13.30	1,193	8.77	3,342	9.90	5,844	15.21
Unrealized gain (loss) on commodity contracts	(1,855)	(17.73)	4,323	31.77	(358)	(1.06)	1,333	3.47
Depletion, depreciation and accretion	(2,942)	(28.12)	(3,805)	(27.97)	(10,450)	(30.98)	(10,627)	(27.65)
Ceiling test impairment	-	-	-	-	(14,276)	(42.34)	-	-
Stock-based compensation expense	(108)	(1.03)	(77)	(0.57)	(235)	(0.70)	(149)	(0.39)
Gain (loss) on sale of pipeline asset	-	-	124	0.91	-	-	(428)	(1.11)
Income (loss) before future income taxes	(3,512)	(33.58)	1,758	12.91	(21,977)	(65.18)	(4,027)	(10.47)
Future income tax recovery (expense)	(275)	(2.63)	(688)	(5.06)	3,592	10.65	898	2.34
Net income (loss)	(3,787)	(36.21)	1,070	7.85	(18,385)	(54.53)	(3,129)	(8.13)
Sales volume (boe/d)	1,137		1,478		1,235		1,403	

<sup>(1)</sup> Non-GAAP measures. See discussion in the following Management Discussion & Analysis.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

November 13, 2009

This management's discussion and analysis (MD&A) should be read in conjunction with the unaudited interim financial statements of Fortress Energy Inc. ("Fortress" or the "Company") as at and for the three and nine months ended September 30, 2009 and the audited consolidated financial statements of Fortress Energy Inc. for the year ended December 31, 2008. The interim 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).

This MD&A provides management's analysis of Fortress' historical financial and operating performance based on information currently available. Actual results will vary from estimates and variances may be significant. Historical results are not indicative of future performance.

### 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		Nine months ended	
	September 30, 2009	2008	September 30, 2009	2008
Cash provided by (used in) operating activities	(396)	1,315	2,079	9,893
Change in non-cash operating working capital	1,789	(122)	1,091	(4,130)
Abandonment expenditures	-	-	172	81
Funds from operations	1,393	1,193	3,342	5,844

Operating netback is calculated on a per boe basis taking petroleum and natural gas sales and deducting royalties, operating expenses and transportation expenses, as follows:

	Three months ended September 30, 2009		2008		Nine months ended September 30, 2009		2008	
	(\$000s)	(\$/boe)	(\$000s)	(\$/boe)	(\$000s)	(\$/boe)	(\$000s)	(\$/boe)
Petroleum and natural gas sales	4,240	40.53	5,802	42.64	13,791	40.90	18,670	48.58
Royalties	135	1.29	(1,158)	(8.51)	(785)	(2.33)	(3,421)	(8.90)
Operating expenses	(1,757)	(16.81)	(2,139)	(15.72)	(5,427)	(16.10)	(5,565)	(14.48)
Transportation expenses	(197)	(1.88)	(258)	(1.90)	(692)	(2.05)	(707)	(1.84)
Operating netback	2,421	23.13	2,247	16.51	6,887	20.42	8,977	23.36

## BOE Presentation

Natural gas reserves and volumes recorded in thousand cubic feet are converted to barrels of oil equivalent (“boe”) on the basis of six thousand cubic feet (“mcf”) of gas to one barrel (“bbl”) of oil. The term “barrels of oil equivalent” may be misleading, particularly if used in isolation. A boe conversion ratio of 6 mcf to 1 bbl is based on an energy equivalent conversion method primarily applicable at the burner tip and is not intended to represent a value equivalent at the wellhead.

## 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 “Production” regarding the Square Creek acquisition; and
- (ii) Under “Liquidity and Capital Resources” regarding working capital requirements.

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 (iii) 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 future 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 associated with the oil and gas industry and regulatory bodies (e.g. operational risks in exploration, development and production, or changes in royalty rates);
- (ii) Delays or changes in plans with respect to exploration or development projects or capital expenditures;
- (iii) Uncertainty of estimates and projections relating to recoverable reserves, costs and expenses;
- (iv) Health, safety and environmental risks;
- (v) Commodity price and exchange rate fluctuations; and
- (vi) Liquidity risk and working capital requirements (refer to “Liquidity and Capital Resources” on page 11 of this MD&A).

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' primary focus is the exploration and development of natural gas reserves in Western Canada. The Company has approximately 80,500 net acres of undeveloped land in the Ladyfern, Velma and Buick Creek areas in northeast British Columbia and the Chigwell, Bashaw, Square Creek, Halverson, and Mearon areas of Alberta.

The Company's strategy is to acquire and exploit properties that are early in their development cycle and that offer exploration, appraisal and development drilling opportunities, while maintaining low finding and development costs. Fortress is the operator of most of its production, providing control over cost management of its operating and capital programs.

## DETAILED FINANCIAL ANALYSIS

### Production

	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
Sales volume:				
Natural gas (mcf/d)	6,741	8,733	7,333	8,272
Oil and NGL (bbls/d)	13	23	13	24
Total (boe/d)	1,137	1,478	1,235	1,403

Sales volumes for the three months ended September 30, 2009 were 1,137 boe/d compared to 1,478 boe/d for the three months ended September 30, 2008, a decrease of 23 percent. This decrease is primarily due to the shut-in of the Company's Velma and Buick Creek fields at various times during the three months ended September 30, 2009. The Velma field was shut-in during August 2009 to accommodate the rerouting of production to another third-party processing facility. One of the two Velma wells remains shut-in and is expected to be back on stream by the end of November 2009. Production from Velma for the three months ended September 30, 2009 decreased to 106 boe/d from 232 boe/d for the three months ended September 30, 2008. Buick Creek was shut-in for a significant plant upgrade in early September 2009 and was brought back on production by mid-October 2009. The sales volumes from Buick Creek for the three months ended September 30, 2009 decreased to 55 boe/d from 129 boe/d for the three months ended September 30, 2008. The balance of the decrease in sales volumes for the three months ended September 30, 2009 when compared to the three months ended September 30, 2008 is attributable to natural declines.

The Company's Square Creek field has shown no decline in production capability since it came onto production in March 2008. In the second quarter of 2009, the Company elected to cut back Square Creek production by approximately 300 boe/d by shutting-in several wells due to low natural gas prices. This shut-in production can be restored at the Company's choice.

Sales volumes for the nine months ended September 30, 2009 were 1,235 boe/d compared to 1,403 boe/d for the nine months ended September 30, 2008, a decrease of 12 percent. This decrease is consistent with that of the three months ended September 30, 2009, as previously noted.

On October 23, 2009, the Company completed the acquisition of its partner's 50 percent working interest at Square Creek for approximately \$7,350,000, subject to final adjustments. Production from the Square Creek area has averaged 1,000 boe/d (net 500 boe/d) in 2009.

## Revenue

	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
Petroleum and natural gas sales (\$000s)	4,240	5,802	13,791	18,670
Average realized prices:				
Natural gas (\$/mcf)	3.41	8.30	4.18	9.00
Realized gain (loss) on commodity contracts (\$/mcf)	3.24	(1.28)	2.58	(0.97)
Realized natural gas price (\$/mcf)	6.65	7.02	6.76	8.03
Oil and NGL (\$/bbl)	82.45	82.29	55.18	86.35
Combined average realized price (\$/boe)	40.53	42.64	40.90	48.58
Benchmark prices:				
AECO average natural gas price (\$/mcf)	3.00	7.76	3.78	8.51
Edmonton par crude oil (\$/bbl)	71.65	123.08	63.23	115.95

For the three months ended September 30, 2009, petroleum and natural gas sales were \$4,240,000 (including realized gains on commodity contracts of \$2,032,000) compared to \$5,802,000 (including realized losses on commodity contracts of \$1,047,000) for the three months ended September 30, 2008, a decrease of 27 percent. This decrease is attributable to a 23 percent decrease in sales volumes in the three months ended September 30, 2009 and a 5 percent decrease in the average realized natural gas price.

Petroleum and natural gas sales were \$13,791,000 (including realized gains on commodity contracts of \$5,224,000) for the nine months ended September 30, 2009 compared to \$18,670,000 (including realized losses on commodity contracts of \$2,232,000) for the nine months ended September 30, 2008 - a decrease of 26 percent. This decrease is attributable to a 16 percent decrease in the average realized natural gas price and a 12 percent decrease in sales volumes in the first nine months of 2009, as previously noted.

The average realized natural gas price for the three months ended September 30, 2009 was \$3.41/mcf compared to the average AECO natural gas price of \$3.00/mcf. The average realized natural gas price in the three months ended September 30, 2008 was \$8.30/mcf and the average AECO natural gas price was \$7.76/mcf. The average realized natural gas price for the nine months ended September 30, 2009 was \$4.18/mcf compared to the average AECO natural gas price for the period of \$3.78/mcf. This compares to the average realized natural gas price in the nine months ended September 30, 2008 of \$9.00/mcf and an average AECO price of \$8.51/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 uses commodity contracts to manage its exposure to fluctuations in the price of natural gas. For the three months ended September 30, 2009, the Company realized a gain on commodity contracts of \$2,032,000, or \$3.24/mcf, compared to a realized loss on commodity contracts of \$1,047,000, or \$1.28/mcf, for the three months ended September 30, 2008. Realized gains and losses on commodity contracts are included in petroleum and natural gas sales. The Company also recorded an unrealized loss on commodity contracts in the three months ended September 30, 2009 of \$1,855,000 compared to an unrealized gain on commodity contracts of \$4,323,000 for the three months ended September 30, 2008.

For the nine months ended September 30, 2009, the Company realized a gain on commodity contracts of \$5,224,000, or \$2.58/mcf, compared to a realized loss on commodity contracts of \$2,232,000 or \$0.97/mcf for the nine months ended September 30, 2008. In addition, the unrealized loss on commodity contracts in the nine months ended September 30, 2009 was \$358,000 compared to an unrealized gain on commodity contracts of \$1,333,000 for the nine months ended September 30, 2008. The Company has sold forward approximately 60 percent of its natural gas production through to the end of the first quarter of 2010 giving the Company a degree of certainty over its cash flow. The estimated mark-to-market value of the Company's commodity contracts at September 30, 2009 was \$2,129,000. Contracts in place as of September 30, 2009 are as follows:

Type	Period	Volume (GJ/d)	Fixed Price (\$/GJ)
Swap	April 1, 2009 to December 31, 2009	5,100	7.20
Swap	January 1, 2010 to March 31, 2010	2,600	8.38
Swap	January 1, 2010 to March 31, 2010	2,500	6.80

### Royalties

	Three months ended		Nine months ended	
	September 30, 2009	September 30, 2008	September 30, 2009	September 30, 2008
Royalties (\$000s)	(135)	1,158	785	3,421
\$/boe	(1.29)	8.51	2.33	8.90
Percentage of petroleum and natural gas sales <sup>(1)</sup>	(6.1%)	16.9%	9.1%	16.4%

<sup>(1)</sup> Before realized gains and losses on commodity contracts.

For the three months ended September 30, 2009, the Company recorded a recovery of royalties of \$135,000 compared to an expense for the three months ended September 30, 2008 of \$1,158,000. The reduction over this period is due to significantly lower natural gas prices upon which Alberta Crown royalties are now based and the recognition of 2008 Alberta Gas Cost Allowance and Custom Processing credits of approximately \$480,000 that were received in the three months ended September 30, 2009. These credits are attributable to the Company's Square Creek property which commenced production in March 2008.

For the nine months ended September 30, 2009, royalties were \$785,000 compared to \$3,421,000 for the nine months ended September 30, 2008. This decrease is attributed to a 54 percent decrease in the average natural gas price and royalty credits processed in the three months ended September 30, 2009, as previously noted. Royalties are not calculated or payable on realized gains and losses on commodity contracts.

### Operating Expenses

	Three months ended		Nine months ended	
	September 30, 2009	September 30, 2008	September 30, 2009	September 30, 2008
Operating costs (\$000s)	1,757	2,139	5,427	5,565
\$/boe	16.81	15.72	16.10	14.48

For the three months ended September 30, 2009, operating expenses were \$1,757,000, or \$16.81/boe, compared to \$2,139,000, or \$15.72/boe, for the three months ended September 30, 2008. Operating expenses decreased in the three months ended September 30, 2009 due to decreased production volumes. On a per boe basis, operating expenses increased in the three months ended September 30, 2009 due to as a significant component of operating expenses are fixed as opposed to varying with production.

For the nine months ended September 30, 2009, operating expenses were \$5,427,000 compared to \$5,565,000 for the nine months ended September 30, 2008. Operating expenses on a per boe basis are higher for the nine months ended September 30, 2009 due to lower production and a higher proportion of fixed costs.

The Company has taken several steps to reduce operating costs including the purchase of a rented compressor, camp, rig mats and other rented equipment at Square Creek. In addition, the Company replaced the field operations contractor at Square Creek effective August 1, 2009 and replaced the field

operations contractor at the third party facility at Clear Prairie that processes the Company's Square Creek production effective November 1, 2009. In August, the Company re-routed its Velma production to another third party processing plant which is expected to improve productivity and reduce gas processing costs at Velma. Finally, the Company has given formal notice to the contract operator of its Ladyfern and Mearon properties that it will be terminating its agreement with it and consequently taking back all field operations of these properties effective December 1, 2009, thereby improving well operation reliability and further reducing operating expenses. These changes are expected to save the Company approximately \$1,700,000 annually.

### Transportation Expenses

	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
Transportation expenses (\$000s)	197	258	692	707
\$/boe	1.88	1.90	2.05	1.84

Transportation expenses include transportation and fuel costs associated with the usage of natural gas pipelines. For the three months ended September 30, 2009, transportation expenses were \$197,000 compared to \$258,000 for the three months ended September 30, 2008. This decrease is due to decreased productivity in the three months ended September 30, 2009. Transportation expenses for the nine months ended September 30, 2009 were \$692,000 compared to \$707,000 for the nine months ended September 30, 2008. The rate that the Company was charged for interruptible transportation services increased in October 2008.

### General and Administrative Expenses

	Three months ended September 30,		Three months ended September 30,		Nine months ended September 30,		Nine months ended September 30,	
	2009		2008		2009		2008	
	(\$000s)	(\$/boe)	(\$000s)	(\$/boe)	(\$000s)	(\$/boe)	(\$000s)	(\$/boe)
General and administrative expenses, net of recoveries	726	6.94	652	4.79	2,087	6.19	1,706	4.44
Professional fees	114	1.09	122	0.90	602	1.79	459	1.19
Bad debts	(17)	(0.16)	(28)	(0.21)	162	0.48	(81)	(0.21)
Total	823	7.87	746	5.48	2,851	8.46	2,084	5.42

General and administrative expenses, net of recoveries, increased to \$726,000 in the three months ended September 30, 2009 from \$652,000 in the three months ended September 30, 2008. This increase is due to fees incurred to update the Company's safety program and site specific emergency response plans. For the nine months ended September 30, 2009, general and administrative expenses, net of recoveries, were \$2,087,000 compared to \$1,706,000 for the nine months ended September 30, 2008. This increase is due to lower overhead recoveries from partners due to reduced capital spending in 2009.

Professional fees include fees for lawyers, auditors, income tax professionals, and independent reserves evaluators. Professional fees decreased slightly in the three months ended September 30, 2009 to \$114,000 from \$122,000 for the three months ended September 30, 2008. Professional fees for the nine months ended September 30, 2009 were \$602,000 compared to \$459,000 for the nine months ended September 30, 2008 due to tax compliance matters arising in 2009.

Bad debts for the three months ended September 30, 2009 was a recovery of \$17,000 compared to a recovery of \$28,000 for the three months ended September 30, 2008. Bad debts expense for the nine months ended September 30, 2009 was \$162,000 compared to a recovery of \$81,000 for the nine months ended September 30, 2008. Bad debts 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.

## Stock-based Compensation Expense

(\$000s except per boe)	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
Stock-based compensation expense:				
Stock options	54	101	150	125
Restricted stock units	54	(24)	85	24
<b>Total</b>	<b>108</b>	<b>77</b>	<b>235</b>	<b>149</b>
<b>\$/boe</b>	<b>1.03</b>	<b>0.57</b>	<b>0.70</b>	<b>0.39</b>

Stock-based compensation expense for the three months ended September 30, 2009 was \$108,000 compared to \$77,000 for the three months ended September 30, 2008. Stock-based compensation expense for the nine months ended September 30, 2009 was \$235,000 compared to \$149,000 for the nine months ended September 30, 2008. In the third quarter of 2008, the Company granted 1,684,633 stock options to employees, officers and directors of the Company with an exercise price of \$1.35 per share, expiring July 8, 2013. Also in the third quarter of 2008, the Company introduced a restricted stock unit plan.

## Interest Expense

	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
Interest expense (\$000s)	187	308	640	1,049
<b>\$/boe</b>	<b>1.79</b>	<b>2.26</b>	<b>1.90</b>	<b>2.73</b>

The Company recorded interest expense of \$187,000 for the three months ended September 30, 2009 compared to \$308,000 for the three months ended September 30, 2008. Interest expense for the three months ended September 30, 2009 reflects interest on the Company's bank indebtedness. Interest expense for the three months ended September 30, 2008 reflects interest on bank indebtedness and accrued interest on flow-through commitments. Interest expense for the nine months ended September 30, 2009 was \$640,000 compared to \$1,049,000 for the nine months ended September 30, 2008. This decrease is due to a decrease in the prime lending rate. Also, interest expense for the nine months ended September 30, 2008 included interest on flow-through commitments.

## Depletion, Depreciation and Accretion Expense

	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
Depletion and depreciation expense (\$000s)	2,885	3,761	10,278	10,508
Accretion of asset retirement obligations (\$000s)	57	44	172	119
<b>Depletion, depreciation and accretion expense (\$000s)</b>	<b>2,942</b>	<b>3,805</b>	<b>10,450</b>	<b>10,627</b>
Ceiling test impairment (\$000s)	-	-	14,276	-
Depletion and depreciation expense (\$/boe)	27.58	27.65	30.47	27.34
Accretion of asset retirement obligations (\$/boe)	0.54	0.32	0.51	0.31
<b>Depletion, depreciation and accretion expense (\$/boe)</b>	<b>28.12</b>	<b>27.97</b>	<b>30.98</b>	<b>27.65</b>
Ceiling test impairment (\$/boe)	-	-	42.34	-

Depletion and depreciation expense is calculated based on capital expenditures, production rates, and proved reserves. Depletion and depreciation expense was \$2,885,000 for the three months ended September 30, 2009 compared to \$3,761,000 for the three months ended September 30, 2008. This decrease is due to a ceiling test impairment charge of \$14,276,000 that was recorded in the second quarter of 2009 decreasing the asset base that is subject to depletion. On a per boe basis, depletion and depreciation expense for the three months ended September 30, 2009 was \$27.58/boe compared to \$27.65/boe for the three months ended September 30, 2008.

Depletion and depreciation expense for the nine months ended September 30, 2009 was \$10,278,000 compared to \$10,508,000 for the nine months ended September 30, 2008. On a per boe basis, depletion and depreciation expense increased to \$30.47/boe for the nine months ended September 30, 2009 from \$27.34/boe for the nine months ended September 30, 2008. The Company drilled three wells in the first

quarter of 2009 for which no new reserves were assigned, resulting in an increase in depletion and depreciation on a per boe basis. In the second quarter of 2009, the Company recorded a ceiling test impairment charge of \$14,276,000 due to a significant decrease in natural gas prices.

Estimated future development costs for proved undeveloped properties included in the calculation of depletion expense at September 30, 2009 decreased to \$11,235,000 from \$15,842,000 at September 30, 2008 due to the Company's development activities at Square Creek in the first quarter of 2009. In addition, pressure testing conducted in March 2009 on wells at Square Creek indicated that the Company does not need to drill any additional wells to drain the Bluesky pool resulting in an additional reduction of future development costs. Undeveloped land costs at September 30, 2009 decreased to \$7,176,000 from \$8,508,000 at September 30, 2008 and were excluded from assets subject to depletion. Undeveloped land costs decreased due to development activity.

Accretion expense for the three months ended September 30, 2009 was \$57,000 compared to \$44,000 for the three months ended September 30, 2008. This increase is due to capital expenditures in the Pine Creek and Square Creek areas. For the nine months ended September 30, 2009, accretion costs amounted to \$172,000 compared to \$119,000 for the nine months ended September 30, 2008. This increase is due to capital expenditures in the first quarter of 2009, as noted.

### Income Tax

(\$000s except per boe)	Three months ended		Nine months ended	
	September 30, 2009	September 30, 2008	September 30, 2009	September 30, 2008
Current income tax expense	18	-	54	-
Future income tax expense (recovery)	275	688	(3,592)	(898)
<b>Total</b>	<b>293</b>	<b>688</b>	<b>(3,538)</b>	<b>(898)</b>
<b>\$/boe</b>	<b>2.80</b>	<b>5.06</b>	<b>(10.49)</b>	<b>(2.34)</b>

The Company recorded income tax expense for the three months ended September 30, 2009 of \$293,000 compared to \$688,000 for the three months ended September 30, 2008. For the nine months ended September 30, 2009, the Company recorded an income tax recovery of \$3,538,000 compared to \$898,000 for the nine months ended September 30, 2008. In the nine months ended September 30, 2009, the Company recorded a ceiling test impairment charge of \$14,276,000 which resulted in the reversal of the previously recorded future income tax liability. A full valuation allowance has been taken against the resulting future income tax asset.

For the three months ended September 30, 2009, the Company recorded current income tax expenses of \$18,000. For the nine months ended September 30, 2009, current income tax expenses of \$54,000 were recorded, consisting of arrears interest. All of the Companies income tax returns have been filed but not all have yet been assessed by CRA.

The estimated tax pools of the Company at September 30, 2009 are as follows:

	(\$000s)
Canadian Oil and Gas Property Expenses	14,423
Canadian Development Expenses	28,039
Canadian Exploration Expenses	14,864
Undepreciated Capital Cost	27,542
	<b>84,868</b>

## Net Income (Loss)

	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
Net income (loss) (\$000s)	(3,787)	1,070	(18,385)	(3,129)
Net loss per share - basic and diluted (\$)	(0.14)	0.04	(0.68)	(0.16)
Net loss (\$/boe)	(36.21)	7.85	(54.53)	(8.13)

The Company recorded a net loss of \$3,787,000 for the three months ended September 30, 2009 compared to net income of \$1,070,000 for the three months ended September 30, 2008. This translates into a basic and diluted net loss per share of \$0.14 for the three months ended September 30, 2009 compared to basic and diluted income per share of \$0.04 for the three months ended September 30, 2008. The net loss of the three months ended September 30, 2009 is mainly due to lower commodity prices, lower production levels and an unrealized loss on commodity contracts. The net loss for the nine months ended September 30, 2009 was \$18,385,000 compared to \$3,129,000 for the nine months ended September 30, 2008. The net loss for the nine months ended September 30, 2009 is mainly attributed to the ceiling test impairment charge in the second quarter of 2009 of \$14,276,000.

## Funds from Operations

	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
Funds from operations (\$000s) <sup>(1)</sup>	1,393	1,193	3,342	5,844
Funds from operations (\$/boe)	13.30	8.77	9.90	15.21
Funds from operations per share – basic and diluted (\$)	0.05	0.04	0.12	0.29

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

Funds from operations for the three months ended September 30, 2009 were \$1,393,000 compared to \$1,193,000 for the three months September 30, 2008. This increase is attributable to an improved operating netback resulting from royalty credits and lower interest expense recorded in the three months ended September 30, 2009. Funds from operations for the nine months ended September 30, 2009 were \$3,342,000 compared to \$5,844,000 for the nine months ended September 30, 2008. This decrease is also due to lower natural gas prices realized and higher administrative expenses experienced in the first nine months of 2009.

## Capital Expenditures

(\$000s)	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
Land and seismic	147	1,578	411	2,161
Drilling and completions	-	48	4,231	5,089
Equipment and facilities	822	(194)	2,823	15,801
Capitalized overhead costs	215	273	701	753
Abandonments	-	-	172	81
Other	7	32	27	65
Dispositions	-	-	-	(8,150)
	1,191	1,737	8,365	15,800

In the three months ended September 30, 2009, the Company commenced a major upgrade to the Buick Creek gas processing facility. The total cost of the upgrade and required maintenance was approximately \$950,000 of which \$650,000 was incurred to September 30, 2009. This facility was brought back onto production in mid-October. Capital expenditures for the three months ended September 30, 2008 included the acquisition of Crown lands at Pine Creek and trade seismic data over the Company's Halverson lands.

Capital expenditures for the nine months ended September 30, 2009 were \$8,365,000 compared to \$15,800,000 for the nine months ended September 30, 2008. During the first quarter of 2009, the Company

finished operations relating to the completion of an exploratory well in the Pine Creek area and undertook the drilling of three wells in the Square Creek area, the Company's core producing property. At Pine Creek, the Company is continuing to analyze the results from the extensive pressure testing undertaken during completion operations. The Company also participated in the drilling of two development wells at Square Creek and drilled one 100 percent working interest exploratory well. One of the development wells was successfully equipped and tied-in during the first quarter of 2009. The other is being evaluated for a potential completion uphole in the shallower Notikewin Formation during the next operating season. The capital program for the first quarter of 2008 was focused on the follow-up to the discovery of the Bluesky and Notikewin gas pools from the 2007 winter drilling program and compression and optimization at Ladyfern. The Company also constructed a 10 mmcf/d gathering and production facility to service eight wells it has in the Square Creek area. The Company completed the construction of a 41 km pipeline to deliver gas to the Clear Prairie gas plant to service the Square Creek area, the corridor along which it owns 41,800 net acres of land opening up a significant exploration area for the Company. The pipeline was completed and commissioned in March 2008 for a total cost of \$8,578,000 and was sold to a mid-stream service provider in April for proceeds of \$8,150,000 resulting in a loss on the sale of the pipeline asset of \$428,000.

### Outstanding Securities

Outstanding securities	
Common shares	55,294,788
Warrants	27,295,700
Stock options	1,265,379
<b>Total outstanding securities at September 30, 2009 and November 13, 2009</b>	
	<b>83,855,867</b>

On September 30, 2009 the Company closed a public offering of 21,779,000 units ("Units") and 6,594,000 flow-through common shares for gross proceeds of \$11,385,185 (\$10,287,000 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 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.

The dilutive effect of the Company's issuable securities at September 30, 2009, which consists of 1,265,379 options (September 30, 2008 – 2,081,633) and 27,295,700 warrants (September 30, 2008 – 5,516,700) to issue common shares, was nil shares. These options and warrants are available for dilution in future periods.

### Liquidity and Capital Resources

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, has an accumulated deficit of \$91,382,000 and a working capital deficiency of \$15,235,000 as at September 30, 2009. Included in this deficiency are short term borrowings of \$20,942,000 under the revolving operating loan. The revolving operating loan limit is \$24,000,000, bears interest at the Bank's prime lending rate plus 1% and is collateralized by an interest over all present and after acquired property and fixed charges on specific assets. The authorized limit is subject to annual review and re-determination of the Company's borrowing base by the Bank.

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 lenders and investors. In the event that natural gas prices remain at current levels or reduce, the future operations of the Company is dependent on its ability to successfully raise capital and receive the continued financial support of its lender. The outcome of these matters cannot be predicted at this time.

Scheduled reviews of the revolving operating loan focus on the borrowing base supporting lending limits and are influenced by the lenders willingness to lend in general, commodity price forecasts used to determine the lending base, lenders interest in particular business sectors, such as energy and the relative strength of the borrower. Given these constraints, there is no assurance that the Company will be able to sustain its current borrowing base and may be required to reduce its outstanding loan. Should there be a requirement of the Company to reduce its outstanding loan, there are a number of options available including, but not limited to:

- (i) Issuance of additional equity;
- (ii) Negotiation of incremental borrowings with subordinated lenders; and
- (iii) Divestiture of assets.

Any adjustment to the revolving operating loan will be completed in connection with the annual bank review, which was scheduled for October 31, 2009 and is currently ongoing.

The Company is required to maintain its working capital ratio at 1:1 or greater while the facilities are outstanding. The working capital ratio is defined as current assets plus the unutilized portion of the credit facility divided by current liabilities less the balance drawn against the credit facility. The Company is in compliance with this covenant as at September 30, 2009. The Company's ability to maintain compliance with these financial covenants is dependent on certain factors, certain of which are outside the Company's control. Such factors include future industry and capital market conditions and commodity pricing. Based on current market conditions and commodity prices, the Company may have difficulty maintaining compliance with this financial covenant in the next 12 month period and the Bank can demand repayment of the operating loan facility.

The Company's capital resources available at September 30, 2009 are as follows:

(\$000s)	As at September 30, 2009
Operating loan available	24,000
Working capital deficiency	(15,235)
Cash held in trust for acquisition of oil and gas assets	(7,000)
<b>Capital resources available</b>	<b>1,765</b>

As at September 30, 2009, the Company had a working capital deficiency of \$15,235,000 that included cash of \$7,000,000 held in trust for the acquisition of a partner's working interest in Square Creek. Available capital resources as at September 30, 2009 were \$1,765,000. Future capital requirements will be funded through cash flows from operations. There is no assurance that Fortress will be able to sustain its current borrowing base and may be required to reduce its outstanding operating loan facility. Fortress has options available to deal with a borrowing base reduction including the sale of non-core properties, dedication of cash flows, and liquidation of its commodity contracts.

Cash used in operating activities for the three months ended September 30, 2009 was \$396,000 compared to cash provided by operating activities for the three months ended September 30, 2008 of \$1,315,000. This decrease is due to a decrease in non-cash working capital balances. Cash provided by operating activities for the nine months ended September 30, 2009 was \$2,079,000 compared to \$9,893,000 for the nine months ended September 30, 2008. This decrease is due to lower natural gas prices realized and a decrease in non-cash working capital balances.

Cash provided by financing activities for of the three months ended September 30, 2009 was \$7,851,000 compared to \$3,363,000 for the three months ended September 30, 2008. Cash provided by financing activities for the three months ended September 30, 2009 represents a decrease in amounts drawn on the operating loan from the prior quarter and the net proceeds of an equity financing that closed on September 30<sup>th</sup> of \$10,287,000. Cash provided by financing activities for the three months ended September 30, 2008 represents an increase in amounts drawn on the operating loan from the prior quarter and net proceeds from the third closing of an equity financing. Cash provided by financing activities for the nine months ended September 30, 2009 was \$10,696,000 compared to \$11,968,000 for the nine months ended September 30, 2008. Cash provided by financing activities for the nine months ended September 30, 2009 reflects the net proceeds from an equity financing. Cash provided by financing activities for the nine months ended September 30, 2008 reflects the net proceeds of an equity financing of \$14,737,000.

Cash used in investing activities for the three months ended September 30, 2009 was \$462,000 compared to \$4,680,000 for the three months ended September 30, 2008. The Company's capital expenditures in the three months ended September 30, 2009 were \$1,191,000 compared to \$1,737,000 in the three months ended September 30, 2008. Cash used in investing activities for the nine months ended September 30, 2009 was \$5,892,000 compared to \$21,869,000 for the nine months ended September 30, 2008. For the

nine months ended September 30, 2009, the Company incurred capital expenditures of \$8,193,000 and \$15,800,000 for the nine months ended September 30, 2008.

### Related-Party Transactions

In the three and nine months ended September 30, 2009, the Company was charged \$160,000 and \$244,000 (three and nine months ended September 30, 2008 - \$218,000 and \$794,000, respectively), for legal fees by a law firm of which a director of the Company is a partner.

In the three and nine months ended September 30, 2009, the Company was charged \$35,000 and \$81,000 (three and nine months ended September 30, 2008 - \$25,000) by a director for consulting services of which \$25,000 is included in accrued liabilities.

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

#### Royalties

The Company has agreed to pay to various university research centres royalties amounting to 2 percent to 5 percent on sales of licensed products related to a research contract and acquired technology rights and 15 percent of sublicense revenues from products related to the acquired technology rights. At September 30, 2009 there were no royalties payable under these agreements. These agreements relate to a predecessor company which was a cancer drug discovery enterprise.

#### Office space and equipment

The Company is committed to minimum annual lease payments under operating leases for office premises and equipment to March, 2013, as follows:

(\$000s)	Equipment Rental \$	Office Lease \$	Total \$
2009	3	114	117
2010	11	470	481
2011	9	475	484
2012	-	474	474
2013	-	119	119
	23	1,652	1,675

#### Transportation and Processing

The Company has an agreement for the transportation and processing of natural gas from the Company's Square Creek, Alberta area. The Company is committed to pay the greater of a fee calculated as monthly volumes at an established rate per mcf, or an established minimum monthly processing fee based on estimated gas throughput of 2 mmcf/d until the earlier of April 1, 2015 or the delivery of a total of 15 bcf. Committed payments are as follows:

	(\$000s)
Balance of 2009	332
2010	1,088
2011	767
2012	767
2013	767
Thereafter	895
	4,616

The Company's joint interest partner in the Square Creek area has agreed to be responsible for all terms and conditions of the agreement related to its 50 percent working interest in this area. Committed payments represent only the Company's 50 percent working interest. From start up in March 2008 to September 30, 2009, the Square Creek property has produced 3.1 bcf (net 1.55 bcf net) of natural gas.

#### Letter of Credit

On February 1, 2009, the Company issued a letter of credit of \$900,000 with an expiry of February 1, 2010, related to a gas transportation and processing agreement.

#### Guarantees

The Company maintains liability insurance for its directors and officers and indemnifies its directors and officers against any and all claims or losses reasonably incurred in the performance of their service to the Company to the extent permitted by law.

#### 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 to the Company the amount of which cannot be determined at this time.

#### 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 of \$277,000 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 cannot be determined at this time.

#### **Subsequent Event**

On October 23, 2009, the Company closed the previously announced acquisition of its partner's 50 percent working interest in the Square Creek area of Alberta for cash consideration of \$7,350,000, subject to final adjustments.

## SELECTED QUARTERLY INFORMATION

	2009				2008			2007
	Q3	Q2	Q1	Q4	Q3	Q2	Q1	Q4
Production:								
Natural gas (mcf/d)	6,741	7,603	7,665	8,118	8,733	8,690	7,391	7,455
Oil and NGLs (bbls/d)	13	12	14	14	23	15	33	13
Total (boe/d)	1,137	1,279	1,292	1,367	1,478	1,463	1,265	1,256
Average realized price:								
Natural gas (\$/mcf) <sup>(1)</sup>	6.65	6.22	7.47	7.88	8.02	8.98	8.03	6.36
Oil and NGLs (\$/bbl)	82.45	45.11	37.72	60.42	82.29	108.04	79.61	86.95
Combined average (\$/boe)	40.53	37.35	44.79	47.41	42.64	54.31	48.96	39.52
Benchmark prices:								
AECO average natural gas price (\$/mcf)	3.00	3.45	4.92	6.69	7.76	9.82	7.90	6.00
Edmonton Par crude oil (\$/bbl)	71.65	66.70	51.13	64.18	123.08	126.37	98.45	80.75
Financial (\$'000s unless otherwise noted):								
Petroleum and natural gas sales <sup>(1)</sup>	4,240	4,346	5,206	5,962	5,802	7,231	5,637	4,599
Net income (loss)	(3,787)	(14,605)	7	(624)	1,070	(744)	(3,455)	(5,442)
Net income (loss) per share – basic (\$)	(0.14)	(0.54)	0.00	(0.02)	0.04	(0.04)	(0.22)	(0.39)
Net income (loss) per share – diluted (\$)	(0.14)	(0.54)	0.00	(0.02)	0.04	(0.04)	(0.22)	(0.39)
Funds from (used in) operations	1,393	557	1,393	1,113	1,193	2,627	2,025	(282)
Operating costs (\$/boe)	16.81	15.95	15.62	14.50	15.72	15.40	11.94	15.26
Weighted average shares	27,230	26,922	26,922	26,965	26,965	16,809	15,980	13,561
outstanding – basic ('000s)								
Weighted average shares	27,230	26,922	26,922	26,965	27,004	16,809	15,980	13,561
outstanding – diluted ('000s)								

<sup>(1)</sup> Restated to include the realized gains or losses on commodity contracts and for the effects of transportation costs which previously were netted from petroleum and natural gas sales.

### 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 time 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 September 30, 2009. Based on their assessment Management determined that the internal controls over financial reporting were effective as at September 30, 2009.

There is 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.

### **Changes in Accounting Policies and Practices**

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*. The standard reduces the differences with 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 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 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.

### **New Canadian Accounting Pronouncements**

The Canadian Accounting Standards Board (AcSB) has confirmed that the use of International Financial Reporting Standards (IFRS) will be required in 2011 for publicly accountable profit-oriented enterprises. IFRS will replace Canada's current GAAP for those enterprises. These include 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. Fortress is currently evaluating the impact of adopting IFRS.

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 will be effective for the annual period ending December 31, 2009.

In December 2008, the CICA issued Handbook Section 1582, *Business Combinations*, which will replace CICA Handbook Section 1581 of the same name. Under this guidance, the purchase price used in a business combination is based on the fair value of shares exchanged at their market price at the date of the exchange. Currently, the purchase price used is based on the market price of the shares for a reasonable period before and after the date of the acquisition is agreed upon and announced. This new standard generally requires all acquisition costs to be expensed, which currently are capitalized as part of the purchase price. Contingent liabilities are to be recognized at fair value at the acquisition date and re measured at fair value through earnings each period until settled. Currently, only contingent liabilities that are resolved and payable are included in the cost to acquire the business. In addition, negative goodwill is required to be recognized immediately in earnings, unlike the current requirement to eliminate it by deducting it from non-current assets in the purchase price allocation. CICA Handbook Section 1582 is effective January 1, 2011.

## **CRITICAL ACCOUNTING ESTIMATES**

The reader is advised that the critical accounting estimates, policies, and practices as described in this MD&A and report 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 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 both productive and non-productive wells, production equipment and overhead charges directly related to acquisition, exploration and development activities.

The application of the full cost method of accounting requires management's judgment to determine the proper designation of 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 gas properties. The process of estimating reserves is complex. It requires significant judgments and decisions based on available geological, geophysical, engineering, and economic data. These estimates may change substantially as additional data from ongoing development activities and production performance becomes available and as economic conditions impacting oil and gas prices and costs change. The Company's reserve estimates are based on current production forecasts, prices and economic conditions. Fortress' reserves were evaluated by the independent engineering firm Sproule Associates Ltd.

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

- Calculating our 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 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 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**

### **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 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.

### **Global Financial Crisis**

Recent market events and conditions, including disruptions in the international credit markets and other financial systems and the deterioration of global economic conditions, have caused significant volatility to commodity prices. These conditions worsened in 2008 and are continuing in 2009, causing a loss of confidence in the broader U.S. and global credit and financial markets and resulting in the collapse of, and government intervention in, major banks, financial institutions and insurers and creating a climate of greater volatility, less liquidity, widening of credit spreads, a lack of price transparency, increased credit losses and tighter credit conditions. Notwithstanding various actions by governments, concerns about the general condition of the capital markets, financial instruments, banks, investment banks, insurers and other financial institutions caused the broader credit markets to further deteriorate and stock markets to decline substantially early in 2009. Notwithstanding certain positive economic signs observed so far in the third quarter of 2009, these factors have negatively impacted company valuations and are expected to impact the performance of the global economy going forward.

Oil and natural gas prices are expected to remain volatile for the near future as a result of market uncertainties over the supply and demand of these commodities due to the current state of economies around the world, OPEC actions and ongoing global credit and liquidity concerns.

### **Substantial Capital Requirements**

The Company anticipates making substantial capital expenditures for the acquisition, exploration, development and production of oil and natural gas reserves in the future. As the Company's revenues may decline as a result of decreased commodity pricing, it may be required to reduce capital expenditures. In addition, uncertain levels of near term industry activity coupled with the current global credit crisis expose the Company to access to capital risk. 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.

### **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 2008 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.

---

**FORTRESS ENERGY INC.**

## CONSOLIDATED BALANCE SHEETS

(See Nature of Operations and Going Concern Uncertainty – note 1)

As at

(in thousands)

(unaudited)

---

	September 30, 2009	December 31, 2008
<b>ASSETS</b> (note 5)		
Current Assets		
Cash and cash equivalents (note 3)	\$ 7,063	\$ 180
Accounts receivable	6,561	6,997
Prepaid expenses and deposits	520	854
Commodity contracts (note 9)	2,129	2,319
	<u>16,273</u>	<u>10,350</u>
Commodity contracts	-	168
Property, plant and equipment (note 4)	88,399	104,904
	<u>\$ 104,672</u>	<u>\$ 115,422</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current Liabilities		
Revolving operating loan (note 5)	\$ 20,942	\$ 20,533
Accounts payable and accrued liabilities (note 12)	10,376	9,990
Income taxes	190	136
Future income taxes	-	684
	<u>31,508</u>	<u>31,343</u>
Future income taxes	-	3,439
Asset retirement obligations (note 7)	3,577	3,395
	<u>35,085</u>	<u>38,177</u>
Commitments and contingencies (note 10)		
Shareholders' Equity		
Share capital (note 8)	139,966	133,346
Warrants (note 8)	5,776	1,834
Contributed surplus (note 8)	15,227	15,062
Deficit	(91,382)	(72,997)
	<u>69,587</u>	<u>77,245</u>
	<u>\$ 104,672</u>	<u>\$ 115,422</u>

---

See accompanying notes to consolidated financial statements.

**FORTRESS ENERGY INC.**

## CONSOLIDATED STATEMENTS OF OPERATIONS, COMPREHENSIVE INCOME (LOSS) AND DEFICIT

(See Nature of Operations and Going Concern Uncertainty – note 1)

For the three and nine months ended September 30

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

(unaudited)

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2009	2008	2009	2008
<b>REVENUES</b>				
Petroleum and natural gas sales (note 13)	\$ 4,240	\$ 5,802	\$ 13,791	\$ 18,670
Royalties	135	(1,158)	(785)	(3,421)
Unrealized gain (loss) on commodity contracts (note 9)	(1,855)	4,323	(358)	1,333
	2,520	8,967	12,648	16,582
<b>EXPENSES</b>				
Operating	1,757	2,139	5,427	5,565
Transportation (note 13)	197	258	692	707
General and administrative (note 13)	726	652	2,087	1,706
Professional fees (note 13)	114	122	602	459
Bad debts (note 13)	(17)	(28)	162	(81)
Stock-based compensation (note 8)	108	77	235	149
Interest (note 13)	187	308	640	1,049
Depletion, depreciation and accretion (note 4)	2,942	3,805	10,450	10,627
Ceiling test impairment (note 4)	-	-	14,276	-
	6,014	7,333	34,571	20,181
Gain (Loss) on sale of pipeline asset	(3,494)	1,634	(21,923)	(3,599)
Income (loss) before income taxes	(3,494)	1,758	(21,923)	(4,027)
Income tax expense (recovery) (note 6)				
Current	18	-	54	-
Future	275	688	(3,592)	(898)
	293	688	(3,538)	(898)
Net income (loss) and comprehensive income (loss) for the period	(3,787)	1,070	(18,385)	(3,129)
Deficit, beginning of period	(87,595)	(73,443)	(72,997)	(69,244)
Deficit, end of period	\$(91,382)	\$(72,373)	\$(91,382)	\$(72,373)
Weighted average shares outstanding (note 8)	27,230,190	27,004,567	27,025,718	19,937,734
Net income (loss) per share – basic and diluted (note 8)	\$(0.14)	\$(0.04)	\$(0.68)	\$(0.16)

See accompanying notes to consolidated financial statements.

**FORTRESS ENERGY INC.**

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(See Nature of Operations and Going Concern Uncertainty – note 1)

For the three and nine months ended September 30

(in thousands)

(unaudited)

	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
<b>CASH PROVIDED BY (USED IN):</b>				
<b>OPERATING ACTIVITIES</b>				
Net income (loss) for the period	\$ (3,787)	\$ 1,070	\$ (18,385)	\$ (3,129)
Items not affecting cash flows:				
Unrealized loss (gain) on commodity contracts	1,855	(4,323)	358	(1,333)
Stock-based compensation	108	77	235	149
Depletion, depreciation and accretion	2,942	3,805	10,450	10,627
Ceiling test impairment	-	-	14,276	-
Gain (loss) on sale of pipeline asset	-	(124)	-	428
Future income tax expense (recovery)	275	688	(3,592)	(898)
Abandonment expenditures	-	-	(172)	(81)
	1,393	1,193	3,170	5,763
Change in non-cash operating working capital (note 11)	(1,789)	122	(1,091)	4,130
Cash provided by (used in) operating activities	(396)	1,315	2,079	9,893
<b>FINANCING ACTIVITIES</b>				
Change in revolving operating loan	(2,436)	1,339	409	(2,769)
Issue of common shares and warrants (note 8)	11,385	2,525	11,385	16,550
Share issuance costs (note 8)	(1,098)	(501)	(1,098)	(1,813)
Cash provided by financing activities	7,851	3,363	10,696	11,968
<b>INVESTING ACTIVITIES</b>				
Property, plant and equipment additions	(1,191)	(1,737)	(8,193)	(23,950)
Proceeds on sale of pipeline asset	-	-	-	8,150
Change in non-cash investing working capital (note 11)	729	(2,943)	2,301	(6,069)
Cash used in investing activities	(462)	(4,680)	(5,892)	(21,869)
Net change in cash	6,993	(2)	6,883	(8)
Cash and cash equivalents - beginning of period	70	38	180	44
Cash and cash equivalents - end of period	\$ 7,063	\$ 36	\$ 7,063	\$ 36
Supplemental cash flow information:				
Interest paid	\$ 187	\$ 308	\$ 640	\$ 1,049

See accompanying notes to consolidated financial statements.

---

# **FORTRESS ENERGY INC.**

## **Notes to Consolidated Financial Statements**

September 30, 2009

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

(unaudited)

---

### **1. NATURE OF OPERATIONS AND GOING CONCERN UNCERTAINTY**

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 gas exploration and development company. All activity is conducted in Western Canada and comprises a single operating segment. Fortress is listed on the TSX under the symbol "FEI".

The financial statements include the accounts of Fortress and its wholly owned subsidiary, 1310639 Alberta Ltd. on a consolidated basis.

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, has an accumulated deficit of \$91,382,000 and a working capital deficiency of \$15,235,000 as at September 30, 2009. Included in this deficiency are short term borrowings of \$20,942,000 under the revolving operating loan. The revolving operating loan limit is \$24,000,000, bears interest at the Bank's prime lending rate plus 1% and is collateralized by an interest over all present and after acquired property of the Company and fixed charges on specific assets. The authorized limit is subject to annual review and re-determination of the Company's borrowing base by the Bank.

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 lenders and investors. In the event that natural gas prices remain at current levels or reduce, the future operations of the Company is dependent on its ability to successfully raise capital and receive the continued financial support of its lender. The outcome of these matters cannot be predicted at this time.

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**

#### **(a) Basis of presentation**

Except as noted below, the unaudited interim financial statements of the Company have been prepared by management in accordance with Canadian generally accepted accounting principles (GAAP) using the same accounting policies as set out in note 2 to the audited consolidated financial statements for the year ended December 31, 2008. Certain information or disclosures normally required to be included in notes to annual audited financial statements have been condensed or omitted. The unaudited interim financial statements should be read in conjunction with the audited consolidated financial statements for the year ended December 31, 2008.

The timely preparation of financial statements requires that management make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from estimates.

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

---

# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

September 30, 2009

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

(unaudited)

---

(b) Comparative figures

Certain comparative figures have been reclassified to conform to the presentation adopted in the current period (see note 14).

(c) Changes in accounting policies

(i) 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*. The standard reduces the differences with 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 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.

(ii) On January 20, 2009 the CICA 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.

(d) Future accounting changes

(i) The Canadian Accounting Standards Board (AcSB) has confirmed that the use of International Financial Reporting Standards (IFRS) will be required in 2011 for publicly accountable profit-oriented enterprises. IFRS will replace Canada's current GAAP for those enterprises. These include 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. Fortress is currently evaluating the impact of adopting IFRS.

(ii) 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 will be effective for the annual period ending December 31, 2009.

# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

September 30, 2009

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

(unaudited)

- (iii) In December 2008, the CICA issued Handbook Section 1582, *Business Combinations*, which will replace CICA Handbook Section 1581 of the same name. Under this guidance, the purchase price used in a business combination is based on the fair value of shares exchanged at their market price at the date of the exchange. Currently, the purchase price used is based on the market price of the shares for a reasonable period before and after the date of the acquisition is agreed upon and announced. This new standard generally requires all acquisition costs to be expensed, which currently are capitalized as part of the purchase price. Contingent liabilities are to be recognized at fair value at the acquisition date and re measured at fair value through earnings each period until settled. Currently, only contingent liabilities that are resolved and payable are included in the cost to acquire the business. In addition, negative goodwill is required to be recognized immediately in earnings, unlike the current requirement to eliminate it by deducting it from non-current assets in the purchase price allocation. CICA Handbook Section 1582 is effective January 1, 2011.

### 3. CASH AND CASH EQUIVALENTS

Cash and cash equivalents at September 30, 2009 includes \$7,000,000 held in trust for the acquisition of an oil and gas property. The acquisition closed on October 23, 2009 (see note 14).

### 4. PROPERTY, PLANT AND EQUIPMENT

	Cost	Accumulated Depletion and Depreciation	Net Book Value
September 30, 2009	\$	\$	\$
Oil and gas properties	144,569	56,351	88,218
Other	417	236	181
	144,986	56,587	88,399

  

	Cost	Accumulated Depletion and Depreciation	Net Book Value
December 31, 2008	\$	\$	\$
Oil and gas properties	136,544	31,857	104,687
Other	393	176	217
	136,937	32,033	104,904

For the three and nine months ended September 30, 2009, the Company capitalized general and administrative expenses of \$189,000 and \$654,000, respectively (three and nine months ended September 30, 2008 - \$222,000 and \$622,000, respectively) directly attributable to exploration and development activities. In addition, the Company capitalized stock-based compensation expense related to exploration and development activities in the three and nine months ended September 30, 2009 of \$27,000 and \$32,000, respectively (three months and nine months ended September 30, 2008 - \$51,000 and \$131,000, respectively).

Estimated future development costs of \$11,235,000 (September 30, 2008 - \$15,842,000) were included in the calculation of depletion expense for the three and nine months ended

---

# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

September 30, 2009

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

(unaudited)

---

September 30, 2009. As at September 30, 2009, undeveloped land costs of \$7,176,000 (September 30, 2008 - \$8,508,000) were excluded from assets subject to depletion.

The Company recorded a ceiling test impairment charge in the nine months ended September 30, 2009 of \$14,276,000.

Liens totaling \$146,000 have been registered against certain oil and gas properties.

### 5. REVOLVING OPERATING LOAN

The Company has a \$24,000,000 demand operating loan facility with its bank (the "Bank"), bearing interest at the Bank's prime lending rate plus 1.0 percent. The effective interest rate for the three and nine months ended September 30, 2009 was 3.25 and 3.5 percent, respectively (three and nine months ended September 30, 2008 - 5.0 and 5.25 percent). At September 30, 2009, a total of \$20,942,000 was drawn on this facility. The Company also has a \$1,000,000 letter of guarantee facility of which \$900,000 is drawn at September 30, 2009 (December 31, 2008 - \$1,000,000). These facilities are collateralized by an interest over all present and subsequently acquired property of the Company.

Scheduled reviews of the revolving operating loan focus on the borrowing base supporting lending limits and are influenced by the lender's willingness to lend in general, commodity price forecasts used to determine the lending base, lender's interest in particular business sectors, such as energy and the relative strength of the borrower. Given these constraints, there is no assurance that the Company will be able to sustain its current borrowing base and may be required to reduce its outstanding loan. Should there be a requirement of the Company to reduce its outstanding loan, there are a number of options available including, but not limited to:

- a) Issuance of additional equity;
- b) Negotiation of incremental borrowings with subordinated lenders; and
- c) Divestiture of assets.

Any adjustment to the revolving operating loan will be completed in connection with the annual bank review, which was scheduled for October 31, 2009 and is currently ongoing.

The Company is required to maintain its working capital ratio at 1:1 or greater while the facilities are outstanding. The working capital ratio is defined as current assets plus the unutilized portion of the credit facility divided by current liabilities less the balance drawn against the credit facility. The Company is in compliance with this covenant as at September 30, 2009. The Company's ability to maintain compliance with this financial covenant is dependent on certain factors, certain of which are outside the Company's control. Such factors include future industry and capital market conditions and commodity pricing. Based on current market conditions and commodity prices, the Company may have difficulty maintaining compliance with this financial covenant in the next 12 month period and the Bank can demand repayment of the operating loan facility.

# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

September 30, 2009

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

### 6. INCOME TAXES

The provision for income tax expense (recovery) is summarized as follows:

	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
	\$	\$	\$	\$
Current income tax expense	18	-	54	-
Future income tax expense (recovery)	275	688	(3,592)	(898)
Income tax expense (recovery)	293	688	(3,538)	(898)

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

	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
Income (loss) before tax	\$(3,494)	\$1,758	\$(21,923)	\$(4,027)
Expected tax expense (recovery) at 29.5% (September 30, 2008 – 30.25%)	(1,031)	532	(6,468)	(1,218)
Add (deduct) income tax effect of:				
Stock-based compensation	32	23	69	45
Non-deductible expenses	1	17	25	10
Non-deductible interest expenses	18	-	54	-
Rate adjustments and other	100	116	(45)	265
Valuation allowance	1,173	-	2,827	-
Income tax expense (recovery)	293	688	(3,538)	(898)

The Company recorded a ceiling test impairment charge of \$14,276,000 in the nine months ended September 30, 2009 which resulted in the Company having tax basis in excess of the carrying amount. The Company recognized a future income tax asset to the extent of future income tax liabilities and recorded a valuation allowance against the remaining future income tax asset due to the Company's history of losses.

# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

September 30, 2009

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

### 7. ASSET RETIREMENT OBLIGATIONS

The Company's asset retirement obligations result from net ownership interests in oil and gas assets including well sites, gathering systems and processing facilities. The Company estimates the net present value of its total asset retirement obligations at September 30, 2009 to be \$3,577,000 (December 31, 2008 - \$3,395,000) based on a total future liability of \$5,083,000 (December 31, 2008 - \$5,027,000) which will be primarily incurred between 2012 and 2029. An inflation rate of 2.0 percent (December 31, 2008 - 2.0 percent) and a credit-adjusted risk-free rate of 7.5 percent (December 31, 2008 - 7.5 percent) were used to calculate the fair value of the asset retirement obligations.

	\$
Balance, December 31, 2008	3,395
Liabilities incurred	37
Accretion expense	171
Abandonment expenditures	(26)
Balance, September 30, 2009	3,577

### 8. SHARE CAPITAL

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

- (b) Common shares issued and outstanding:

	Number of Common Shares	\$
Balance December 31, 2008	26,921,788	133,346
Public offering (i)	28,373,000	7,443
Share issuance costs (i)	-	(1,098)
Tax effect of share issuance costs	-	275
Balance, September 30, 2009	55,294,788	139,966

- (i) On September 30, 2009 the Company closed a public offering of 21,779,000 units ("Units") and 6,594,000 flow-through common shares (total common shares issued of 28,373,000) for gross proceeds of \$11,385,185 (\$10,287,000 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 is \$3,942,000 as determined using the Black-Scholes option pricing model with a risk-free interest rate of 1.2%, an expected weighted average life of 1.5 years, an expected volatility of 152.75% 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.

# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

September 30, 2009

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

(unaudited)

(c) Warrants issued and outstanding:

	Number of Warrants	\$
Balance December 31, 2008	5,516,700	1,834
Public offering (note 8 (b)(i))	21,779,000	3,942
Balance, September 30, 2009	27,295,700	5,776

(d) Contributed surplus:

	\$
Balance, December 31, 2008	15,062
Stock-based compensation expense	165
Balance, September 30, 2009	15,227

(e) Stock option plan:

The Company grants stock options to employees, officers, directors and consultants of the Company pursuant to an incentive plan (the "Plan"). Under the 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 for the nine months ended September 30, 2009:

	Number	Weighted average exercise price \$
Outstanding, December 31, 2008	1,805,873	1.56
Expired	(19,600)	(19.54)
Forfeited	(520,894)	(1.23)
Outstanding, September 30, 2009	1,265,379	1.38
Exercisable, September 30, 2009	423,385	1.49

The Company has the following stock options outstanding:

Outstanding at September 30, 2009				Exercisable at September 30, 2009	
Exercise Price	Number	Weighted average years to expiry	Weighted Average Exercise Price	Number exercisable	Weighted Average Exercise Price
\$			\$		\$
1.18 – 1.35	1,262,979	3.7	1.32	420,985	1.32
20.00 – 50.00	2,400	0.9	30.67	2,400	30.67
	1,265,379	3.7	1.38	423,385	1.49

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 did not grant any stock options in the three and nine months ended September 30, 2009.

---

# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

September 30, 2009

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

(unaudited)

---

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.

The estimated fair value of stock options of \$0.55 per share (September 30, 2008 - \$0.56) is amortized to expense over the vesting period on a straight-line basis. For the three and nine months ended September 30, 2009; the Company recorded compensation expense of \$54,000 and \$150,000, respectively, related to stock options (September 30, 2008 - \$93,000 and \$125,000, respectively). The Company capitalized stock-based compensation expense related to exploration and development activities in the three and nine months ended September 30, 2009 of \$27,000 and \$32,000, respectively (three months and nine months ended September 30, 2008 - \$51,000 and \$131,000, respectively).

(f) Restricted stock unit plan:

As at September 30, 2009, there were 875,000 restricted stock units outstanding of which 300,000 mature on December 31, 2010 and 575,000 mature on November 17, 2011. All vest over a three year period on a straight-line basis. The Company recorded a liability at September 30, 2009 based on the intrinsic value of the units. For the three and nine months ended September 30, 2009, the Company recorded compensation expense related to the restricted stock unit plan of \$54,000 and \$86,000, respectively (three and nine months ended September 30, 2008 \$14,000 and \$62,000, respectively).

(g) Per share amounts:

The weighted average number of common shares outstanding for the three and nine months ended September 30, 2009 and 2008 are as follows:

	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
Weighted average – basic and diluted	27,230,190	27,004,567	27,025,718	19,937,734

The dilutive effect of the Company's issuable securities at September 30, 2009, which consists of 1,265,379 options (September 30, 2008 - 2,081,633) and 27,295,700 warrants (September 30, 2008 - 5,516,700) to issue common shares, was nil shares. These options and warrants are available for dilution in future periods.

---

# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

September 30, 2009

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

---

### 9. 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; to set appropriate limits and controls; and to 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 are with customers in the energy industry and are subject to normal industry credit risk. The Company generally grants unsecured credit but routinely assesses the financial strength of its customers.

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 two petroleum and natural gas marketers 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 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 both operated and non-operated projects to further manage capital

---

# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

September 30, 2009

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

(unaudited)

---

expenditures. To facilitate the capital expenditure program, the Company has a revolving credit facility (note 5) that is reviewed annually by the lender.

### 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 or during the three and nine months ended September 30, 2009.

### 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. The Company has attempted to mitigate commodity price risk through the use of financial derivative sales contracts. The Company's contracts in place as of September 30, 2009 are as follows:

Type	Period	Volume (GJ/d)	Fixed Price (\$/GJ)
Swap	April 1, 2009 to December 31, 2009	5,100	7.20
Swap	January 1, 2010 to March 31, 2010	2,600	8.38
Swap	January 1, 2010 to March 31, 2010	2,500	6.80

For the three and nine months ended September 30, 2009, the Company realized a gain related to commodity contracts of \$2,032,000 and \$5,224,000, respectively (three and nine months ended September 30, 2008 – realized loss of \$1,047,000 and \$2,232,000, respectively) which has been included in petroleum and natural gas sales. In the three and nine months ended September 30, 2009 the Company also recorded an unrealized loss on commodity contracts of \$1,855,000 and \$358,000, respectively (recorded an unrealized gain of \$4,323,000 and \$1,333,000 for the three and nine months ended September 30, 2008, respectively). A \$1.00/GJ change in the AECO price would increase or decrease the unrealized gain on commodity contracts for the three and nine months ended September 30, 2009 by \$928,000.

### Interest Rate Risk

The Company is exposed to interest rate risk to the extent that changes in market interest rates impact its borrowings under the revolving credit facility. The Company has no interest rate swaps or hedges at September 30, 2009. A difference in the average effective interest rate of 1.0 percent would change net income by an estimated \$56,000 for the three months ended September 30, 2009.

---

# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

September 30, 2009

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

(unaudited)

---

### Capital Management

The Company's policy is to maintain a capital base for the objectives of maintaining financial flexibility, creditor and market confidence and to sustain the future development of the business.

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 net debt and working capital which is a non-GAAP measure and calculated as follows:

	September 30, 2009	December 31, 2008
Current assets	\$ 16,273	\$ 10,350
Current liabilities	(31,508)	(31,343)
Net debt and working capital deficiency	\$ (15,235)	\$ (20,993)

The net debt and working capital deficiency is a result of normal operating conditions in periods when the Company incurs significant capital expenditures relative to revenue. The Company's lands can only be accessed during winter months and it is in these months when the Company incurs most of its annual capital expenditures. Net debt and working capital deficiency is defined as current assets less current liabilities.

The Company's share capital is not subject to external restrictions; however the credit facility is based on petroleum and natural gas reserves. The Company has not paid or declared any dividends since the date of incorporation, nor are any contemplated in the foreseeable future.

### Fair Value of Financial Instruments

The Company's financial instruments as at September 30, 2009 include cash and cash equivalents, accounts receivable, commodity contracts, accounts payable and the revolving operating loan. The fair value of cash and cash equivalents, 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.

# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

September 30, 2009

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

(unaudited)

The carrying and fair values of the Company's financial instruments as at September 30, 2009 are as follows:

Classification	Carrying Value \$	Fair Value \$
Held-for-trading (cash and cash equivalents and commodity contracts)	9,192	9,192
Loans and receivables (accounts receivable)	6,561	6,561
Held-to-maturity	-	-
Other liabilities (accounts payable and revolving operating loan)	(31,318)	(31,318)
Total	(15,565)	(15,565)

10.

### COMMITMENTS AND CONTINGENCIES

#### Office space and equipment

The Company is committed to minimum annual lease payments under operating leases for office premises and equipment to March, 2013, as follows:

	Equipment Rental \$	Office Lease \$	Total \$
Balance of 2009	3	114	117
2010	11	470	481
2011	9	475	484
2012	-	474	474
2013	-	119	119
	23	1,652	1,675

#### Transportation and Processing

The Company has an agreement for the transportation and processing of natural gas from the Company's Square Creek, Alberta area. The Company is committed to paying the greater of a fee calculated as monthly volumes at an established rate per mcf, or an established minimum monthly processing fee based on estimated gas throughput of 2 mmcf per day until the earlier of April 1, 2015 or the delivery of a total of 15 bcf.

Committed payments are as follows:

	\$
Balance of 2009	332
2010	1,088
2011	767
2012	767
2013	767
Thereafter	895
	4,616

The Company's joint interest partner in the Square Creek area has agreed to be responsible for all terms and conditions of the agreement related to its 50 percent working interest in this area. Accordingly, committed payments listed above represent only the Company's 50 percent working interest (note 14).

---

# **FORTRESS ENERGY INC.**

## **Notes to Consolidated Financial Statements**

September 30, 2009

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

(unaudited)

---

### **Letter of Credit**

On February 1, 2009, the Company issued a letter of credit of \$900,000 with an expiry of February 1, 2010, related to a natural gas transportation and processing agreement.

### **Claims and Litigation**

The Company maintains liability insurance for its directors and officers and indemnifies its directors and officers against any and all claims or losses reasonably incurred in the performance of their service to the Company to the extent permitted by law.

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 to the Company the amount of which cannot be determined at this time.

### **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 cannot be determined at this time.

# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

September 30, 2009

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

### 11. CHANGE IN NON-CASH WORKING CAPITAL

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

	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
	\$	\$	\$	\$
Accounts receivable	(161)	4,264	436	745
Prepaid expenses and deposits	261	(406)	334	(227)
Accounts payable and accrued liabilities	(1,178)	(6,665)	386	(2,428)
Income taxes payable	18	-	54	-
	(1,060)	(2,807)	1,210	(1,910)
Accounts payable settled through issuance of shares	-	-	-	25
Stock-based compensation included in accounts payable	-	(14)	-	(54)
	(1,060)	(2,821)	1,210	(1,939)
Attributable to investing activities	729	(2,943)	2,301	(6,069)
Attributable to operating activities	(1,789)	122	(1,091)	4,130

### 12. RELATED-PARTY TRANSACTIONS

- (a) In the three and nine months ended September 30, 2009, the Company was charged \$160,000 and \$244,000 (three and nine months ended September 30, 2008 - \$218,000 and \$794,000) by a law firm of which a director of the Company is a partner.
- (b) In the three and nine months ended September 30, 2009, the Company was charged and recorded \$35,000 and \$81,000 (three and nine months ended September 30, 2008 - \$25,000) by a director for consulting services of which \$25,000 is included in accrued liabilities.

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.

# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

September 30, 2009

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

(unaudited)

### 13. RECLASSIFICATION

In 2008, the Company changed its presentation of petroleum and natural gas sales, transportation costs, realized gain or loss on commodity contracts, and general and administrative expenses. The Company previously reported petroleum and natural gas sales net of transportation costs and before realized gain or loss on commodity contracts. The Company also changed its presentation of general and administrative expenses to provide separate disclosure of professional fees and bad debts. At September 30, 2008 bad debts expense was recorded as part of interest expense. There is no impact on the reported net loss for the three and nine months ended September 30, 2008.

The effect of these changes for the three and nine months ended September 30, 2008 is as follows:

	Three months ended September 30, 2008 As Previously Classified	Adjustments	Three months ended September 30, 2008 Reclassified
	\$	\$	\$
Petroleum and natural gas sales	6,591	(789)	5,802
Realized loss on commodity contracts	(1,047)	1,047	-
Transportation expense	-	258	258
General and administrative expenses	693	(41)	652
Professional fees	-	122	122
Bad debts	-	(28)	(28)
Interest	361	(53)	308

	Nine months ended September 30, 2008 As Previously Classified	Adjustments	Nine months ended September 30, 2008 Reclassified
	\$	\$	\$
Petroleum and natural gas sales	20,195	(1,525)	18,670
Realized loss on commodity contracts	(2,232)	2,232	-
Transportation expense	-	707	707
General and administrative expenses	2,084	(378)	1,706
Professional fees	-	459	459
Bad debts	-	(81)	(81)
Interest	1,049	-	1,049

### 14. SUBSEQUENT EVENT

On October 23, 2009, the Company closed the previously announced acquisition of its partner's 50 percent working interest in the Square Creek area of Alberta for cash consideration of \$7,350,000, subject to final adjustments.