

# Q1 QUARTERLY REPORT



**FORTRESS  
ENERGY INC.**

FOR THE THREE MONTHS ENDED MARCH 31, 2010

## FINANCIAL AND OPERATING SUMMARY

	Three months ended March 31,			
	2010		2009	
	(\$000s)	\$/Mcf	(\$000s)	\$/Mcf
Petroleum and natural gas sales	6,148	6.58	5,206	7.47
Royalties	(585)	(0.63)	(478)	(0.69)
Operating expenses	(2,225)	(2.38)	(1,815)	(2.60)
Transportation expenses	(348)	(0.37)	(246)	(0.35)
Operating netback <sup>(1)</sup>	2,990	3.20	2,667	3.83
General and administrative expenses	(723)	(0.77)	(722)	(1.04)
Professional fees	(98)	(0.11)	(151)	(0.22)
Bad debts	(3)	-	(142)	(0.20)
Interest expense	(454)	(0.49)	(241)	(0.35)
Current income tax expense	(13)	(0.01)	(18)	(0.03)
Funds from operations before transaction costs	1,699	1.82	1,393	1.99
Transaction costs	(494)	(0.52)	-	-
Funds from operations <sup>(1)</sup>	1,205	1.30	1,393	1.99
Unrealized gain on commodity contracts	2,261	2.42	2,418	3.47
Depletion, depreciation and accretion expense	(3,419)	(3.67)	(3,813)	(5.47)
Ceiling test impairment	(10,715)	(11.47)	-	-
Stock-based compensation	(94)	(0.10)	(79)	(0.11)
Loss before future income taxes	(10,762)	(11.52)	(81)	(0.12)
Future income tax reduction	750	0.80	88	0.13
Net (loss) income	(10,012)	(10.72)	7	0.01
Sales volume (Mcf/d)	10,374		7,752	

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

## MANAGEMENT'S DISCUSSION AND ANALYSIS

May 13, 2010

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

### Non-GAAP Measurements

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

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

(\$000s)	Three months ended March 31, 2010	Three months ended March 31, 2009
Cash provided by operating activities	1,690	597
Change in non-cash operating working capital	(485)	626
Abandonment expenditures	-	170
Funds from operations	1,205	1,393

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

	Three months ended March 31, 2010		Three months ended March 31, 2009	
	(\$000s)	(\$/Mcfe)	(\$000s)	(\$/Mcfe)
Petroleum and natural gas sales	6,148	6.58	5,206	7.47
Royalties	(585)	(0.63)	(478)	(0.69)
Operating expenses	(2,225)	(2.38)	(1,815)	(2.60)
Transportation expenses	(348)	(0.37)	(246)	(0.35)
Operating netback	2,990	3.20	2,667	3.83

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

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

## Forward-Looking Statements

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

- (i) Under “Operating Expenses ” regarding the expected reduction in operating costs;
- (ii) Under “Liquidity and Capital Resources” regarding working capital requirements, repayment of the non-revolving loan facility, continued support of the Company’s bank, options to deal with borrowing base and ability to continue as a going concern;
- (iii) Under “Liquidity and Capital Resources and Subsequent Events” regarding a revised offer for the Boyer assets;
- (iv) Under “Income Tax Refund” regarding potential refunds;
- (v) Under “Income Tax Audit” regarding expected resolution of the matter; and
- (vi) Under “Outstanding Securities” regarding plans to incur flow-through expenditures.

The forward-looking statements are based on certain assumptions including acceptance of a revised offer for the Boyer property, obtaining a new credit facility, continued operating efficiencies and the continued performance of the Corporation’s properties. 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: risks associated with the Boyer acquisition or not realizing the benefits of the acquisition (applicable to the forward-looking statements (i), (ii) and (iv) above) the risks associated with the oil and natural 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), (ii) and (iv) above), and delays or changes in plans (applicable to the forward-looking statements identified in (i) through (iv) 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 and include industry conditions and changes in laws and regulations, changes in income tax regulations, increased competition, fluctuations in commodity prices, interest rates, and variations in the Canadian/United States dollar exchange rate. The reader is cautioned not to place undue reliance on this forward-looking information.

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

- (i) Risks associated with the oil and natural gas industry and regulatory bodies (e.g. operational risks in exploration, development and production, or changes in royalty rates);
- (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").

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 126,000 net acres of undeveloped land in the Ladyfern, Velma and Buick Creek areas in northeast British Columbia and the Chigwell, Bashaw, Square Creek, Halverson, Mearon and Dahl 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 enabling it to have control over cost management of its operating and capital programs.

## CORPORATE HIGHLIGHTS

During the three months ended March 31, 2010, Fortress accomplished the following considered important by management:

- AECO natural gas prices averaged \$4.94/Mcf, and Fortress was able to enjoy the benefits of its forward sale to receive an average price of \$6.49/Mcf for the three months ended March 31, 2010.
- Increased average production by 34 percent to 10,374 Mcfe for the three months ended March 31, 2010 from 7,752 Mcfe for the three months ended March 31, 2009 (an increase of 23 percent from the three months ended December 31, 2009).
- Increased funds from operations for the three months ended March 31, 2010 to \$1,205,000 from \$1,172,000 for the three months ended December 31, 2009.

## DETAILED FINANCIAL ANALYSIS

### Production

	Three months ended March 31,	
	2010	2009
Sales volume:		
Natural gas (Mcf/d)	10,212	7,665
Oil and NGL (bbl/d)	27	14
Total (Mcf/d)	10,374	7,752

Sales volumes for the three months ended March 31, 2010 were 10,374 Mcfe/d compared to 7,752 Mcfe/d for the three months ended March 31, 2009. The Company's share of sales volumes from Square Creek increased to 6,569 Mcfe/d for the three months ended March 31, 2010 from 3,363 Mcfe/d for the three months ended March 31, 2009, reflecting the Company's acquisition of its partner's 50 percent working interest on October 23, 2009. In addition, in the three months ended March 31, 2010, sales volumes at Velma increased by 325 Mcfe/d due to better well performance and improved run times as a result of re-routing of this gas to another third party gas processing plant. The increase in sales volumes was reduced by several wells that were shut-in and other operational issues during the three months ended March 31, 2010 resulting in lost production of approximately 1,800 Mcfe/d.

## Revenue

	Three months ended March 31,	
	2010	2009
Petroleum and natural gas sales (\$000s)	6,148	5,206
Average realized prices:		
Natural gas (\$/Mcf)	5.25	5.36
Realized gain on commodity contracts (\$/Mcf)	1.24	2.11
Realized natural gas price (\$/Mcf)	6.49	7.47
Oil and NGL (\$/bbl)	63.54	37.72
Total (\$/Mcf)	6.58	7.47
Benchmark prices:		
AECO average natural gas price (\$/Mcf)	4.94	4.92
Edmonton Par crude oil (\$/bbl)	80.92	51.13

For the three months ended March 31, 2010, petroleum and natural gas sales were \$6,148,000 (including realized gains on commodity contracts of \$1,162,000) compared to \$5,206,000 (including realized gains on commodity contracts of \$1,459,000) for the three months ended March 31, 2009 - an increase of 18 percent. This is attributable to a 34 percent increase in sales volumes in the three months ended March 31, 2010 reduced by a 20 percent decrease in realized gains on commodity contracts.

The average realized natural gas price for the three months ended March 31, 2010 was \$5.25/Mcf compared to the average AECO natural gas price of \$4.94/Mcf. The average realized natural gas price in the three months ended March 31, 2009 was \$5.36/Mcf and the average AECO natural gas price was \$4.92/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 March 31, 2010, the Company realized a gain on commodity contracts of \$1,162,000, or \$1.24/Mcf, compared to \$1,459,000, or \$2.11/Mcf for the three months ended March 31, 2009. Realized gains and losses on commodity contracts are included in petroleum and natural gas sales. The Company also recorded an unrealized gain on commodity contracts in the three months ended March 31, 2010 of \$2,261,000 compared to \$2,418,000 for the three months ended March 31, 2009.

The Company has sold forward approximately 63 percent of its natural gas production through to end 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 March 31, 2010 was \$3,582,000. A \$1.00/GJ change in the AECO price would increase or decrease the mark-to-market value of commodity contracts at March 31, 2010 by \$2,105,000. Contracts in place as of March 31, 2010 are as follows:

Type	Period	Volume (GJ/d)	Fixed Price (\$/GJ)
Swap	April 1, 2010 to December 31, 2010	5,000	5.69
Swap	April 1, 2010 to March 31, 2011	2,000	5.50

Subsequent to March 31, 2010, the Company entered into a commodity price contract to sell 5,000 GJ/d of natural gas at \$4.92/GJ for the period of January 1, 2011 to December 31, 2011. The Company has currently sold forward the maximum volume of natural gas permitted under the terms of its credit facilities.

## Royalties

	Three months ended March 31,	
	2010	2009
Royalties (\$000s)	585	478
\$/Mcf	0.63	0.69
Percentage of petroleum and natural gas sales <sup>(1)</sup>	11.7%	12.8%

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

For the three months ended March 31, 2010, the Company recorded royalties of \$585,000 compared to \$478,000 for the three months ended March 31, 2009. This increase is due to additional sales volumes from the Square Creek property which attracts the highest Alberta crown royalty rates due to the high productivity of these wells. The Company recognized Gas Cost Allowance and Custom Processing credits of approximately \$480,000 in the three months ended March 31, 2010 reducing its overall royalty expense (three months ended March 31, 2009 - \$nil). These credits are mainly attributable to the Company's Square Creek property which commenced production in March 2008. The effective royalty rate for the three months ended March 31, 2010 was 11.7 percent (as a percentage of petroleum and natural gas sales) compared to 12.8 percent for the three months ended March 31, 2009. Royalties are not calculated or payable on realized gains and losses on commodity contracts.

On March 11, 2010, the Government of Alberta announced the results of its natural gas and conventional oil competitiveness review and published its policy response to the review, *Energizing Investment, a Framework to Improve Alberta's Natural Gas and Conventional Oil Competitiveness*, which will modify Alberta's royalty framework effective January 1, 2011. The intent of the modified royalty framework is to advance Alberta's competitiveness in the upstream oil and gas sector and promote investment in the province. The Alberta government has indicated it plans to announce the royalty percentages at various commodity prices by May 31, 2010. Fortress continues to monitor these proposed amendments to the Alberta royalty framework and the possible impacts on the Company's business.

### Operating Expenses

	Three months ended	
	March 31,	
	2010	2009
Operating costs (\$000s)	2,225	1,815
\$/Mcf	2.38	2.60

For the three months ended March 31, 2010, operating expenses were \$2,225,000, or \$2.38/Mcfe, compared to \$1,815,000, or \$2.60/Mcfe, for the three months ended March 31, 2009. Operating expenses increased in the three months ended March 31, 2010 due to the Square Creek acquisition on October 2009. The Company also incurred approximately \$162,000 (\$0.17/Mcfe) of additional operating expenses related to previously disputed charges for prior production periods that were settled in the three months ended March 31, 2010. On a per Mcfe basis, operating expenses decreased in the three months ended March 31, 2010 to \$2.38/Mcfe from \$2.60/Mcfe for the three months ended March 31, 2009 due to higher production levels as a significant component of operating expenses are fixed as opposed to varying with production.

The Company took several key steps in 2009 to materially reduce operating costs going forward in its main areas of operation. At Square Creek the Company purchased the rental compressor, camp, rig mats and other rented equipment. The Company also replaced the field operations contractor at Square Creek, effective August 1, and replaced the field operations contractor at the third party facility at Clear Prairie through which the Company's Square Creek production is produced effective November 15. At Ladyfern North, Ladyfern South and Mearon North the Company negotiated a significant reduction in contract operating fees for its field operations. At Velma the Company replaced the contract operator and re-routed its production to another third party processing plant thereby reducing contract operating, gathering and processing fees. These changes are expected to save the Company approximately \$1,700,000 annually.

### Transportation Expenses

	Three months ended	
	March 31,	
	2010	2009
Transportation expenses (\$000s)	348	246
\$/Mcf	0.37	0.35

Transportation expenses include transportation and fuel costs associated with the usage of natural gas pipelines. For the three months ended March 31, 2010, transportation expenses were \$348,000 compared to \$246,000 for the three months ended March 31, 2009. This increase is due to the additional Square Creek volumes. In addition, the rate that the Company was charged for interruptible transportation services increased in the fourth quarter of 2009.

## General and Administrative Expenses

	Three months ended March 31,		Three months ended March 31,	
	2010 (\$000s)	2010 (\$/Mcf)	2009 (\$000s)	2009 (\$/Mcf)
General and administrative expenses, net of recoveries	723	0.77	722	1.04
Professional fees	98	0.11	151	0.22
Bad debts	3	-	142	0.20
Transaction costs	494	0.52	-	-
<b>Total</b>	<b>1,318</b>	<b>1.40</b>	<b>1,015</b>	<b>1.46</b>

General and administrative expenses, net of recoveries, for the three months ended March 31, 2010 was \$723,000 compared to \$722,000 for the three months ended March 31, 2009. There have been no significant changes to the Company's administration over this period.

Professional fees include fees for lawyers, auditors, income tax professionals, and independent reserves evaluators. Professional fees decreased in the three months ended March 31, 2010 to \$98,000 from \$151,000 for the three months ended March 31, 2009. This decrease is due to a reduction in the Company's audit, accounting and tax compliance fees.

Bad debts for the three months ended March 31, 2010 were \$3,000 compared to \$142,000 for the three months ended March 31, 2009. 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.

The Company incurred transaction costs of \$494,000 related to the Boyer assets that were expensed in the three months ended March 31, 2010.

## Stock-based Compensation Expense

(\$000s except \$/Mcf)	Three months ended March 31,	
	2010	2009
Stock-based compensation expense:		
Stock options	81	61
Restricted stock units	13	18
<b>Total</b>	<b>94</b>	<b>79</b>
<b>\$/Mcf</b>	<b>0.10</b>	<b>0.11</b>

Stock-based compensation expense for the three months ended March 31, 2010 was \$94,000 compared to \$79,000 for the three months ended March 31, 2009. In November 2009, the Company granted 3,680,000 stock options and issued 400,000 restricted stock units resulting in an increase in stock-based compensation expense for the period.

## Interest Expense

	Three months ended March 31,	
	2010	2009
Interest expense (\$000s)	454	241
<b>\$/Mcf</b>	<b>0.49</b>	<b>0.35</b>

The Company recorded interest expense of \$454,000 for the three months ended March 31, 2010 compared to \$241,000 for the three months ended March 31, 2009. Interest expense for the three months ended March 31, 2010 reflects interest and facility renewal fees on the Company's bank indebtedness and accrued interest on flow-through commitments. Interest expense for the three months ended March 31, 2009 reflects interest on bank indebtedness and accrued interest on flow-through commitments.

## Depletion, Depreciation and Accretion Expense

	Three months ended March 31,	
	2010	2009
Depletion and depreciation expense (\$000s)	3,343	3,756
Accretion of asset retirement obligations (\$000s)	76	57
Depletion, depreciation and accretion expense (\$000s)	3,419	3,813
Ceiling test impairment (\$000s)	10,715	-
Depletion and depreciation expense (\$/Mcf)	3.59	5.39
Accretion of asset retirement obligations (\$/Mcf)	0.08	0.08
Depletion, depreciation and accretion expense (\$/Mcf)	3.67	5.47
Ceiling test impairment (\$/Mcf)	11.47	-

Depletion and depreciation expense is calculated based on capital expenditures, production rates, and proved reserves. Depletion and depreciation expense was \$3,343,000 for the three months ended March 31, 2010 compared to \$3,756,000 for the three months ended March 31, 2009. This decrease is due to the ceiling test impairment charge of \$10,715,000 recorded in three months ended March 31, 2010, decreasing the asset base that is subject to depletion. Depletion and depreciation expense for the three months ended March 31, 2010 amounted to \$3.59/Mcfe compared to \$5.39/Mcfe for the three months ended March 31, 2009.

Estimated future development costs for proved undeveloped properties included in the calculation of depletion expense at March 31, 2010 decreased to \$7,456,000 from \$11,235,000 at March 31, 2009. Pressure testing conducted in January 2010 on wells at Square Creek indicated that the Company does not need to drill any additional wells to drain the Bluesky pool, resulting in a reduction of future development costs and an increase in recoverable reserves. Undeveloped land costs at March 31, 2010 decreased to \$7,565,000 from \$8,630,000 at March 31, 2009 and were excluded from assets subject to depletion. Undeveloped land costs decreased in the three months ended March 31, 2010 due to expiries in the Halverson area in the second quarter of 2009.

Accretion expense for the three months ended March 31, 2010 was \$76,000 compared to \$57,000 for the three months ended March 31, 2009. Accretion expense for the three months ended March 31, 2010 reflects changes to the assumptions used to calculate the Company's asset retirement obligations.

The Company recorded a ceiling test impairment in the three months ended March 31, 2010 of \$10,715,000 due to a significant decrease in natural gas prices from December 31, 2009 levels. The impact of the ceiling test impairment charge was \$11.47/Mcfe.

## Income Tax

	Three months ended March 31,	
	2010	2009
(\$000s except \$/Mcf)		
Current income tax expense	13	18
Future income tax reduction	(750)	(88)
Total	(737)	(70)
\$/Mcf	(0.79)	(0.60)

The Company recorded an income tax reduction for the three months ended March 31, 2010 of \$737,000 compared to \$70,000 for the three months ended March 31, 2009. The future income tax reduction of \$750,000 reflects the tax effect of the renunciation of flow-through expenditures in the three months ended March 31, 2010.

For the three months ended March 31, 2010, the Company recorded current income tax expense of \$13,000 compared to \$18,000 for the three months March 31, 2009, consisting of arrears interest and penalties. All of the Company's income tax returns have been filed but not all have yet been assessed by CRA.

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

	(\$000s)
Canadian Oil and Gas Property Expenses	20,604
Canadian Development Expenses	28,505
Canadian Exploration Expenses	10,114
Undepreciated Capital Cost	28,612
	<u>87,835</u>

#### Net (Loss) Income

	Three months ended March 31,	
	2010	2009
Net (loss) income (\$000s)	(10,012)	7
Net (loss) income per share - basic and diluted (\$)	(0.18)	0.00
Net (loss) income (\$/Mcf)	(10.72)	0.01

The Company recorded a net loss of \$10,012,000 for the three months ended March 31, 2010 compared to net income of \$7,000 for the three months ended March 31, 2009. This translates into a net loss per basic and diluted share of \$0.18 for the three months ended March 31, 2010 and net income per basic and diluted share of \$0.00 for the three months ended March 31, 2009. The net loss for the three months ended March 31, 2010 is due to the ceiling test impairment charge that was recorded in the period.

#### Funds from Operations

	Three months ended March 31,	
	2010	2009
Funds from operations (\$000s)	1,205	1,393
Funds from operations (\$/Mcf)	1.30	1.99
Funds from operations per share – basic and diluted (\$)	0.02	0.05

Funds from operations for the three months ended March 31, 2010 were \$1,205,000 compared to \$1,393,000 for the three months March 31, 2009. This decrease is attributable to transaction costs that were expensed in the period of \$494,000 offset by a higher operating netback due to increased sales volumes in the three months ended March 31, 2010.

#### Capital Expenditures

(\$000s)	Three months ended March 31,	
	2010	2009
Land and seismic	370	119
Drilling and completions	386	4,043
Equipment and facilities	422	1,385
Capitalized overhead costs	118	216
Abandonments	-	170
Other	-	2
	<u>1,296</u>	<u>5,935</u>

In the three months ended March 31, 2010, the Company completed a fuel gas conversion at its Square Creek camp to reduce its operating costs, completed workover operations on two wells at Buick Creek and completed pipeline header repairs at Mearon North to restore lost production. In the three months ended March 31, 2009, the Company completed the drilling of an exploratory well in the Pine Creek area and the drilling of two development wells and one exploratory well in the Square Creek area.

At the Clear Prairie facility, Fortress has arrangements for 5.0 MMcf/d (2.5 MMcf/d net) of firm processing capacity and has processing service available on a best efforts basis for larger volumes. Fortress' ability to produce natural gas at an optimum rate from the Square Creek area is restricted by processing capacity at the Clear Prairie facility, which is owned by a third party. Due to low natural gas prices the Company has not pursued the plant expansion at the Clear Prairie Facility.

### Outstanding Securities

Outstanding securities	
Common shares	55,294,788
Warrants (exercise price \$2.00)	5,516,700
Warrants – A (exercise price \$0.55)	21,779,000
Stock options	4,774,579
Total outstanding securities at March 31, 2010 and May 13, 2010	
	87,365,067

On September 30, 2009, the Company closed a public offering of 21,779,000 units and 6,594,000 flow-through common shares for gross proceeds of \$11,385,185 (\$10,320,000 net of issuance costs). Each unit consists of one common share of the Company and one common share purchase warrant. The warrants are exercisable on or before December 31, 2011. Each warrant entitles the holder thereof to purchase one common share at an exercise price of \$0.55. The expenditure commitment resulting from the issuance of 6,594,000 flow-through common shares is \$3,000,270 and was renounced to subscribers effective December 31, 2009 with all expenditures to be incurred by December 31, 2010. The Company is currently planning to incur these expenditures in the fourth quarter of 2010.

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

### 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 \$108,751,000 and a working capital deficiency of \$21,340,000 as at March 31, 2010.

The Company has a \$17,000,000 demand operating loan facility with its bank bearing interest at the bank's prime lending rate plus 2.0 percent. The effective interest rate for the three months ended March 31, 2010 on the operating loan was 4.0 percent (March 31, 2009 – 4.0 percent). In addition, the Company has a \$7,000,000 demand non-revolving loan facility bearing interest at the bank's prime lending rate plus 5.0 percent. The effective interest rate for the three months ending March 31, 2010 on the non-revolving loan was 7.25 percent. At March 31, 2010, a total of \$23,355,000 was drawn on these facilities. The Company also has a \$810,000 letter of guarantee facility of which \$810,000 was drawn at March 31, 2010 (December 31, 2009 - \$900,000). These facilities are collateralized by an interest over all present and after acquired property of the Company.

The demand non-revolving loan was due to be repaid on March 31, 2010. The repayment date was subsequently extended to May 31, 2010. On March 4, 2010, the Company announced that it had entered into a Letter of Intent to acquire a significant natural gas property located in the Boyer area of Alberta. It was a condition under the Letter of Intent that the Company file a final prospectus in relation to financing a portion of the purchase price for the Boyer Assets on or before April 26, 2010. Due to current market conditions and the resulting delays in financing Fortress was unable to satisfy this condition. As a result, Fortress was informed on April 27, 2010 that the Letter of Intent had been terminated. Fortress intends to resubmit an offer to the vendor for the Boyer Assets and has elected not to withdraw its preliminary prospectus filed on April 1, 2010. The vendor has no obligation to consider any revised offer and there is no certainty that they will do so. If the Company is unable to close the acquisition of the Boyer assets or a similar transaction, the Company anticipates that its bank will continue to work with the Company to establish a repayment schedule.

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, the lender's interest in particular business sectors, such as energy and the relative strength of the borrower. The next review is May 31, 2010.

There is substantial doubt 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. The future operations of the Company are 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.

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 March 31, 2010. 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 March 31, 2010 are as follows:

(\$000s)	As at March 31, 2010
Loan facilities available (including \$7,000 due May 31, 2010)	24,000
Working capital deficiency	(21,340)
Capital resources available	2,660

As at March 31, 2010, the Company had a working capital deficiency of \$21,340,000. Available capital resources as at March 31, 2010 were \$2,660,000. 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 it 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 provided by operating activities for the three months ended March 31, 2010 was \$1,690,000 compared to \$597,000 for the three months ended March 31, 2009. This increase is due to an increase in non-cash working capital balances and improved operating netbacks for the three months ended March 31, 2010.

Cash provided by financing activities for the three months ended March 31, 2010 was \$311,000 compared to \$2,362,000 for the three months ended March 31, 2009. Cash provided by financing activities for the three months ended March 31, 2010 and 2009 represents an increase in the amounts drawn on loan facilities from the prior quarter.

Cash used in investing activities for the three months ended March 31, 2010 was \$2,065,000 compared to \$3,069,000 for the three months ended March 31, 2009. The Company's capital expenditures in the three months ended March 31, 2010 were \$1,296,000 compared to \$5,765,000 in the three months ended March 31, 2009.

### Related-Party Transactions

In the three months ended March 31, 2010, the Company was charged \$190,000 (the months ended March 31, 2009 - \$68,000) by a law firm of which a director of the Company is a partner.

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

## Commitments and Contingencies

### Office 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
2010	9	355	364
2011	9	475	484
2012	-	475	475
2013	-	119	119
	18	1,424	1,442

### 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 per day until the earlier of April 1, 2015 or the delivery of a total of 15 Bcf.

Committed payments are as follows:

	\$000s
2010	1,255
2011	1,533
2012	1,533
2013	1,533
2014	1,533
2015	545
	7,932

### Letter of Credit

On February 1, 2010, the Company issued a letter of credit of \$810,000 with an expiry of February 1, 2011, related to a gas transportation and processing agreement.

### Flow-Through Share Expenditures

In September 2009, the Company issued 6,594,000 flow-through common shares at \$0.455 per share for gross proceeds of \$3,000,270 and renounced the related resource expenditures to the subscribers effective December 31, 2009 with all expenditures to be incurred by December 31, 2010. As of March 31, 2010, the Company had not incurred any eligible expenditures.

### Income Tax Refund

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

## Income Tax Reassessment

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

## Income Tax Audit

In January 2010, the Company received an audit letter from the CRA pertaining to the conversion of SignalEnergy Inc., predecessor to the Company and formerly known as SignalGene Inc., into an oil and natural gas enterprise. The CRA proposes to deny the use of tax pools existing at the time of the conversion. The Company responded to the CRA audit letter on March 26, 2010 and believes that this matter will be resolved in the Company's favour. If the CRA are successful in their challenge to the Company's interpretation of the tax legislation, it will result in additional taxes, interest and penalties of a material amount.

## Subsequent Events

- (a) Subsequent to March 31, 2010, the Company's bank extended the repayment requirement for the \$7,000,000 non-revolving loan facility to May 31, 2010.
- (b) Subsequent to March 31, 2010, the Company entered into a commodity price contract to sell 5,000 GJ/d of natural gas at \$4.92/GJ for the period of January 1, 2011 to December 31, 2011.
- (c) On March 4, 2010, the Company announced that it had entered into a Letter of Intent to acquire a significant natural gas property located in the Boyer area of Alberta. It was a condition under the Letter of Intent that the Company file a final prospectus in relation to financing a portion of the purchase price for the Boyer assets on or before April 26, 2010. Due to current market conditions and the resulting delays in financing Fortress was unable to satisfy this condition. As a result, Fortress was informed on April 27, 2010 that the Letter of Intent had been terminated.

Fortress intends to resubmit an offer to the vendor for the Boyer assets and has elected not to withdraw its preliminary prospectus filed on April 1, 2010. The vendor has no obligation to consider any revised offer and there is no certainty that they will do so.

## SELECTED QUARTERLY INFORMATION

	2010			2009		2008		
	Q1	Q4	Q3	Q2	Q1	Q4	Q3	Q2
Production:								
Natural gas (Mcf/d)	10,212	8,288	6,741	7,603	7,665	8,118	8,733	8,690
Oil and NGL (bbl/d)	27	19	13	12	14	14	23	15
Total (Mcf/d)	10,374	8,418	6,822	7,674	7,752	8,202	8,868	8,778
Average realized price:								
Natural gas (\$/Mcf)	6.49	6.15	6.65	6.22	7.47	6.69	7.99	10.02
Oil and NGL (\$/bbl)	63.54	51.10	82.45	45.11	37.72	60.42	82.29	108.04
Combined average (\$/Mcf)	6.58	37.17	40.53	37.35	44.79	47.50	48.44	60.58
Benchmark prices:								
AECO average natural gas price (\$/Mcf)	4.94	4.55	3.00	3.45	4.92	6.69	7.76	9.82
Edmonton Par crude oil price (\$/bbl)	80.92	76.99	71.65	66.70	51.13	64.18	123.08	126.37
Financial (\$000s unless otherwise noted):								
Petroleum and natural gas sales	6,148	4,798	4,240	4,346	5,206	5,962	5,811	7,232
Net income (loss)	(10,012)	(7,357)	(3,787)	(14,605)	7	(624)	1,070	(744)
Net income (loss) per share – basic (\$)	(0.18)	(0.13)	(0.14)	(0.54)	0.00	(0.02)	0.04	(0.04)
Net income (loss) per share – diluted (\$)	(0.18)	(0.13)	(0.14)	(0.54)	0.00	(0.02)	0.04	(0.04)
Funds from operations	1,205	1,172	1,393	557	1,393	1,113	1,193	2,627
Operating expenses (\$/Mcf)	2.38	15.45	16.81	15.95	15.62	14.50	15.72	15.40
Weighted average shares outstanding – basic (000)	55,295	55,295	27,230	26,922	26,922	26,965	26,965	16,809
Weighted average shares outstanding – diluted (000)	55,295	55,295	27,230	26,922	26,922	26,965	27,004	16,809

### Disclosure Controls and Procedures

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

### Internal Controls over Financial Reporting

The Company's Chief Executive Officer and Chief Financial Officer have designed or caused to be designed under their supervision, internal controls over financial reporting to provide reasonable assurance regarding the reliability of the Company's financial reporting and the preparation of financial statements for external purposes in accordance with Canadian GAAP.

No material changes in the Company's internal controls over financial reporting were identified during the three months ended March 31, 2010, that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

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

### New Canadian Accounting Pronouncements

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

## International Financial Reporting Standards

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

The Company has started the process to transition from current Canadian GAAP to IFRS. The Company's Chief Financial Officer has been appointed to lead the conversion project. Resource requirements have been identified and all IFRS requirements will be met with internal employees supplemented with consultants as needed. Regular progress reporting to the Board of Directors on the status of the IFRS conversion has been implemented. The Company has begun the process of training key personnel within the accounting function. Training occurred through external IFRS oil and gas workshops that were attended by key members of the accounting team in 2008 through to the first quarter of 2010. A training session will be scheduled for the Board of Directors in the third quarter of 2010.

The Company's IFRS conversion project is made up of three phases:

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

The Company has completed the scoping and diagnostic phase of the project and has commenced the analysis of various accounting policy choices available under IFRS. The Company has not yet completed its accounting policies and is unable to quantify the impact of adopting IFRS on the financial statements. Due to the impact of low natural gas prices experienced in 2009 and the resulting reallocation of staff resources, the Company is behind on its schedule. As a result of the 2009 reporting requirements and the proposed acquisition of the Boyer assets, no further progress was made on the Company's IFRS project in the three months ended March 31, 2010. The Company is in discussions with consultants and other external resources to assist with the project.

### First-Time Adoption of IFRS

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

- Business Combinations – IFRS 1 would allow the Company to use the IFRS rules for business combinations on a prospective basis rather than re-stating all business combinations. The IFRS business combination rules converge with the new CICA Handbook Section 1582 that is also effective for the Company on January 1, 2011; however, early adoption is permitted.

- Property, Plant and Equipment (“PP&E”) – IFRS 1 provides the option to value the PP&E assets at their deemed cost being the Canadian GAAP net book value assigned to these assets as at the date of transition, January 1, 2010. This amendment is permissible for entities, such as Fortress, that currently follow the full cost accounting guideline under Canadian GAAP that accumulates all oil and gas assets into one cost centre. Under IFRS, the Company’s PP&E assets must be divided into smaller cost centres. The net book value of the assets on the date of transition will be allocated to the new cost centres on the basis of reserve volumes or values at January 1, 2010.
- Share-Based Payments – IFRS 1 allows Fortress an exemption on IFRS 2, “*Share-Based Payments*” to equity instruments granted on or before November 2, 2002 or which are vested before the Company’s transition date to IFRS.

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

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

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

- Internal controls over financial reporting – As the review of the Company's accounting policies is completed, an assessment will be made to determine changes required for internal controls over financial reporting. As an example, additional controls will be implemented for the IFRS 1 changes such as the allocation of PP&E as well as the process for re-classifying E&E expenditures from PP&E. This will be an ongoing process through 2010 to ensure that all changes in accounting policies include the appropriate additional controls and procedures for future IFRS reporting requirements.
- Disclosure controls and procedures – Throughout the transition process, the Company will be assessing stakeholders' information requirements and will ensure that adequate and timely information is provided so that all stakeholders are kept apprised. The Company anticipates delivering investor presentations during the fourth quarter of 2010 to explain the differences between the historical Canadian GAAP statements and the IFRS statements.
- Business activities – The Company has been cognizant of the upcoming transition to IFRS and as such will work with counterparties and lenders to ensure that agreement references to Canadian GAAP statements are modified to allow for IFRS statements. Based on the expected changes to the Company's accounting policies, there are no foreseen issues with the existing wording of debt covenants and related agreements as a result of the conversion to IFRS.
- Information technology systems – The Company has identified several accounting system upgrades required for IFRS reporting and is working with its software provider to make the necessary changes. The modifications are not significant; however, they are critical in order to allow for reporting of both Canadian GAAP and IFRS statements in 2010 as well as the modifications required to track PP&E costs and E&E costs to a more granular level of detail for IFRS reporting. Additional system modifications may be required based on final policy choices.

## **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 natural gas exploration and production can involve environmental risks such as pollution of the environment and destruction of natural habitat, as well as safety risks such as personal injury. In order to mitigate such risks, Fortress conducts its operations at high standards and follows safety procedures intended to reduce the potential for personal injury to employees, contractors and the public at large. The Company maintains current insurance coverage for general and comprehensive liability as well as limited

pollution liability. The amount and terms of this insurance are reviewed on an ongoing basis and adjusted as necessary to reflect changing corporate requirements, as well as industry standards and government regulations. Fortress may periodically use financial or physical delivery hedges to reduce its exposure against the potential adverse impact of commodity price volatility, as governed by formal policies approved by senior management subject to controls established by the Board of Directors.

### **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.

### **Going Concern Uncertainty**

The Company's consolidated financial statements have been prepared on a going concern basis, which assumes the realization of assets and discharge of liabilities in the normal course of business for the foreseeable future. The Company has experienced consecutive losses, has an accumulated deficit of \$108,751,000 and has a working capital deficiency of \$21,340,000 as at March 31, 2010. Included in this deficiency are short-term borrowings of \$23,355,000 which consists of a \$17,000,000 demand operating facility and a \$7,000,000 demand non-revolving loan facility that is due to be repaid on May 31, 2010.

There is substantial doubt 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. The future operations of the Company are 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.

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

### **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 2009 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.

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**FORTRESS ENERGY INC.**

## CONSOLIDATED BALANCE SHEETS

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

As at

(in thousands)

(unaudited)

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	March 31, 2010	December 31, 2009
<b>ASSETS</b>		
Current Assets		
Cash and cash equivalents	\$ -	\$ 64
Accounts receivable	4,951	5,576
Prepaid expenses and deposits	586	470
Commodity contracts (note 8)	3,582	1,321
	9,119	7,431
Property, plant and equipment (notes 3 and 4)	77,375	90,017
	\$ 86,494	\$ 97,448
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current Liabilities		
Bank indebtedness (note 4)	\$ 23,355	\$ 23,044
Accounts payable and accrued liabilities	6,919	7,712
Income taxes	185	172
	30,459	30,928
Asset retirement obligations (note 6)	4,487	4,324
	34,946	35,252
Shareholders' Equity		
Share capital (note 7)	139,344	140,094
Warrants (note 7)	5,406	5,406
Contributed surplus (note 7)	15,549	15,435
Deficit	(108,751)	(98,739)
	51,548	62,196
Commitments and contingencies (note 9)		
Subsequent events (note 12)		
	\$ 86,494	\$ 97,448

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See accompanying notes to consolidated financial statements.

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**FORTRESS ENERGY INC.**

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

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

For the three months ended March 31

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

(unaudited)

	2010	2009
<b>REVENUES</b>		
Petroleum and natural gas sales	\$ 6,148	\$ 5,206
Royalties	(585)	(478)
Unrealized gain on commodity contracts (note 8)	2,261	2,418
	7,824	7,146
<b>EXPENSES</b>		
Operating	2,225	1,815
Transportation	348	246
General and administrative	723	722
Professional fees (note 11)	98	151
Bad debts	3	142
Transaction costs	494	-
Stock-based compensation (note 7)	94	79
Interest	454	241
Depletion, depreciation and accretion	3,419	3,813
Ceiling test impairment (note 3)	10,715	-
	18,573	7,209
Loss before income taxes	(10,749)	(63)
Income tax expense (reduction) (note 5)		
Current	13	18
Future	(750)	(88)
	(737)	(70)
Net (loss) income and comprehensive (loss) income for the period	(10,012)	7
Deficit, beginning of period	(98,739)	(72,997)
Deficit, end of period	\$ (108,751)	\$ (72,990)
Weighted average shares outstanding (note 7)	55,294,788	26,921,788
Net (loss) income per share – basic and diluted	\$ (0.18)	\$ 0.00

See accompanying notes to consolidated financial statements.

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**FORTRESS ENERGY INC.**

## CONSOLIDATED STATEMENTS OF CASH FLOWS

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

For the three months ended March 31

(in thousands)

(unaudited)

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	2010	2009
<b>CASH PROVIDED BY (USED IN):</b>		
<b>OPERATING ACTIVITIES</b>		
Net (loss) income for the period	\$ (10,012)	\$ 7
Items not affecting cash flows:		
Unrealized gain on commodity contracts	(2,261)	(2,418)
Stock-based compensation	94	79
Depletion, depreciation and accretion	3,419	3,813
Ceiling test impairment	10,715	-
Future income tax reduction	(750)	(88)
Abandonment expenditures	-	(170)
	1,205	1,223
Change in non-cash operating working capital (note 10)	485	(626)
Cash provided by operating activities	1,690	597
<b>FINANCING ACTIVITIES</b>		
Change in bank indebtedness	311	2,362
Cash provided by financing activities	311	2,362
<b>INVESTING ACTIVITIES</b>		
Property, plant and equipment additions	(1,296)	(5,765)
Change in non-cash investing working capital (note 10)	(769)	2,696
Cash used in investing activities	(2,065)	(3,069)
Net change in cash	(64)	(110)
Cash and cash equivalents - beginning of year	64	180
Cash and cash equivalents - end of year	\$ -	\$ 70
Supplemental cash flow information:		
Interest paid	439	241

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See accompanying notes to consolidated financial statements.

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# **FORTRESS ENERGY INC.**

## **Notes to Consolidated Financial Statements**

March 31, 2010

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

(unaudited)

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### **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 natural 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 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 \$108,751,000 and has a working capital deficiency of \$21,340,000 as at March 31, 2010. Included in this deficiency are short-term borrowings of \$23,355,000 which consists of a \$17,000,000 demand operating facility and a \$7,000,000 demand non-revolving loan facility that is due to be repaid on May 31, 2010 (refer to note 4).

There is substantial doubt 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. The future operations of the Company are 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, 2009. 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, 2009.

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

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# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

March 31, 2010

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

(unaudited)

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b) Change in accounting policy

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

c) Future accounting changes

The Canadian Accounting Standards Board (AcSB) has confirmed that the use of IFRS will be required in 2011 for publicly accountable profit-oriented enterprises. IFRS will replace Canada's current GAAP for those enterprises. These include stock exchange-listed companies and other profit-oriented enterprises that are responsible to large or diverse groups of stakeholders. The official changeover date is for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. Companies will be required to provide comparative IFRS information for the previous fiscal year. The impact of IFRS on the consolidated financial statements is not reasonably determinable at this time.

### 3.

#### PROPERTY, PLANT AND EQUIPMENT

	Cost	Accumulated Depletion and Depreciation	Net Book Value
March 31, 2010	\$	\$	\$
Oil and natural gas properties	155,078	77,859	77,219
Other	420	264	156
	155,498	78,123	77,375

  

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

In the three months ended March 31, 2010, the Company capitalized general and administrative and stock-based compensation expenses of \$151,000 (three months ended March 31, 2009 - \$208,000) directly attributable to exploration and development activities.

Estimated future development costs of \$7,456,000 (December 31, 2009 - \$7,456,000) were included in the calculation of depletion expense for the three months ended March 31, 2010. As at March 31, 2010, undeveloped land costs of \$7,565,000 (December 31, 2009 - \$7,519,000) were excluded from assets subject to depletion.

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# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

March 31, 2010

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

(unaudited)

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The Company performed a ceiling test calculation at March 31, 2010 which resulted in the carrying amount of the Company's oil and gas properties exceeding the estimated undiscounted future cash flows associated with the Company's proved reserves. As a result, the Company performed the second step of the ceiling test by comparing the discounted cash flows from proven plus probable reserves to the carrying amount of oil and gas properties. As a result of performing this second step, a ceiling test impairment charge of \$10,715,000 has been recorded in the consolidated statements of operations. The natural gas prices used in the ceiling test calculation are based on the March 31, 2010 commodity price forecast of our independent reserve evaluators and are as follows:

Year	AECO Gas (Cdn\$/MMbtu)
Balance of 2010	4.30
2011	5.19
2012	5.59
2013	7.28
2014	7.77
2015	7.90
2016	8.03
2017	8.16
2018	8.29
2019	8.43
2020	8.57

Prices increase at a rate of 1.5% per year after 2020. The benchmark prices were adjusted for quality and transportation.

#### 4. CREDIT FACILITIES

The Company has a \$17,000,000 demand operating loan facility with its bank bearing interest at the bank's prime lending rate plus 2.0 percent. The effective interest rate for the three months ended March 31, 2010 on the operating loan was 4.0 percent (March 31, 2009 – 4.0 percent). In addition, the Company also has a \$7,000,000 demand non-revolving loan facility bearing interest at the bank's prime lending rate plus 5.0 percent. The effective interest rate for the three months ending March 31, 2010 on the non-revolving loan was 7.25 percent. At March 31, 2010, a total of \$23,355,000 was drawn on these facilities. The Company also has a \$810,000 letter of guarantee facility of which \$810,000 was drawn at March 31, 2010 (December 31, 2009 - \$900,000). These facilities are collateralized by an interest over all present and after acquired property of the Company.

The demand non-revolving loan was due to be repaid on March 31, 2010. The repayment date was subsequently extended to May 31, 2010. On March 4, 2010, the Company announced that it had entered into a Letter of Intent to acquire a significant natural gas property located in the Boyer area of Alberta (the "Boyer Assets"). It was a condition under the Letter of Intent that the Company file a final prospectus in relation to financing a portion of the purchase price for the Boyer Assets on or before April 26, 2010. Due to current market conditions and the resulting delays in financing Fortress was unable to satisfy this condition. As a result, Fortress was informed on April 27, 2010 that the Letter of Intent had been terminated. Fortress intends to resubmit an offer to the vendor for the Boyer Assets and has elected not to withdraw its preliminary prospectus filed on April 1, 2010. The vendor has no obligation to consider any revised offer and there is no certainty that they will do so. If the Company is unable to close the acquisition of the Boyer Assets or a similar transaction, the Company anticipates that its bank will continue to work with the Company to establish a repayment schedule.

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

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# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

March 31, 2010

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

(unaudited)

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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 it may be required to repay its outstanding loan. Should this occur, 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.

The next review is May 31, 2010.

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 March 31, 2010. 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 its bank can demand repayment of the operating loan facility.

### 5. INCOME TAXES

The provision for income tax reduction is summarized as follows:

	March 31, 2010	March 31, 2009
	\$	\$
Current income tax expense	13	18
Future income tax reduction	(750)	(88)
Income tax reduction	(737)	(70)

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

	March 31, 2010	March 31, 2009
	\$	\$
Loss before income taxes	(10,749)	(63)
Expected tax reduction at 28.25% (2009 – 29.50%)	(3,037)	(19)
Add (deduct) income tax effect of:		
Stock-based compensation	27	23
Non-deductible interest and penalties	13	21
Rate adjustments and other	371	(95)
Change in valuation allowance	1,889	-
Income tax reduction	(737)	(70)

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# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

March 31, 2010

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

(unaudited)

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### 6. ASSET RETIREMENT OBLIGATIONS

The Company's asset retirement obligations result from net ownership interests in oil and natural gas assets including well sites, gathering systems and processing facilities. The Company estimates the net present value of its total asset retirement obligations at March 31, 2010 to be \$4,487,000 (December 31, 2009 - \$4,324,000) based on a total undiscounted future liability at March 31, 2010 of \$8,565,000 (December 31, 2009 - \$8,655,000) which will be primarily incurred between 2012 and 2029. An inflation rate of 2.0 percent (2009 - 2.0 percent) and a credit-adjusted risk-free interest rate of 9.0 percent (December 31, 2009 - 9.0 percent) were used to calculate the fair value of the asset retirement obligations.

Asset Retirement Obligations	\$
Balance, December 31, 2009	4,324
Adjustments to assumptions	87
Accretion expense	76
Balance, March 31, 2010	4,487

### 7. 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, 2009	55,294,788	140,094
Tax effect of flow-through share renoucement	-	(750)
Balance, March 31, 2010	55,294,788	139,344

(c) Warrants issued and outstanding:

	Number of Warrants	\$
Balance, March 31, 2010 and December 31, 2009	27,295,700	5,406

(d) Contributed surplus:

	\$
Balance, December 31, 2009	15,435
Stock-based compensation expense	114
Balance, March 31, 2010	15,549

(e) Stock option plan:

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

# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

March 31, 2010

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

(unaudited)

The Company has the following stock options outstanding:

Outstanding at March 31, 2010				Exercisable at March 31, 2010	
Exercise Price	Number	Weighted average years to expiry	Weighted Average Exercise Price	Number exercisable	Weighted Average Exercise Price
\$			\$		\$
0.245	3,680,000	4.5	0.245	973,334	0.245
1.18 – 1.35	1,092,979	3.2	1.32	439,326	1.29
19.50 – 50.00	1,600	0.8	36.00	1,600	36.00
	4,774,579	4.2	0.50	1,414,260	0.61

There were no stock option transactions in the three months ended March 31, 2010.

The Company records compensation costs on the granting of stock options using the fair value method. Compensation expense is calculated using the Black-Scholes option pricing model.

The Company has not incorporated an estimated forfeiture rate for stock options that will not vest but accounts for the actual forfeitures as they occur.

The estimated fair value of stock options of \$0.27 per share at March 31, 2010 (March 31, 2009 - \$0.55) is amortized to expense over the vesting period on a straight-line basis. For the three months ended March 31, 2010, the Company recorded compensation expense of \$82,000 related to stock options (March 31, 2009 – \$61,000). The Company capitalized stock-based compensation expense related to stock options for the three months ended March 31, 2010 of \$32,000 (March 31, 2009 - \$20,000).

(f) Per share amounts:

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

	March 31, 2010	March 31, 2009
Weighted average – basic and diluted	55,294,788	26,921,788

Options to purchase 4,774,579 (March 31, 2009 – 1,787,873) common shares and warrants to purchase 27,295,700 (March 31, 2009 – 5,516,700) common shares at March 31, 2010 were not included in the calculation of diluted common shares outstanding because they were anti-dilutive.

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# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

March 31, 2010

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

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(g) Restricted stock unit plan:

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

As at March 31, 2010, there were 1,275,000 (December 31, 2009 – 1,275,000) restricted stock units outstanding of which 300,000 mature on December 31, 2010, 575,000 mature on December 31, 2011 and 400,000 mature on December 31, 2012. The Company recorded a liability and expense at March 31, 2010 based on the intrinsic value of the units. For the three months ended March 31, 2010, the Company recorded compensation expense related to the restricted stock unit plan of \$12,000 (March 31, 2009 - \$18,000). The Company capitalized stock-based compensation expense related to restricted stock units in the three months ended March 31, 2010 of \$1,000 (March 31, 2009 - \$8,000).

## 8. FINANCIAL INSTRUMENTS

### Overview

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

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

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

### Credit Risk

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

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# **FORTRESS ENERGY INC.**

## **Notes to Consolidated Financial Statements**

March 31, 2010

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

(unaudited)

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

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

### **Liquidity Risk**

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

The Company prepares capital expenditures budgets which are regularly monitored and updated as considered necessary. As well, the Company utilizes authorizations for expenditures on operated and non-operated projects to further manage capital expenditures. To facilitate the capital expenditure program, the Company has credit facilities (note 4) that are reviewed periodically 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 March 31, 2010.

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# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

March 31, 2010

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

(unaudited)

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### Commodity Price Risk

Commodity price risk is the risk that the fair value of financial instruments or future cash flows will fluctuate as a result of changes in commodity prices. Commodity prices for petroleum and natural gas are impacted by world economic events that dictate the levels of supply and demand. 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 March 31, 2010 are as follows:

Type	Period	Volume (GJ/d)	Fixed Price (\$/GJ)
Swap	April 1, 2010 to December 31, 2010	5,000	5.69
Swap	April 1, 2010 to March 31, 2011	2,000	5.50

For the three months ended March 31, 2010, the Company realized a gain related to commodity contracts of \$1,162,000 (three months ended March 31, 2009 – \$1,459,000) which has been included in petroleum and natural gas sales. The Company also recorded an unrealized gain on commodity contracts of \$2,261,000 for the three months ended March 31, 2010 (three months ended March 31, 2009 – \$2,418,000). A \$1.00/GJ change in the AECO price would increase or decrease the unrealized gain on commodity contracts for the period ended March 31, 2010 by \$2,105,000.

### 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 March 31, 2010. A difference in interest rate of 1.0 percent would change interest expense by an estimated \$56,000 for the three months ended March 31, 2010.

### Capital Management

The Company manages its capital structure and makes adjustments to it in light of changes in economic conditions and the risk characteristics of the underlying petroleum and natural gas assets. The Company considers its capital structure to include shareholders' equity and working capital. In order to maintain or adjust the capital structure, the Company may from time to time issue shares and adjust its capital spending to manage current and projected debt levels. To assess capital and operating efficiency and financial strength, the Company continually monitors its net debt and working capital deficiency which is a non-GAAP measure and is calculated as follows:

	March 31, 2010 \$	December 31, 2009 \$
Current assets	9,119	7,431
Current liabilities	(30,459)	(30,928)
Net debt and working capital deficiency	(21,340)	(23,497)

# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

March 31, 2010

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

### Fair Value of Financial Instruments

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

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

Classification	Carrying Value \$	Fair Value \$
Held-for-trading (cash and commodity contracts)	3,582	3,582
Loans and receivables (accounts receivable)	4,951	4,951
Other liabilities (accounts payable and bank credit facilities)	(30,274)	(30,274)
Total	(21,741)	(21,741)

The Company's commodity contracts asset is a derivative financial instrument that is recorded at fair value using quoted market prices and is classified as a level 2 asset in the fair value hierarchy. The change in value from December 31, 2009 is the result of a change in the underlying commodity contracts and commodity prices.

## 9. COMMITMENTS AND CONTINGENCIES

### Office space and equipment

As at March 31, 2010 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 \$
2010	9	355	364
2011	9	475	484
2012	-	475	475
2013	-	119	119
	18	1,424	1,442

### 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.

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# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

March 31, 2010

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

(unaudited)

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As at March 31, 2010, committed payments are as follows:

	\$
2010	1,255
2011	1,533
2012	1,533
2013	1,533
2014	1,533
2015	545
	<hr/> 7,932

### Letter of Credit

On February 1, 2010, the Company issued a letter of credit of \$810,000 with an expiry of February 1, 2011, related to a natural gas transportation and processing agreement.

### Flow-Through Share Expenditures

In September 2009, the Company issued 6,594,000 flow-through common shares at \$0.455 per share for gross proceeds of \$3,000,270 and renounced the related resource expenditures to the subscribers effective December 31, 2009 with all expenditures to be incurred by December 31, 2010. As of March 31, 2010, the Company had not incurred any eligible expenditures.

### Claims and Litigation

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

### Income Tax Refund

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

### Income Tax Reassessment

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

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# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

March 31, 2010

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

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### Income Tax Audit

In January 2010, the Company received an audit letter from the CRA pertaining to the conversion of SignalEnergy Inc., predecessor to the Company and formerly known as SignalGene Inc., into an oil and natural gas enterprise. The CRA proposes to deny the use of tax pools existing at the time of the conversion. The Company responded to the CRA audit letter on March 26, 2010 and believes that this matter will be resolved in the Company's favour. If the CRA are successful in their challenge to the Company's interpretation of the tax legislation, it will result in additional taxes, interest and penalties of a material amount.

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

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

	March 31, 2010	March 31, 2009
	\$	\$
Accounts receivable	625	(1,670)
Prepaid expenses and deposits	(116)	(374)
Accounts payable and accrued liabilities	(793)	4,096
Income taxes payable	13	18
Non-cash items included in accounts payable	(13)	-
	(284)	2,070
Attributable to investing activities	(769)	2,696
Attributable to operating activities	485	(626)

### 11. RELATED PARTY TRANSACTIONS

In the three months ended March 31, 2010 the Company was charged \$190,000 (three months ended March 31, 2009 - \$68,000) by a law firm of which a director of the Company is a partner, of which \$150,000 is included in accounts payable and accrued liabilities at March 31, 2010.

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

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# FORTRESS ENERGY INC.

## Notes to Consolidated Financial Statements

March 31, 2010

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

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### 12. SUBSEQUENT EVENTS

- (a) Subsequent to March 31, 2010, the Company's bank extended the repayment requirement for the \$7,000,000 non-revolving loan facility to May 31, 2010.
- (b) Subsequent to March 31, 2010, the Company entered into a commodity price contract to sell 5,000 GJ/d of natural gas at \$4.92/GJ for the period of January 1, 2011 to December 31, 2011.
- (c) On March 4, 2010, the Company announced that it had entered into a Letter of Intent to acquire a significant natural gas property located in the Boyer area of Alberta (the "Boyer Assets"). It was a condition under the Letter of Intent that the Company file a final prospectus in relation to financing a portion of the purchase price for the Boyer Assets on or before April 26, 2010. Due to current market conditions and the resulting delays in financing Fortress was unable to satisfy this condition. As a result, Fortress was informed on April 27, 2010 that the Letter of Intent had been terminated.

Fortress intends to resubmit an offer to the vendor for the Boyer Assets and has elected not to withdraw its preliminary prospectus filed on April 1, 2010. The vendor has no obligation to consider any revised offer and there is no certainty that they will do so.