

*A copy of this preliminary prospectus has been filed with the securities regulatory authorities in each of the provinces of Alberta, Manitoba and Ontario but has not yet become final for the purpose of the sale of securities. Information contained in this preliminary prospectus may not be complete and may have to be amended. The securities may not be sold until a receipt for the prospectus is obtained from the securities regulatory authorities.*

*This prospectus constitutes a public offering of these securities only in those jurisdictions where they may be lawfully offered for sale and therein only by persons permitted to sell such securities. No securities regulatory authority has expressed an opinion about these securities and it is an offence to claim otherwise. See "Plan of Distribution". These securities have not been and will not be registered under the United States Securities Act of 1933, as amended. Accordingly, except to the extent exempt from such registration requirements, these securities may not be offered or sold in the United States and this prospectus does not constitute an offer to sell or a solicitation of an offer to buy any of these securities within the United States. See "Plan of Distribution".*

New Issue

September 19, 2002

## PRELIMINARY PROSPECTUS



### 11,000,000 Common Shares issuable on exercise of outstanding Special Warrants

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**Price: \$0.50 per Special Warrant**

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Terraquest Energy Corporation ("**Terraquest**" or the "**Corporation**") is hereby qualifying for distribution 11,000,000 Common Shares of the Corporation (the "**Qualified Shares**") issuable upon exercise of 11,000,000 issued and outstanding special warrants (the "**Special Warrants**"). The Special Warrants were issued on July 31, 2002 (the "**Closing Date**") pursuant to the Special Warrant Indenture (as defined herein) and sold to purchasers in the provinces of Alberta, Manitoba and Ontario (the "**Filing Provinces**") on a private placement basis pursuant to prospectus exemptions under applicable securities legislation through Griffiths McBurney & Partners and Peters & Co. Limited (collectively, the "**Underwriters**"). The Special Warrants are not available for purchase pursuant to this prospectus. See "Plan of Distribution".

The issue price of \$0.50 per Special Warrant was determined by negotiation between the Corporation and the Underwriters. No commission or fee will be payable to the Underwriters by the Corporation in connection with the distribution of the Qualified Shares upon the exercise of the Special Warrants.

|                     | <b>Offering Price</b> | <b>Underwriters' Fee <sup>(1)</sup></b> | <b>Net Proceeds <sup>(2)</sup></b> |
|---------------------|-----------------------|-----------------------------------------|------------------------------------|
| Per Special Warrant | \$ 0.50               | \$ 0.03                                 | \$ 0.47                            |
| Total               | \$ 5,500,000          | \$ 330,000                              | \$ 5,170,000                       |

**Notes:**

- (1) The Corporation paid a fee of 6.0% to the Underwriters in connection with the sale of the Special Warrants. No commission or fee is payable to the Underwriters in connection with the distribution of the Qualified Shares upon the exercise of the Special Warrants.
- (2) Before deducting the expenses in connection with the issuance of the Special Warrants and qualification for distribution of the Qualified Shares estimated to be \$100,000.

Each Special Warrant entitles the holder to acquire, at no additional cost, one Qualified Share at any time until 5:00 p.m. (Calgary time) on the earlier of: (i) five (5) Business Days (as defined herein) after the Final Receipt Date (as defined herein); and (ii) the first anniversary of the Closing Date (the first of such events to occur is hereinafter referred to as the "**Expiry Time**").

In the event that a receipt for this prospectus is not obtained by the Corporation on or prior to the Qualification Deadline (as defined herein) from the Canadian securities regulatory authority in each of the Filing Provinces, then each holder of Special

Warrants in each of the Filing Provinces in which a receipt has not been obtained (or, if a receipt has not been obtained in the provinces of Alberta or Ontario, all holders wherever resident) shall be entitled after the Qualification Deadline to receive on the exercise of the Special Warrants an additional 0.15 of a Common Share for each such Special Warrant so exercised without additional payment. Special Warrants not previously exercised by the holders thereof shall be deemed to be exercised immediately prior to the Expiry Time without further action on the part of the holder. The Corporation will continue to use its best efforts to obtain a receipt for this prospectus from the Canadian securities regulatory authority in each Filing Province where a receipt for this prospectus is not obtained on or before the Qualification Deadline.

**Any Common Shares issued upon the exercise of Special Warrants prior to the Final Receipt Date will be subject to relevant hold periods under applicable securities legislation.**

**An investment in the Qualified Shares is highly speculative due to the nature of the Corporation's involvement in the exploration for, and the acquisition, development and production of, oil and natural gas reserves and the Corporation's early stage of development. The Corporation's business is subject to the risks normally encountered in the oil and natural gas industry such as the marketability of, and prices for, oil and natural gas, competition with companies having greater resources, acquisition, exploration and production risks, need for capital, fluctuations in the market price and demand for oil and natural gas and the regulation of the oil and natural gas industry by various levels of government. The reserve and recovery information contained in this prospectus are estimates only and the actual production and ultimate reserves recovered from the Corporation's properties may be greater or less than the estimates contained in this prospectus. The success of further exploration or development projects cannot be assured. Investors must rely upon the ability, expertise, judgement, discretion, integrity and good faith of the management of the Corporation. See "Risk Factors".**

The Common Shares of the Corporation are listed and posted for trading on the Toronto Stock Exchange (the "TSX") under the trading symbol "TRQ". The TSX has conditionally approved the listing of the Qualified Shares subject to the Corporation fulfilling all of the requirements of such exchange. On July 18, 2002, being the day of negotiation of the issue price of the Special Warrants, the closing price of the Common Shares on the TSX was \$0.50. On September 18, 2002, being the last day on which the Common Shares traded prior to the date of this prospectus, the closing price of the Common Shares on the TSX was \$0.42. See "Price Range and Trading Volume".

Certificates for the Common Shares will be available for delivery within five (5) Business Days from the date of the exercise or deemed exercise of the Special Warrants. Certain legal matters in connection with this offering will be reviewed on behalf of Terraquest by Burnet, Duckworth & Palmer LLP, and on behalf of the Underwriters by McCarthy Tétrault LLP.

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### SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

Certain statements contained in this prospectus constitute forward-looking statements. The use of any of the words "anticipate", "continue", "estimate", "expect", "may", "will", "project", "should", "believe" and similar expressions are intended to identify forward-looking statements. These statements involve known and unknown risks, uncertainties and other factors that may cause actual results or events to differ materially from those anticipated in such forward-looking statements. The Corporation believes the expectations reflected in those forward-looking statements are reasonable but no assurance can be given that these expectations will prove to be correct and such forward-looking statements included in this prospectus should not be unduly relied upon. These forward-looking statements speak only as of the date of this prospectus.

In particular, this prospectus contains forward-looking statements pertaining to the following:

- oil and natural gas production levels;
- capital expenditure programs;
- the quantity of oil and natural gas reserves;
- projections of market prices and costs;
- supply and demand for oil and natural gas;
- expectations regarding the ability to raise capital and to continually add to reserves through acquisitions, exploration and development; and
- treatment under governmental regulatory regimes.

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

- volatility in market prices for oil and natural gas;
- liabilities inherent in oil and natural gas operations;
- uncertainties associated with estimating oil and natural gas reserves;
- competition for, among other things, capital, acquisitions of reserves, undeveloped lands and skilled personnel;
- incorrect assessments of the value of acquisitions;
- geological, technical, drilling and processing problems;
- fluctuations in foreign exchange or interest rates and stock market volatility; and
- the other factors discussed under "Risk Factors".

These factors should not be considered exhaustive. The Corporation undertakes no obligation to publicly update or revise any forward-looking statements.

## GLOSSARY OF TERMS

In this prospectus, the abbreviations set forth below have the following meanings:

|                   |                               |          |                                          |
|-------------------|-------------------------------|----------|------------------------------------------|
| "M\$"             | thousands of Canadian dollars | "mcf"    | 1,000 cubic feet                         |
| "MM\$"            | millions of Canadian dollars  | "mmcf"   | 1,000,000 cubic feet                     |
| "bbls"            | barrels                       | "bcf"    | 1,000,000,000 cubic feet                 |
| "mbbls"           | 1,000 barrels                 | "mcf/d"  | one thousand standard cubic feet per day |
| "mmbbls"          | 1,000,000 barrels             | "mmcf/d" | one million standard cubic feet per day  |
| "bpd"             | barrels per day               | "mmbtu"  | one million British Thermal Units        |
| "bopd"            | barrels of oil per day        | "boe"    | barrel of oil equivalent                 |
| "NGL"             | natural gas liquids           | "mboe"   | 1,000 barrels of oil equivalent          |
| "m <sup>3</sup> " | cubic metre volume            | "boed"   | barrel of oil equivalent per day         |
|                   |                               | "GJ"     | gigajoules (one billion joules)          |

For the purposes of this prospectus, six mcf of natural gas and 1 bbl of NGL each equal 1 bbl of oil, such conversion not being based on either price or energy content.

In this prospectus, the capitalized terms set forth below have the following meanings:

"**ABCA**" means the *Business Corporations Act* (Alberta), S.A. 1981, c. B-15, together with any amendments thereto and all regulations promulgated thereunder;

"**Approach**" means Approach Energy Inc., a corporation incorporated under the ABCA, which was amalgamated with the Corporation on August 2, 2002;

"**Approach Acquisition**" means the acquisition of all of the issued and outstanding securities of Approach by the Corporation for an aggregate cash purchase price of \$9.5 million;

"**Approach GLJ Report**" means the independent engineering evaluation of the crude oil, NGL and natural gas interests associated with the Iron Springs property prepared by GLJ effective August 1, 2002;

"**Approach McDaniel Report**" means the independent engineering evaluation of the crude oil, NGL and natural gas interests associated with the Approach Properties other than Iron Springs prepared by McDaniel effective August 1, 2002;

"**Approach Properties**" means the oil and natural gas and exploration properties located in the Iron Springs, Long Coulee, Robin, Birch, Medicine Hat and Retlaw areas of Alberta acquired by Terraquest pursuant to the Approach Acquisition, which properties are described herein under the section entitled "Business of the Corporation";

"**Approach Reports**" means, collectively, the Approach GLJ Report and the Approach McDaniel Report;

"**Arrangement**" means the arrangement, under the provisions of Section 186 of the ABCA, and effected pursuant to the terms of the Arrangement Agreement which became effective on January 16, 2002 and by which, among other things, Terraquest acquired the Initial Properties from Richland and the 27,893,117 Common Shares issued by Terraquest to Richland as part of the Richland Consideration for the Initial Properties were distributed to former shareholders of Richland;

"**Arrangement Agreement**" means the arrangement agreement dated as of November 26, 2001, among Richland, Terraquest, Provident and Provident Energy Trust pursuant to which such parties implemented the Arrangement;

"**API**" means the American Petroleum Institute. "°API" is an indication of the specific gravity of crude oil measured on the API gravity scale. Liquid petroleum with a specific gravity of 28 ° API or higher is generally referred to as light crude oil;

"**ARTC**" means the Alberta royalty tax credit;

"**Board**" means the board of directors of the Corporation;

"**Business Day**" means a day which is not a Saturday, Sunday or a legal holiday in the City of Calgary, in the Province of Alberta;

"**CDN**" means Canadian;

"**Closing Date**" means July 31, 2002, being the date on which the Corporation issued the Special Warrants;

"**Common Shares**" means the common shares in the share capital of the Corporation;

"**Filing Provinces**" means the provinces of Alberta, Manitoba and Ontario;

"**Final Prospectus**" means the final prospectus of the Corporation which qualifies the distribution of the Common Shares issuable upon the exercise of the Special Warrants;

"**Final Receipt Date**" means the latest date on which a receipt for the Final Prospectus is issued by the Canadian securities regulatory authorities in the Filing Provinces;

"**GLJ**" means Gilbert Laustsen Jung Associates Ltd., independent oil and gas reservoir engineers of Calgary, Alberta;

"**Independent Reserve Reports**" means, collectively, the Terraquest Report and the Approach Reports;

"**Initial Properties**" means the oil and natural gas properties and exploration properties located in the Bow Island, Firebird, McLeans Creek, Eyremore, Little Bow, Whitecourt and Wildwood/Bigoray areas of Alberta acquired by Terraquest from Richland pursuant to the Richland Purchase and Sale Agreement, which properties are described herein under the section entitled "Business of the Corporation";

"**McDaniel**" means McDaniel & Associates Consultants Ltd., independent oil and gas reservoir engineers of Calgary, Alberta;

"**Provident**" means Provident Energy Ltd., a corporation wholly-owned by Provident Energy Trust;

"**Qualification Deadline**" means 5:00 p.m. (Calgary time) on November 28, 2002;

"**Qualified Shares**" means the common shares issuable upon exercise of the Special Warrants and which are being qualified for distribution by the Final Prospectus;

"**Richland**" means Richland Petroleum Corporation;

"**Richland Consideration**" means the issuance of 27,893,117 Common Shares to Richland (subsequently distributed by Richland to the former holders of Richland Shares pursuant to the Arrangement) and the granting of certain overriding royalties and other rights to Richland as set forth in the Richland Purchase and Sale Agreement;

"**Richland Purchase and Sale Agreement**" means the agreement between Richland and Terraquest dated November 26, 2001 pursuant to which Richland transferred its interest in the Initial Properties to Terraquest in exchange for the Richland Consideration as part of the transactions effected under the Arrangement;

"**Richland Shares**" means the common shares in the share capital of Richland;

"**Special Warrant Indenture**" means the special warrant indenture entered into between Terraquest and the Trust Company dated effective as of the Closing Date governing the terms and conditions of the Special Warrants;

"**Special Warrants**" means the 11,000,000 special warrants of the Corporation created and issued pursuant to the Special Warrant Indenture entitling the holders thereof to acquire, subject to adjustment, one Qualified Share for each Special Warrant;

"**Tax Act**" means the *Income Tax Act* (Canada) and the regulations promulgated thereunder, as amended from time to time;

"**Terraquest**" or the "**Corporation**" means Terraquest Energy Corporation;

"**Terraquest Report**" means the independent engineering evaluation of Terraquest's crude oil, NGL and natural gas interests prepared by McDaniel effective May 1, 2002;

"**Trust Company**" means Valiant Corporate Trust Company;

"**Trustee**" means the Trust Company, as trustee under the Special Warrant Indenture;

"**TSX**" means the Toronto Stock Exchange;

"**Underwriters**" means, collectively, Griffiths McBurney & Partners and Peters & Co. Limited;

"**Underwriting Agreement**" means the underwriting agreement entered into between Terraquest and the Underwriters dated effective July 25, 2002, with respect to the sale of the Special Warrants;

"**United States**" or "**U.S.**" means the United States as defined in Rule 902(d) under Regulation S to the *United States Securities Act of 1933*, as amended;

"**Undeveloped Land Report**" means the independent appraisal of Terraquest's undeveloped land holdings prepared by Seaton Jordan & Associates Ltd. ("**Seaton**"), independent land evaluators of Calgary, Alberta, dated and effective June 30, 2002; and

"**WTI**" means West Texas Intermediate, the reference price paid in U.S. dollars at Cushing, Oklahoma for crude oil of standard grade.

*Words importing the singular include the plural and vice versa and words importing any gender include all genders.*

*In this prospectus, references to "dollars" and "\$" are to the currency of Canada, unless otherwise indicated.*

## PROSPECTUS SUMMARY

*The following is a summary of the principal features of this distribution and should be read together with the more detailed information and financial data and statements contained elsewhere in this prospectus.*

|                         |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                        |
|-------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>The Corporation</b>  | Terraquest is a publicly traded oil and gas company engaged in the exploration for, and the acquisition, development and production of, oil and natural gas reserves primarily in the Province of Alberta. See "The Corporation" and "Business of the Corporation".                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    |
| <b>The Offering</b>     | 11,000,000 Qualified Shares issuable on the exercise or deemed exercise of 11,000,000 issued and outstanding Special Warrants. See "Plan of Distribution".                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |
| <b>Price</b>            | The Special Warrants were sold on the Closing Date at a price of \$0.50 per Special Warrant. The offering price of the Special Warrants was determined by negotiation between the Corporation and the Underwriters.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    |
| <b>Special Warrants</b> | 11,000,000 Special Warrants were issued on the Closing Date pursuant to prospectus exemptions under applicable securities legislation at a price of \$0.50 per Special Warrant for gross proceeds of \$5,500,000 (\$5,070,000 net after deducting the Underwriter's fee and associated expenses).                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      |
| <b>Exercise Details</b> | <p>Each Special Warrant entitles the holder thereof to acquire, at no additional cost, one Qualified Share at any time until 5:00 p.m. (Calgary time) on the earlier of: (i) five (5) Business Days after the Final Receipt Date; and (ii) the first anniversary of the Closing Date (the first of such events to occur is hereinafter referred to as the "<b>Expiry Time</b>"). Any Common Shares issued upon the exercise of Special Warrants prior to the Final Receipt Date will be subject to relevant hold periods under applicable securities legislation. Any Special Warrants not previously exercised by holders thereof shall be deemed to have been exercised immediately prior to the Expiry Time. As at the date hereof, none of the Special Warrants have been exercised.</p> <p>In the event that a receipt for this prospectus is not obtained by the Corporation on or prior to the Qualification Deadline from the Canadian securities regulatory authority in each of the Filing Provinces, then each holder of Special Warrants in each of the Filing Provinces in which a receipt has not been obtained (or, if a receipt has not been obtained in the provinces of Alberta or Ontario, all holders wherever resident) shall be entitled after the Qualification Deadline to receive on the exercise of the Special Warrants an additional 0.15 of a Common Share for each such Special Warrant so exercised without additional payment. Special Warrants not previously exercised by the holders thereof shall be deemed to be exercised immediately prior to the Expiry Time without further action on the part of the holder. See "Plan of Distribution".</p> |
| <b>Use of Proceeds</b>  | The gross proceeds realized by the Corporation from the issuance of the Special Warrants of \$5,500,000 (before deducting the Underwriters' fee of \$330,000 and the expenses in connection with the issuance of the Special Warrants and the qualification for distribution of the Qualified Shares, estimated to be \$100,000, which will be paid out of the general funds of the Corporation) were utilized by the Corporation to fund a portion of the purchase price of Approach. See "Use of Proceeds".                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                          |
| <b>Risk Factors</b>     | <b>An investment in the Qualified Shares is highly speculative due to the nature of the Corporation's involvement in the exploration for, and the acquisition, development and production of, oil and natural gas reserves and the Corporation's early stage of development. The Corporation's business is subject to the risks normally encountered in the oil and natural gas industry such as the marketability of, and prices for, oil and natural gas, competition with companies having greater resources, acquisition,</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      |

exploration and production risks, need for capital, fluctuations in the market price and demand for oil and natural gas and the regulation of the oil and natural gas industry by various levels of government. The reserve and recovery information contained in this prospectus are estimates only and the actual production and ultimate reserves recovered from the Corporation's properties may be greater or less than the estimates contained in this prospectus. The success of further exploration or development projects cannot be assured. Investors must rely upon the ability, expertise, judgement, discretion, integrity and good faith of the management of the Corporation. See "Risk Factors".

### Selected Reserve Information

The tables below summarize the crude oil, NGL and natural gas reserves and the present worth of future net cash flows associated with the reserves of Terraquest evaluated in the Independent Reserve Reports, based on constant and escalated price assumptions. The tables summarize the data contained in the Independent Reserve Reports and, as a result, may contain slightly different numbers than the Independent Reserve Reports due to rounding. **All future cash flows are stated prior to provision for income taxes and indirect costs and after deduction of royalties, estimated future capital expenditures and well abandonment costs. It should not be assumed that the present worth of estimated future cash flows shown below is representative of the fair market value of the reserves. There is no assurance that such price and cost assumptions will be attained and variances could be material. The recovery and reserve estimates of Terraquest's crude oil, NGL and natural gas reserves provided herein are estimates only and there is no guarantee that the estimated reserves will be recovered. Actual reserves may be greater than or less than the estimates provided herein.**

### *Terraquest Report*

The following table summarizes, as at May 1, 2002, the crude oil, NGL and natural gas reserves and the present worth of future net cash flows associated with the reserves of Terraquest evaluated in the Terraquest Report. The following table does not include the crude oil, NGL and natural gas reserves associated with the Approach Properties which have been evaluated in the Approach Reports, or any other reserves added by Terraquest subsequent to May 1, 2002.

### Oil and Natural Gas Reserves and Present Value of Estimated Future Cash Flows Based on Escalated Price Assumptions

|                 | Gross Reserves         |                 |                          | Net Reserves   |                 |                          | Present Worth Value Discounted at |              |              |              |
|-----------------|------------------------|-----------------|--------------------------|----------------|-----------------|--------------------------|-----------------------------------|--------------|--------------|--------------|
|                 | Oil<br>(mbbls)         | NGLs<br>(mbbls) | Natural<br>Gas<br>(mmcf) | Oil<br>(mbbls) | NGLs<br>(mbbls) | Natural<br>Gas<br>(mmcf) | 0%                                | 10%          | 15%          | 20%          |
|                 | (Thousands of Dollars) |                 |                          |                |                 |                          |                                   |              |              |              |
| Proved Reserves |                        |                 |                          |                |                 |                          |                                   |              |              |              |
| Producing       | 66.0                   | 1.8             | 306.4                    | 56.6           | 1.1             | 199.6                    | 1,887                             | 1,678        | 1,594        | 1,521        |
| Non-Producing   | 67.1                   | 12.6            | 1,656.5                  | 56.8           | 7.3             | 992.6                    | 5,205                             | 4,322        | 3,986        | 3,700        |
| Undeveloped     | -                      | -               | -                        | -              | -               | -                        | -                                 | -            | -            | -            |
| Total Proved    | 133.1                  | 14.4            | 1,962.6                  | 113.4          | 8.4             | 1,192.2                  | 7,092                             | 6,000        | 5,580        | 5,221        |
| Probable        | 33.2                   | 2.7             | 288.3                    | 28             | 1.8             | 188.8                    | 1,374                             | 968          | 836          | 733          |
| <b>TOTAL</b>    | <b>166.3</b>           | <b>17.1</b>     | <b>2,250.9</b>           | <b>141.4</b>   | <b>10.2</b>     | <b>1,381.0</b>           | <b>8,466</b>                      | <b>6,968</b> | <b>6,416</b> | <b>5,954</b> |

**Oil and Natural Gas Reserves and Present Value of Estimated Future Cash Flows  
Based on Constant Price Assumptions**

|                 | Gross Reserves |                 |                       | Net Reserves   |                 |                       | Present Worth Value Discounted at |              |              |              |
|-----------------|----------------|-----------------|-----------------------|----------------|-----------------|-----------------------|-----------------------------------|--------------|--------------|--------------|
|                 | Oil<br>(mbbls) | NGLs<br>(mbbls) | Natural Gas<br>(mmcf) | Oil<br>(mbbls) | NGLs<br>(mbbls) | Natural Gas<br>(mmcf) | 0%                                | 10%          | 15%          | 20%          |
|                 |                |                 |                       |                |                 |                       | (Thousands of Dollars)            |              |              |              |
| Proved Reserves |                |                 |                       |                |                 |                       |                                   |              |              |              |
| Producing       | 66.2           | 1.8             | 306.4                 | 55.6           | 1.1             | 199.6                 | 2,230                             | 1,938        | 1,826        | 1,730        |
| Non-Producing   | 67.0           | 12.9            | 1,676.7               | 55.3           | 7.4             | 999.2                 | 5,355                             | 4,413        | 4,058        | 3,756        |
| Undeveloped     | -              | -               | -                     | -              | -               | -                     | -                                 | -            | -            | -            |
| Total Proved    | 133.2          | 14.7            | 1,983.1               | 111.0          | 8.5             | 1,198.8               | 7,585                             | 6,352        | 5,884        | 5,486        |
| Probable        | 33.1           | 2.7             | 291.4                 | 27.0           | 1.8             | 189.7                 | 1,569                             | 1,084        | 930          | 811          |
| <b>TOTAL</b>    | <b>166.3</b>   | <b>17.4</b>     | <b>2,274.5</b>        | <b>138.0</b>   | <b>10.3</b>     | <b>1,388.6</b>        | <b>9,154</b>                      | <b>7,436</b> | <b>6,814</b> | <b>6,297</b> |

**Approach GLJ Report**

The following table summarizes, as at August 1, 2002, the crude oil, NGL and natural gas reserves and the present worth of future net cash flows associated with Terraquest's Iron Springs property as evaluated in the Approach GLJ Report.

**Oil and Natural Gas Reserves and Present Value of Estimated Future Cash Flows  
Based on Escalated Price Assumptions**

|                 | Gross Reserves |                 |                       | Net Reserves   |                 |                       | Present Worth Value Discounted at |              |              |              |
|-----------------|----------------|-----------------|-----------------------|----------------|-----------------|-----------------------|-----------------------------------|--------------|--------------|--------------|
|                 | Oil<br>(mbbls) | NGLs<br>(mbbls) | Natural Gas<br>(mmcf) | Oil<br>(mbbls) | NGLs<br>(mbbls) | Natural Gas<br>(mmcf) | 0%                                | 10%          | 15%          | 20%          |
|                 |                |                 |                       |                |                 |                       | (Thousands of Dollars)            |              |              |              |
| Proved Reserves |                |                 |                       |                |                 |                       |                                   |              |              |              |
| Producing       | -              | -               | 1,759                 | -              | -               | 1,495                 | 5,789                             | 5,044        | 4,750        | 4,495        |
| Non-Producing   | -              | -               | 181                   | -              | -               | 154                   | 564                               | 253          | 176          | 125          |
| Undeveloped     | -              | -               | -                     | -              | -               | -                     | -                                 | -            | -            | -            |
| Total Proved    | -              | -               | 1,940                 | -              | -               | 1,649                 | 6,353                             | 5,297        | 4,926        | 4,620        |
| Probable        | -              | -               | 237                   | -              | -               | 201                   | 752                               | 545          | 476          | 421          |
| <b>TOTAL</b>    | <b>-</b>       | <b>-</b>        | <b>2,177</b>          | <b>-</b>       | <b>-</b>        | <b>1,850</b>          | <b>7,105</b>                      | <b>5,842</b> | <b>5,402</b> | <b>5,041</b> |

**Oil and Natural Gas Reserves and Present Value of Estimated Future Cash Flows  
Based on Constant Price Assumptions**

|                 | Gross Reserves |                 |                       | Net Reserves   |                 |                       | Present Worth Value Discounted at |              |              |              |
|-----------------|----------------|-----------------|-----------------------|----------------|-----------------|-----------------------|-----------------------------------|--------------|--------------|--------------|
|                 | Oil<br>(mbbls) | NGLs<br>(mbbls) | Natural Gas<br>(mmcf) | Oil<br>(mbbls) | NGLs<br>(mbbls) | Natural Gas<br>(mmcf) | 0%                                | 10%          | 15%          | 20%          |
|                 |                |                 |                       |                |                 |                       | (Thousands of Dollars)            |              |              |              |
| Proved Reserves |                |                 |                       |                |                 |                       |                                   |              |              |              |
| Producing       | -              | -               | 1,759                 | -              | -               | 1,495                 | 3,153                             | 2,757        | 2,600        | 2,464        |
| Non-Producing   | -              | -               | 181                   | -              | -               | 154                   | 258                               | 115          | 81           | 57           |
| Undeveloped     | -              | -               | -                     | -              | -               | -                     | -                                 | -            | -            | -            |
| Total Proved    | -              | -               | 1,940                 | -              | -               | 1,649                 | 3,411                             | 2,872        | 2,681        | 2,521        |
| Probable        | -              | -               | 237                   | -              | -               | 201                   | 376                               | 270          | 233          | 205          |
| <b>TOTAL</b>    | <b>-</b>       | <b>-</b>        | <b>2,177</b>          | <b>-</b>       | <b>-</b>        | <b>1,850</b>          | <b>3,787</b>                      | <b>3,142</b> | <b>2,914</b> | <b>2,726</b> |

### Approach McDaniel Report

The following table summarizes, as at August 1, 2002, the crude oil, NGL and natural gas reserves and the present worth of future net cash flows associated with the Approach Properties (other than the Iron Springs property) as evaluated in the Approach McDaniel Report.

#### Oil and Natural Gas Reserves and Present Value of Estimated Future Cash Flows Based on Escalated Price Assumptions

|                 | Gross Reserves |                 |                       | Net Reserves   |                 |                       | Present Worth Value Discounted at |              |              |              |
|-----------------|----------------|-----------------|-----------------------|----------------|-----------------|-----------------------|-----------------------------------|--------------|--------------|--------------|
|                 | Oil<br>(mbbls) | NGLs<br>(mbbls) | Natural Gas<br>(mmcf) | Oil<br>(mbbls) | NGLs<br>(mbbls) | Natural Gas<br>(mmcf) | 0%                                | 10%          | 15%          | 20%          |
|                 |                |                 |                       |                |                 |                       | (Thousands of Dollars)            |              |              |              |
| Proved Reserves |                |                 |                       |                |                 |                       |                                   |              |              |              |
| Producing       | 117.8          | 2.1             | 1,164.8               | 109.8          | 1.8             | 492.2                 | 4,785                             | 3,671        | 3,318        | 3,042        |
| Non-Producing   | —              | —               | —                     | —              | —               | —                     | —                                 | —            | —            | —            |
| Undeveloped     | —              | —               | 878.5                 | —              | —               | 670.4                 | 1,965                             | 1,485        | 1,313        | 1,173        |
| Total Proved    | 117.8          | 2.1             | 2,043.3               | 109.8          | 1.8             | 1,662.6               | 6,750                             | 5,156        | 4,631        | 4,215        |
| Probable        | 21.3           | 0.6             | 220.7                 | 19.8           | 0.5             | 184.5                 | 943                               | 515          | 418          | 352          |
| <b>TOTAL</b>    | <b>139.1</b>   | <b>2.7</b>      | <b>2,264.0</b>        | <b>129.6</b>   | <b>2.3</b>      | <b>1,847.1</b>        | <b>7,693</b>                      | <b>5,671</b> | <b>5,049</b> | <b>4,567</b> |

#### Oil and Natural Gas Reserves and Present Value of Estimated Future Cash Flows Based on Constant Price Assumptions

|                 | Gross Reserves |                 |                       | Net Reserves   |                 |                       | Present Worth Value Discounted at |              |              |              |
|-----------------|----------------|-----------------|-----------------------|----------------|-----------------|-----------------------|-----------------------------------|--------------|--------------|--------------|
|                 | Oil<br>(mbbls) | NGLs<br>(mbbls) | Natural Gas<br>(mmcf) | Oil<br>(mbbls) | NGLs<br>(mbbls) | Natural Gas<br>(mmcf) | 0%                                | 10%          | 15%          | 20%          |
|                 |                |                 |                       |                |                 |                       | (Thousands of Dollars)            |              |              |              |
| Proved Reserves |                |                 |                       |                |                 |                       |                                   |              |              |              |
| Producing       | 117.8          | 2.1             | 1,164.8               | 108.6          | 1.8             | 996.3                 | 3,755                             | 2,632        | 2,313        | 2,074        |
| Non-Producing   | —              | —               | —                     | —              | —               | —                     | —                                 | —            | —            | —            |
| Undeveloped     | —              | —               | 878.5                 | —              | —               | 687.2                 | 605                               | 430          | 367          | 316          |
| Total Proved    | 117.8          | 2.1             | 2,043.3               | 108.6          | 1.8             | 1,683.5               | 4,360                             | 3,062        | 2,680        | 2,390        |
| Probable        | 21.3           | 0.6             | 220.7                 | 19.6           | 0.5             | 185.4                 | 718                               | 337          | 262          | 213          |
| <b>TOTAL</b>    | <b>139.1</b>   | <b>2.7</b>      | <b>2,264.0</b>        | <b>128.2</b>   | <b>2.3</b>      | <b>1,868.9</b>        | <b>5,078</b>                      | <b>3,399</b> | <b>2,942</b> | <b>2,603</b> |

### Selected Financial Information

The following is a summary of selected historic and pro forma financial information for Terraquest, for the periods indicated.

|                           | Six Months Ended<br>June 30, 2002 <sup>(1)</sup> | Pro Forma<br>Six Months Ended<br>June 30, 2002 <sup>(2)</sup> | Pro Forma<br>Year Ended<br>December 31, 2001 <sup>(2)</sup> |
|---------------------------|--------------------------------------------------|---------------------------------------------------------------|-------------------------------------------------------------|
|                           | (unaudited)                                      | (unaudited)                                                   | (unaudited)                                                 |
| Revenue, net of royalties | \$ 786,888                                       | \$ 2,529,174                                                  | \$ 4,599,061                                                |
| Operating costs           | 362,468                                          | 898,517                                                       | 1,342,412                                                   |
| Net operating revenue     | 424,420                                          | 1,630,657                                                     | 3,256,649                                                   |
| Net income (loss)         | (1,416,815)                                      | (1,719,376)                                                   | (130,777)                                                   |
| Cash flow from operations | (29,139)                                         | N/A                                                           | N/A                                                         |
| Total assets              | 15,432,647                                       | 30,888,807                                                    | N/A                                                         |
| Bank indebtedness         | nil                                              | 5,061,782                                                     | N/A                                                         |
| Equity                    | 12,380,349                                       | 17,450,349                                                    | N/A                                                         |

## Notes:

- (1) For this period, the information presented is contained in the interim unaudited financial statements of the Corporation for the six months ended June 30, 2002.
- (2) For this period, the information presented is contained in the unaudited pro forma consolidated financial statements of the Corporation set forth herein and should be read in conjunction with such financial statements. The unaudited pro forma consolidated financial statements may not be indicative of results that actually would have occurred if the events reflected therein had been in effect on the dates indicated or of the results expected in future periods.

## **THE CORPORATION**

The Corporation was incorporated as 961982 Alberta Ltd. by certificate of incorporation issued pursuant to the provisions of the ABCA on November 22, 2001. On December 13, 2001, the Corporation filed Articles of Amendment to change its name to "Terraquest Energy Corporation" and to remove certain private company provisions from its Articles. On August 2, 2002, the Corporation amalgamated with its wholly-owned subsidiary, Approach Energy Inc.

On January 16, 2002, on completion of the Arrangement, Terraquest became engaged in the exploration for, and the acquisition, development and production of, oil and natural gas reserves primarily in the Province of Alberta by the acquisition of the Initial Properties from Richland. See "Business of the Corporation - Background".

The Corporation's head office is located at Suite 700, 550 – 11<sup>th</sup> Avenue S.W., Calgary, Alberta, T2R 1M7, and its registered office is located at Burnet Duckworth & Palmer LLP, Suite 1400, 350 - 7<sup>th</sup> Avenue S.W., Calgary, Alberta, T2P 3N9.

## **BUSINESS OF THE CORPORATION**

### **Background**

Pursuant to the Arrangement and the Richland Purchase and Sale Agreement, Richland transferred its interest in the Initial Properties to Terraquest effective January 16, 2002 in exchange for the Richland Consideration. Under the terms of the Richland Purchase and Sale Agreement, Terraquest assumed all liabilities, including environmental liabilities, relating to the Initial Properties and acquired the Initial Properties without any representations and warranties from Richland. Pursuant to the Arrangement, the 27,893,117 Common Shares issued by Terraquest to Richland as part of the Richland Consideration were distributed by Richland on January 16, 2002 to former shareholders of Richland on the basis of one Common Share for each Richland Share that such shareholder held prior to the Arrangement.

On February 8, 2002, the Corporation completed a private placement of 6,723,670 Common Shares and 2,765,464 "flow-through" Common Shares for aggregate cash proceeds of \$2,036,100.

On May 14, 2002, the Corporation completed a private placement of 5,130,000 Special Warrants for aggregate cash proceeds of \$2,565,000. The special warrants were subsequently exchanged for 5,130,000 Common Shares.

On August 2, 2002, the Corporation acquired all of the issued and outstanding securities of Approach for an aggregate cash purchase price of \$9.5 million plus the assumption of Approach's net debt of approximately \$1.5 million. See "Acquisition of Approach Energy Inc."

### **Trends**

There are a number of trends that have been developing in the oil and gas industry that appear to be shaping the near future of the business. The first trend is the consolidation phase that the industry has been going through. This has affected companies of all sizes from the small emerging companies to the senior integrated organizations. This trend appears to be continuing as a number of publicly traded companies are trading below asset or break-up value and as a result it is less expensive for companies to grow by acquiring companies than by focusing entirely on drilling and prospect generation.

The second trend is the difficult access to external capital that the industry currently is experiencing. This can be partly attributed to the higher returns that have been experienced in other sectors of the market relative to the returns in the resource sector, as well as the general negative investor sentiment in the broader market. Many institutional investors who have traditionally invested in junior oil and gas securities have little cash for investment in new issues as a result of heavy unit redemptions in the past six to nine months. During the last two quarters this trend has been correcting somewhat and institutional investors appear to be beginning to refocus on traditional sectors for investment opportunities. It will require some time to see if this results in additional investment in the junior oil and gas sector.

The third trend relates to the size and nature of entities that oil and gas investors are focusing on. The larger market capitalization companies provide for greater liquidity and can appear more attractive investments than smaller market capitalization companies.

The fourth trend is the current influence of royalty trusts on the Canadian oil and gas industry. While American companies dominated the acquisition market in the first three quarters of 2001, royalty trusts have been acquiring companies and assets in Canada in order to grow their cash flows and distributions. Some oil and gas production companies have also reorganized themselves into royalty trusts to capture the more attractive unit valuations in the equity markets. The ability of the trusts to access the capital markets when traditional production companies generally cannot will continue to change the structure of the Canadian oil and gas industry.

The Canadian/U.S. exchange rate also influences commodity prices for Canadian producers as there is a high correlation between Canadian and U.S. oil and natural gas prices.

### **Corporate Strategy**

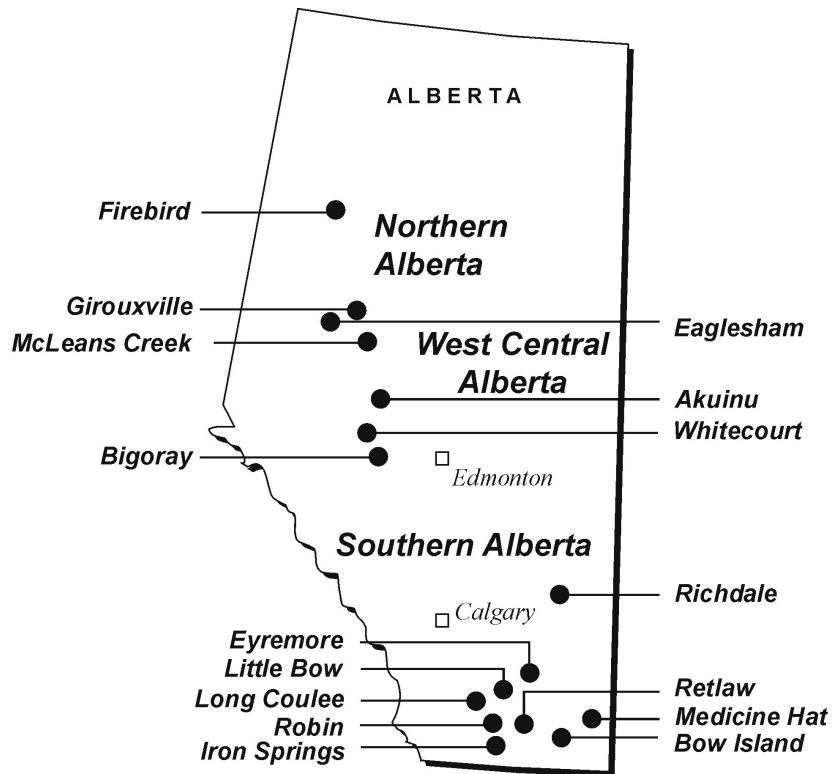
Terraquest's strategy is to create value primarily through the generation and drilling of exploration and development prospects and the strategic acquisition of additional properties. Terraquest targets areas and prospects that it believes can result in meaningful reserve and production additions. Terraquest is focused on unlocking the value inherent in its existing asset base, which includes over 83,000 net acres of undeveloped land. Terraquest is also focusing on expanding its existing asset base through crown land sales, farm-ins, farm-outs and acquisitions where viewed as strategic. The Approach Acquisition is a significant milestone in the implementation of this strategy.

New areas will be developed based on the following criteria: corporate skills, experience, fit with existing asset base and the potential to add to shareholder value. Terraquest's focus on developing new activity areas will be on natural gas and light oil prospects.

## Principal Properties

The following is a description of the Corporation's principal oil and gas properties including the Initial Properties and the Approach Properties.

References to the reserves associated with the properties are taken from the escalated price and cost evaluation of the McDaniel Reports.



## Principal Producing Properties

### *Bow Island, Alberta*

The Bow Island area is located approximately 30 miles Southeast of the City of Medicine Hat. Terraquest has an average working interest of 53% in 15,360 (8,068 net) acres of land in this area. Terraquest has seven natural gas wells in this area which are currently shut in due to high water cuts. Terraquest owns a 50% working interest in a 10 mmcf/d sour gas plant constructed in 1999.

As at May 1, 2002, the total proved natural gas reserves in this area were estimated by McDaniel in the Terraquest Report to be 397 mmcf. See "Business of the Corporation – Oil and Natural Gas Reserves".

For the year ended December 31, 2001, production from the Bow Island area averaged 450 mcf/d of natural gas. For the six month period ended June 30, 2002, production from the Bow Island area averaged 196 mcf/d of natural gas.

### *Firebird, Alberta*

The Firebird area is located approximately 150 miles North of the Town of Slave Lake. Terraquest has an average working interest of 49% in 480 (236 net) acres of land and one (0.8 net) producing gas well in this area.

As at May 1, 2002, the total proved reserves in this area were estimated by McDaniel in the Terraquest Report to be 833 mmcf of natural gas and 34,490 bbls of crude oil and NGL. See "Business of the Corporation – Oil and Natural Gas Reserves".

For the year ended December 31, 2001, production from the Firebird area averaged 37 bopd of crude oil and NGL and 180 mcf of natural gas. For the six month period ended June 30, 2002, production from the Firebird area averaged 40 bopd of crude oil and NGL and 209 mcf of natural gas. The property has been shut-in since May 15, 2002, pending facility modifications by the operator. Production is expected to recommence in the fourth quarter of 2002

#### *Iron Springs, Alberta*

The Iron Springs area is located approximately 10 miles North of the City of Lethbridge. Terraquest has an average working interest of 90% in 3,840 (3,456 net) acres of land and three (3.0 net) producing gas wells and one (1.0 net) cased gas well in this area. Terraquest also owns a 100% working interest in a 4 mmcf sweet gas plant.

As at August 1, 2002, the total proved natural gas reserves in this area were estimated by GLJ in the Approach GLJ Report to be 1,940 mmcf. See "Business of the Corporation – Oil and Natural Gas Reserves".

For the year ended December 31, 2001, production from the Iron Springs area averaged 184 mcf of natural gas. For the six month period ended June 30, 2002, production from the Iron Springs area averaged 1,517 mcf of natural gas.

#### *Long Coulee, Alberta*

The Long Coulee area is located approximately 30 miles North of the City of Lethbridge. Terraquest has an average working interest of 54% in 9,120 (4,936 net) acres of land and 11 (4.4 net) producing oil wells in this area.

As at August 1, 2002, the total proved reserves in this area were estimated by McDaniel in the Approach McDaniel Report to be 117,700 bbls of crude oil and 54.4 mmcf of natural gas. See "Business of the Corporation – Oil and Natural Gas Reserves".

For the year ended December 31, 2001, production from the Long Coulee area averaged 45 bopd of crude oil. For the six month period ended June 30, 2002, production from the Long Coulee area averaged 44 bopd of crude oil.

#### *McLeans Creek, Alberta*

The McLeans Creek area is located approximately 35 miles West of the Town of High Prairie. Terraquest has an average working interest of 50% in 43,840 (20,608 net) acres of land and four (1.80 net) producing oil wells in this area.

As at May 1, 2002, the total proved crude oil reserves in this area were estimated by McDaniel in the Terraquest Report to be 110,330 bbls. See "Business of the Corporation – Oil and Natural Gas Reserves".

For the year ended December 31, 2001, production from the McLeans Creek area averaged 61 bopd of crude oil. For the six month period ended June 30, 2002, production from the McLeans Creek area averaged 65 bopd of crude oil.

#### *Robin, Alberta*

The Robin area is located approximately 20 miles Northeast of the City of Lethbridge. Terraquest has an average working interest of 70% in 2,560 (1,792 net) acres of land and seven (5.0 net) producing gas wells in this area.

As at August 1, 2002, the total proved reserves in this area were estimated by McDaniel in the Approach McDaniel Report to be 744.9 mmcf of natural gas and 2,070 bbls of NGL. See "Business of the Corporation – Oil and Natural Gas Reserves".

For the year ended December 31, 2001, production from the Robin area averaged 1,043 mcf of natural gas. For the six month period ended June 30, 2002, production from the Robin area averaged 1,052 mcf of natural gas.

### *Other Producing Properties*

Terraquest has additional minor producing properties in the Birch, Medicine Hat and Retlaw areas of Southern Alberta.

### ***Principal Exploration Properties***

#### *Bigoray, Alberta*

The Bigoray area is located approximately 60 miles West of the City of Edmonton. Terraquest has an average working interest of 88% in 13,760 (12,160 net) acres of undeveloped land in this area.

The primary exploration targets in this area are the Nordegg and Pekisko zones at depths of approximately 1,600 metres. Terraquest plans to drill two wells in this area in 2002, through a joint venture farm-out, which will see Terraquest retain a carried 50% working interest in the wells being drilled.

#### *Eyremore, Alberta*

The Eyremore area is located approximately 15 miles Southwest of the Town of Brooks. Terraquest has a 100% working interest in 4,160 acres of undeveloped land in this area. Terraquest has also entered into an agreement with Provident, whereby Terraquest has the exclusive right to farm-in on all of Provident's undeveloped lands in the Eyremore area. Any wells drilled within a 90 day period extend the farm-in for an additional 90 days, subject to a maximum of six extensions. Terraquest will earn a 100% working interest in each spacing unit drilled, subject to a standard non-convertible overriding royalty. Provident retains the right to participate up to a one-third interest in all wells proposed by Terraquest. Three wells have been drilled to date on farm-in lands.

The primary exploration target in this area is the Ostracod zone, at depths of 1,200 metres, with secondary targets in the Upper and Lower Mannville zones. Two successful wells have been drilled in this area in 2002 and are expected to be tied in and placed on production in the fourth quarter of 2002.

#### *McLeans Creek, Alberta*

The McLeans Creek area is located approximately 35 miles West of the Town of High Prairie, Alberta. Terraquest has an average 47% working interest in 43,840 (20,608 net) acres of undeveloped land and four (1.8 net) producing oil wells in this area.

The primary crude oil exploration target is the Granite Wash zone, with secondary gas targets in the Bluesky and Paddy zones. Terraquest has drilled three wells at McLeans Creek in 2002, one of which is producing. Two more wells are planned to be drilled in the second half of 2002.

#### *Whitcourt, Alberta*

The Whitcourt area is located approximately 120 miles Northwest of the City of Edmonton. Terraquest has an average working interest of 60% in 3,200 (1,920 net) acres of land in this area.

The primary exploration target is the Nordegg zone, at depths of 1,600 metres, with secondary targets in the Pekisko zone.

### **Oil and Natural Gas Reserves**

The crude oil, NGL and natural gas reserves of Terraquest have been evaluated in the Independent Reserve Reports. The tables below summarize the crude oil, NGL and natural gas reserves and the present worth of future net cash flows associated with such reserves of Terraquest as evaluated in the Independent Reserve Reports, based on constant and escalated price assumptions. The tables summarize the data contained in the Independent Reserve Reports and, as a result, may contain slightly different numbers than the Independent Reserve Reports due to rounding. **All future cash flows are stated prior to provision for income taxes and indirect costs and after deduction of royalties, estimated future capital expenditures and well abandonment costs. It should not be assumed that the present worth of estimated future cash flows shown below is representative of the fair market value of the reserves. There is no assurance that such price and cost assumptions will be attained and variances**

could be material. The recovery and reserve estimates of Terraquest's crude oil, NGL and natural gas reserves provided herein are estimates only and there is no guarantee that the estimated reserves will be recovered. Actual reserves may be greater than or less than the estimates provided herein.

### ***Terraquest Report***

The following table summarizes, as at May 1, 2002, the crude oil, NGL and natural gas reserves and the present worth of future net cash flows associated with the reserves of Terraquest evaluated in the Terraquest Report. The following table does not include the crude oil, NGL and natural gas reserves associated with the Approach Properties which have been evaluated in the Approach Reports or any other reserves added by Terraquest subsequent to May 1, 2002.

#### **Oil and Natural Gas Reserves and Present Value of Estimated Future Cash Flows Based on Escalated Price Assumptions**

|                         | Gross Reserves |                 |                       | Net Reserves   |                 |                       | Present Worth Value Discounted at |              |              |              |
|-------------------------|----------------|-----------------|-----------------------|----------------|-----------------|-----------------------|-----------------------------------|--------------|--------------|--------------|
|                         | Oil<br>(mbbls) | NGLs<br>(mbbls) | Natural Gas<br>(mmcf) | Oil<br>(mbbls) | NGLs<br>(mbbls) | Natural Gas<br>(mmcf) | 0%                                | 10%          | 15%          | 20%          |
|                         |                |                 |                       |                |                 |                       | (Thousands of Dollars)            |              |              |              |
| Proved Reserves         |                |                 |                       |                |                 |                       |                                   |              |              |              |
| Producing               | 66.0           | 1.8             | 306.4                 | 56.6           | 1.1             | 199.6                 | 1,887                             | 1,678        | 1,594        | 1,521        |
| Non-Producing           | 67.1           | 12.6            | 1,656.5               | 56.8           | 7.3             | 992.6                 | 5,205                             | 4,322        | 3,986        | 3,700        |
| Undeveloped             | —              | —               | —                     | —              | —               | —                     | —                                 | —            | —            | —            |
| Total Proved            | 133.1          | 14.4            | 1,962.6               | 113.4          | 8.4             | 1,192.2               | 7,092                             | 6,000        | 5,580        | 5,221        |
| Probable <sup>(6)</sup> | 33.2           | 2.7             | 288.3                 | 28             | 1.8             | 188.8                 | 1,374                             | 968          | 836          | 733          |
| <b>TOTAL</b>            | <b>166.3</b>   | <b>17.1</b>     | <b>2,250.9</b>        | <b>141.4</b>   | <b>10.2</b>     | <b>1,381.0</b>        | <b>8,466</b>                      | <b>6,968</b> | <b>6,416</b> | <b>5,954</b> |

#### **Oil and Natural Gas Reserves and Present Value of Estimated Future Cash Flows Based on Constant Price Assumptions**

|                         | Gross Reserves |                 |                       | Net Reserves   |                 |                       | Present Worth Value Discounted at |              |              |              |
|-------------------------|----------------|-----------------|-----------------------|----------------|-----------------|-----------------------|-----------------------------------|--------------|--------------|--------------|
|                         | Oil<br>(mbbls) | NGLs<br>(mbbls) | Natural Gas<br>(mmcf) | Oil<br>(mbbls) | NGLs<br>(mbbls) | Natural Gas<br>(mmcf) | 0%                                | 10%          | 15%          | 20%          |
|                         |                |                 |                       |                |                 |                       | (Thousands of Dollars)            |              |              |              |
| Proved Reserves         |                |                 |                       |                |                 |                       |                                   |              |              |              |
| Producing               | 66.2           | 1.8             | 306.4                 | 55.6           | 1.1             | 199.6                 | 2,230                             | 1,938        | 1,826        | 1,730        |
| Non-Producing           | 67.0           | 12.9            | 1,676.7               | 55.3           | 7.4             | 999.2                 | 5,355                             | 4,413        | 4,058        | 3,756        |
| Undeveloped             | —              | —               | —                     | —              | —               | —                     | —                                 | —            | —            | —            |
| Total Proved            | 133.2          | 14.7            | 1,983.1               | 111.0          | 8.5             | 1,198.8               | 7,585                             | 6,352        | 5,884        | 5,486        |
| Probable <sup>(6)</sup> | 33.1           | 2.7             | 291.4                 | 27.0           | 1.8             | 189.7                 | 1,569                             | 1,084        | 930          | 811          |
| <b>TOTAL</b>            | <b>166.3</b>   | <b>17.4</b>     | <b>2,274.5</b>        | <b>138.0</b>   | <b>10.3</b>     | <b>1,388.6</b>        | <b>9,154</b>                      | <b>7,436</b> | <b>6,814</b> | <b>6,297</b> |

Notes:

- (1) "Gross" means Terraquest's working interests and/or royalty interests share of reserves before deducting royalties owned by others. "Net" means Terraquest's working interests and/or royalty interests share of reserves after deducting the amounts attributable to the royalties owned by others. In order to estimate reserves after giving effect to the deduction of provincial royalties, certain assumptions must be made including forecasts of future prices and production. The net reserves are based on forecasts prepared by McDaniel of these and other factors necessary to estimate provincial and other royalties.
- (2) "Proved reserves" means those reserves estimated as recoverable with a high degree of certainty under current technology and existing economic conditions, from that portion of a reservoir which can be reasonably evaluated as economically productive on the basis of analysis of drilling, geological, geophysical and engineering data, including the reserves to be obtained by enhanced recovery processes demonstrated to be economic and technically successful in the subject reservoir. Reserves assigned to non-producing zones in producing wells were classified as producing if the reserve quantities were estimated to be minor relative to Terraquest's reserves in the area.

- (3) "Proved producing reserves" means those proved reserves that are actually on production, or if not producing, that could be recovered from existing wells or facilities and where the reasons for the current non-producing status is the choice of the owner. An illustration of such a situation is where a well or zone is capable of production but is shut-in because its deliverability is not required to meet contract commitments. Reserves assigned to non-producing zones in producing wells were classified as producing if the reserve quantities were estimated to be minor relative to Terraquest's reserves in the area.
- (4) "Proved non-producing reserves" are those non-producing proved reserves from existing wells that require relatively minor capital expenditures to produce.
- (5) "Proved undeveloped reserves" are those reserves expected to be recovered from new wells on undrilled acreage, or from existing wells where a relatively major expenditure will be required.
- (6) "Probable additional reserves" means those reserves which analysis of drilling, geological, geophysical and engineering data does not demonstrate to be proved under current technology and existing economic conditions, but where such analysis suggests the likelihood of their existence and future recovery. Probable additional reserves to be obtained by the application of enhanced recovery processes will be the increased recovery over and above that estimated in the proved category which can be realistically estimated for the pool on the basis of enhanced recovery processes which can be reasonably expected to be instituted in the future. **A risk adjustment factor of 50 percent to allow for geological and engineering risks associated with probable reserves has been applied to the McDaniel Report.**
- (7) The constant price assumptions assume the continuance of current laws, regulations and productions costs in effect on the date of the Terraquest Report. The constant oil and gas price assumptions are based on the actual March 31, 2002 crude oil, natural gas and natural gas product prices: Edmonton light crude Cdn.\$40.60/bbl; Bow River medium crude Cdn.\$37.82/bbl; Alberta average natural gas Cdn.\$4.25/mmbtu; propane Cdn.\$23.00/bbl; field butane Cdn.\$25.00; NGL mix Cdn.\$27.20/bbl; and natural gasolines & condensate Cdn.\$40.60/bbl. Prices, production and capital costs have not been adjusted for the effects of inflation.
- (8) Escalated prices used based on McDaniel's price forecasts at April 1, 2002 are as follows:

| Year            | Crude Oil         |                               |                                     |                                   | Edmonton<br>Cond. &<br>Natural<br>Gasolines | Edmonton<br>Propane | Edmonton<br>Butanes | Edmonton<br>NGL Mix |
|-----------------|-------------------|-------------------------------|-------------------------------------|-----------------------------------|---------------------------------------------|---------------------|---------------------|---------------------|
|                 | WTI at<br>Cushing | Light<br>Crude at<br>Edmonton | Bow<br>River<br>Medium<br>Crude Oil | Natural Gas<br>Average<br>Alberta |                                             |                     |                     |                     |
|                 | \$US/bbl          | \$CDN/bbl                     | \$CDN/bbl                           | \$CDN/mmbtu                       | \$/bbl                                      | \$/bbl              | \$/bbl              | \$/bbl              |
| 2002 (9 mo)     | 23.00             | 35.20                         | 29.20                               | 4.80                              | 35.20                                       | 25.00               | 23.20               | 26.40               |
| 2003            | 22.40             | 33.40                         | 28.40                               | 4.65                              | 33.40                                       | 23.90               | 22.00               | 25.10               |
| 2004            | 21.80             | 32.00                         | 27.00                               | 4.55                              | 32.00                                       | 23.10               | 21.10               | 24.20               |
| 2005            | 22.20             | 32.10                         | 27.10                               | 4.50                              | 32.10                                       | 23.00               | 21.20               | 24.20               |
| 2006            | 22.60             | 32.20                         | 27.20                               | 4.45                              | 32.20                                       | 23.00               | 21.20               | 24.20               |
| 2007            | 23.10             | 32.90                         | 27.90                               | 4.50                              | 32.90                                       | 23.40               | 21.70               | 24.70               |
| 2008            | 23.60             | 33.60                         | 28.60                               | 4.50                              | 33.60                                       | 23.60               | 22.20               | 25.10               |
| 2009            | 24.10             | 34.30                         | 29.30                               | 4.55                              | 34.30                                       | 24.00               | 22.60               | 25.60               |
| 2010            | 24.60             | 35.00                         | 30.00                               | 4.65                              | 35.00                                       | 24.50               | 23.10               | 26.10               |
| 2011            | 25.10             | 35.70                         | 30.70                               | 4.75                              | 35.70                                       | 25.00               | 23.50               | 26.60               |
| 2012            | 25.60             | 36.40                         | 31.40                               | 4.85                              | 36.40                                       | 25.50               | 24.00               | 27.20               |
| 2013            | 26.10             | 37.10                         | 32.10                               | 4.95                              | 37.10                                       | 26.10               | 24.50               | 27.70               |
| 2014            | 26.60             | 37.80                         | 32.80                               | 5.00                              | 37.80                                       | 26.40               | 24.90               | 28.20               |
| 2015            | 27.10             | 38.60                         | 33.60                               | 5.10                              | 38.60                                       | 27.00               | 25.50               | 28.80               |
| 2016            | 27.60             | 39.30                         | 34.30                               | 5.20                              | 39.30                                       | 27.50               | 25.90               | 29.30               |
| 2017            | 28.20             | 40.10                         | 35.10                               | 5.35                              | 40.10                                       | 28.20               | 26.40               | 30.00               |
| 2018            | 28.80             | 41.00                         | 36.00                               | 5.45                              | 41.00                                       | 28.70               | 27.00               | 30.60               |
| 2019            | 29.40             | 41.80                         | 36.80                               | 5.55                              | 41.80                                       | 29.30               | 27.60               | 31.20               |
| 2020            | 30.00             | 42.70                         | 37.70                               | 5.65                              | 42.70                                       | 29.30               | 28.20               | 31.90               |
| 2021            | 30.60             | 43.50                         | 38.50                               | 5.80                              | 43.50                                       | 30.50               | 28.70               | 32.50               |
| Thereafter flat |                   |                               |                                     |                                   |                                             |                     |                     |                     |

- (9) The Canadian dollar exchange rate for United States dollars is assumed to be \$0.635 = \$1.00 CDN for 2002, \$0.65 U.S. = \$1.00 CDN for 2003, \$0.66 U.S. = \$1.00 CDN for 2004, \$0.67 U.S. = \$1.00 CDN for 2005 and \$0.68 U.S. = \$1.00 CDN from 2005 for the life of the forecast.
- (10) Capital and operating costs were escalated from 2001 values using inflation forecasts of 2 percent per year in the escalated price cases.
- (11) The estimated total capital expenditures necessary to achieve the estimated future net production revenue from total proved and probable reserves in the escalated price case are \$396,000. The estimated capital expenditures required to produce the estimated total proved and probable reserves in each of the first two years in the escalated price case are \$358,300 (2002) and \$nil (2003).
- (12) The estimated total capital expenditures necessary to achieve the estimated future net production revenue from total proved and probable reserves in the constant price case are \$391,700. The estimated capital expenditures required to produce the estimated total proved and probable reserves in each of the first two years in the constant price case are \$358,300 (2002) and \$nil (2003).
- (13) Alberta gas cost allowance and Jumping Pound allowances on a remaining undepreciated capital basis were included in the economic evaluation. Mineral taxes on freehold interests were also included.
- (14) ARTC has been included in this analysis in the corporate cash flows.
- (15) Approximately 61% of the proved producing reserves are currently on production. Production from the Firebird property, which comprises 39% of the proved producing reserves, is currently shut-in as a result of modifications being made to a third party processing facility. Production is expected to recommence in the fourth quarter of 2002.

### **Approach GLJ Report**

The following table summarizes, as at August 1, 2002, the crude oil, NGL and natural gas reserves and the present worth of future net cash flows associated with Terraquest's Iron Springs property as evaluated in the Approach GLJ Report.

#### **Oil and Natural Gas Reserves and Present Value of Estimated Future Cash Flows Based on Escalated Price Assumptions**

|                         | <b>Gross Reserves</b> |                        |                              | <b>Net Reserves</b>   |                        |                              | <b>Present Worth Value Discounted at</b> |            |            |            |
|-------------------------|-----------------------|------------------------|------------------------------|-----------------------|------------------------|------------------------------|------------------------------------------|------------|------------|------------|
|                         | <b>Oil</b><br>(mbbls) | <b>NGLs</b><br>(mbbls) | <b>Natural Gas</b><br>(mmcf) | <b>Oil</b><br>(mbbls) | <b>NGLs</b><br>(mbbls) | <b>Natural Gas</b><br>(mmcf) | <b>0%</b>                                | <b>10%</b> | <b>15%</b> | <b>20%</b> |
|                         |                       |                        |                              |                       |                        |                              | (Thousands of Dollars)                   |            |            |            |
| Proved Reserves         |                       |                        |                              |                       |                        |                              |                                          |            |            |            |
| Producing               | —                     | —                      | 1,759                        | —                     | —                      | 1,495                        | 5,789                                    | 5,044      | 4,750      | 4,495      |
| Non-Producing           | —                     | —                      | 181                          | —                     | —                      | 154                          | 564                                      | 253        | 176        | 125        |
| Undeveloped             | —                     | —                      | —                            | —                     | —                      | —                            | —                                        | —          | —          | —          |
| Total Proved            | —                     | —                      | 1,940                        | —                     | —                      | 1,649                        | 6,353                                    | 5,297      | 4,926      | 4,620      |
| Probable <sup>(6)</sup> | —                     | —                      | 237                          | —                     | —                      | 201                          | 752                                      | 545        | 476        | 421        |
| <b>TOTAL</b>            | —                     | —                      | 2,177                        | —                     | —                      | 1,850                        | 7,105                                    | 5,842      | 5,402      | 5,041      |

**Oil and Natural Gas Reserves and Present Value of Estimated Future Cash Flows  
Based on Constant Price Assumptions**

|                         | Gross Reserves  |                  |                          | Net Reserves    |                  |                          | Present Worth Value Discounted at |                               |       |       |
|-------------------------|-----------------|------------------|--------------------------|-----------------|------------------|--------------------------|-----------------------------------|-------------------------------|-------|-------|
|                         | Oil<br>(mmbbls) | NGLs<br>(mmbbls) | Natural<br>Gas<br>(mmcf) | Oil<br>(mmbbls) | NGLs<br>(mmbbls) | Natural<br>Gas<br>(mmcf) | 0%                                | 10%<br>(Thousands of Dollars) | 15%   | 20%   |
| Proved Reserves         |                 |                  |                          |                 |                  |                          |                                   |                               |       |       |
| Producing               | —               | —                | 1,759                    | —               | —                | 1,495                    | 3,153                             | 2,757                         | 2,600 | 2,464 |
| Non-Producing           | —               | —                | 181                      | —               | —                | 154                      | 258                               | 115                           | 81    | 57    |
| Undeveloped             | —               | —                | —                        | —               | —                | —                        | —                                 | —                             | —     | —     |
| Total Proved            | —               | —                | 1,940                    | —               | —                | 1,649                    | 3,411                             | 2,872                         | 2,681 | 2,521 |
| Probable <sup>(6)</sup> | —               | —                | 237                      | —               | —                | 201                      | 376                               | 270                           | 233   | 205   |
| <b>TOTAL</b>            | —               | —                | 2,177                    | —               | —                | 1,850                    | 3,787                             | 3,142                         | 2,914 | 2,726 |

Notes:

- (1) "Gross" means Terraquest's working interests and/or royalty interests share of reserves before deducting royalties owned by others. "Net" means Terraquest's working interests and/or royalty interests share of reserves after deducting the amounts attributable to the royalties owned by others. In order to estimate reserves after giving effect to the deduction of provincial royalties, certain assumptions must be made including forecasts of future prices and production. The net reserves are based on forecasts prepared by GLJ of these and other factors necessary to estimate provincial and other royalties.
- (2) "Proved reserves" means those reserves estimated as recoverable with a high degree of certainty under current technology and existing economic conditions, from that portion of a reservoir which can be reasonably evaluated as economically productive on the basis of analysis of drilling, geological, geophysical and engineering data, including the reserves to be obtained by enhanced recovery processes demonstrated to be economic and technically successful in the subject reservoir. Reserves assigned to non-producing zones in producing wells were classified as producing if the reserve quantities were estimated to be minor relative to Terraquest's reserves in the area.
- (3) "Proved producing reserves" means those proved reserves that are actually on production, or if not producing, that could be recovered from existing wells or facilities and where the reasons for the current non-producing status is the choice of the owner. An illustration of such a situation is where a well or zone is capable of production but is shut-in because its deliverability is not required to meet contract commitments. Reserves assigned to non-producing zones in producing wells were classified as producing if the reserve quantities were estimated to be minor relative to Terraquest's reserves in the area.
- (4) "Proved non-producing reserves" are those non-producing proved reserves from existing wells that require relatively minor capital expenditures to produce.
- (5) "Proved undeveloped reserves" are those reserves expected to be recovered from new wells on undrilled acreage, or from existing wells where a relatively major expenditure will be required.
- (6) "Probable additional reserves" means those reserves which analysis of drilling, geological, geophysical and engineering data does not demonstrate to be proved under current technology and existing economic conditions, but where such analysis suggests the likelihood of their existence and future recovery. Probable additional reserves to be obtained by the application of enhanced recovery processes will be the increased recovery over and above that estimated in the proved category which can be realistically estimated for the pool on the basis of enhanced recovery processes which can be reasonably expected to be instituted in the future. **A risk adjustment factor of 50 percent to allow for geological and engineering risks associated with probable reserves has been applied to the Approach GLJ Report.**
- (7) The constant price assumptions assume the continuance of current laws, regulations and productions costs in effect on the date of the Approach GLJ Report. The constant oil and gas price assumptions are based on the actual natural gas price on July 31, 2001: AECO-C natural gas Cdn.\$2.56/mmbtu. Prices, production and capital costs have not been adjusted for the effects of inflation.
- (8) Escalated prices used based on GLJ's price forecasts at July 1, 2002 are as follows:

| Year | Crude Oil      |                | Bow River | Natural Gas | Alberta Plant |
|------|----------------|----------------|-----------|-------------|---------------|
|      | WTI at Cushing | Light Crude at |           |             |               |

|             |          | <u>Edmonton</u> | <u>Medium Crude Oil</u>    | <u>AECO-C Spot</u> | <u>Gate Spot</u> |
|-------------|----------|-----------------|----------------------------|--------------------|------------------|
|             | \$US/bbl | \$CDN/bbl       | \$CDN/bbl                  | \$CDN/mmbtu        | \$/bbl           |
| 2002 (6 mo) | 25.00    | 37.25           | 30.25                      | 4.35               | 4.15             |
| 2003        | 22.00    | 33.00           | 26.50                      | 4.65               | 4.45             |
| 2004        | 21.00    | 30.50           | 24.50                      | 4.70               | 4.50             |
| 2005        | 21.00    | 29.50           | 24.00                      | 4.70               | 4.50             |
| 2006        | 21.25    | 29.50           | 24.00                      | 4.70               | 4.50             |
| 2007        | 21.75    | 30.00           | 24.50                      | 4.70               | 4.50             |
| 2008        | 22.00    | 30.50           | 25.00                      | 4.70               | 4.50             |
| 2009        | 22.25    | 31.00           | 25.50                      | 4.75               | 4.55             |
| 2010        | 22.50    | 31.50           | 26.00                      | 4.80               | 4.60             |
| 2011        | 23.00    | 32.00           | 26.50                      | 4.90               | 4.70             |
| 2012        | 23.25    | 32.50           | 27.00                      | 4.95               | 4.75             |
| Thereafter  |          |                 | escalated at 1.5% per year |                    |                  |

- (9) The Canadian dollar exchange rate for United States dollars is assumed to be \$0.65 = \$1.00 CDN for 2002, \$0.65 U.S. = \$1.00 CDN for 2003, \$0.67 U.S. = \$1.00 CDN for 2004, \$0.69 U.S. = \$1.00 CDN for 2005 and \$0.70 U.S. = \$1.00 CDN from 2005 for the life of the forecast.
- (10) Capital and operating costs were escalated from 2002 values using inflation forecasts of 1.5 percent per year in the escalated price cases.
- (11) The estimated total capital expenditures necessary to achieve the estimated future net production revenue from total proved and probable reserves in the escalated price case are \$134,000. The estimated capital expenditures required to produce the estimated total proved and probable reserves in each of the first two years in the escalated price case are \$90,000 (2002) and \$nil (2003).
- (12) The estimated total capital expenditures necessary to achieve the estimated future net production revenue from total proved and probable reserves in the constant price case are \$130,000. The estimated capital expenditures required to produce the estimated total proved and probable reserves in each of the first two years in the constant price case are \$90,000 (2002) and \$nil (2003).
- (13) Alberta gas cost allowance and Jumping Pound allowances on a remaining undepreciated capital basis were included in the economic evaluation. Mineral taxes on freehold interests were also included.
- (14) ARTC has been included in this analysis in the corporate cash flows.
- (15) All of the proved producing reserves are currently on production.

### Approach McDaniel Report

The following table summarizes, as at August 1, 2002, the crude oil, NGL and natural gas reserves and the present worth of future net cash flows associated with the Approach Properties (other than the Iron Springs property) as evaluated in the Approach McDaniel Report.

#### Oil and Natural Gas Reserves and Present Value of Estimated Future Cash Flows Based on Escalated Price Assumptions

|                         | Gross Reserves |                 |                          | Net Reserves   |                 |                          | Present Worth Value Discounted at |              |              |              |
|-------------------------|----------------|-----------------|--------------------------|----------------|-----------------|--------------------------|-----------------------------------|--------------|--------------|--------------|
|                         | Oil<br>(mbbls) | NGLs<br>(mbbls) | Natural<br>Gas<br>(mmcf) | Oil<br>(mbbls) | NGLs<br>(mbbls) | Natural<br>Gas<br>(mmcf) | 0%                                | 10%          | 15%          | 20%          |
|                         |                |                 |                          |                |                 |                          | (Thousands of Dollars)            |              |              |              |
| Proved Reserves         |                |                 |                          |                |                 |                          |                                   |              |              |              |
| Producing               | 117.8          | 2.1             | 1,164.8                  | 109.8          | 1.8             | 492.2                    | 4,785                             | 3,671        | 3,318        | 3,042        |
| Non-Producing           | –              | –               | –                        | –              | –               | –                        | –                                 | –            | –            | –            |
| Undeveloped             | –              | –               | 878.5                    | –              | –               | 670.4                    | 1,965                             | 1,485        | 1,313        | 1,173        |
| Total Proved            | 117.8          | 2.1             | 2,043.3                  | 109.8          | 1.8             | 1,662.6                  | 6,750                             | 5,156        | 4,631        | 4,215        |
| Probable <sup>(6)</sup> | 21.3           | 0.6             | 220.7                    | 19.8           | 0.5             | 184.5                    | 943                               | 515          | 418          | 352          |
| <b>TOTAL</b>            | <b>139.1</b>   | <b>2.7</b>      | <b>2,264.0</b>           | <b>129.6</b>   | <b>2.3</b>      | <b>1,847.1</b>           | <b>7,693</b>                      | <b>5,671</b> | <b>5,049</b> | <b>4,567</b> |

#### Oil and Natural Gas Reserves and Present Value of Estimated Future Cash Flows Based on Constant Price Assumptions

|                         | Gross Reserves |                 |                          | Net Reserves   |                 |                          | Present Worth Value Discounted at |              |              |              |
|-------------------------|----------------|-----------------|--------------------------|----------------|-----------------|--------------------------|-----------------------------------|--------------|--------------|--------------|
|                         | Oil<br>(mbbls) | NGLs<br>(mbbls) | Natural<br>Gas<br>(mmcf) | Oil<br>(mbbls) | NGLs<br>(mbbls) | Natural<br>Gas<br>(mmcf) | 0%                                | 10%          | 15%          | 20%          |
|                         |                |                 |                          |                |                 |                          | (Thousands of Dollars)            |              |              |              |
| Proved Reserves         |                |                 |                          |                |                 |                          |                                   |              |              |              |
| Producing               | 117.8          | 2.1             | 1,164.8                  | 108.6          | 1.8             | 996.3                    | 3,755                             | 2,632        | 2,313        | 2,074        |
| Non-Producing           | –              | –               | –                        | –              | –               | –                        | –                                 | –            | –            | –            |
| Undeveloped             | –              | –               | 878.5                    | –              | –               | 687.2                    | 605                               | 430          | 367          | 316          |
| Total Proved            | 117.8          | 2.1             | 2,043.3                  | 108.6          | 1.8             | 1,683.5                  | 4,360                             | 3,062        | 2,680        | 2,390        |
| Probable <sup>(6)</sup> | 21.3           | 0.6             | 220.7                    | 19.6           | 0.5             | 185.4                    | 718                               | 337          | 262          | 213          |
| <b>TOTAL</b>            | <b>139.1</b>   | <b>2.7</b>      | <b>2,264.0</b>           | <b>128.2</b>   | <b>2.3</b>      | <b>1,868.9</b>           | <b>5,078</b>                      | <b>3,399</b> | <b>2,942</b> | <b>2,603</b> |

#### Notes:

- (1) "Gross" means Terraquest's working interests and/or royalty interests share of reserves before deducting royalties owned by others. "Net" means Terraquest's working interests and/or royalty interests share of reserves after deducting the amounts attributable to the royalties owned by others. In order to estimate reserves after giving effect to the deduction of provincial royalties, certain assumptions must be made including forecasts of future prices and production. The net reserves are based on forecasts prepared by McDaniel of these and other factors necessary to estimate provincial and other royalties.
- (2) "Proved reserves" means those reserves estimated as recoverable with a high degree of certainty under current technology and existing economic conditions, from that portion of a reservoir which can be reasonably evaluated as economically productive on the basis of analysis of drilling, geological, geophysical and engineering data, including the reserves to be obtained by enhanced recovery processes demonstrated to be economic and technically successful in the subject reservoir. Reserves assigned to non-producing zones in producing wells were classified as producing if the reserve quantities were estimated to be minor relative to Terraquest's reserves in the area.
- (3) "Proved producing reserves" means those proved reserves that are actually on production, or if not producing, that could be recovered from existing wells or facilities and where the reasons for the current non-producing status is the choice of the owner. An illustration of such a situation is where a well or zone is capable of production but is shut-in because its deliverability is not required to meet contract commitments. Reserves assigned to non-producing zones in producing wells were classified as producing if the reserve quantities were estimated to be minor relative to Terraquest's reserves in the area.

- (4) "Proved non-producing reserves" are those non-producing proved reserves from existing wells that require relatively minor capital expenditures to produce.
- (5) "Proved undeveloped reserves" are those reserves expected to be recovered from new wells on undrilled acreage, or from existing wells where a relatively major expenditure will be required.
- (6) "Probable additional reserves" means those reserves which analysis of drilling, geological, geophysical and engineering data does not demonstrate to be proved under current technology and existing economic conditions, but where such analysis suggests the likelihood of their existence and future recovery. Probable additional reserves to be obtained by the application of enhanced recovery processes will be the increased recovery over and above that estimated in the proved category which can be realistically estimated for the pool on the basis of enhanced recovery processes which can be reasonably expected to be instituted in the future. **A risk adjustment factor of 50 percent to allow for geological and engineering risks associated with probable reserves has been applied to the McDaniel Report.**
- (7) The constant price assumptions assume the continuance of current laws, regulations and productions costs in effect on the date of the McDaniel Report. The constant oil and gas price assumptions are based on the actual July 31, 2002 crude oil, natural gas and natural gas product prices: Edmonton light crude Cdn.\$42.86/bbl; Bow River medium crude Cdn.\$35.49/bbl; Alberta average natural gas Cdn.\$2.55/mmbtu; propane Cdn.\$22.80/bbl; field butane Cdn.\$28.30; NGL mix Cdn.\$28.70/bbl; and natural gasolines & condensate Cdn.\$42.86/bbl. Prices, production and capital costs have not been adjusted for the effects of inflation.
- (8) Escalated prices used based on McDaniel's price forecasts at July 1, 2002 are as follows:

| Year        | Crude Oil         |                               |                                     | Natural Gas<br>Average<br>Alberta | Edmonton<br>Cond. &<br>Natural<br>Gasolines | Edmonton<br>Propane | Edmonton<br>Butanes | Edmonton<br>NGL Mix |
|-------------|-------------------|-------------------------------|-------------------------------------|-----------------------------------|---------------------------------------------|---------------------|---------------------|---------------------|
|             | WTI at<br>Cushing | Light<br>Crude at<br>Edmonton | Bow<br>River<br>Medium<br>Crude Oil |                                   |                                             |                     |                     |                     |
|             | \$US/bbl          | \$CDN/bbl                     | \$CDN/bbl                           | \$CDN/mmbtu                       | \$/bbl                                      | \$/bbl              | \$/bbl              | \$/bbl              |
| 2002 (6 mo) | 25.00             | 37.50                         | 31.50                               | 4.50                              | 37.50                                       | 25.20               | 24.70               | 27.50               |
| 2003        | 23.50             | 35.10                         | 30.10                               | 4.70                              | 35.10                                       | 24.70               | 23.10               | 26.20               |
| 2004        | 21.80             | 32.00                         | 27.00                               | 4.55                              | 32.00                                       | 23.10               | 21.10               | 24.20               |
| 2005        | 22.20             | 32.10                         | 27.10                               | 4.50                              | 32.10                                       | 23.00               | 21.20               | 24.20               |
| 2006        | 22.60             | 32.20                         | 27.20                               | 4.45                              | 32.20                                       | 23.00               | 21.20               | 24.20               |
| 2007        | 23.10             | 32.90                         | 27.90                               | 4.50                              | 32.90                                       | 23.40               | 21.70               | 24.70               |
| 2008        | 23.60             | 33.60                         | 28.60                               | 4.50                              | 33.60                                       | 23.60               | 22.20               | 25.10               |
| 2009        | 24.10             | 34.30                         | 29.30                               | 4.55                              | 34.30                                       | 24.00               | 22.60               | 25.60               |
| 2010        | 24.60             | 35.00                         | 30.00                               | 4.65                              | 35.00                                       | 24.50               | 23.10               | 26.10               |
| 2011        | 25.10             | 35.70                         | 30.70                               | 4.75                              | 35.70                                       | 25.00               | 23.50               | 26.60               |
| 2012        | 25.60             | 36.40                         | 31.40                               | 4.85                              | 36.40                                       | 25.50               | 24.00               | 27.20               |
| 2013        | 26.10             | 37.10                         | 32.10                               | 4.95                              | 37.10                                       | 26.10               | 24.50               | 27.70               |
| 2014        | 26.60             | 37.80                         | 32.80                               | 5.00                              | 37.80                                       | 26.40               | 24.90               | 28.20               |
| 2015        | 27.10             | 38.60                         | 33.60                               | 5.10                              | 38.60                                       | 27.00               | 25.50               | 28.80               |
| 2016        | 27.60             | 39.30                         | 34.30                               | 5.20                              | 39.30                                       | 27.50               | 25.90               | 29.30               |
| 2017        | 28.20             | 40.10                         | 35.10                               | 5.35                              | 40.10                                       | 28.20               | 26.40               | 30.00               |
| 2018        | 28.80             | 41.00                         | 36.00                               | 5.45                              | 41.00                                       | 28.70               | 27.00               | 30.60               |
| 2019        | 29.40             | 41.80                         | 36.80                               | 5.55                              | 41.80                                       | 29.30               | 27.60               | 31.20               |
| 2020        | 30.00             | 42.70                         | 37.70                               | 5.65                              | 42.70                                       | 29.30               | 28.20               | 31.90               |
| 2021        | 30.60             | 43.50                         | 38.50                               | 5.80                              | 43.50                                       | 30.50               | 28.70               | 32.50               |

Thereafter flat

- (9) The Canadian dollar exchange rate for United States dollars is assumed to be \$0.65 = \$1.00 CDN for 2002, \$0.65 U.S. = \$1.00 CDN for 2003, \$0.66 U.S. = \$1.00 CDN for 2004, \$0.67 U.S. = \$1.00 CDN for 2005 and \$0.68 U.S. = \$1.00 CDN from 2005 for the life of the forecast.
- (10) Capital and operating costs were escalated from 2002 values using inflation forecasts of 2 percent per year in the escalated price cases.

- (11) The estimated total capital expenditures necessary to achieve the estimated future net production revenue from total proved and probable reserves in the escalated price case are \$541,000. The estimated capital expenditures required to produce the estimated total proved and probable reserves in each of the first two years in the escalated price case are \$541,000 (2002) and \$nil (2003).
- (12) The estimated total capital expenditures necessary to achieve the estimated future net production revenue from total proved and probable reserves in the constant price case are \$530,000. The estimated capital expenditures required to produce the estimated total proved and probable reserves in each of the first two years in the constant price case are \$530,000 (2002) and \$nil (2003).
- (13) Alberta gas cost allowance and Jumping Pound allowances on a remaining undepreciated capital basis were included in the economic evaluation. Mineral taxes on freehold interests were also included.
- (14) ARTC has been included in this analysis in the corporate cash flows.
- (15) All of the proved producing reserves are currently on production.

### Landholdings

The developed and undeveloped landholdings of Terraquest as at August 31, 2002, are set forth in the following table.

|         | Undeveloped <sup>(1)</sup> |                    | Developed            |                    | Total                |                    |
|---------|----------------------------|--------------------|----------------------|--------------------|----------------------|--------------------|
|         | Gross <sup>(2)</sup>       | Net <sup>(3)</sup> | Gross <sup>(2)</sup> | Net <sup>(3)</sup> | Gross <sup>(2)</sup> | Net <sup>(3)</sup> |
| Alberta | 139,643                    | 87,476             | 24,756               | 15,376             | 164,399              | 102,852            |
| Total   | 139,643                    | 87,476             | 24,756               | 15,376             | 165,399              | 102,852            |

Notes:

- (1) "Gross" means the total number of acres in which Terraquest has an interest.
- (2) "Net" means the aggregate of the percentage working interests of Terraquest in the gross acres.

Based on an independent land evaluation conducted by Seaton and summarized in the Undeveloped Land Report, at June 30, 2002, the value of Terraquest's then 78,233 net acres (127,825 gross) of undeveloped landholdings was estimated to be \$6.9 million. The Undeveloped Land Report is based on certain factual data supplied by Terraquest and Seaton's opinion of market value for the evaluated land and does not include the 9,243 net acres (11,818 gross) acquired subsequent to June 30, 2002 including through the Approach Acquisition and other minor acquisitions.

### Oil and Natural Gas Wells

The following table summarizes Terraquest's interest as at August 31, 2002 in wells which are producing or which Terraquest considers to be capable of production.

|         | Producing Wells      |                    |                      |                    | Shut-in Wells <sup>(3)</sup> |                    |                      |                    |
|---------|----------------------|--------------------|----------------------|--------------------|------------------------------|--------------------|----------------------|--------------------|
|         | Oil                  |                    | Natural Gas          |                    | Oil                          |                    | Natural Gas          |                    |
|         | Gross <sup>(1)</sup> | Net <sup>(2)</sup> | Gross <sup>(1)</sup> | Net <sup>(2)</sup> | Gross <sup>(1)</sup>         | Net <sup>(2)</sup> | Gross <sup>(1)</sup> | Net <sup>(2)</sup> |
| Alberta | 16                   | 6.2                | 17                   | 11.4               | 4                            | 2.8                | 14                   | 9.3                |
| Total   | 16                   | 6.2                | 17                   | 11.4               | 4                            | 2.8                | 14                   | 9.3                |

Notes:

- (1) "Gross" refers to all wells in which Terraquest has either a working interest or a royalty interest.
- (2) "Net" refers to the aggregate of the percentage working interests of Terraquest in the gross wells, before the deduction of royalties.
- (3) "Shut-in Wells" refers to wells which have encountered and are capable of producing crude oil or natural gas but which are not producing due to lack of available transportation facilities, available markets or other reasons. Shut-in wells in which Terraquest has an interest are located no further than 10 kilometres from existing pipelines.

## Capital Expenditures

The following table shows (in thousands) Terraquest's capital expenditures for the six months ended June 30, 2002 and Richland's capital expenditures in respect of the Initial Properties during each of the years ended December 31, 2001, 2000 and 1999 in the categories indicated.

|                             | Six Months ended<br>June 30, 2002 | Year ended December 31, |          |          |
|-----------------------------|-----------------------------------|-------------------------|----------|----------|
|                             |                                   | 2001                    | 2000     | 1999     |
| Land                        | \$ 163                            | \$ 70                   | \$ 682   | \$ 304   |
| Seismic costs               | 86                                | 249                     | 336      | 41       |
| Drilling and Completion     | 2,011                             | 1,147                   | 1,413    | 1,319    |
| Facilities and equipment    | 329                               | 246                     | 79       | 605      |
| Acquisitions / Dispositions | —                                 | 96                      | (900)    | 3,646    |
| Total                       | \$ 2,589                          | \$ 1,808                | \$ 1,610 | \$ 5,915 |

## Drilling Activity

The following table summarizes Richland's drilling results on the Initial Properties for the years ended December 31, 2001 and December 31, 2000 and Terraquest's drilling results for the six months ended June 30, 2002.

|                 | Six Months ended<br>June 30, 2002 |                    | Year ended<br>December 31, 2001 |                    | Year ended<br>December 31, 2000 |                    |
|-----------------|-----------------------------------|--------------------|---------------------------------|--------------------|---------------------------------|--------------------|
|                 | Gross <sup>(1)</sup>              | Net <sup>(2)</sup> | Gross <sup>(1)</sup>            | Net <sup>(2)</sup> | Gross <sup>(1)</sup>            | Net <sup>(2)</sup> |
| Oil             | 1                                 | 0.3                | —                               | —                  | 3                               | 1.1                |
| Natural Gas     | 3                                 | 2.2                | —                               | —                  | 2                               | 2.0                |
| Service         | —                                 | —                  | —                               | —                  | —                               | —                  |
| Dry & Abandoned | 3                                 | 1.6                | 1                               | 0.5                | 1                               | 0.5                |
| Total           | 7                                 | 4.1                | 1                               | 0.5                | 6                               | 3.6                |

Notes:

(1) "Gross" wells refers to all wells in which the Corporation has either a working interest or a royalty interest.

(2) "Net" wells refers to the aggregate of the percentage working interests of the Corporation in the gross wells, before the deduction of royalties.

## History - Daily Sales Volumes and Netbacks

The following tables set forth the daily sales volumes and netbacks to the Initial Properties on a quarterly basis for 2001 and 2000.

|                                   | <b>First Quarter<br/>2001</b> | <b>Second<br/>Quarter 2001</b> | <b>Third<br/>Quarter 2001</b> | <b>Fourth<br/>Quarter<br/>2001</b> | <b>Year 2001</b> |
|-----------------------------------|-------------------------------|--------------------------------|-------------------------------|------------------------------------|------------------|
| Production Volumes                |                               |                                |                               |                                    |                  |
| Oil and NGL (bpd)                 | 54                            | 124                            | 114                           | 98                                 | 97               |
| Gas (mcf)                         | 628                           | 676                            | 670                           | 553                                | 630              |
| Oil and NGL Netbacks (\$ per bbl) |                               |                                |                               |                                    |                  |
| Sale price                        | 44.13                         | 43.52                          | 39.87                         | 30.71                              | 39.13            |
| Royalty                           | 7.87                          | 10.16                          | 10.59                         | 7.58                               | 9.32             |
| Production expense <sup>(1)</sup> | 13.17                         | 11.69                          | 11.57                         | 13.33                              | 12.35            |
| Netback                           | 23.09                         | 21.67                          | 17.71                         | 9.80                               | 17.46            |
| Gas Netbacks (\$ per mcf)         |                               |                                |                               |                                    |                  |
| Sales price                       | 8.14                          | 5.85                           | 3.20                          | 2.86                               | 5.23             |
| Royalty                           | 1.35                          | 2.02                           | 1.24                          | 0.69                               | 1.39             |
| Production expense <sup>(1)</sup> | 0.83                          | 0.74                           | 0.65                          | 0.59                               | 0.71             |
| Netback                           | 5.96                          | 3.09                           | 1.31                          | 1.58                               | 3.13             |
|                                   |                               |                                |                               |                                    |                  |
|                                   | <b>First Quarter<br/>2000</b> | <b>Second<br/>Quarter 2000</b> | <b>Third<br/>Quarter 2000</b> | <b>Fourth<br/>Quarter<br/>2000</b> | <b>Year 2000</b> |
| Daily Sales Volumes               |                               |                                |                               |                                    |                  |
| Oil and NGL (bpd)                 | 68                            | 80                             | 79                            | 51                                 | 69               |
| Gas (mcf)                         | 1,649                         | 1,421                          | 591                           | 529                                | 1,043            |
| Oil and NGL Netbacks (\$ per bbl) |                               |                                |                               |                                    |                  |
| Sale price                        | 38.71                         | 39.94                          | 45.40                         | 46.79                              | 42.74            |
| Royalty                           | 1.66                          | 2.49                           | 4.31                          | 4.88                               | 3.28             |
| Production expense <sup>(1)</sup> | 10.91                         | 8.38                           | 9.11                          | 6.98                               | 9.00             |
| Netback                           | 26.14                         | 29.07                          | 31.98                         | 34.93                              | 30.46            |
| Gas Netbacks (\$ per mcf)         |                               |                                |                               |                                    |                  |
| Sales price                       | 3.26                          | 4.34                           | 4.94                          | 8.91                               | 4.59             |
| Royalty                           | 0.75                          | 1.18                           | 1.45                          | 2.24                               | 1.18             |
| Production expense <sup>(1)</sup> | 0.45                          | 0.31                           | 1.19                          | 0.51                               | 0.52             |
| Netback                           | 2.06                          | 2.85                           | 2.30                          | 6.16                               | 2.89             |

### Note:

- (1) Production expenses, which include all costs relating to lifting, gathering, transporting and processing, have been allocated to oil volumes for the Firebird area.

## Production History

The following table summarizes Richland's historical production from the Initial Properties, before deduction of royalties, during the three year period ended December 31, 2001 and Terraquest's historical production, before deduction of royalties, during the six months ended June 30, 2002.

|                           | Six Months<br>ended<br>June 30, 2002 | Years ended December 31, |       |      |
|---------------------------|--------------------------------------|--------------------------|-------|------|
|                           |                                      | 2001                     | 2000  | 1999 |
| Crude Oil and NGL (bblsd) | 105                                  | 98                       | 69    | 76   |
| Natural Gas (mcf)         | 542                                  | 630                      | 1,043 | 218  |
| Equivalent (boed)         | 195                                  | 203                      | 243   | 112  |

## Future Commitments

Terraquest has the following hedge commitments in place: (a) a fixed swap with respect to 50 bpd of crude oil at U.S.\$26.43/bbl WTI for the period from September 1, 2002 through August 31, 2003; (b) a fixed swap with respect to 1,000 GJ/d of natural gas at Cdn.\$4.72/GJ AECO for the period from October 1, 2002 through December 31, 2002; and (c) a fixed swap with respect to 1,500 GJ/d of natural gas at Cdn.\$5.09/GJ AECO for the period from November 1, 2002, through October 31, 2003.

## Acquisition of Approach Energy Ltd.

On August 2, 2002, Terraquest acquired all of the issued and outstanding securities of Approach for an aggregate purchase price of \$9.5 million plus the assumption of Approach's net debt of approximately \$1.5 million. Subsequent to the completion of the acquisition, Approach was amalgamated with the Corporation.

Approach was incorporated under the ABCA on April 10, 2000 and was engaged in the oil and gas business in the province of Alberta.

The Approach Properties include oil and natural gas and exploration properties located in the Iron Springs, Long Coulee, Robin, Birch, Medicine Hat and Retlaw areas of Alberta. More detailed information with respect to the Approach Properties is included under the heading "Business of the Corporation".

## Selected Approach Financial Information

The following table sets out certain Approach financial information as at and for the years ended December 31, 2001 and 2000 and as at and for the six months ended June 30, 2002 and 2001. The selected financial information has been derived from Approach's annual audited financial statements and from Approach's interim unaudited financial statements for the periods indicated. Interim results are not necessarily indicative of the results that may be expected for any other interim period or for a full year. Such financial statements are presented in Canadian dollars and are prepared in accordance with Canadian generally accepted accounting principles.

|                                          | Six Months Ended June 30, |           | Year Ended December 31, |                     |
|------------------------------------------|---------------------------|-----------|-------------------------|---------------------|
|                                          | 2002                      | 2001      | 2001                    | 2000 <sup>(1)</sup> |
| <b>Income Statement Items</b>            |                           |           |                         |                     |
| Gross Revenue                            | 2,140,310                 | 2,119,597 | 3,173,988               | 468,574             |
| Net income                               | 133,270                   | 854,422   | 583,450                 | 110,961             |
| <b>Cash Flow Statement Items</b>         |                           |           |                         |                     |
| Cash flow from operations <sup>(2)</sup> | 866,755                   | 1,205,398 | 1,626,988               | 264,938             |
| Capital expenditures, net                | 1,679,652                 | 1,520,402 | 3,270,585               | 1,732,151           |

|                                          | <b>Six Months Ended June 30,</b> |             | <b>Year Ended December 31,</b> |                            |
|------------------------------------------|----------------------------------|-------------|--------------------------------|----------------------------|
|                                          | <b>2002</b>                      | <b>2001</b> | <b>2001</b>                    | <b>2000 <sup>(1)</sup></b> |
| <b>Balance Sheet Items</b>               |                                  |             |                                |                            |
| Total assets                             | 5,637,484                        | N/A         | 4,677,654                      | 2,952,790                  |
| Working Capital <sup>(3)</sup>           | (1,197,137)                      | N/A         | (934,240)                      | 609,357                    |
| Long term debt including current portion | 650,000                          | N/A         | 100,000                        | —                          |
| Shareholders' equity                     | 2,983,898                        | N/A         | 2,849,713                      | 2,227,708                  |

**Notes:**

- (1) From incorporation on April 10, 2000.  
(2) Cash flow from operations is calculated as earnings plus non-cash expenses less non-cash income.  
(3) Working capital excludes the current portion of long-term debt.

**Selected Approach Operational Information**

The following table sets out certain Approach operating information regarding production for the years ended December 31, 2001 and 2000 and for the six months ended June 30, 2002. Interim results are not necessarily indicative of the results that may be expected for any other interim period or for a full year.

|                                      | <b>Six Months<br/>Ended<br/>June 20, 2002</b> | <b>Year Ended December 31,</b> |                            |
|--------------------------------------|-----------------------------------------------|--------------------------------|----------------------------|
|                                      |                                               | <b>2001</b>                    | <b>2000 <sup>(1)</sup></b> |
| <b>Production (before royalties)</b> |                                               |                                |                            |
| Crude oil and NGLs (bblsd)           | 47                                            | 50                             | 40                         |
| Natural Gas (mcf)                    | 3,035                                         | 1,340                          | 19                         |

**Note:**

- (1) From incorporation on April 10, 2000.

The following table sets out certain information regarding reserves associated with the Approach Properties as at August 1, 2002.

**Proven Reserves (before royalties) <sup>(1)</sup>**

|                           |       |
|---------------------------|-------|
| Crude oil and NGL (Mbbls) | 120   |
| Natural Gas (mmcf)        | 3,983 |

**Established Reserves: Total Proven and Restated****Probable Reserves (before royalties) <sup>(1)(2)</sup>**

|                           |       |
|---------------------------|-------|
| Crude oil and NGL (mbbls) | 142   |
| Natural gas (mmcf)        | 4,441 |

**Note:**

- (1) Reserves are based on escalating pricing as evaluated by McDaniel and GLJ in the Approach Reports.  
(2) Probable reserves have been reduced by 50 percent for risk.

### ***Effect of the Acquisition of Approach on Terraquest***

The following table sets out certain operational information for Terraquest and Approach and certain pro forma combined operational information after giving effect to the Arrangement and certain other adjustments.

#### ***Selected Pro Forma Combined Operational Information***

|                                                            | <b>Terraquest</b> | <b>Approach</b> | <b>Pro Forma Combined <sup>(2)</sup></b> |
|------------------------------------------------------------|-------------------|-----------------|------------------------------------------|
| <b>Average Daily Production</b>                            |                   |                 |                                          |
| (before royalties, for the six months ended June 30, 2002) |                   |                 |                                          |
| Crude oil and NGL (bbls/d)                                 | 105               | 47              | 152                                      |
| Natural gas (mcf)                                          | 542               | 3,035           | 3,577                                    |
| Oil equivalent (boed)                                      | 195               | 553             | 748                                      |
| <b>Proven Reserves <sup>(1)</sup></b>                      |                   |                 |                                          |
| (before royalties)                                         |                   |                 |                                          |
| Crude oil and NGL (mbbls)                                  | 148               | 120             | 268                                      |
| Natural gas (mmcf)                                         | 1,963             | 3,983           | 5,946                                    |
| Oil equivalent (mboe)                                      | 475               | 784             | 1,259                                    |
| <b>Established Reserves: Total Proven and Risked</b>       |                   |                 |                                          |
| <b>Probable Reserves <sup>(1)(2)</sup></b>                 |                   |                 |                                          |
| (before royalties)                                         |                   |                 |                                          |
| Crude oil and NGL (mbbls)                                  | 166               | 142             | 308                                      |
| Natural gas (mmcf)                                         | 2,107             | 4,441           | 6,548                                    |
| Oil equivalent (mboe)                                      | 517               | 882             | 1,399                                    |

#### **Notes:**

- (1) As at May 20, 2002 for Terraquest's properties before the Approach Acquisition and any other reserve additions subsequent to May 1, 2002 and as at August 1, 2002 for the Approach Properties.
- (2) Probable reserves have been reduced by 50 percent for risk.

#### ***Selected Pro Forma Consolidated Financial Information***

Certain selected pro forma consolidated financial information is set forth in the following table. Such information should be read in conjunction with the unaudited pro forma consolidated financial statements of Terraquest after giving effect to the Approach Acquisition as at and for the six months ended June 30, 2002 and the year ended December 31, 2001 included in this prospectus.

The pro forma adjustments are based upon the assumptions described in the notes to the unaudited pro forma consolidated financial statements. The pro forma consolidated financial statements are presented for illustrative purposes only and are not necessarily indicative of the operating or financial results that would have occurred had the Approach Acquisition actually occurred at the times contemplated by the notes to the unaudited pro forma consolidated financial statements.

|                           | <b>For the year Ended December 31, 2001</b> |                                |                                           |
|---------------------------|---------------------------------------------|--------------------------------|-------------------------------------------|
|                           | <b>Initial Properties <sup>(1)</sup></b>    | <b>Approach <sup>(2)</sup></b> | <b>Pro Forma Consolidated (unaudited)</b> |
| Revenue, net of royalties | 1,942,888                                   | 2,656,173                      | 4,599,061                                 |
| Operating costs           | 599,642                                     | 742,770                        | 1,342,412                                 |
| Net operating revenues    | 1,343,246                                   | 1,913,403                      | 3,256,649                                 |

|                                          | For the Six Months Ended June 30, 2002 |                         |                                       |
|------------------------------------------|----------------------------------------|-------------------------|---------------------------------------|
|                                          | Terraquest <sup>(1)</sup>              | Approach <sup>(2)</sup> | Pro Forma Consolidated<br>(unaudited) |
| Revenue, net of royalties                | \$ 786,888                             | 1,709,922               | 2,529,174                             |
| Operating costs                          | 362,468                                | 523,854                 | 898,517                               |
| Net operating revenues                   | 424,420                                | 1,186,068               | 1,630,657                             |
| Net income (loss)                        | (1,416,815)                            | 133,270                 | (1,719,376)                           |
| Cash flow from operations <sup>(3)</sup> | (29,139)                               | 866,755                 | N/A                                   |
| Total assets                             | 15,432,647                             | 5,637,484               | 30,888,807                            |
| Bank indebtedness                        | nil                                    | 650,000                 | 5,061,782                             |
| Equity                                   | 12,380,349                             | 2,983,898               | 17,450,349                            |

**Notes:**

- (1) Terraquest financial information was obtained from Terraquest's unaudited financial statements for the six months ended June 30, 2002.
- (2) Approach financial information was obtained from Approach's unaudited financial statements for the six months ended June 30, 2002.
- (3) Cash flow from operations is before changes in non-cash working capital.

**SELECTED FINANCIAL INFORMATION****Annual Information**

The following is a summary of selected financial information for Terraquest and for the Initial Properties for the periods indicated. The following information should be read in conjunction with the unaudited financial statements of the Corporation for the six months ended June 30, 2002, and the audited statement of revenue and operating expenses for the Initial Properties for the three years ended December 31, 2001, 2000 and 1999.

|                          | Six Months ended<br>June 30, 2002 <sup>(1)</sup><br>(unaudited) | Years ended December 31 <sup>(2)</sup> |                   |                   |
|--------------------------|-----------------------------------------------------------------|----------------------------------------|-------------------|-------------------|
|                          |                                                                 | 2001<br>(audited)                      | 2000<br>(audited) | 1999<br>(audited) |
| Oil and gas sales        | \$ 1,006,025                                                    | \$ 2,592,440                           | \$ 2,830,464      | \$ 954,413        |
| Royalties                | 219,137                                                         | 649,552                                | 533,609           | 175,169           |
| Operating costs          | 362,468                                                         | 599,642                                | 423,123           | 299,106           |
| Net operating income     | 424,420                                                         | 1,343,246                              | 1,873,732         | 480,138           |
| Loss before income taxes | (2,331,785)                                                     | —                                      | —                 | —                 |
| Net Loss                 | (1,416,815)                                                     | —                                      | —                 | —                 |
| Per Share <sup>(3)</sup> | (0.04)                                                          | —                                      | —                 | —                 |
| Total assets             | 15,432,647                                                      | —                                      | —                 | —                 |
| Long-term liabilities    | 119,398                                                         | —                                      | —                 | —                 |

**Notes:**

- (1) For this period, the information presented is contained in the interim unaudited financial statements of the Corporation for the six months ended June 30, 2002.
- (2) For these periods, the information presented is contained in the audited statement of revenue and operating expenses for the Initial Properties for the three years ended December 31, 2001, 2000 and 1999.
- (3) Basic and fully-diluted.

## Quarterly Information

The following is a summary of selected financial information of the Initial Properties for the periods indicated.

| (M\$)                               | Fiscal 2001<br>Quarter Ended |              |         |          |           |
|-------------------------------------|------------------------------|--------------|---------|----------|-----------|
|                                     | December 31                  | September 30 | June 30 | March 31 | Total     |
| Revenue before royalties            | 422,363                      | 610,594      | 845,518 | 713,965  | 2,592,440 |
| Net operating income <sup>(1)</sup> | 167,899                      | 262,106      | 431,246 | 481,995  | 1,343,246 |

| (M\$)                               | Fiscal 2000<br>Quarter Ended |              |         |          |           |
|-------------------------------------|------------------------------|--------------|---------|----------|-----------|
|                                     | December 31                  | September 30 | June 30 | March 31 | Total     |
| Revenue before royalties            | 659,202                      | 598,357      | 852,360 | 720,545  | 2,830,464 |
| Net operating income <sup>(1)</sup> | 470,008                      | 357,141      | 580,835 | 465,748  | 1,873,732 |

Note:

- (1) Net operating income is before general and administrative costs, interest, income and capital taxes or any provisions related to depletion, depreciation or future site restoration or site abandonments.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

### Six Months Ended June 30, 2002

Results include operations from January 16, 2002.

Terraquest's oil and gas sales averaged 190 boed in the second quarter and 195 boed for the first half of 2002. Natural gas sales averaged 507 mcf in the second quarter and 542 mcf for the first six months of 2002, and crude oil and NGL sales averaged 105 bopd for both periods. In northwest Alberta, a Slave Point well which averaged 95 boepd net to the Corporation since January 15, 2002, has been shut in since May 15, 2002 while battery modifications are completed by the operator. The well is anticipated to be on-stream by the end of September. In addition, increasing water cuts led to reduced volumes at the Bow Island gas property in Southern Alberta during the quarter.

Strong crude oil prices resulted in gross revenues of \$579,047 for the second quarter of 2002 and \$1,006,025 for the first six months. Terraquest's average wellhead sales price of crude oil for the six month period was \$36.73 per barrel, and the \$3.93 per mcf for natural gas.

Royalties were \$99,946 in the second quarter and \$219,137 or 21.8% of sales in the first six months of 2002. Royalty rates include all overriding royalties payable. Operating expenses were \$232,079 or \$13.44 per boe for the quarter and \$362,468 or \$11.20 per boe for the first six months of 2002, as production was minimal during this start-up period. Operating costs per boe will decrease as the shut-in production comes on stream and the lower operating cost Approach Properties are added.

General and administrative expenses were \$251,983 for the second quarter and \$482,960 for the first six months of 2002. Depletion and depreciation expense for the first half was \$2,257,598, which includes a \$1,815,000 ceiling test writedown at June 30, 2002. The ceiling test writedown reflects the relatively high cost base transferred to Terraquest from Richland and lower natural gas prices at the end of June. Future taxes reflect a recovery of \$918,720, as a result of the loss recorded for the period. Terraquest has approximately \$12.0 million of tax pools available to shelter future income.

Cash flow from operations for the second quarter was \$20,358 or \$nil per share, while the six month total was a deficiency of \$29,139 or \$nil per share. The Corporation incurred a net loss during this six month start-up period of \$1,416,815 or \$0.04 per share and a net loss of \$1,232,283 or \$0.03 per share in the second quarter, as administrative and depletion charges, including the

ceiling test writedown, were greater than the cash flow from the modest production base acquired. As new production is added during the year and the recently completed Approach Acquisition is included in the results, this situation is expected to change.

Net capital expenditures for the second quarter were \$1,428,363, bringing total capital spending for the six months to \$2,589,670. Terraquest had net working capital of \$1,715,895 at the end of the period to fund future capital programs.

The weighted average shares outstanding were 34.4 million basic and diluted year to date. There are currently 53.5 million shares and 3.0 million stock options outstanding, assuming the issuance of the 11 million Common Shares issuable on exercise of the Special Warrants.

### **Liquidity and Capital Resources**

Terraquest is in a unique position as a newly established full cycle exploration and development company, with an asset base of approximately 83,000 net acres of undeveloped land and current production of approximately 850 boed in Alberta. The key to Terraquest's growth will be the successful exploration and development of its large land position. These lands provide Terraquest with a strong inventory of exploration and development prospects to fuel the Corporation's growth.

Terraquest's total capital costs for the balance of 2002 are estimated to be approximately \$2.5 million which will be funded from the Corporation's working capital of approximately \$1.7 million at June 30, 2002, cash flow and the Corporation's revolving term credit facility.

Terraquest is on solid financial footing to continue the exploration and development of its extensive asset base in Alberta, leveraging its land and seismic base into promoted deals wherever possible. New projects will focus on natural gas and light oil, with joint venture partners reducing Terraquest's risk exposure to acceptable levels.

Other than hedge transactions entered into to limit Terraquest's exposure to fluctuations in oil and natural gas prices, the Corporation does not have any financial instruments outstanding. See "Future Commitments". The Corporation's current policy is to hedge up to 50% of its estimated net production and to endeavour to mitigate counterparty credit risk, to the extent practicable, by undertaking counterparty credit reviews and diversifying its counterparty exposure.

### **USE OF PROCEEDS**

The Corporation raised gross proceeds from the issuance of the Special Warrants of \$5,500,000 (before deducting the Underwriters' fee of \$330,000 and the expenses of the issuance of the Special Warrants and the qualification for distribution of the Qualified Shares, estimated to be \$100,000, which will be paid out of the general funds of the Corporation). The Corporation will not receive any cash proceeds upon the exercise of the Special Warrants. All of the net proceeds from the financing were used to fund a portion of the purchase price for the Approach Acquisition. See "Business of the Corporation — Information Respecting Approach Energy Inc.".

## CAPITALIZATION

The following table outlines the capitalization of the Corporation as at the dates noted.

|                                      |           | Outstanding<br>as at<br>December 31, 2001<br>(audited) | Outstanding<br>as at<br>June 30, 2002<br>(unaudited) | Outstanding<br>as at<br>August 31, 2002<br>(unaudited) | Outstanding<br>as at<br>August 31, 2002<br>after giving<br>effect to the<br>Exercise of<br>Special<br>Warrants <sup>(5)</sup><br>(unaudited) |
|--------------------------------------|-----------|--------------------------------------------------------|------------------------------------------------------|--------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Debt:</b>                         |           |                                                        |                                                      |                                                        |                                                                                                                                              |
| Bank Loan <sup>(1)</sup>             |           | \$nil                                                  | \$ nil                                               | \$ 4,650,000                                           | \$ 4,650,000                                                                                                                                 |
| <b>Share Capital:</b> <sup>(2)</sup> |           |                                                        |                                                      |                                                        |                                                                                                                                              |
| Common Shares <sup>(3)</sup>         | Unlimited | \$1.00<br>(1 share)                                    | \$ 13,797,164<br>(42,512,252<br>shares)              | \$ 13,797,164<br>(42,512,252<br>shares)                | \$ 18,867,164<br>(53,512,252<br>shares)                                                                                                      |

Notes:

- (1) The Corporation has a revolving demand credit facility with a Canadian chartered bank in the amount of \$6,000,000. The facility may be drawn down or repaid at any time and bears interest at the bank's prime rate plus one-half of one percent. Security for the facility includes a general assignment of book debts and a \$10 million demand debenture secured by a first floating charge over all assets. The bank also has the right to require fixed charge security at its discretion. The facility will revolve until January 1, 2003, at which time an interim review of the facility will occur. The Corporation is required to meet certain financial based covenants to maintain the facility.
- (2) The Corporation is authorized to issue an unlimited number of Common Shares and an unlimited number of First Preferred Shares and Second Preferred Shares, issuable in series. At the date referred to in this table, there were no Preferred Shares outstanding.
- (3) Terraquest has a stock option plan which permits the issuance of stock options to acquire up to 3,750,000 Common Shares. As at August 31, 2002, 2,972,000 Common Shares were reserved for issuance under the plan at exercise prices ranging from \$0.24 to \$0.48. See "Stock Option Plan".
- (4) As at June 30, 2002, the Corporation's deficit was \$1,416,815 and provision for future site restoration was \$119,398.
- (5) Share capital is net of Underwriters' fees and other expenses related to the offering of Special Warrants.

## DESCRIPTION OF SHARE CAPITAL

The following is a summary of the rights, privileges, restrictions and conditions attaching to the Common Shares and preferred shares of the Corporation. No preferred shares are presently issued and outstanding.

### Common Shares

The Corporation is authorized to issue an unlimited number of Common Shares without nominal or par value. The Common Shares rank junior to the preferred shares. Holders of Common Shares are entitled to one vote per share at meetings of shareholders of the Corporation, to receive dividends if, as and when declared by the Board and to receive pro rata the remaining property and assets of the Corporation upon its dissolution or winding-up, subject to the rights of shares having priority over the Common Shares.

### First Preferred Shares

The First Preferred Shares are issuable in series and will have such rights, restrictions, conditions and limitations as the Board may from time to time determine. No First Preferred Shares have been issued.

The Corporation is authorized to issue an unlimited number of First Preferred Shares without nominal or par value. Holders of First Preferred Shares are not entitled to vote at meetings of the shareholders of the Corporation. Holders of First Preferred

Shares are entitled to receive dividends if, as and when declared by the Board, in priority to holders of Common Shares and Second Preferred Shares. In the event of a liquidation, dissolution or winding-up of the Corporation, holders of the First Preferred Shares are entitled to receive a rateable share of all distributions made in priority to the holders of the Common Shares.

### **Second Preferred Shares**

The Second Preferred Shares are issuable in series and will have such rights, restrictions, conditions and limitations as the Board may from time to time determine. No Second Preferred Shares have been issued.

The Corporation is authorized to issue an unlimited number of Second Preferred Shares without nominal or par value. Holders of Second Preferred Shares are not entitled to vote at meetings of the shareholders of the Corporation. Holders of Second Preferred Shares are entitled to receive dividends if, as and when declared by the Board subject to the priority of First Preferred Share but, in priority to holders of Common Shares. In the event of a liquidation, dissolution or winding-up of the Corporation, holders of the Second Preferred Shares are entitled to receive a rateable share of all distributions made, subject to the preference of holders of First Preferred Shares but in priority to holders of Common Shares.

### **Dividend Policy**

The Corporation has not declared or paid any dividends on its Common Shares since its incorporation. Any decision to pay dividends on the Common Shares will be made by the Board on the basis of the Corporation's earnings, financial requirements and other conditions existing at such future time.

### **Prior Sales**

On November 22, 2001, the Corporation issued one Common Share to Richland at a price of \$1.00 to facilitate its organization.

On January 16, 2002, 27,893,117 Common Shares were issued to Richland and subsequently distributed by Richland to former shareholders of Richland pursuant to the Purchase and Sale Agreement and the Arrangement Agreement.

On February 8, 2002, the Corporation closed a private placement of 6,723,670 Common Shares at a price of \$0.20 per share and 2,765,464 "flow-through" Common Shares at a price of \$0.25 per share, for aggregate proceeds of \$2,036,100.

On May 14, 2002, the Corporation closed a private placement of 5,130,000 special warrants at a price of \$0.50 per special warrant, for aggregate proceeds of \$2,565,000. The special warrants were subsequently exchanged for 5,130,000 Common Shares.

### **PRICE RANGE AND TRADING VOLUME**

The Common Shares have been listed and posted for trading on the TSX under the trading symbol "TRQ" since February 1, 2002. The following table sets forth the reported high and low sales prices and the trading volumes for the Common Shares for the periods indicated as reported by the TSX.

|                                  | <b>High</b> | <b>Low</b> | <b>Volume</b> |
|----------------------------------|-------------|------------|---------------|
| February (from February 1).....  | \$ 0.48     | \$ 0.20    | 16,335,645    |
| March .....                      | 0.55        | 0.39       | 5,555,972     |
| April .....                      | 0.65        | 0.48       | 4,110,022     |
| May .....                        | 0.65        | 0.46       | 1,943,126     |
| June .....                       | 0.64        | 0.52       | 989,345       |
| July .....                       | 0.54        | 0.45       | 666,243       |
| August .....                     | 0.53        | 0.45       | 406,191       |
| September (to September 18)..... | 0.50        | 0.40       | 373,000       |

On July 18, 2002, being the day of negotiation of the issue price of the Special Warrants, the closing price of the Common Shares on the TSX was \$0.50. On September 18, 2002, being the last day on which the Common Shares traded prior to the date of this prospectus, the closing price of the Common Shares on the TSX was \$0.42.

### DIRECTORS AND OFFICERS

The name, municipality of residence and principal occupation of each of the directors and senior officers of Terraquest are as follows:

| <b>Name and Municipality of Residence</b>                  | <b>Positions with Terraquest <sup>(1)</sup></b>                  | <b>Principal Occupation</b>                                                                                                                                                                                                                                                                                                                                                                                 |
|------------------------------------------------------------|------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Kerry D. Lyons<br>Calgary, Alberta                         | President and Chief Executive Officer and Director               | President and Chief Executive Officer of Terraquest since January 16, 2002. Prior thereto, President and Chief Executive Officer of Richland (oil and gas company) from March, 1999 and prior thereto Executive Vice President and Chief Operating Officer of Richland from November, 1997. Prior thereto Mr. Lyons was Vice President, Engineering at Newport Petroleum Corporation (oil and gas company). |
| R. James Brown<br>Calgary, Alberta                         | Vice President, Finance and Chief Financial Officer and Director | Vice-President, Finance and Chief Financial Officer of Terraquest since January 16, 2002. Prior thereto, Vice-President, Finance and Chief Financial Officer of Richland (oil and gas company) from 1997 to January, 2002. From 1995 to 1997 Mr. Brown was Vice President of Finance and Chief Financial Officer of Dorset Exploration Ltd. (oil and gas company)                                           |
| Robert G. Puchniak <sup>(2)(3)</sup><br>Winnipeg, Manitoba | Chairman and Director                                            | Executive Vice President and Chief Financial Officer of James Richardson & Sons, Limited (private investment and holding company) since 2001 and prior thereto Vice President, Finance and Investment of James Richardson & Sons, Limited since 1996.                                                                                                                                                       |
| Lorenzo Donadeo <sup>(2)(3)</sup><br>Calgary, Alberta      | Director                                                         | Executive Vice President and Chief Operating Officer of Vermillion Resources Ltd. (oil and gas company) since December, 2000 and prior thereto Executive Vice President of Vermillion Resources Ltd. from February, 1995.                                                                                                                                                                                   |
| Bill Maslechko <sup>(2)(3)</sup><br>Calgary, Alberta       | Director                                                         | Partner, Burnet, Duckworth & Palmer LLP (law firm).                                                                                                                                                                                                                                                                                                                                                         |
| Tim F. Jerhoff<br>Calgary, Alberta                         | Vice President, Engineering                                      | Vice President, Engineering of Terraquest since January 16, 2002. Prior thereto, Vice President, Engineering and Corporate Development of Richland (oil and gas company) from April, 1999 and prior thereto Manager, Exploitation at Richland from December, 1997.                                                                                                                                          |

| <b>Name and Municipality of Residence</b> | <b>Positions with Terraquest <sup>(1)</sup></b> | <b>Principal Occupation</b>                                                                                                                                                                                                                                                                         |
|-------------------------------------------|-------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| John S. Kanderka<br>Calgary, Alberta      | Vice President, Land                            | Vice President, Land of Terraquest since January 16, 2002. Prior thereto, Vice President, Land of Richland (oil and gas company) since 1998 and prior thereto Land Manager with Dorset Exploration Ltd. (oil and gas company) and Vice President, Land of Baytex Energy Ltd. (oil and gas company). |

Notes:

- (1) All of the directors of Terraquest have been appointed to hold office until the next annual general meeting of shareholders or until their successor is duly elected or appointed, unless their office is earlier vacated. Mr. Lyons has been a director of the Corporation since November 22, 2001 and Messrs. Brown, Puchniak, Donadeo and Maslechko have been directors of the Corporation since January 9, 2002.
- (2) Member of the Audit Committee.
- (3) Member of the Compensation Committee.

Assuming the exercise of all Special Warrants, the number of Common Shares beneficially owned, directly or indirectly, by James Richardson & Sons, Limited and all of the directors, officers of the Corporation is 13,868,968 Common Shares, being approximately 25.9% of the issued and outstanding Common Shares.

## PERSONNEL

As at the date of this prospectus, Terraquest has seven full-time employees, all of whom are located at its office in Calgary.

## PRINCIPAL SHAREHOLDERS

To the best of the knowledge of the directors and officers of the Corporation, the only person that owns, directly or indirectly, or exercises control or direction over Common Shares carrying more than 10% of the votes attached to all of the issued and outstanding Common Shares of the Corporation is:

| <b>Name and Address of Shareholder</b>                 | <b>Type of Ownership</b> | <b>Number of Common Shares Owned</b>       |                                           | <b>Percentage of Common Shares</b>         |                                           |
|--------------------------------------------------------|--------------------------|--------------------------------------------|-------------------------------------------|--------------------------------------------|-------------------------------------------|
|                                                        |                          | <b>Before Exercise of Special Warrants</b> | <b>After Exercise of Special Warrants</b> | <b>Before Exercise of Special Warrants</b> | <b>After Exercise of Special Warrants</b> |
| James Richardson & Sons, Limited<br>Winnipeg, Manitoba | Beneficial               | 6,965,000                                  | 8,965,000                                 | 16.4%                                      | 16.8%                                     |

## COMPENSATION OF EXECUTIVE OFFICERS AND DIRECTORS

To date, Terraquest has not completed a fiscal year of operations.

There are no employment contracts between Terraquest and any of the executive officers of the Corporation.

Terraquest has entered into "change in control agreements" with each of its executive officers which provide that if a change in control of the Corporation occurs and their employment is subsequently terminated (other than for "just cause") or they elect to terminate their employment within 90 days of the date of change in control, they are entitled to be paid a severance payment based upon the officer's salary, benefits and bonus. In each case the officer is entitled to a 12 month severance payment (24 months in the case of the Chief Executive Officer).

The Corporation has no retirement plans, pension plans or other forms of retirement compensation for its employees.

Directors are not paid annual retainer fees or for attendance at board or committee meetings but are entitled to be reimbursed for all reasonable expenses incurred in order to attend such meetings. Directors are entitled to participate in the Corporation's stock option plan and each of the directors who is not also an employee of the Corporation has been granted options to purchase 75,000 Common Shares at an exercise price of \$0.24 and options to purchase 15,000 Common Shares at an exercise price of \$0.45. See "Stock Option Plan".

## CANADIAN FEDERAL INCOME TAX CONSIDERATIONS

In the opinion of Burnet, Duckworth & Palmer LLP, counsel to the Corporation, the following is a summary of the principal Canadian federal income tax consequences generally applicable to persons who have acquired Special Warrants pursuant to the Special Warrant Indenture and who will acquire and dispose of Common Shares issuable on the exercise of the Special Warrants and who, for the purposes of the Tax Act and at all relevant times, are resident in Canada, hold such Special Warrants and Common Shares as capital property, and deal at arm's length and are not affiliated with the Corporation. The Special Warrants and Common Shares will generally be considered capital property to the holder thereof unless either the holder holds the Special Warrants and the Common Shares in the course of carrying on a business or the holder has acquired the Special Warrants and Common Shares in a transaction or transactions considered to be, individually or collectively, an adventure in the nature of trade.

This summary is based upon the current provisions of the Tax Act, counsel's understanding of the current published administrative practices of the CCRA and proposed amendments to the Tax Act publicly announced by the Minister of Finance (Canada) prior to the date hereof (the "**Proposed Amendments**"). This summary assumes that the Proposed Amendments will be enacted as proposed but does not take into account or anticipate any other changes in law, whether by way of judicial, legislative or governmental decision or action, nor does it take into account provincial, territorial or foreign income tax considerations. No assurances can be given that the Proposed Amendments will be enacted as proposed, if at all, or that legislative, judicial or administrative changes will not modify or change the statements expressed herein. No application has been made to the CCRA for an advance income tax ruling with respect to this offering.

This summary does not apply to holders that are "financial institutions" within the meaning of the "mark-to-market" rules contained in the Tax Act, or who, at any time, have an "at-risk adjustment" as defined in the Tax Act.

The Canadian federal income tax consequences of a particular holder will vary depending on a number of factors. **The following discussion of the income tax consequences is of a general nature only and is not exhaustive of all the income tax consequences and is not intended to constitute income tax advice to any particular holder. Accordingly, holders should consult their own income tax advisors with respect to the Canadian federal income tax consequences which will result from holding Special Warrants and acquiring, holding and disposing of Common Shares issuable on the exercise of the Special Warrants.**

### Exercise or Disposition of Special Warrants

An original holder of a Special Warrant will have a cost for tax purposes equal to the amount paid for such Special Warrant (plus any related acquisition costs). A holder will not realize a gain or loss upon the exercise or deemed exercise of Special Warrants to acquire Common Shares. The cost for tax purposes of Common Shares acquired pursuant to the exercise of the Special Warrants will generally be equal to the tax cost of such Special Warrants. In computing the adjusted cost base of a holder's Common Shares acquired pursuant to the exercise of the Special Warrants, the cost of such Common Shares must be averaged with the cost of any other Common Shares of the Corporation held as capital property at that time.

A disposition or deemed disposition of Special Warrants (other than on the exercise of such Special Warrants) will result in the realization of a capital gain (or capital loss) in the taxation year of the disposition to the extent the proceeds of disposition exceed (or are exceeded by) the aggregate of the adjusted cost base of such Special Warrants, net of any reasonable disposition costs.

### Disposition of Common Shares

Any disposition or deemed disposition (other than to the Corporation) of Common Shares will result in the realization of a capital gain (or capital loss) in the taxation year of the disposition to the extent the proceeds of disposition exceed (are exceeded by) the aggregate of the adjusted cost base of such Common Shares, net of any reasonable disposition costs.

### **Taxation of Capital Gains (Capital Losses)**

A holder will generally be required to include one-half of the amount of any capital gain (a "taxable capital gain") in income and will be required to deduct one-half of the amount of any resulting capital loss (an "allowable capital loss") against taxable capital gains. Allowable capital losses not deducted in the taxation year in which they are realized may generally be carried back and deducted in any of the three preceding taxation years or carried forward and deducted in any following taxation year against taxable capital gains realized in such years, to the extent and under the circumstances specified in the Tax Act.

A capital loss otherwise realized by a holder which is a corporation on the disposition of a Common Share may be reduced to the extent the holder has received dividends deductible in computing taxable income on the share or another share for which such share was exchanged, to the extent and under the circumstances prescribed in the Tax Act. Similar rules may apply where shares are owned by a trust or partnership of which a corporation, trust or partnership is a beneficiary or member.

A holder that is, throughout the relevant year, a "Canadian-controlled private corporation" as defined in the Tax Act may be liable to pay, in addition to the tax otherwise payable under the Tax Act, a refundable tax of 6-2/3% determined by reference to its aggregate investment income for the year, which is defined to include an amount in respect of taxable capital gains.

### **Eligibility for Investment**

Provided that the Common Shares are listed on a prescribed stock exchange at the relevant time, then the Common Shares when issued will be qualified investments, within the meaning of the Tax Act, for trusts governed by registered retirement savings plans, registered education savings plans, registered retirement income funds and deferred profit sharing plans, and will not constitute "foreign property" under the Tax Act and the regulations thereunder.

### **INDEBTEDNESS OF DIRECTORS AND OFFICERS**

At no time since incorporation was there any indebtedness of any director or officer, or any associate of any such director or officer, to the Corporation or to any other entity which is, or at any time since the beginning of the most recently completed financial period has been, the subject of a guarantee, support agreement, letter of credit or other similar arrangement or understanding provided by the Corporation.

### **STOCK OPTION PLAN**

Terraquest has an incentive Common Share option plan (the "Stock Option Plan"). The purpose of the Stock Option Plan is to afford persons who provide services to the Corporation, whether as directors, officers, employees or consultants, an opportunity to obtain a proprietary interest in the Corporation by permitting them to purchase Common Shares and to aid in attracting as well as retaining and encouraging the continued involvement of such persons with the Corporation. The total number of shares issuable under the Stock Option Plan is 3,750,000 Common Shares.

Under the Stock Option Plan, stock options ("Options") may be issued to directors, officers, employees of, and consultants to, the Corporation in such numbers and with vesting provisions as the Board may determine. The exercise price of Options shall not be less than the "market price" of the Common Shares. For purposes of the Stock Option Plan, "market price" means the closing price of the Common Shares on the stock exchange on which the shares are listed and posted for trading at the time of the grant or, if the Common Shares are not then listed and posted for trading on any stock exchange, the exercise price shall be determined by the Board in its sole discretion. The maximum term for Options is ten years.

The Stock Option Plan provides that any Options shall terminate on the date the optionee ceases to be an employee, director or officer of, or consultant to, the Corporation provided that if such termination is as a result of death of the optionee, the optionee's personal representative shall have six months to exercise such Options and further provided that if the optionee has ceased to be an employee, director or officer of, or consultant to, the Corporation for any reason, other than for cause, the optionee shall have 90 days to exercise the Options.

At no time will any one person be entitled to Options exceeding five percent of the issued and outstanding Common Shares. Furthermore, Options granted to insiders of the Corporation within a one year period will not exceed ten percent of the issued and

outstanding Common Shares and Options granted to any one insider and such insider and its associates within a one year period will not exceed five percent of the issued and outstanding Common Shares.

The following table sets forth information with respect to the Options outstanding under the Stock Option Plan on the date hereof.

| Group                     | Date Options Granted | Shares Under Option | Exercise Price | Closing Price One Day Prior to Grant | Expiry Date      | Market Value of Options <sup>(1)</sup> |
|---------------------------|----------------------|---------------------|----------------|--------------------------------------|------------------|----------------------------------------|
| Executive Officers (four) | February 7, 2002     | 1,550,000           | \$ 0.24        | \$ 0.235                             | January 16, 2007 | \$ 279,000                             |
|                           | August 19, 2002      | 350,000             | \$ 0.45        | \$ 0.45                              | August 19, 2007  | \$ nil                                 |
| Directors (three)         | February 7, 2002     | 225,000             | \$ 0.24        | \$ 0.235                             | January 16, 2007 | \$ 40,500                              |
|                           | August 19, 2002      | 45,000              | \$ 0.45        | \$ 0.45                              | August 19, 2007  | \$ nil                                 |
| Employees (five)          | February 7, 2002     | 485,000             | \$ 0.24        | \$ 0.235                             | January 16, 2007 | \$ 87,300                              |
|                           | May 8, 2002          | 25,000              | \$ 0.48        | \$ 0.480                             | May 8, 2007      | \$ nil                                 |
|                           | August 19, 2002      | 292,000             | \$ 0.45        | \$ 0.45                              | August 19, 2007  | \$ nil                                 |

Note:

- (1) Based on the difference between the closing price of \$0.42 per Common Shares on the TSX on September 18, 2002 and the exercise price of the Option multiplied by the number of Common Shares under the Option.

### PLAN OF DISTRIBUTION

This prospectus is being filed in the Filing Provinces to qualify the distribution of the Qualified Shares to be issued upon the exercise of the Special Warrants. All of the issued and outstanding Special Warrants are fully-paid and non-assessable and the Qualified Shares, or the Common Shares in the event that the Special Warrants are exercised prior to the issuance of a receipt for a final prospectus, issuable upon the exercise of the Special Warrants will, when issued, be fully-paid and non-assessable.

On the Closing Date, Terraquest completed a private placement of 11,000,000 Special Warrants pursuant to prospectus exemptions under applicable securities legislation through the Underwriters in accordance with the Underwriting Agreement. Pursuant to the Underwriting Agreement, the Underwriters agreed to act as, and the Corporation appointed the Underwriters as, sole and exclusive agents of the Corporation to offer the Special Warrants in the Filing Provinces on a private placement basis at a price of \$0.50 per Special Warrant. The Underwriters sold the Special Warrants as agents and, except for 200,000 Special Warrants purchased by Peters & Co. Limited as principal, presently do not hold any Special Warrants. Pursuant to the Underwriting Agreement, Terraquest has paid a fee of \$330,000 to the Underwriters. The Underwriters will receive no other fees in connection with the distribution of the Qualified Shares under this prospectus. The offering price of the Special Warrants was determined by negotiation between the Corporation and the Underwriters.

Terraquest has agreed that, subject to certain exceptions, until November 28, 2002, it will not offer, or announce the offering of, or make or announce any agreement to issue, sell, or exchange Common Shares or securities convertible or exchangeable into Common Shares without the prior written consent of Griffiths McBurney & Partners, which consent shall not be unreasonably withheld.

The Special Warrants were issued pursuant to the Special Warrant Indenture. Since the date of issuance, no Special Warrants have been exercised. Each Special Warrant entitles the holder to acquire, at no additional cost, one Qualified Share of Terraquest at any time until 5:00 p.m. (Calgary time) on the earlier of: (i) five (5) Business Days after the Final Receipt Date; and (ii) the first anniversary of the Closing Date (the first of such events to occur is hereinafter referred to as the "**Expiry Time**").

The TSX has conditionally approved the listing of the Qualified Shares subject to the Corporation fulfilling all of the requirements of such exchange.

In the event that a receipt for this prospectus is not obtained by the Corporation on or prior to the Qualification Deadline from the Canadian securities regulatory authority in each of the Filing Provinces, then each holder of Special Warrants in the Filing Provinces in which a receipt has not been obtained (or, if a receipt has not been obtained in the provinces of Alberta or Ontario, all holders wherever resident) shall be entitled after the Qualification Deadline to receive on the exercise of the Special Warrants

an additional 0.15 of a Common Share for each such Special Warrant so exercised without additional payment. This prospectus also qualifies the distribution of the additional 0.15 of a Common Share per Special Warrant in the event that such shares are issued. Special Warrants not previously exercised by the holders thereof shall be deemed to be exercised immediately prior to the Expiry Time without further action on the part of the holder. The Corporation will continue to use its best efforts to obtain a receipt for this prospectus from the Canadian securities regulatory authority in each Filing Province where a receipt for this prospectus is not obtained on or before the Qualification Deadline.

**Any Common Shares issued in exchange for Special Warrants exercised on or after the Closing Date and prior to the Final Receipt Date will be subject to relevant hold periods under applicable securities legislation.**

Holders of Special Warrants who wish to exercise the Special Warrants held by them in order to acquire Common Shares hereunder should complete the exercise form attached to the Special Warrant certificate and deliver the certificates and the executed exercise forms to the Trustee at its principal office in Calgary, Alberta. The Special Warrants represented by a Special Warrant certificate shall be deemed to be surrendered only upon personal delivery of the certificate or, if sent by mail or other means of transmission, upon actual receipt thereof by the Trustee at the office referred to above.

The Special Warrant Indenture provides that in the event of certain alterations of the Common Shares, including any subdivision, consolidation or reclassification, and in the event of any form of reorganization of the Corporation, including any amalgamation, merger or arrangement, an adjustment shall be made to the terms of the Special Warrants such that the holders shall, upon exercise of the Special Warrants following the occurrence of any of those events, be entitled to receive the same number and kind of securities that they would have been entitled to receive had they exercised their Special Warrants prior to the occurrence of those events. The holding of Special Warrants does not constitute the holder thereof a shareholder of the Corporation or entitle the holder to any right or interest in respect thereof except as expressly provided in the Special Warrant Indenture.

The Special Warrant Indenture provides that all holders of Special Warrant certificates shall be bound by any resolution passed at a meeting of the holders of Special Warrants held in accordance with the provisions of the Special Warrant Indenture and resolutions signed by the holders of Special Warrants entitled to acquire a specified majority of the Common Shares which may be acquired pursuant to all the then outstanding Special Warrant certificates.

The Qualified Shares offered hereby have not been and will not be registered under the *United States Securities Act of 1933*, as amended, (the "**U.S. Securities Act**"). Accordingly, the Qualified Shares may not be offered or sold within the United States except in certain transactions exempt from the registration requirements of the U.S. Securities Act. In addition, until 40 days after the commencement of this offering, any offer or sale of the Qualified Shares offered hereby within the United States by any dealer (whether or not participating in this offering) may violate the registration requirements of the U.S. Securities Act if such offer or sale is made otherwise than in accordance with Rule 144A under the U.S. Securities Act.

The name and address for service of Griffiths McBurney & Partners' agent for service of process in the Province of Ontario is 1100, 145 King Street, Toronto, Ontario, M5H 1J8.

## **RISK FACTORS**

**The securities qualified hereby should be considered highly speculative due to the nature of the Corporation's business and the present stage of its development. A prospective investor should consider carefully the risk factors set out below. In addition, prospective investors should carefully review and consider all other information contained in this prospectus before making an investment decision. An investment in securities of the Corporation should only be made by persons who can afford a significant or total loss of their investment.**

Oil and gas operations involve many risks which even a combination of experience and knowledge and careful evaluation may not be able to overcome. The long-term commercial success of the Corporation depends on its ability to find, acquire, develop and commercially produce oil and natural gas reserves. Without the continual addition of new reserves, any existing reserves the Corporation may have at any particular time and the production therefrom will decline over time as such existing reserves are exploited. A future increase in the Corporation's reserves will depend not only on the Corporation's ability to explore and develop any properties it may have from time to time, but also on its ability to select and acquire suitable producing properties or prospects. No assurance can be given that the Corporation will be able to continue to locate satisfactory properties for acquisition or participation. Moreover, if such acquisitions or participations are identified, the Corporation may determine that current

markets, terms of acquisition and participation or pricing conditions make such acquisitions or participations uneconomic. There is no assurance that further commercial quantities of oil and natural gas will be discovered or acquired by the Corporation.

Future oil and gas exploration may involve unprofitable efforts, not only from dry wells, but from wells that are productive but do not produce sufficient net revenues to return a profit after drilling, operating and other costs. Completion of a well does not assure a profit on the investment or recovery of drilling, completion and operating costs. In addition, drilling hazards or environmental damage could greatly increase the cost of operations, and various field operating conditions may adversely affect the production from successful wells. These conditions include delays in obtaining governmental approvals or consents, shut-ins of connected wells resulting from extreme weather conditions, insufficient storage or transportation capacity or other geological and mechanical conditions. While diligent well supervision and effective maintenance operations can contribute to maximizing production rates over time, production delays and declines from normal field operating conditions cannot be eliminated and can be expected to adversely affect revenue and cash flow levels to varying degrees.

The petroleum industry is competitive in all its phases. Terraquest competes with numerous other participants in the search for the acquisition of oil and natural gas properties and in the marketing of oil and natural gas. Terraquest's competitors include oil and gas companies which have substantially greater financial resources, staff and facilities than those of Terraquest. Terraquest's ability to increase reserves in the future will depend not only on its ability to explore and develop its present properties, but also on its ability to select and acquire suitable producing properties or prospects for exploratory drilling. Competitive factors in the distribution and marketing of oil and natural gas include price and methods and reliability of delivery.

Oil and natural gas operations (exploration, production, pricing, marketing and transportation) are subject to extensive controls and regulations imposed by various levels of government which may be amended from time to time. See "Industry Conditions". The operations of the Corporation may require licenses from various governmental authorities. There can be no assurance that the Corporation will be able to obtain all necessary licenses and permits that may be required to carry out exploration and development at its projects.

Canada's Prime Minister has announced that he will call for ratification by Canada of the Kyoto Protocol by the end of 2002. This protocol calls for Canada to reduce its greenhouse gas emissions to 6 percent below 1990 levels during the period between 2008 and 2012. The Protocol will only become legally binding when it is ratified by at least 55 countries, covering at least 55 percent of the emissions addressed by the Protocol. If the Protocol is ratified and becomes legally binding, it is expected to affect the operation of all industries in Canada, including the oil and gas industry. As details of the implementation of this Protocol have yet to be announced, the effect on Terraquest cannot be determined at this time.

All phases of the oil and natural gas business present environmental risks and hazards and are subject to environmental regulation pursuant to a variety of federal, provincial and local laws and regulations. Environmental legislation provides for, among other things, restrictions and prohibitions on spills, releases or emissions of various substances produced in association with oil and gas operations. The legislation also requires that wells and facility sites be operated, maintained, abandoned and reclaimed to the satisfaction of applicable regulatory authorities. Compliance with such legislation can require significant expenditures and a breach may result in the imposition of fines and penalties, some of which may be material. Environmental legislation is evolving in a manner expected to result in stricter standards and enforcement, larger fines and liability and potentially increased capital expenditures and operating costs. The discharge of oil, natural gas or other pollutants into the air, soil or water may give rise to liabilities to governments and third parties and may require the Corporation to incur costs to remedy such discharge. Although the Corporation believes that it is in material compliance with current applicable environmental regulations no assurance can be given that environmental laws will not result in a curtailment of production or a material increase in the costs of production, development or exploration activities or otherwise adversely affect the Corporation's financial condition, results of operations or prospects. See "Industry Conditions - Environmental Regulation".

The marketability and price of oil and natural gas which may be acquired or discovered by the Corporation will be affected by numerous factors beyond its control. The ability of the Corporation to market its natural gas may depend upon its ability to acquire space on pipelines which deliver natural gas to commercial markets. The Corporation may also be affected by deliverability uncertainties related to the proximity of its reserves to pipelines and processing facilities and related to operational problems with such pipelines and facilities and extensive government regulation relating to price, taxes, royalties, land tenure, allowable production, the export of oil and natural gas and many other aspects of the oil and natural gas business.

Both oil and natural gas prices are unstable and are subject to fluctuation. Any material decline in prices could result in a reduction of Terraquest's net production revenue. The economics of producing from some wells may change as a result of lower

prices, which could result in a reduction in the volumes of Terraquest's reserves. Terraquest might also elect not to produce from certain wells at lower prices. All of these factors could result in a material decrease in Terraquest's net production revenue causing a reduction in its oil and gas acquisition, development and exploration activities. In addition, bank borrowings available to the Corporation are in part determined by the borrowing base of the Corporation. A sustained material decline in prices from historical average prices could further reduce the Corporation's borrowing base, therefore reducing the bank credit available to the Corporation and could require that a portion of the Corporation's bank debt be repaid.

The Corporation anticipates that it will make substantial capital expenditures for the acquisition, exploration, development and production of oil and natural gas reserves in the future. If the Corporation's revenues or reserves decline, the Corporation may have limited ability to expend the capital necessary to undertake or complete future drilling programs. 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 Corporation. Moreover, future activities may require the Corporation to alter its capitalization significantly. The inability of the Corporation to access sufficient capital for its operations could have a material adverse effect on the Corporation's financial condition, results of operations or prospects.

The Corporation's cash flow from its reserves may not be sufficient to fund its ongoing activities at all times. From time to time, the Corporation may require additional financing in order to carry out its oil and gas acquisition, exploration and development activities. Failure to obtain such financing on a timely basis could cause the Corporation to forfeit its interest in certain properties, miss certain acquisition opportunities and reduce or terminate its operations. If the Corporation's revenues from its reserves decrease as a result of lower oil and natural gas prices or otherwise, it will affect the Corporation's ability to expend the necessary capital to replace its reserves or to maintain its production. If the Corporation's cash flow from operations is not sufficient to satisfy its capital expenditure requirements, there can be no assurance that additional debt or equity financing will be available to meet these requirements or available on terms acceptable to the Corporation.

From time to time the Corporation may enter into transactions to acquire assets or the shares of other corporations. These transactions may be financed partially or wholly with debt, which may increase the Corporation's debt levels above industry standards. Depending on future exploration and development plans, the Corporation may require additional equity and/or debt financing which may not be available or, if available, may not be available on favourable terms. Neither the Corporation's articles nor its by-laws limit the amount of indebtedness that the Corporation may incur. The level of the Corporation's indebtedness from time to time, could impair the Corporation's ability to obtain additional financing in the future on a timely basis to take advantage of business opportunities that may arise.

The Corporation uses the full cost method of accounting for oil and natural gas properties. Under this accounting method, capitalized costs are reviewed for impairment to ensure that the carrying amount of these costs is recoverable based on expected future cash flows. To the extent that such capitalized costs (net of accumulated depreciation and depletion) less future taxes exceed the present value of estimated future net cash flows from the Corporation's proved oil and natural gas reserves, those excess costs would be required to be charged to operations.

From time to time the Corporation may enter into agreements to receive fixed prices on its oil and natural gas production to offset the risk of revenue losses if commodity prices decline; however, if commodity prices increase beyond the levels set in such agreements, the Corporation will not benefit from such increases. Similarly, from time to time the Corporation may enter into agreements to fix the exchange rate of Canadian to United States dollars in order to offset the risk of revenue losses if the Canadian dollar increases in value compared to the United States dollar; however, if the Canadian dollar declines in value compared to the United States dollar, the Corporation will not benefit from the fluctuating exchange rate.

Oil and natural gas exploration, development and production operations are subject to all the risks and hazards typically associated with such operations, including hazards such as fire, explosion, blowouts, cratering, sour gas releases and spills, each of which could result in substantial damage to oil and natural gas wells, production facilities, other property and the environment or in personal injury. In accordance with industry practice, the Corporation is not fully insured against all of these risks, nor are all such risks insurable. Although Terraquest maintains liability insurance in an amount which it considers consistent with industry practice, the nature of these risks is such that liabilities could exceed policy limits, in which event Terraquest could incur significant costs that could have a material adverse effect upon its financial condition. Oil and natural gas production operations are also subject to all the risks typically associated with such operations, including encountering unexpected formations or pressures, premature decline of reservoirs and the invasion of water into producing formations. Losses resulting from the

occurrence of any of these risks could have a materially adverse effect on future results of operations, liquidity and financial condition.

Oil and natural gas exploration and development activities are dependent on the availability of drilling and related equipment in the particular areas where such activities will be conducted. Demand for such limited equipment or access restrictions may affect the availability of such equipment to the Corporation and may delay exploration and development activities. To the extent Terraquest is not the operator of its oil and gas properties, Terraquest will be dependent on such operators for the timing of activities related to such properties and will be largely unable to direct or control the activities of the operators.

Although title reviews will generally be conducted prior to the purchase of most oil and natural gas producing properties or the commencement of drilling wells, such reviews do not guarantee or certify that an unforeseen defect in the chain of title will not arise to defeat the claim of Terraquest which could result in a reduction of the revenue received by Terraquest.

There are numerous uncertainties inherent in estimating quantities of reserves and cash flows to be derived therefrom, including many factors that are beyond the control of the Corporation. The reserve and cash flow information set forth in this prospectus represent estimates only. The reserves and estimated future net cash flow from the Corporation's properties have been independently evaluated effective May 1, 2002 by McDaniel. These evaluations include a number of assumptions relating to factors such as initial production rates, production decline rates, ultimate recovery of reserves, timing and amount of capital expenditures, marketability of production, future prices of oil and natural gas, operating costs and royalties and other government levies that may be imposed over the producing life of the reserves. These assumptions were based on price forecasts in use at the date the relevant evaluations were prepared and many of these assumptions are subject to change and are beyond the control of the Corporation. Actual production and cash flows derived therefrom will vary from these evaluations, and such variations could be material. The foregoing evaluations are based in part on the assumed success of activities intended to be undertaken in future years. The reserves and estimated cash flows to be derived therefrom contained in such evaluations will be reduced to the extent that such activities do not achieve the level of success assumed in the evaluations.

Pursuant to the terms of the Purchase and Sale Agreement, Terraquest acquired the Initial Properties from Richland without any representations and warranties and assumed all liabilities, including environmental liabilities, relating to the Initial Properties. Although the Corporation is not aware of any material liabilities relating to the Initial Properties, it is possible that liabilities may arise which could have a material adverse effect on the Corporation. In addition, in the Arrangement Agreement Terraquest has agreed to indemnify and save harmless Richland from all losses suffered as a result of any misrepresentation in the disclosure relating to Terraquest that is contained in the Information Circular of Richland dated December 14, 2001.

Certain directors of Terraquest are also directors of other oil and gas companies and as such may, in certain circumstances, have a conflict of interest requiring them to abstain from certain decisions. Conflicts, if any, will be subject to the procedures and remedies of the ABCA.

Terraquest's success depends in large measure on certain key personnel including Kerry D. Lyons and R. James Brown. The loss of the services of such key personnel could have a material adverse effect on Terraquest. Terraquest does not have key person insurance in effect for management. The contributions of these individuals to the immediate operations of the Corporation are likely to be of central importance. In addition, the competition for qualified personnel in the oil and natural gas industry is intense and there can be no assurance that Terraquest will be able to continue to attract and retain all personnel necessary for the development and operation of its business. Investors must rely upon the ability, expertise, judgment, discretion, integrity and good faith of the management of the Corporation.

## **INDUSTRY CONDITIONS**

The oil and natural gas industry is subject to extensive controls and regulations governing its operations (including land tenure, exploration, development, production, refining, transportation and marketing) imposed by legislation enacted by various levels of government and with respect to pricing and taxation of oil and natural gas by agreements among the governments of Canada, Alberta, British Columbia and Saskatchewan, all of which should be carefully considered by investors in the oil and gas industry. It is not expected that any of these controls or regulations will affect the operations of Terraquest in a manner materially different than they would affect other oil and gas companies of similar size. All current legislation is a matter of public record and Terraquest is unable to predict what additional legislation or amendments may be enacted. Outlined below are some of the principal aspects of legislation, regulations and agreements governing the oil and gas industry.

## **Pricing and Marketing - Oil and Natural Gas**

The producers of oil are entitled to negotiate sales contracts directly with oil purchasers, with the result that the market determines the price of oil. Such price depends in part on oil quality, prices of competing oils, distance to market, the value of refined products and the supply/demand balance. Oil exporters are also entitled to enter into export contracts with terms not exceeding one year in the case of light crude oil and two years in the case of heavy crude oil, provided that an order approving such export has been obtained from the National Energy Board of Canada (the "NEB"). Any oil export to be made pursuant to a contract of longer duration (to a maximum of 25 years) requires an exporter to obtain an export licence from the NEB and the issuance of such licence requires the approval of the Governor in Council.

The price of natural gas is determined by negotiation between buyers and sellers. Natural gas exported from Canada is subject to regulation by the NEB and the Government of Canada. Exporters are free to negotiate prices with purchasers, provided that the export contracts must continue to meet certain other criteria prescribed by the NEB and the Government of Canada. Natural gas exports for a term of less than 2 years or for a term of 2 to 20 years (in quantities of not more than 30,000 m<sup>3</sup>/day), must be made pursuant to an NEB order. Any natural gas export to be made pursuant to a contract of longer duration (to a maximum of 25 years) or a larger quantity requires an exporter to obtain an export licence from the NEB and the issuance of such licence requires the approval of the Governor in Council.

The governments of Alberta, British Columbia and Saskatchewan also regulate the volume of natural gas which may be removed from those provinces for consumption elsewhere based on such factors as reserve ability, transportation arrangements and market considerations.

The lack of firm pipeline capacity continues to limit the ability to produce and market natural gas production although pipeline expansions are ongoing. In addition, the prorationing of capacity on the interprovincial pipeline systems continues to limit oil exports.

## **The North American Free Trade Agreement**

The North American Free Trade Agreement ("NAFTA") among the governments of Canada, United States of America and Mexico became effective on January 1, 1994. NAFTA carries forward most of the material energy terms that are contained in the Canada - United States Free Trade Agreement. Canada continues to remain free to determine whether exports of energy resources to the United States or Mexico will be allowed, provided that any export restrictions do not: (i) reduce the proportion of energy resources exported relative to domestic use (based upon the proportion prevailing in the most recent 36 month period); (ii) impose an export price higher than the domestic price; or (iii) disrupt normal channels of supply. All three countries are prohibited from imposing minimum export or import price requirements.

NAFTA contemplates the reduction of Mexican restrictive trade practices in the energy sector and prohibits discriminatory border restrictions and export taxes. The agreement also contemplates clearer disciplines on regulators to ensure fair implementation of any regulatory changes and to minimize disruption of contractual arrangements, which is important for Canadian natural gas exports.

## **Provincial Royalties and Incentives**

In addition to federal regulation, each province has legislation and regulations which govern land tenure, royalties, production rates, environmental protection and other matters. The royalty regime is a significant factor in the profitability of crude oil, natural gas liquids, sulphur and natural gas production. Royalties payable on production from lands other than Crown lands are determined by negotiations between the mineral owner and the lessee, although production from such lands is subject to certain provincial taxes and royalties. Crown royalties are determined by governmental regulation and are generally calculated as a percentage of the value of the gross production. The rate of royalties payable generally depends in part on prescribed reference prices, well productivity, geographical location, field discovery date and the type or quality of the petroleum product produced.

From time to time the governments of the western Canadian provinces create incentive programs for exploration and development. Such programs often provide for royalty rate reductions, royalty holidays and tax credits, and are generally introduced when commodity prices are low. The programs are designed to encourage exploration and development activity by improving earnings and cash flow within the industry.

Regulations made pursuant to the *Mines and Minerals Act* (Alberta) provide various incentives for exploring and developing oil reserves in Alberta. Oil produced from horizontal extensions commenced at least 5 years after the well was originally spudded may also qualify for a royalty reduction. A 24 month, 8,000 m<sup>3</sup> exemption is available to production from a well that has not produced for a 12 month period, if resuming production after February 1, 1993. As well, oil production from eligible new field and new pool wildcat wells and deeper pool test wells spudded or deepened after September 30, 1992 is entitled to a 12 month royalty exemption (to a maximum of \$1 million). Oil produced from low productivity wells, enhanced recovery schemes (such as injection wells) and experimental projects is also subject to royalty reductions.

The Alberta government has also introduced a Third Tier Royalty with a base rate of 10% and a rate cap of 25% for oil pools discovered after September 30, 1992. The new oil royalty reserved to the Crown has a base rate of 10% and a rate cap of 30%. The old oil royalty reserved to the Crown has a base rate of 10% and a rate cap of 35%.

In the Province of Alberta, the royalty reserved to the Crown in respect of natural gas production, subject to various incentives, is between 15% and 30%, in the case of new gas, and between 15% and 35%, in the case of old gas, depending upon a prescribed or corporate average reference price. Natural gas produced from qualifying exploratory gas wells spudded or deepened after July 31, 1985 and before June 1, 1988 is eligible for a royalty exemption for a period of 12 months, up to a prescribed maximum amount. Natural gas produced from qualifying intervals in eligible gas wells spudded or deepened to a depth below 2,500 meters is also subject to a royalty exemption, the amount of which depends on the depth of the well.

In the Province of Alberta, a producer of oil or natural gas is entitled to a credit against the royalties payable to the Crown by virtue of the Alberta royalty tax credit ("ARTC") program. The ARTC rate is based on a price sensitive formula and the ARTC rate varies between 75% at prices at and below \$100 per m<sup>3</sup> and 25% at prices at and above \$210 per m<sup>3</sup>. The ARTC rate is applied to a maximum of \$2,000,000 of Alberta Crown royalties payable for each producer or associated group of producers. Crown royalties on production from producing properties acquired from a corporation claiming maximum entitlement to ARTC will generally not be eligible for ARTC. The rate will be established quarterly based on the average "par price", as determined by the Alberta Department of Energy for the previous quarterly period.

On December 22, 1997, the Alberta government announced that it was conducting a review of the ARTC program with the objective of setting out better targeted objectives for a smaller program and to deal with administrative difficulties. On August 30, 1999, the Alberta government announced that it would not be reducing the size of the program but that it would introduce new rules to reduce the number of persons who qualify for the program. The new rules will preclude companies that pay less than \$10,000 in royalties per year and non-corporate entities from qualifying for the program. Such rules will not presently preclude Terraquest from being eligible for the ARTC program.

Crude oil and natural gas royalty holidays for specific wells and royalty reductions reduce the amount of Crown royalties paid by the Corporation to the provincial governments. In general, the ARTC program provides a rebate on Alberta Crown royalties paid in respect of eligible producing properties.

### **Land Tenure**

Crude oil and natural gas located in the western provinces is owned predominantly by the respective provincial governments. Provincial governments grant rights to explore for and produce oil and natural gas pursuant to leases, licences and permits for varying terms from two years and on conditions set forth in provincial legislation including requirements to perform specific work or make payments. Oil and natural gas located in such provinces can also be privately owned and rights to explore for and produce such oil and natural gas are granted by lease on such terms and conditions as may be negotiated.

### **Environmental Regulation**

The oil and natural gas industry is currently subject to environmental regulations pursuant to a variety of provincial and federal legislation. Such legislation provides for restrictions and prohibitions on the release or emission of various substances produced in association with certain oil and gas industry operations. In addition, such legislation requires that well and facility sites be abandoned and reclaimed to the satisfaction of provincial authorities. Compliance with such legislation can require significant expenditures and a breach of such requirements may result in suspension or revocation of necessary licenses and authorizations, civil liability for pollution damage and the imposition of material fines and penalties.

Environmental legislation in the Province of Alberta has been consolidated into the Alberta Environmental Protection and Enhancement Act (the "APEA"), which came into force on September 1, 1993. The APEA imposes stricter environmental standards, requires more stringent compliance, reporting and monitoring obligations and significantly increases penalties. The Corporation is committed to meeting its responsibilities to protect the environment wherever it operates and anticipates making increased expenditures of both a capital and an expense nature as a result of the increasingly stringent laws relating to the protection of the environment and will be taking such steps as required to ensure compliance with the APEA and similar legislation in other jurisdictions in which it operates. The Corporation believes that it is in material compliance with applicable environmental laws and regulations. The Corporation also believes that it is reasonably likely that the trend towards stricter standards in environmental legislation and regulation will continue.

### **MATERIAL CONTRACTS**

Except for contracts entered into in the ordinary course of business, the only material contracts entered into by the Corporation since its incorporation which can reasonably be regarded as presently material are the following:

- (a) the Underwriting Agreement dated effective July 25, 2002 as described under "Plan of Distribution"; and
- (b) the Special Warrant Indenture dated July 31, 2002 as described under "Plan of Distribution".

Copies of these agreements will be available for inspection at the offices of the Corporation, Suite 700, 550 – 11<sup>th</sup> Avenue S.W., Calgary, Alberta, T2R 1M7, and at the offices of Goodmans, Barristers and Solicitors, Suite 2400, 250 Yonge Street, Toronto, Ontario, M3B 2M6, during normal business hours during the period of distribution and for a period of 30 days thereafter, and at the offices of the Alberta Securities Commission in Calgary and Edmonton at any time.

### **LEGAL PROCEEDINGS**

To the knowledge of the management, Terraquest is not a party to, nor are any of Terraquest's properties subject to, any material legal proceedings.

### **LEGAL MATTERS**

Legal matters in connection with the distribution of the Qualified Shares issuable on the exercise or deemed exercise of the Special Warrants will be passed upon on behalf of the Corporation by Burnet, Duckworth & Palmer LLP and on behalf of the Underwriters by McCarthy Tétrault LLP.

### **INTEREST OF EXPERTS**

None of Burnet, Duckworth & Palmer LLP, McCarthy Tétrault LLP, Collins Barrow Calgary LLP, McDaniel, GLJ or Seaton has received or will receive a direct or indirect interest in the property of the Corporation or of any associate or affiliate of the Corporation. As at the date hereof, the aforementioned persons and companies beneficially own, directly or indirectly, less than 1% of the securities of the Corporation and its associates and affiliates. Further, as of the date hereof, the partners of Collins Barrow Calgary LLP, as a group, did not beneficially own, directly or indirectly, any of the Common Shares of the Corporation. In addition, except for Mr. Maslechko, a partner of Burnet, Duckworth & Palmer LLP who is a director of the Corporation, none of the aforementioned persons or companies, nor any director, officer or employee of any of the aforementioned persons or companies, is or is expected to be elected, appointed or employed as a director, officer or employee of the Corporation or of any associates or affiliates of the Corporation.

### **INTEREST OF MANAGEMENT IN MATERIAL TRANSACTIONS**

No director, executive officer, or principal holder of securities as described under "Principal Shareholders" or any associate or affiliate or the foregoing has, or has had, any material interest in any transaction prior to the date hereof or any proposed transaction that has materially affected or will materially affect Terraquest or any of its affiliates, except as disclosed in this prospectus. Mr. Maslechko, a director of the Corporation, is a partner of Burnet, Duckworth & Palmer LLP which firm receives fees for legal services provided to the Corporation.

### **AUDITORS, REGISTRAR AND TRANSFER AGENT**

The auditors of the Corporation are Collins Barrow Calgary LLP, Chartered Accountants, Suite 1400, 777 - 8th Avenue S.W., Calgary, Alberta, T2P 3R5.

Valiant Corporate Trust Company, at its principal offices in Calgary, Alberta and Equity Transfer Services, Inc., Toronto, Ontario, is the registrar and transfer agent for the Common Shares of the Corporation.

### **PURCHASERS' STATUTORY RIGHTS**

Securities legislation in several of the provinces provide purchasers with the right to withdraw from an agreement to purchase securities within two business days after receipt or deemed receipt of a prospectus and any amendment. In several of the provinces and territories, securities legislation further provides a purchaser with remedies for rescission or, in some jurisdictions, damages where the prospectus and any amendment contains a misrepresentation or is not delivered to the purchaser, provided that such remedies for rescission or damages are exercised by the purchaser within the time limit prescribed by the securities legislation of his province or territory. The purchaser should refer to any applicable provisions of the securities legislation of his province or territory for the particulars of these rights or consult with a legal advisor.

### **CONTRACTUAL RIGHT OF ACTION FOR RESCISSION**

In the event that a holder of a Special Warrant, who acquires a Qualified Share upon the exercise of a Special Warrant as provided for in this prospectus, is or becomes entitled under applicable legislation to the remedy of rescission by reason of this prospectus or any amendment thereto containing a misrepresentation, the holder shall be entitled to rescission not only of the holder's exercise of its Special Warrant but also of the private placement transaction pursuant to which the Special Warrant was initially acquired and shall be entitled, in connection with such rescission, to a full refund of all consideration paid to the Corporation on the acquisition of the Special Warrant. In the event that such holder is a permitted assignee of the interest of the original Special Warrant subscriber, such permitted assignee shall be entitled to exercise the rights of rescission and refund described herein as if the permitted assignee was the original subscriber. The foregoing is in addition to any other right or remedy available to a holder of the Special Warrant under Section 203 of the *Securities Act* (Alberta), Section 131 of the *Securities Act* (British Columbia), Section 130 of the *Securities Act* (Ontario), similar sections of other applicable securities legislation or otherwise at law.

## **Compilation Report**

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To the Directors  
Terraquest Energy Corporation

We have reviewed, as to compilation only, the accompanying pro forma balance sheet of Terraquest Energy Corporation (the "Company") at June 30, 2002 and the pro forma statements of operations for the six months ended June 30, 2002 and for the year ended December 31, 2001. The pro forma financial statements have been prepared solely for inclusion in the prospectus of the Company dated •, 2002. In our opinion, the pro forma financial statements have been properly compiled to give effect to the transactions and the assumptions described in the notes thereto.

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**CHARTERED ACCOUNTANTS**

Calgary, Alberta  
•, 2002

**Terraquest Energy Corporation**  
**Pro Forma Balance Sheet**  
**As at June 30, 2002**  
*(unaudited)*

|                                             | <b>Terraquest<br/>Energy<br/>Corporation<br/>(unaudited)</b> | <b>Approach<br/>Energy<br/>Inc.<br/>(unaudited)</b> | <b>Note</b>                      | <b>Pro Forma<br/>Adjustments</b>    | <b>Terraquest<br/>Energy<br/>Corporation<br/>Pro Forma</b> |
|---------------------------------------------|--------------------------------------------------------------|-----------------------------------------------------|----------------------------------|-------------------------------------|------------------------------------------------------------|
| <b>Assets</b>                               |                                                              |                                                     |                                  |                                     |                                                            |
| Current assets                              |                                                              |                                                     |                                  |                                     |                                                            |
| Cash                                        | \$ 2,957,310                                                 | \$ -                                                | 2(a)(ii)                         | \$ 5,070,000                        | \$ 2,957,310                                               |
| Accounts receivable                         | 1,684,460                                                    | 440,493                                             | 2(a)(i)                          | (5,070,000)                         | 2,124,953                                                  |
| Prepaid expenses and<br>deposits            | 7,025                                                        | 35,821                                              |                                  |                                     | 42,846                                                     |
|                                             | <u>4,648,795</u>                                             | <u>476,314</u>                                      |                                  |                                     | <u>5,125,109</u>                                           |
| Property, plant and equipment               | 9,859,760                                                    | 5,161,170                                           | 2(a)(i)                          | 10,742,768                          | 25,763,698                                                 |
| Future income taxes                         | <u>924,092</u>                                               | <u>-</u>                                            |                                  | (924,092)                           | <u>-</u>                                                   |
|                                             | <u><u>\$15,432,647</u></u>                                   | <u><u>\$ 5,637,484</u></u>                          |                                  |                                     | <u><u>\$ 30,888,807</u></u>                                |
| <b>Liabilities</b>                          |                                                              |                                                     |                                  |                                     |                                                            |
| Current liabilities                         |                                                              |                                                     |                                  |                                     |                                                            |
| Bank overdraft                              | \$ -                                                         | \$ 273,926                                          | 2(a)(iii)                        | \$ (227,750)                        | \$ 46,176                                                  |
| Bank indebtedness                           | -                                                            | 650,000                                             | 2(a)(i)                          | 4,411,782                           | 5,061,782                                                  |
| Accounts payable and accrued<br>liabilities | 2,932,900                                                    | 1,347,103                                           |                                  |                                     | 4,280,003                                                  |
| Income taxes payable                        | <u>-</u>                                                     | <u>52,422</u>                                       |                                  | (52,422)                            | <u>-</u>                                                   |
|                                             | <u>2,932,900</u>                                             | <u>2,323,451</u>                                    |                                  |                                     | <u>9,387,961</u>                                           |
| Provision for future site<br>restoration    | 119,398                                                      | 139,761                                             |                                  |                                     | 259,159                                                    |
| Future income taxes                         | -                                                            | 190,374                                             | 2(a)(i)                          | 4,472,634<br>52,422<br>(924,092)    | <u>3,791,338</u>                                           |
|                                             | <u>3,052,298</u>                                             | <u>2,653,586</u>                                    |                                  |                                     | <u>13,438,458</u>                                          |
| <b>Shareholders' Equity</b>                 |                                                              |                                                     |                                  |                                     |                                                            |
| Share capital                               | 13,797,164                                                   | 2,156,217                                           | 2(a)(ii)<br>2(a)(iii)<br>2(a)(i) | 5,070,000<br>227,750<br>(2,383,967) | 18,867,164                                                 |
| Retained earnings (deficit)                 | <u>(1,416,815)</u>                                           | <u>827,681</u>                                      | 2(a)(i)                          | (827,681)                           | <u>(1,416,815)</u>                                         |
|                                             | <u>12,380,349</u>                                            | <u>2,983,898</u>                                    |                                  |                                     | <u>17,450,349</u>                                          |
|                                             | <u><u>\$15,432,647</u></u>                                   | <u><u>\$ 5,637,484</u></u>                          |                                  |                                     | <u><u>\$ 30,888,807</u></u>                                |

**Terraquest Energy Corporation**  
**Pro Forma Statement of Operations**  
**Six Months Ended June 30, 2002**  
*(unaudited)*

|                                   | <b>Terraquest<br/>Energy<br/>Corporation</b><br><i>(unaudited)</i> | <b>Approach<br/>Energy<br/>Inc.</b><br><i>(unaudited)</i> | <b>Note</b> | <b>Pro Forma<br/>Adjustments</b> | <b>Terraquest<br/>Energy<br/>Corporation<br/>Pro Forma</b> |
|-----------------------------------|--------------------------------------------------------------------|-----------------------------------------------------------|-------------|----------------------------------|------------------------------------------------------------|
| Revenue                           |                                                                    |                                                           |             |                                  |                                                            |
| Oil and gas sales                 | \$ 1,006,025                                                       | \$ 2,140,310                                              | 2(c)(iii)   | \$ 40,125                        | \$ 3,186,460                                               |
| Royalties, net of ARTC            | <u>219,137</u>                                                     | <u>430,388</u>                                            | 2(c)(iii)   | 7,761                            | <u>657,286</u>                                             |
|                                   | 786,888                                                            | 1,709,922                                                 |             |                                  | 2,529,174                                                  |
| Interest income                   | <u>33,151</u>                                                      | <u>165</u>                                                |             |                                  | <u>33,316</u>                                              |
|                                   | <u>820,039</u>                                                     | <u>1,710,087</u>                                          |             |                                  | <u>2,562,490</u>                                           |
| Expenses                          |                                                                    |                                                           |             |                                  |                                                            |
| Operating                         | 362,468                                                            | 523,854                                                   | 2(c)(iii)   | 12,195                           | 898,517                                                    |
| General and administrative        | 482,960                                                            | 247,846                                                   |             |                                  | 730,806                                                    |
| Interest                          | -                                                                  | 20,125                                                    |             |                                  | 20,125                                                     |
| Provision for site restoration    | 48,798                                                             | 55,996                                                    | 2(c)(i)     | (11,000)                         | 93,794                                                     |
| Depletion and depreciation        | <u>2,257,598</u>                                                   | <u>717,960</u>                                            | 2(c)(i)     | 755,000                          | <u>3,730,558</u>                                           |
|                                   | <u>3,151,824</u>                                                   | <u>1,565,781</u>                                          |             |                                  | <u>5,473,800</u>                                           |
| Income (loss) before income taxes | (2,331,785)                                                        | 144,306                                                   |             |                                  | (2,911,310)                                                |
| Income taxes (recovery)           | <u>(914,970)</u>                                                   | <u>11,036</u>                                             | 2(c)(ii)    | (288,000)                        | <u>(1,191,934)</u>                                         |
| Net income (loss)                 | <u><u>\$(1,416,815)</u></u>                                        | <u><u>\$ 133,270</u></u>                                  |             |                                  | <u><u>\$(1,719,376)</u></u>                                |

**Terraquest Energy Corporation**  
**Pro Forma Statement of Operations**  
**Year Ended December 31, 2001**  
*(unaudited)*

|                                      | <b>Terraquest<br/>Energy<br/>Corporation</b><br><i>(audited)</i> | <b>Acquired<br/>Petroleum<br/>and Natural<br/>Gas<br/>Properties</b><br><i>(audited)</i> | <b>Approach<br/>Energy<br/>Inc.</b><br><i>(audited)</i> | <b>Note</b> | <b>Pro Forma<br/>Adjustments</b> | <b>Terraquest<br/>Energy<br/>Corporation<br/>Pro Forma</b> |
|--------------------------------------|------------------------------------------------------------------|------------------------------------------------------------------------------------------|---------------------------------------------------------|-------------|----------------------------------|------------------------------------------------------------|
| Revenue                              |                                                                  |                                                                                          |                                                         |             |                                  |                                                            |
| Oil and gas sales                    | \$ -                                                             | \$ 2,592,440                                                                             | \$ 3,173,988                                            |             |                                  | \$ 5,766,428                                               |
| Royalties, net of ARTC               | -                                                                | 649,552                                                                                  | 517,815                                                 |             |                                  | 1,167,367                                                  |
|                                      | -                                                                | 1,942,888                                                                                | 2,656,173                                               |             |                                  | 4,599,061                                                  |
| Interest income                      | -                                                                | -                                                                                        | 57,449                                                  |             |                                  | 57,449                                                     |
|                                      | -                                                                | 1,942,888                                                                                | 2,713,622                                               |             |                                  | 4,656,510                                                  |
| Expenses                             |                                                                  |                                                                                          |                                                         |             |                                  |                                                            |
| Operating                            | -                                                                | 599,642                                                                                  | 742,770                                                 |             |                                  | 1,342,412                                                  |
| General and adminis-<br>trative      | -                                                                | -                                                                                        | 382,419                                                 |             |                                  | 382,419                                                    |
| Provision for site<br>restoration    | -                                                                | -                                                                                        | 75,847                                                  | 2(b)(i)     | \$95,000                         | 170,847                                                    |
| Depletion and<br>depreciation        | -                                                                | -                                                                                        | 749,609                                                 | 2(b)(i)     | 2,315,000                        | 3,064,609                                                  |
|                                      | -                                                                | 599,642                                                                                  | 1,950,645                                               |             |                                  | 4,960,287                                                  |
| Income (loss) before income<br>taxes | -                                                                | 1,343,246                                                                                | 762,977                                                 |             | -                                | (303,777)                                                  |
| Income taxes (recovery)              | -                                                                | -                                                                                        | 179,527                                                 | 2(b)(ii)    | (352,527)                        | (173,000)                                                  |
| Net income (loss)                    | \$ -                                                             | \$ 1,343,246                                                                             | \$ 583,450                                              |             |                                  | \$ (130,777)                                               |

**Terraquest Energy Corporation**  
**Notes to Pro Forma Financial Statements**  
**As at and for the Six Months Ended June 30, 2002**  
**and for the Year Ended December 31, 2001**  
*(unaudited)*

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1. Basis of presentation

Terraquest Energy Corporation (the "Company") was incorporated under the Alberta Business Corporations Act on November 22, 2001 as 961982 Alberta Ltd. and on December 13, 2001 filed Articles of Amendment to change its name to Terraquest Energy Corporation and to remove certain private company provisions from its articles.

The unaudited pro forma balance sheet and statements of operations (the "pro forma financial statements") have been prepared by the management of the Company in accordance with Canadian generally accepted accounting principles, to give effect to the transactions described in note 2 using the following assumptions.

The pro forma financial statements reflect:

- (a) the acquisition of selected oil and gas properties from Richland Petroleum Corporation ("Richland") pursuant to a Plan of Arrangement whereby certain oil and gas properties were sold to the Company and each shareholder of Richland received one common share of the Company for each Richland common share held;
- (b) the acquisition by the Company of all the issued and outstanding shares of Approach Energy Inc. ("Approach") (note 2(i)) for cash consideration of \$9,481,782; and
- (c) the issuance by the Company of 11,000,000 special warrants at \$0.50 per special warrant for gross proceeds of \$5,500,000 before commissions and other issuance costs (note 2(ii)).

Pro Forma Balance Sheet

The pro forma balance sheet at June 30, 2002 has been prepared by combining the unaudited balance sheet of the Company as at June 30, 2002 with the unaudited balance sheet of Approach as at June 30, 2002 and assuming the acquisition of Approach occurred June 30, 2002, not on the actual acquisition date. The Company believes that this assumption provides a reasonable basis for presenting the pro forma balance sheet.

Pro Forma Statements of Operations

The pro forma statement of operations for the six-month period ended June 30, 2002 has been prepared by combining the unaudited statement of operations of the Company for the six-month period ended June 30, 2002 with the unaudited statement of operations of Approach for the six-month period ended June 30, 2002. The pro forma statement of operations is then adjusted for unaudited adjustments that relate to the operations of the properties acquired from Richland from January 1 to January 15, 2002, the period prior to acquisition by the Company.

**Terraquest Energy Corporation**  
**Notes to Pro Forma Financial Statements**  
**As at and for the Six Months Ended June 30, 2002**  
**and for the Year Ended December 31, 2001**  
*(unaudited)*

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The pro forma statement of operations for the year ended December 31, 2001 has been prepared by combining the audited statement of operations of the Company for the period from incorporation, November 22, 2001 to December 31, 2001, with the audited Schedule of Revenue and Expenses for Selected Properties acquired from Richland for the year ended December 31, 2001 and the audited statement of operations of Approach for the year ended December 31, 2001.

The pro forma statements of operations have been prepared assuming both the acquisition of Approach and the acquisition of oil and gas properties from Richland occurred on January 1, 2001, not on the actual acquisition dates. The Company believes that these assumptions provide a reasonable basis for presenting the pro forma statements of operations.

These pro forma financial statements should be read in conjunction with the unaudited financial statements of the Company for the six months ended June 30, 2002, the audited balance sheet of the Company as at December 31, 2001, the unaudited financial statements of Approach for the six months ended June 30, 2002, the audited financial statements of Approach for the year ended December 31, 2001, and the audited Schedule of Revenue and Expenses for Selected Properties acquired from Richland presented elsewhere in this prospectus.

The pro forma financial statements are not intended to reflect the operations which would have actually occurred had the transactions and other adjustments been effected on June 30, 2002 and January 1, 2001, for the pro forma balance sheet and the pro forma statements of operations, respectively. Further, the pro forma results of operations are not necessarily indicative of the results of operations that may be obtained by the Company in the future.

2. Pro forma assumptions and adjustments

(a) The unaudited pro forma balance sheet as at June 30, 2002 has been prepared assuming:

(i) the acquisition of Approach was effected June 30, 2002. The acquisition is accounted for as a purchase business combination with the purchase price being allocated, based on the fair values of the net assets acquired, as follows:

Purchase price:

|                                                                            |                     |
|----------------------------------------------------------------------------|---------------------|
| Cash - 4,451,451 common shares and special warrants at<br>\$2.13 per share | <u>\$ 9,481,782</u> |
|----------------------------------------------------------------------------|---------------------|

It is assumed that the purchase price will be paid using the \$5,070,000 special warrant proceeds (note 2(a)(ii)) with the remainder of \$4,411,782 being drawn on the debt facility.

**Terraquest Energy Corporation**  
**Notes to Pro Forma Financial Statements**  
**As at and for the Six Months Ended June 30, 2002**  
**and for the Year Ended December 31, 2001**  
*(unaudited)*

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|                                          |                            |
|------------------------------------------|----------------------------|
| Allocation of purchase price:            |                            |
| Accounts receivable                      | \$ 440,493                 |
| Prepaid expenses and deposits            | 35,821                     |
| Property, plant and equipment            | 15,903,938                 |
| Bank overdraft                           | (46,176)                   |
| Bank indebtedness                        | (650,000)                  |
| Accounts payable and accrued liabilities | (1,347,103)                |
| Income taxes payable                     | (52,422)                   |
| Provision for future site restoration    | (139,761)                  |
| Future income taxes                      | <u>(4,663,008)</u>         |
|                                          | <u><u>\$ 9,481,782</u></u> |

- (ii) the issuance of 11,000,000 special warrants of the Company was executed June 30, 2002. The special warrants were issued for \$0.50 each for total gross proceeds of \$5,500,000, and are exchangeable into one common share of the Company for no additional consideration. Commissions, professional fees, and other costs of the equity financing are estimated to be \$430,000.
  - (iii) the exercise of 397,000 stock options of Approach for gross proceeds of \$227,750 prior to the acquisition by Terraquest.
- (b) The unaudited pro forma statement of operations for the year ended December 31, 2001 has been prepared assuming both the acquisition of selected oil and gas properties from Richland and the acquisition of Approach was effected January 1, 2001 with the following effects:
- (i) depletion and depreciation expense and the provision for site restoration has been recorded on the unit-of-production basis for the entire year based on 2001 production rates.
  - (ii) current and future income tax expense has been recorded based on temporary differences between the deductibility of amounts for accounting and income tax purposes and large corporation's tax has been recorded.
- (c) The unaudited pro forma statement of operations for the six months ended June 30, 2002 has been prepared assuming both the acquisition of selected oil and gas properties from Richland and the acquisition of Approach were effected January 1, 2001 with the following effects:

**Terraquest Energy Corporation**  
**Notes to Pro Forma Financial Statements**  
**As at and for the Six Months Ended June 30, 2002**  
**and for the Year Ended December 31, 2001**  
*(unaudited)*

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- (i) depletion and depreciation expense and the provision for site restoration has been recorded on the unit-of-production basis for the entire period based on production rates from January 1 to June 30, 2002.
- (ii) current and future income tax expense has been recorded based on temporary differences between the deductibility of amounts for accounting and income tax purposes and large corporation's tax has been recorded.
- (iii) the addition of net operating revenues for the properties acquired from Richland for the period January 1 to January 15, 2002, being the period for which these results are not included in the Company's unaudited statement of operations for the six-month period ended June 30, 2002.

**Terraquest Energy Corporation**  
**Balance Sheet**  
**December 31, 2001**

## **Auditors' Report**

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To the Directors  
Terraquest Energy Corporation

We have audited the balance sheet of Terraquest Energy Corporation as at December 31, 2001. This balance sheet is the responsibility of the Company's management. Our responsibility is to express an opinion on this balance sheet based on our audit.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the balance sheet is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the balance sheet. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, this balance sheet presents fairly, in all material respects, the financial position of the Company as at December 31, 2001 in accordance with Canadian generally accepted accounting principles.

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**CHARTERED ACCOUNTANTS**

Calgary, Alberta  
May 14, 2002 (except for note 4  
which is dated •, 2002)

# Terraquest Energy Corporation

## Balance Sheet

December 31, 2001

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### Assets

Current asset

Cash

\$ 1

### Shareholder's Equity

Share capital (note 3)

\$ 1

Approved by the Board,

(signed) "Lorenzo Donadeo", Director

(signed) "Bill Maslechko", Director

**Terraquest Energy Corporation**  
**Notes to Balance Sheet**  
**December 31, 2001**

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1. Significant accounting policies

The balance sheet of Terraquest Energy Corporation (the "Company") has been prepared in accordance with Canadian generally accepted accounting principles.

(a) Petroleum and natural gas properties

The Company will follow the full cost method of accounting for petroleum and natural gas properties whereby all costs related to the exploration and development of petroleum and natural gas properties, including applicable administrative expenses, are capitalized. The proceeds on disposition of petroleum and natural gas properties are deducted from capitalized costs, with no gain or loss calculated unless such disposal would alter the annual depletion rate by 20% or more.

(b) Depletion and depreciation

Costs related to petroleum and natural gas properties will be depleted and depreciated on the unit-of-production basis, based on the Company's share of total proved petroleum and natural gas reserves as determined by independent and Company engineers. Costs eligible for depletion and depreciation include total capitalized costs, less the cost of unproved properties, plus estimated future development costs of proved undeveloped reserves. Costs of acquiring and evaluating unproved properties are excluded from costs subject to depletion and depreciation until it is determined whether proved reserves are attributable to the properties or impairment occurs. Natural gas volumes are converted to equivalent barrels of crude oil on the basis of relative energy content, where six thousand cubic feet of natural gas equates to one barrel of oil.

The costs of corporate and other capital assets will be depreciated at rates approximating their useful life on a declining balance basis of 20% per year.

(c) Ceiling test

The Company will apply a ceiling test to capitalized costs to ensure that these costs, net of future income taxes and estimated future site restoration costs, do not exceed the estimated value of future net revenues from the production of proved reserves plus the lower of cost or estimated fair market value of unproved properties, less estimated future administrative costs, future site restoration costs, financing costs and income taxes ("cost ceiling"). Future net revenues are based on prices in effect at period-end. Any required provisions are charges to income as additional depletion and depreciation expense.

(d) Future site restoration costs

Estimated future site restoration and abandonment costs will be charged against income using the unit-of-production method. Costs are estimated by the Company's engineers based on current regulations, costs, technology and industry standards.

**Terraquest Energy Corporation**  
**Notes to Balance Sheet**  
**December 31, 2001**

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(e) Measurement uncertainty

The amounts recorded for depletion and depreciation of oil and gas properties, the provision for site restoration and abandonment costs and the ceiling test are based on estimates. These estimates include proven reserves, production rates, oil and natural gas prices, future costs and other relevant assumptions. By their nature, these estimates are subject to measurement uncertainty and the effect of changes in such estimates on the financial statements of future periods could be significant.

(f) Flow-through shares

The Company, from time to time, will issue flow-through shares to finance a portion of its capital expenditure program. Pursuant to the terms of the flow-through share agreements, the tax deductions associated with the expenditures are renounced to the subscribers. Accordingly, share capital is reduced and a future tax liability is recorded equal to the estimated amount of future income taxes payable by the Company as a result of the renunciations, when the expenditures are made.

(g) Future income taxes

Future income taxes are accounted for using the liability method of income tax allocation. Under the liability method, income tax assets and liabilities are recorded to recognize future income tax inflows and outflows arising from the settlement or recovery of assets and liabilities at the carrying values. Income tax assets are also recognized for the benefits from tax losses and deductions that cannot be identified with particular assets or liabilities, provided those benefits are more likely than not to be realized. Future income tax assets and liabilities are determined based on the tax laws and rates that are anticipated to apply in the period of realization.

(h) Joint ventures

Certain of the Company's petroleum and natural gas exploration and production activities will be conducted jointly with others. The financial statements will include only the Company's proportionate interest in such activities.

(i) Stock-based compensation

The Company issues stock options to directors, officers, and employees. No compensation expense is recognized when stock options are issued. Any consideration received by the Company on exercise of stock options is credited to share capital.

**Terraquest Energy Corporation**  
**Notes to Balance Sheet**  
**December 31, 2001**

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(j) Hedging activities

Swap agreements are used by the Company to hedge its exposure to fluctuations in oil and natural gas prices. Gains and losses arising from these swap arrangements are reported as adjustments to the related revenue account over the term of the financial instrument.

The contracts entered into are not speculative derivative transactions and are determined to be effective hedges.

2. Incorporation and commencement of operations

The Company was incorporated under the Alberta Business Corporations Act on November 22, 2001 as 961982 Alberta Ltd. and on December 13, 2001 filed Articles of Amendment to change its name to Terraquest Energy Corporation and to remove certain private company provisions from its articles. As at December 31, 2001 the Company has not commenced active operations.

3. Share capital

(a) Authorized

The Company's authorized share capital consists of an unlimited number of voting common shares and an unlimited number of first preferred and second preferred shares, issuable in series.

(b) Issued

|                                                                | <b>Number</b> | <b>Stated<br/>Value</b> |
|----------------------------------------------------------------|---------------|-------------------------|
| Issued on incorporation, being balance at<br>December 31, 2001 | 1             | \$ 1                    |
|                                                                | <u>1</u>      | <u>\$ 1</u>             |

4. Subsequent events

(a) Plan of arrangement

Pursuant to a Plan of Arrangement effective January 16, 2002 whereby Richland Petroleum Corporation ("Richland") was sold to Provident Energy Trust, each shareholder of Richland received one common share of the Company for each Richland common share held. The Company also acquired certain petroleum and natural gas assets from Richland in exchange for 27,893,117 common shares of the Company and certain overriding royalties at an assigned value for accounting purposes of \$9,457,088, based on the carrying values in Richland as follows:

**Terraquest Energy Corporation**  
**Notes to Balance Sheet**  
**December 31, 2001**

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|                                       |                     |
|---------------------------------------|---------------------|
| Petroleum and natural gas properties  | \$ 9,527,688        |
| Provision for future site restoration | <u>(70,600)</u>     |
|                                       | <u>\$ 9,457,088</u> |

The acquisition of properties from Richland will be recorded using the continuity of interests method, whereby the assets are recorded at the carrying amount in Richland immediately prior to acquisition. The continuity of interests method will be used as there was no substantive change in the ownership of the properties as a result of the transaction. Net revenues from the acquired properties will be included in income from January 16, 2002, the effective date of the Arrangement.

(b) Initial Private Placement

On February 8, 2002, the Company closed an initial private placement of 9,489,134 common shares for gross proceeds of \$2,036,100. Of the shares issued, 2,765,464 were "flow-through" shares, issued at \$0.25 per share, the weighted average price for the first five days' trading. The balance of the common shares were issued at \$0.20 per share. The Company has incurred the full \$691,366 in expenditures to be renounced pursuant to the flow-through share agreements in the first quarter of 2002 and will renounce the expenditures effective December 31, 2002.

(c) Special warrant financings

On May 14, 2002 the Company issued 5,130,000 Special Warrants at \$0.50 each for total gross proceeds of \$2,565,000. Each Special Warrant was exercisable for one common share of the Company for no additional consideration. The Company filed a prospectus to qualify the distribution of common shares on exercise of the Special Warrants and all Special Warrants have now been converted to common shares.

Subsequent to December 31, 2001, the Company also issued 11,000,000 Special Warrants at \$0.50 each for total gross proceeds of \$5,500,000. Each Special Warrant is exercisable into one common share of the Company for no additional consideration. The issue closed on July 31, 2002. The Company has agreed to file a prospectus to qualify the distribution of common shares on exercise of the Special Warrants within 120 days of the closing date. If approval for such prospectus is not received, each Special Warrant holder will receive an additional 0.15 of a common share for each Special Warrant exercised.

(d) Stock options

The Company has a stock option plan for directors, officers, employees and other service providers. Under the terms of the option plan, options granted normally have a life of 5 years and vest over a three year period. Subsequent to December 31, 2001, the Company granted a total of 2,972,000 options to employees, officers, and directors. The options are

**Terraquest Energy Corporation**  
**Notes to Balance Sheet**  
**December 31, 2001**

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exercisable at prices ranging from \$0.24 to \$0.48 per share with a weighted average exercise price of \$0.29 per share, vest over a three year period and expire at various dates in 2007.

(e) Lease commitment

Subsequent to December 31, 2001, the Company became obligated, under the terms of a sublease agreement for office premises, to make lease payments of \$8,308 per month until expiry of the sublease in June 2003.

(f) Joint venture arrangement

On July 4, 2002, the Company entered into a joint venture agreement with a non-industry partner, whereby the partner will spend a minimum of \$2,000,000 in 2002 on exploration expenditures on the Company's lands. The Company will retain 50 percent of its original interest in the lands and production and will expend capital on completion and facilities if the wells are successful. The Company has an obligation to make a fair market value offer in cash or, at the option of the non-industry partner, stock to acquire the shares of the partner immediately after January 1, 2004.

(g) Revolving credit facility

On July 30, 2002 the Company executed a revolving demand credit facility with a Canadian chartered bank in the amount of \$6,000,000. The facility may be drawn down or repaid at any time and bears interest at prime plus one-half percent. Security pledged consists of a general assignment of book debts and a \$10,000,000 demand debenture secured by a first floating charge over all assets. The bank also reserves the right to require fixed charge security at its discretion. The credit facility will revolve until January 1, 2003, at which time an interim review of the facility will occur. The Company is required to meet certain financial based covenants under the lending agreement.

(h) Acquisition of Approach Energy Inc.

On August 2, 2002, the Company acquired all of the outstanding shares of Approach Energy Inc., a private company, for cash consideration of \$9.5 million plus assumption of net debt of approximately \$1.5 million. The acquired company currently produces approximately 750 boe per day from seven properties in Southern Alberta.

(i) Hedging activities

Subsequent to December 31, 2001, the Company entered into hedge transactions for oil and natural gas sales. The agreements entered into are forward financial transactions providing the Company with a range of fixed prices.

**Terraquest Energy Corporation**  
**Notes to Balance Sheet**  
**December 31, 2001**

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The following hedge transactions were entered into subsequent to December 31, 2001:

| <b>Commodity</b> | <b>Notional Volume</b> | <b>Strike Price</b> | <b>Term</b>                         |
|------------------|------------------------|---------------------|-------------------------------------|
| Oil              | 50 bbls/day            | \$26.43/bbl U.S.    | September 1, 2002 - August 31, 2003 |
| Natural gas      | 1,000 GJ/day           | \$4.72/GJ CDN       | October 1, 2002 - December 31, 2002 |
| Natural gas      | 1,500 GJ/day           | \$5.09/GJ CDN       | November 1, 2002 - October 31, 2003 |

**Terraquest Energy Corporation**  
**Financial Statements**  
**June 30, 2002**  
*(unaudited)*

# Terraquest Energy Corporation

## Balance Sheets

|                                          | June 30,<br>2002<br>(unaudited) | December 31,<br>2001<br>(audited) |
|------------------------------------------|---------------------------------|-----------------------------------|
| <b>Assets</b>                            |                                 |                                   |
| Current assets                           |                                 |                                   |
| Cash                                     | \$ 2,957,310                    | \$ 1                              |
| Accounts receivable                      | 1,684,460                       | -                                 |
| Prepaid expenses                         | <u>7,025</u>                    | <u>-</u>                          |
|                                          | 4,648,795                       | 1                                 |
| Property, plant and equipment            | 9,859,760                       | -                                 |
| Future income taxes                      | <u>924,092</u>                  | <u>-</u>                          |
|                                          | <u><u>\$ 15,432,647</u></u>     | <u><u>\$ 1</u></u>                |
| <b>Liabilities</b>                       |                                 |                                   |
| Current liabilities                      |                                 |                                   |
| Accounts payable and accrued liabilities | \$ 2,932,900                    | \$ -                              |
| Provision for future site restoration    | <u>119,398</u>                  | <u>-</u>                          |
|                                          | <u>3,052,298</u>                | <u>-</u>                          |
| <b>Shareholders' Equity</b>              |                                 |                                   |
| Share capital                            | 13,797,164                      | 1                                 |
| Deficit                                  | <u>(1,416,815)</u>              | <u>-</u>                          |
|                                          | <u>12,380,349</u>               | <u>1</u>                          |
|                                          | <u><u>\$ 15,432,647</u></u>     | <u><u>\$ 1</u></u>                |

Approved by the Board,

(signed) "*Lorenzo Donadeo*", Director

(signed) "*Bill Maslechko*", Director

# Terraquest Energy Corporation

## Statements of Loss and Deficit

|                                               | For the<br>three months<br>ended<br>June 30, 2002<br>(unaudited) | For the<br>six months<br>ended<br>June 30,<br>2002<br>(unaudited) |
|-----------------------------------------------|------------------------------------------------------------------|-------------------------------------------------------------------|
| Revenue                                       |                                                                  |                                                                   |
| Oil and gas sales                             | \$ 579,047                                                       | \$ 1,006,025                                                      |
| Royalties, net of ARTC                        | 99,946                                                           | 219,137                                                           |
|                                               | 479,101                                                          | 786,888                                                           |
| Interest and other income                     | 26,069                                                           | 33,151                                                            |
|                                               | 505,170                                                          | 820,039                                                           |
| Expenses                                      |                                                                  |                                                                   |
| Operating                                     | 232,079                                                          | 362,468                                                           |
| General and administrative                    | 251,983                                                          | 482,960                                                           |
| Provision for site restoration                | 23,706                                                           | 48,798                                                            |
| Depletion and depreciation                    | 2,073,003                                                        | 2,257,598                                                         |
|                                               | 2,580,771                                                        | 3,151,824                                                         |
| Loss before income taxes                      | (2,075,601)                                                      | (2,331,785)                                                       |
| Income taxes (recovery)                       | 750                                                              | 3,750                                                             |
| - capital                                     | (844,068)                                                        | (918,720)                                                         |
| - future                                      | (843,318)                                                        | (914,970)                                                         |
| Net loss                                      | (1,232,283)                                                      | (1,416,815)                                                       |
| Deficit, beginning of period                  | (184,532)                                                        | -                                                                 |
| Deficit, end of period                        | \$ (1,416,815)                                                   | \$ (1,416,815)                                                    |
| Weighted average number of shares outstanding |                                                                  |                                                                   |
| Basic                                         | 40,088,186                                                       | 34,438,916                                                        |
| Loss per share                                |                                                                  |                                                                   |
| - basic                                       | \$ (0.03)                                                        | \$ (0.04)                                                         |
| - diluted                                     | \$ (0.03)                                                        | \$ (0.04)                                                         |

# Terraquest Energy Corporation

## Statements of Cash Flows

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|                                               | For the<br>three months<br>ended<br>June 30, 2002<br><i>(unaudited)</i> | For the<br>six months<br>ended<br>June 30,<br>2002<br><i>(unaudited)</i> |
|-----------------------------------------------|-------------------------------------------------------------------------|--------------------------------------------------------------------------|
| Operating activities                          |                                                                         |                                                                          |
| Net loss                                      | \$ (1,232,283)                                                          | \$ (1,416,815)                                                           |
| Add (deduct) non-cash items                   |                                                                         |                                                                          |
| Site restoration                              | 23,706                                                                  | 48,798                                                                   |
| Depletion and depreciation                    | 2,073,003                                                               | 2,257,598                                                                |
| Future income taxes                           | <u>(844,068)</u>                                                        | <u>(918,720)</u>                                                         |
| Cash flow from (used in) operations           | 20,358                                                                  | (29,139)                                                                 |
| Change in non-cash working capital items      | <u>94,600</u>                                                           | <u>(111,094)</u>                                                         |
|                                               | <u>114,958</u>                                                          | <u>(140,233)</u>                                                         |
| Financing activities                          |                                                                         |                                                                          |
| Issuance of common shares, net of issue costs | <u>2,335,603</u>                                                        | <u>4,334,703</u>                                                         |
| Cash available for investing activities       | <u>2,450,561</u>                                                        | <u>4,194,470</u>                                                         |
| Investing activities                          |                                                                         |                                                                          |
| Additions to property, plant and equipment    | (1,428,363)                                                             | (2,589,670)                                                              |
| Change in non-cash working capital items      | <u>63,844</u>                                                           | <u>1,352,509</u>                                                         |
|                                               | (1,364,519)                                                             | <u>(1,237,161)</u>                                                       |
| Increase in cash                              | 1,086,042                                                               | 2,957,309                                                                |
| Cash, beginning of period                     | <u>1,871,268</u>                                                        | <u>1</u>                                                                 |
| Cash, end of period                           | <u><u>\$ 2,957,310</u></u>                                              | <u><u>\$ 2,957,310</u></u>                                               |

**Terraquest Energy Corporation**  
**Notes to Financial Statements**  
**June 30, 2002**  
(unaudited)

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1. Significant accounting policies

The financial statements of Terraquest Energy Corporation (the "Company") have been prepared in accordance with Canadian generally accepted accounting principles.

(a) Petroleum and natural gas properties

The Company follows the full cost method of accounting for petroleum and natural gas properties whereby all costs related to the exploration and development of petroleum and natural gas properties, including applicable administrative expenses, are capitalized. The proceeds on disposition of petroleum and natural gas properties are deducted from capitalized costs, with no gain or loss calculated unless such disposal would alter the annual depletion rate by 20 percent or more.

(b) Depletion and depreciation

Costs related to petroleum and natural gas properties are depleted and depreciated on the unit-of-production basis, based on the Company's share of total proved petroleum and natural gas reserves as determined by independent and Company engineers. Costs eligible for depletion and depreciation include total capitalized costs, less the cost of unproved properties, plus estimated future development costs of proved undeveloped reserves. Costs of acquiring and evaluating unproved properties are excluded from costs subject to depletion and depreciation until it is determined whether proved reserves are attributable to the properties or impairment occurs. Natural gas volumes are converted to equivalent barrels of crude oil on the basis of relative energy content, where six thousand cubic feet of natural gas equates to one barrel of oil.

The costs of corporate and other capital assets are depreciated at rates approximating their useful life on a declining balance basis of 20 percent per year.

(c) Ceiling test

The Company applies a ceiling test to capitalized costs to ensure that these costs, net of future income taxes and estimated future site restoration costs, do not exceed the estimated value of future net revenues from the production of proved reserves plus the lower of cost or estimated fair market value of unproved properties, less estimated future administrative costs, future site restoration costs, financing costs and income taxes ("cost ceiling"). Future net revenues are based on prices in effect at period-end. Any required provisions are charged to income as additional depletion and depreciation expense.

(d) Future site restoration costs

Estimated future site restoration and abandonment costs are charged against income using the unit-of-production method. Costs are estimated by the Company's engineers based on current regulations, costs, technology and industry standards. At June 30, 2002, Company engineers estimate this cost to be \$900,000.

**Terraquest Energy Corporation**  
**Notes to Financial Statements**  
**June 30, 2002**  
(unaudited)

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(e) Measurement uncertainty

The amounts recorded for depletion and depreciation of oil and gas properties, the provision for site restoration and abandonment costs and the ceiling test are based on estimates. These estimates include proven reserves, production rates, oil and natural gas prices, future costs and other relevant assumptions. By their nature, these estimates are subject to measurement uncertainty and the effect of changes in such estimates on the financial statements of future periods could be significant.

(f) Flow-through shares

The Company, from time to time, issues flow-through shares to finance a portion of its capital expenditure program. Pursuant to the terms of the flow-through share agreements, the tax deductions associated with the expenditures are renounced to the subscribers. Accordingly, share capital is reduced and a future tax liability is recorded equal to the estimated amount of future income taxes payable by the Company as a result of the renunciations, when the expenditures are made.

(g) Future income taxes

Future income taxes are recorded using the liability method of income tax allocation. Under the liability method, income tax assets and liabilities are recorded to recognize future tax inflows and outflows arising from the settlement or recovery of assets and liabilities at the carrying values. Income tax assets are also recognized for the benefits from tax losses and deductions that cannot be identified with particular assets or liabilities, provided those liabilities are more likely than not to be realized. Future income tax assets and liabilities are determined based on the tax laws and rates that are anticipated to apply in the period of realization.

(h) Joint ventures

Certain of the Company's petroleum and natural gas exploration and production activities are conducted jointly with others. These financial statements include only the Company's proportionate interest in such activities.

**Terraquest Energy Corporation**  
**Notes to Financial Statements**  
**June 30, 2002**  
(unaudited)

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(i) Stock-based compensation

The Company issues stock options to directors, officers, employees and other service providers. No compensation expense is recognized when stock options are issued to employees or directors. Any consideration received by the Company on exercise of stock options is credited to share capital. On January 1, 2002, the Canadian Institute of Chartered Accountants issued Section 3870, *Stock-Based Compensation and Other Stock-Based Payments*, which requires additional disclosure as presented in Note 5.

(j) Hedging activities

Swap agreements are used by the Company to hedge its exposure to fluctuations in oil and natural gas prices. Gains and losses arising from these swap arrangements are reported as adjustments to the related revenue account over the term of the financial instrument.

The contracts entered into are not speculative derivative transactions and are determined to be effective hedges.

2. Incorporation and commencement of operations

The Company was incorporated under the Alberta Business Corporations Act on November 22, 2001 as 961982 Alberta Ltd. and on December 13, 2001 filed Articles of Amendment to change its name to Terraquest Energy Corporation and to remove certain private company provisions from its articles.

Pursuant to a Plan of Arrangement effective January 16, 2002, whereby Richland Petroleum Corporation ("Richland") was sold to Provident Energy Trust, each shareholder of Richland received one common share of the Company for each Richland common share held. The Company also acquired certain petroleum and natural gas assets from Richland in exchange for common shares of the Company and certain overriding royalties at an assigned value for accounting purposes of \$9,457,088, based on the carrying values in Richland as follows:

|                                       |                     |
|---------------------------------------|---------------------|
| Petroleum and natural gas properties  | \$ 9,527,688        |
| Provision for future site restoration | <u>(70,600)</u>     |
|                                       | <u>\$ 9,457,088</u> |

The acquisition of properties from Richland has been recorded using the continuity of interests method, whereby the assets are recorded at the carrying amount in Richland immediately prior to acquisition. The continuity of interests method has been used as there was no substantive change in the ownership of the properties as a result of the transaction. Net revenues from the acquired properties have been included in income from January 16, 2002, the effective date of the Arrangement.

**Terraquest Energy Corporation**  
**Notes to Financial Statements**  
**June 30, 2002**  
(unaudited)

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3. Property, plant and equipment

|                                      | <b>Cost</b>          | <b>Accumulated<br/>Depletion and<br/>Depreciation</b> | <b>Net Book<br/>Value</b> |
|--------------------------------------|----------------------|-------------------------------------------------------|---------------------------|
| Petroleum and natural gas properties | \$ 11,896,639        | \$ 2,249,881                                          | \$ 9,646,758              |
| Corporate and other                  | <u>220,719</u>       | <u>7,717</u>                                          | <u>213,002</u>            |
|                                      | <u>\$ 12,117,358</u> | <u>\$ 2,257,598</u>                                   | <u>\$ 9,859,760</u>       |

At June 30, 2002, the cost ceiling of the Company's petroleum and natural gas properties, based on month-end prices and calculated as in Note 1(c), was \$1,051,000 less than the capitalized costs of those properties. As a result, the carrying value of the petroleum and natural gas properties was written down by \$1,815,000, before a recovery of future income taxes of \$764,000, for a net write-down of \$1,051,000.

4. Lending facility

On January 14, 2002, the Company executed a revolving term credit facility with a Canadian chartered bank in the amount of \$1,500,000. The amount available for drawing under the facility cannot be greater than the borrowing base calculated by the bank, which has been set at \$1,000,000 for the initial term of the facility. The facility may be drawn down or repaid at any time and bears interest at prime plus 1.0 percent. Security pledged consists of a general assignment of book debts and a \$5,000,000 demand debenture secured by a first floating charge over all assets. The bank also reserves the right to require fixed charge security at its discretion. The credit facility will revolve until May 31, 2002, at which time it will convert to a term facility, with a term not exceeding five years. The Company is required to meet certain financial and reserve based covenants under the lending agreement.

Subsequent to June 30, 2002, this facility was cancelled and replaced as described in note 7.

5. Share capital

(a) Authorized

The Company's authorized share capital consists of an unlimited number of voting common shares and an unlimited number of first preferred and second preferred shares, issuable in series.

**Terraquest Energy Corporation**  
**Notes to Financial Statements**  
**June 30, 2002**  
(unaudited)

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(b) Issued

|                                                                      | Number            | Stated<br>Value      |
|----------------------------------------------------------------------|-------------------|----------------------|
| Balance, beginning of period                                         | 1                 | \$ 1                 |
| Issued pursuant to Plan of Arrangement (note 2)                      | 27,893,117        | 9,457,088            |
| Common shares issued pursuant to private placement (note 5[c])       | 6,723,670         | 1,344,734            |
| Flow-through shares issued, net of tax cost of \$108,166 (note 5[c]) | 2,765,464         | 583,200              |
|                                                                      | 37,382,252        | 11,385,023           |
| Special warrants issued during the period (note 5[c])                | 5,130,000         | 2,565,000            |
|                                                                      | 42,512,252        | 13,950,023           |
| Issue costs, net of income taxes of \$113,538                        | -                 | (152,859)            |
| Balance, June 30, 2002                                               | <u>42,512,252</u> | <u>\$ 13,797,164</u> |

(c) Private Placement

On February 8, 2002, the Company closed an initial private placement of 9,489,134 common shares for gross proceeds of \$2,036,100. Of the shares issued, 2,765,464 were "flow-through" shares, issued at \$0.25 per share, the weighted average price for the first five days' trading. The balance of the common shares were issued at \$0.20 per share. The Company has incurred the full \$691,366 in expenditures to be renounced pursuant to the flow-through share agreements and will renounce the expenditures effective December 31, 2002.

On May 14, 2002, the Company closed a private placement of 5,130,000 special warrants at a price of \$0.50 each, for gross proceeds of \$2,565,000. Each special warrant was subsequently exchanged for one common share for no additional consideration. Subsequent to June 30, 2002, the Company filed the final prospectus relating to the qualification of these shares for distribution.

**Terraquest Energy Corporation**  
**Notes to Financial Statements**  
**June 30, 2002**  
(unaudited)

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(d) Stock options

The Company has a stock option plan for directors, officers, employees and other service providers. Under the terms of the option plan, options granted normally have a life of 5 years and vest over a three-year period. The following is a summary of the Company's Stock Option Plan at June 30, 2002 and changes for the period then ended:

Issued

|                                              | Number of<br>Options | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Life<br>Remaining |
|----------------------------------------------|----------------------|------------------------------------------|------------------------------------------|
| Balance, April 1, 2002                       | 2,260,000            | \$ 0.24                                  |                                          |
| Granted to directors, officers and employees | <u>25,000</u>        | <u>0.48</u>                              | <u></u>                                  |
| Balance, June 30, 2002                       | 2,285,000            | \$ 0.24                                  | 4.54 years                               |
| Exercisable, June 30, 2002                   | <u>565,000</u>       | <u>\$ 0.24</u>                           | <u>4.54 years</u>                        |

On August 19, 2002, the Company granted options on 687,000 shares to directors, officers and employees with an exercise price of \$0.45 per share, with all other terms as described above.

6. Stock-based compensation

On February 7, 2002, the Company issued options to purchase 2,260,000 common shares at a price of \$0.24 per share and on May 8, 2002 issued an additional 25,000 stock options at \$0.48 per share. The stock options have a five year term and become fully vested over a three-year period. On a pro forma basis, had compensation cost for the stock options been determined based on the fair value method, the Company's net loss and loss per share would have been as follows for the six months ended June 30, 2002:

|                |             |              |
|----------------|-------------|--------------|
| Net loss       | As reported | \$ 1,416,815 |
|                | Pro forma   | \$ 1,525,115 |
| Loss per share | As reported | \$ 0.04      |
|                | Pro forma   | \$ 0.04      |

**Terraquest Energy Corporation**  
**Notes to Financial Statements**  
**June 30, 2002**  
(unaudited)

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The fair value of the stock options at the date of grant was estimated to be \$392,950, using the Black-Scholes model with the following assumptions:

|                       |      |
|-----------------------|------|
| Expected life (years) | 5    |
| Interest rate         | 4.9% |
| Volatility            | 90%  |

In calculating pro forma net loss, the fair value of options is amortized to compensation expense over the vesting period of the options, which resulted in a \$108,300 adjustment in the first half of 2002.

7. Subsequent events

- (a) On July 4, 2002, the Company entered into a joint venture agreement with a non-industry partner, whereby the partner will spend a minimum of \$2,000,000 in 2002 on exploration expenditures on the Company's lands. The Company will retain 50 percent of its original interest in the lands and production and will expend capital on completion and facilities if the wells are successful. The Company has an obligation to make a fair market value offer in cash or, at the option of the non-industry partner, stock to acquire the shares of the partner immediately after January 1, 2004.
- (b) Subsequent to June 30, 2002, the Company issued 11,000,000 Special Warrants at \$0.50 each for total gross proceeds of \$5,500,000. Each Special Warrant is exchangeable into one common share of the Company for no additional consideration. The issue closed on July 31, 2002. The Company has agreed to file a prospectus to qualify the distribution of common shares on exercise of the Special Warrants within 120 days of the closing date. If approval for such prospectus is not received, each Special Warrant holder will receive an additional 0.15 of a common share for each Special Warrant exercised.
- (c) On July 30, 2002 the Company executed a revolving demand credit facility with a Canadian chartered bank in the amount of \$6,000,000. The facility may be drawn down or repaid at any time and bears interest at prime plus one-half percent. Security pledged consists of a general assignment of book debts and a \$10,000,000 demand debenture secured by a first floating charge over all assets. The bank also reserves the right to require fixed charge security at its discretion. The credit facility will revolve until January 1, 2003, at which time an interim review of the facility will occur. The Company is required to meet certain financial based covenants under the lending agreement.
- (d) On August 2, 2002, the Company acquired all of the outstanding shares of Approach Energy Inc., a private company, for cash consideration of \$9.5 million plus assumption of net debt of approximately \$1.5 million. The acquired company currently produces approximately 750 boe per day from seven properties in Southern Alberta.

**Terraquest Energy Corporation**  
**Notes to Financial Statements**  
**June 30, 2002**  
(unaudited)

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(e) Hedging activities

Subsequent to June 30, 2002, the Company entered into hedge transactions for oil and natural gas sales. The agreements entered into are forward financial transactions providing the Company with a range of fixed prices.

The following hedge transactions were entered into subsequent to June 30, 2002:

| Commodity   | Notional Volume | Strike Price     | Term                                |
|-------------|-----------------|------------------|-------------------------------------|
| Oil         | 50 bbls/day     | \$26.43/bbl U.S. | September 1, 2002 - August 31, 2003 |
| Natural gas | 1,000 GJ/day    | \$4.72/GJ CDN    | October 1, 2002 - December 31, 2002 |
| Natural gas | 1,500 GJ/day    | \$5.09/GJ CDN    | November 1, 2002 - October 31, 2003 |

8. Lease commitment

The Company is obligated, under the terms of a sub-lease agreement for office premises, to make lease payments of \$8,308 per month until expiry of the sublease in June, 2003.

**APPROACH ENERGY INC.  
FINANCIAL STATEMENTS  
DECEMBER 31, 2001 AND 2000**

## AUDITORS' REPORT

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To the Directors  
Approach Energy Inc.

We have audited the balance sheets of Approach Energy Inc. as at December 31, 2001 and 2000 and the statements of income and retained earnings and cash flows for the year ended December 31, 2001 and for the period from commencement of operations, April 10, 2000 to December 31, 2000. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2001 and 2000 and the results of its operations and its cash flows for the periods then ended in accordance with Canadian generally accepted accounting principles.

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CHARTERED ACCOUNTANTS

Calgary, Alberta  
September 5, 2002

## APPROACH ENERGY INC.

### BALANCE SHEETS

|                                           | June 30,<br>2002<br>(unaudited) | December 31,<br>2001 | December 31,<br>2000 |
|-------------------------------------------|---------------------------------|----------------------|----------------------|
| <b>Assets</b>                             |                                 |                      |                      |
| Current assets                            |                                 |                      |                      |
| Cash and cash equivalents                 | \$ -                            | \$ -                 | \$ 1,048,228         |
| Accounts receivable                       | 440,493                         | 462,155              | 208,057              |
| Prepaid expenses and deposits             | 35,821                          | 16,021               | 18,003               |
|                                           | 476,314                         | 478,176              | 1,274,288            |
| Property and equipment (note 3)           | 5,161,170                       | 4,199,478            | 1,678,502            |
|                                           | \$ 5,637,484                    | \$ 4,677,654         | \$ 2,952,790         |
| <b>Liabilities</b>                        |                                 |                      |                      |
| Current liabilities                       |                                 |                      |                      |
| Bank overdraft                            | \$ 273,926                      | \$ 63,024            | \$ -                 |
| Bank indebtedness (note 4)                | 650,000                         | 100,000              | -                    |
| Accounts payable and accrued liabilities  | 1,347,103                       | 1,349,392            | 664,931              |
| Income taxes payable                      | 52,422                          | -                    | -                    |
|                                           | 2,323,451                       | 1,512,416            | 664,931              |
| Future removal and site restoration costs | 139,761                         | 83,765               | 7,918                |
| Future income taxes                       | 190,374                         | 231,760              | 52,233               |
|                                           | 2,653,586                       | 1,827,941            | 725,082              |
| <b>Shareholders' Equity</b>               |                                 |                      |                      |
| Share capital (note 5)                    | 2,156,217                       | 2,155,302            | 2,116,747            |
| Retained earnings                         | 827,681                         | 694,411              | 110,961              |
|                                           | 2,983,898                       | 2,849,713            | 2,227,708            |
|                                           | \$ 5,637,484                    | \$ 4,677,654         | \$ 2,952,790         |

# **APPROACH ENERGY INC.** **STATEMENTS OF INCOME AND RETAINED EARNINGS**

|                                                       | Six Months Ended |              | Year Ended   | Period from    |
|-------------------------------------------------------|------------------|--------------|--------------|----------------|
|                                                       | June 30,         | June 30,     | December 31, | April 10, 2000 |
|                                                       | 2002             | 2001         | December 31, | to             |
|                                                       | (unaudited)      | (unaudited)  | 2001         | December 31,   |
|                                                       |                  |              |              | 2000           |
| Revenue                                               |                  |              |              |                |
| Petroleum and natural gas sales                       | \$ 2,140,310     | \$ 2,119,597 | \$ 3,173,988 | \$ 468,574     |
| Less: Royalties, net of Alberta<br>Royalty Tax Credit | (430,388)        | (354,284)    | (517,815)    | (40,724)       |
| Interest and other                                    | 165              | 31,925       | 57,449       | 23,721         |
|                                                       | 1,710,087        | 1,797,238    | 2,713,622    | 451,571        |
| Expenses                                              |                  |              |              |                |
| Production                                            | 523,854          | 321,378      | 742,770      | 130,143        |
| General and administrative                            | 247,846          | 110,620      | 382,419      | 70,406         |
| Interest                                              | 20,125           | -            | -            | -              |
| Depletion and depreciation                            | 773,956          | 236,917      | 825,456      | 61,567         |
|                                                       | 1,565,781        | 668,915      | 1,950,645    | 262,116        |
| Income before income taxes                            | 144,306          | 1,128,323    | 762,977      | 189,455        |
| Income taxes (recovery)                               |                  |              |              |                |
| Current                                               | 52,422           | 179,597      | -            | -              |
| Future                                                | (41,386)         | 94,304       | 179,527      | 78,494         |
|                                                       | 11,036           | 273,901      | 179,527      | 78,494         |
| Net income                                            | 133,270          | 854,422      | 583,450      | 110,961        |
| Retained earnings, beginning of period                | 694,411          | 110,961      | 110,961      | -              |
| Retained earnings, end of period                      | \$ 827,681       | \$ 965,383   | \$ 694,411   | \$ 110,961     |

# **APPROACH ENERGY INC.** **STATEMENTS OF CASH FLOWS**

|                                                                             | Six Months Ended |               | Year Ended        | Period from                         |
|-----------------------------------------------------------------------------|------------------|---------------|-------------------|-------------------------------------|
|                                                                             | June 30, 2002    | June 30, 2001 | December 31, 2001 | April 10, 2000 to December 31, 2000 |
|                                                                             | (unaudited)      | (unaudited)   |                   |                                     |
| Operating activities                                                        |                  |               |                   |                                     |
| Net income                                                                  | \$ 133,270       | \$ 854,422    | \$ 583,450        | \$ 110,961                          |
| Add (deduct) items not requiring cash                                       |                  |               |                   |                                     |
| Depletion and depreciation                                                  | 773,956          | 236,917       | 825,456           | 61,567                              |
| Future income taxes (recovery)                                              | (41,386)         | 94,304        | 179,527           | 78,494                              |
| Non-cash consulting fees (note 5[b])                                        | 915              | 19,755        | 38,555            | 13,916                              |
| Cash flow from operations                                                   | 866,755          | 1,205,398     | 1,626,988         | 264,938                             |
| Changes in non-cash working capital                                         | (122,764)        | 814,740       | 669,713           | (54,559)                            |
|                                                                             | 743,991          | 2,020,138     | 2,296,701         | 210,379                             |
| Financing activities                                                        |                  |               |                   |                                     |
| Increase in bank overdraft                                                  | 210,902          | -             | 63,024            | -                                   |
| Increase in bank indebtedness                                               | 550,000          | -             | 100,000           | -                                   |
| Proceeds from issuance of common shares and warrants, net of issuance costs | -                | -             | -                 | 2,076,570                           |
|                                                                             | 760,902          | -             | 163,024           | 2,076,570                           |
| Investing activities                                                        |                  |               |                   |                                     |
| Capital, exploration and development expenditures, net                      | (1,679,652)      | (1,520,402)   | (3,270,585)       | (1,732,151)                         |
| Changes in non-cash working capital                                         | 174,759          | 245,399       | (237,368)         | 493,430                             |
|                                                                             | (1,504,893)      | (1,275,003)   | (3,507,953)       | (1,238,721)                         |
| Cash inflow (outflow)                                                       | -                | 745,135       | (1,048,228)       | 1,048,228                           |
| Cash and cash equivalents, beginning of period                              | -                | 1,048,228     | 1,048,228         | -                                   |
| Cash and cash equivalents, end of period                                    | \$ -             | \$ 1,793,363  | \$ -              | \$ 1,048,228                        |
| Cash and cash equivalents is comprised of:                                  |                  |               |                   |                                     |
| Amounts on deposit with banks                                               | \$ -             | \$ 797,303    | \$ -              | \$ 53,048                           |
| Short-term corporate paper and banker's acceptances                         | -                | 996,060       | -                 | 995,180                             |
|                                                                             | \$ -             | \$ 1,793,363  | \$ -              | \$ 1,048,228                        |
| Supplemental cash flows disclosure:                                         |                  |               |                   |                                     |
| Interest paid                                                               | \$20,125         | \$ -          | \$ -              | \$ -                                |

**Approach Energy Inc.**  
**Notes to Financial Statements**  
**December 31, 2001**

*(Information as at June 20, 2002 and for the six month periods ended June 30, 2002 and 2001 is unaudited)*

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1. Company activities

The Company was incorporated as 874756 Alberta Ltd. under the laws of Alberta by Articles of Incorporation dated April 10, 2000. The Company filed Articles of Amendment on July 20, 2000 to change the Company's name to Approach Energy Inc. The Company is engaged in the exploration for and development of petroleum and natural gas in western Canada.

2. Summary of significant accounting policies

These financial statements have been prepared using accounting principles generally accepted in Canada which include:

(a) Cash and cash equivalents

Cash and cash equivalents consist of amounts on deposit with banks and highly liquid investments with maturities of 90 days or less at issue.

(b) Petroleum and natural gas exploration and development expenditures

(i) Capitalized costs

The Company follows the full cost method of accounting for petroleum and natural gas properties whereby all costs related to the exploration and development of petroleum and natural gas properties, including applicable administrative expenses, are capitalized. The proceeds on disposition of petroleum and natural gas properties are deducted from capitalized costs, with no gain or loss calculated unless such disposal would alter the annual depletion rate by 20 percent or more.

(ii) Depletion and depreciation

Costs related to petroleum and natural gas properties are depleted and depreciated on the unit-of-production basis, based on the Company's share of total proved petroleum and natural gas reserves as determined by independent and Company engineers. Costs eligible for depletion and depreciation include total capitalized costs, less the cost of unproved properties, plus estimated future development costs of proved undeveloped reserves. Costs of acquiring and evaluating unproved properties are excluded from costs subject to depletion and depreciation until it is determined whether proved reserves are attributable to the properties or impairment occurs. Natural gas volumes are converted to equivalent barrels of crude oil on the basis of relative energy content, where six thousand cubic feet of natural gas equates to one barrel of oil.

**Approach Energy Inc.**  
**Notes to Financial Statements**  
**December 31, 2001**

*(Information as at June 30, 2002 and for the six month periods ended June 30, 2002 and 2001 is unaudited)*

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(iii) Ceiling test

The Company applies a ceiling test to capitalized costs to ensure that these costs, net of future income taxes and estimated future site restoration costs, do not exceed the estimated value of future net revenues from the production of proved reserves plus the lower of cost or estimated fair market value of unproved properties, less estimated future administrative costs, future site restoration costs, financing costs and income taxes ("cost ceiling"). Future net revenues are based on prices in effect at period-end. Any required provisions are charged to income as additional depletion and depreciation expense.

(iv) Future site restoration costs

Estimated future site restoration and abandonment costs are charged against income using the unit-of-production method. Costs are estimated by the Company's engineers based on current regulations, costs, technology and industry standards. At June 30, 2002, Company engineers estimate this cost to be \$500,000.

(v) Measurement uncertainty

The amounts recorded for depletion and depreciation of oil and gas properties, the provision for site restoration and abandonment costs and the ceiling test are based on estimates. These estimates include proven reserves, production rates, oil and natural gas prices, future costs and other relevant assumptions. By their nature, these estimates are subject to measurement uncertainty and the effect of changes in such estimates on the financial statements of future periods could be significant.

(c) Depreciation

Other assets are depreciated using the declining balance method at annual rates of 20% to 30%.

(d) Income taxes

Income taxes are accounted for using the liability method of income tax allocation. Under the liability method, income tax assets and liabilities are recorded to recognize future income tax inflows and outflows arising from the settlement or recovery of assets and liabilities at the carrying values. Income tax assets are also recognized for the benefits from tax losses and deductions that cannot be identified with particular assets or liabilities, provided those benefits are more likely than not to be realized. Future income tax assets and liabilities are determined based on the tax laws and rates that are anticipated to apply in the year of realization.

**Approach Energy Inc.**  
**Notes to Financial Statements**  
**December 31, 2001**

*(Information as at June 30, 2002 and for the six month periods ended June 30, 2002 and 2001 is unaudited)*

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(e) Stock options

The Company has a stock option plan as described in note 5(e). No compensation expense is recognized when stock options are issued to officers, directors, employees and consultants. Any consideration received by the Company on exercise of stock options is credited to share capital.

(f) Joint venture accounting

Substantially all of the Company's exploration and production activities are conducted jointly with others, and accordingly, these financial statements reflect only the Company's proportionate interest in such activities.

3. Property and equipment

| <b>June 30, 2002</b>                                                                     |                    |                                                       |                           |
|------------------------------------------------------------------------------------------|--------------------|-------------------------------------------------------|---------------------------|
|                                                                                          | <b>Cost</b>        | <b>Accumulated<br/>Depletion and<br/>Depreciation</b> | <b>Net Book<br/>Value</b> |
| Petroleum and natural gas properties<br>including exploration and development<br>thereon | \$6,650,312        | \$1,507,280                                           | \$5,143,032               |
| Other                                                                                    | 32,076             | 13,938                                                | 18,138                    |
|                                                                                          | <u>\$6,682,388</u> | <u>\$1,521,218</u>                                    | <u>\$5,161,170</u>        |
| <b>December 31, 2001</b>                                                                 |                    |                                                       |                           |
|                                                                                          | <b>Cost</b>        | <b>Accumulated<br/>Depletion and<br/>Depreciation</b> | <b>Net Book<br/>Value</b> |
| Petroleum and natural gas properties<br>including exploration and development<br>thereon | \$4,972,655        | \$792,443                                             | \$4,180,212               |
| Other                                                                                    | 30,081             | 10,815                                                | 19,266                    |
|                                                                                          | <u>\$5,002,736</u> | <u>\$803,258</u>                                      | <u>\$4,199,478</u>        |

**Approach Energy Inc.**  
**Notes to Financial Statements**  
**December 31, 2001**

*(Information as at June 30, 2002 and for the six month periods ended June 30, 2002 and 2001 is unaudited)*

|                                                                                          | December 31, 2000  |                                              |                    |
|------------------------------------------------------------------------------------------|--------------------|----------------------------------------------|--------------------|
|                                                                                          | Cost               | Accumulated<br>Depletion and<br>Depreciation | Net Book<br>Value  |
| Petroleum and natural gas properties<br>including exploration and development<br>thereon | \$1,702,770        | \$44,943                                     | \$1,657,827        |
| Other                                                                                    | 29,381             | 8,706                                        | 20,675             |
|                                                                                          | <u>\$1,732,151</u> | <u>\$53,649</u>                              | <u>\$1,678,502</u> |

Future removal and site restoration costs are estimated in aggregate to be \$500,000 at June 30, 2002 (June 30, 2001 - \$400,000; December 31, 2001 - \$500,000; December 31, 2000 - \$300,000) of which \$55,996 (June 30, 2001 - \$25,148; December 31, 2001 - \$75,847; December 31, 2000 - \$7,918) has been charged to income in the period.

4. Bank indebtedness

At June 30, 2002, the Company has available a demand revolving credit facility to a maximum of \$1,500,000. The facility is available to the Company by way of a revolving operating loan, letters of credit and various risk management products for interest rate and foreign exchange risk management. The revolving operating loan may be drawn down or repaid at any time and bears interest at a Canadian chartered bank's prime rate plus 0.75% per annum. The Company has provided security for the facility by way of a \$10,000,000 floating charge demand debenture on all assets and a general assignment of book debts.

Under the terms of the agreement, the Company is required to meet certain financial reporting requirements and may not breach certain financial tests without prior consent of the bank. The credit facility is subject to review on a periodic basis.

On July 4, 2002, the maximum amount available for the revolving operating loan increased to \$2,500,000. Subsequently, the credit facility was cancelled as a result of the agreement described in note 9.

5. Share capital

(a) Authorized

The Company's authorized share capital consists of an unlimited number of voting Common Shares.

**Approach Energy Inc.**  
**Notes to Financial Statements**  
**December 31, 2001**

*(Information as at June 30, 2002 and for the six month periods ended June 30, 2002 and 2001 is unaudited)*

| Issued                                                                          |           |                     |              |                     |           |                     |
|---------------------------------------------------------------------------------|-----------|---------------------|--------------|---------------------|-----------|---------------------|
|                                                                                 | June 30,  |                     | December 31, |                     |           |                     |
|                                                                                 | 2002      |                     | 2001         |                     | 2000      |                     |
|                                                                                 | Number    | Stated Value        | Number       | Stated Value        | Number    | Stated Value        |
| Common Shares                                                                   |           |                     |              |                     |           |                     |
| Balance, beginning of period                                                    | 2,071,645 | \$ 702,471          | 2,006,620    | \$ 652,872          | -         | \$ -                |
| Issued for cash pursuant to private placements                                  | -         | -                   | -            | -                   | 2,000,000 | 650,000             |
| Issued for services pursuant to consultant compensation plan (note 5[c])        | -         | -                   | 65,025       | 49,599              | 6,620     | 2,872               |
| Balance, end of period                                                          | 2,071,645 | 702,471             | 2,071,645    | 702,471             | 2,006,620 | 652,872             |
| Obligation to Issue Common Shares                                               |           |                     |              |                     |           |                     |
| Balance, beginning of period                                                    | -         | -                   | 14,725       | 11,044              | -         | -                   |
| Obligation to issue shares for services (note 5[c])                             | 2,330     | 915                 | -            | -                   | 14,725    | 11,044              |
| Issued for Common Shares                                                        | -         | -                   | (14,725)     | (11,044)            | -         | -                   |
| Balance, end of period                                                          | 2,330     | 915                 | -            | -                   | 14,725    | 11,044              |
| Convertible Special Warrants                                                    |           |                     |              |                     |           |                     |
| Balance, beginning of period                                                    | 1,980,566 | 1,485,425           | 1,980,566    | 1,485,425           | -         | -                   |
| Issued for cash (note 5[d])                                                     | -         | -                   | -            | -                   | 1,980,566 | 1,485,425           |
| Balance, end of period                                                          | 1,980,566 | 1,485,425           | 1,980,566    | 1,485,425           | 1,980,566 | 1,485,425           |
|                                                                                 |           | 2,188,811           |              | 2,187,896           |           | 2,149,341           |
| Less: Issue costs, net of income taxes of \$NIL (2001 – \$NIL; 2000 – \$26,261) |           | 32,594              |              | 32,594              |           | 32,594              |
| Balance, end of period                                                          |           | <u>\$ 2,156,217</u> |              | <u>\$ 2,155,302</u> |           | <u>\$ 2,116,747</u> |

**Approach Energy Inc.**  
**Notes to Financial Statements**  
**December 31, 2001**

*(Information as at June 30, 2002 and for the six month periods ended June 30, 2002 and 2001 is unaudited)*

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- (b) The Company has entered into arrangements with consultants, employees or other third parties to compensate them for services provided by the issuance of Common Shares in lieu of cash.

The share price for any such issuance is set to be the last share price issued from treasury at the time the service was performed.

These transactions are measured at the fair value of the services provided at the date of which the service is complete. The shares are issued on a quarterly basis for the applicable period during which the services are performed.

- (c) During the period ended December 31, 2000, the Company issued 1,980,566 Special Warrants pursuant to a private placement at a price of \$0.75 per Special Warrant for total proceeds of \$1,485,425. Each Special Warrant allows the holder to acquire one Common Share at no additional cost until the fifth business day after the date of issuance of a receipt for a prospectus by the Securities Commission in each of the provinces of Alberta, British Columbia and Ontario.

- (d) Stock option plan

Under the Company's stock option plan, the Company may grant options to its directors, officers, employees and consultants. The maximum number of shares which may be reserved for issuance under the plan is 10% of the issued Common Shares. The maximum number of shares which may be reserved for issuance to any one person under the plan is 5% of the issued Common Shares. The plan also provides that the price at which the options may be granted can not be less than the market price of the Common Shares at the time the option is granted. Options granted under the plan will have a term not exceeding five years. The vesting period is set by the Board of Directors at the time the options are granted.

At June 30, 2002, 200,000 stock options were outstanding with an exercise price of \$0.40, expiring May 15, 2005 and 197,000 stock options were outstanding with an exercise price of \$0.75, expiring October 15, 2005. As part of the agreement described in note 9, all options vested and were exercised subsequent to June 30, 2002. The Common Shares received on exercise were then acquired as described in note 9.

A summary of the status of the Company's stock option plan as of June 30, 2002 and December 31, 2001 and 2000, and changes during the periods then ended is as follows:

**Approach Energy Inc.**  
**Notes to Financial Statements**  
**December 31, 2001**

*(Information as at June 30, 2002 and for the six month periods ended June 30, 2002 and 2001 is unaudited)*

|                                    | June 30,          |                                 | December 31,      |                                 |                   |                                 |
|------------------------------------|-------------------|---------------------------------|-------------------|---------------------------------|-------------------|---------------------------------|
|                                    | 2002              |                                 | 2001              |                                 | 2000              |                                 |
|                                    | Number of Options | Weighted Average Exercise Price | Number of Options | Weighted Average Exercise Price | Number of Options | Weighted Average Exercise Price |
| Outstanding, beginning of period   | 397,000           | \$ 0.57                         | 397,000           | \$0.57                          | -                 | \$ -                            |
| Granted                            | -                 | -                               | -                 | -                               | 397,000           | \$ 0.57                         |
| Outstanding, end of period         | 397,000           | \$ 0.57                         | 397,000           | \$ 0.57                         | 397,000           | \$ 0.57                         |
| Options exercisable, end of period | 375,107           | \$ 0.56                         | 314,487           | \$ 0.56                         | 182,163           | \$ 0.55                         |

6. Related party transactions

- (a) During the period ended December 31, 2000, the Company entered into a management services agreement with a company related by virtue of common shareholders, officers and directors. During the period ended June 30, 2002, the Company paid management fees in the amount of \$132,000 (June 30, 2001 - \$66,000; December 31, 2001- \$293,000; December 31, 2000 - \$5,500).

Subsequent to June 30, 2002, the management services agreement was terminated for a fee of \$396,000 as a result of the agreement described in note 9.

- (b) During the period ended June 30, 2002, the Company incurred rental expenses for office premises to a company related by virtue of common shareholders, officers and directors of \$21,241 (June 30, 2001 - \$19,778; December 31, 2001 - \$39,556; December 31, 2000 - \$22,104).
- (c) During the period ended December 31, 2000, the Company paid agency fees in the amount of \$58,855 on the issuance of Common Shares and Special Warrants to a corporation in which a director and shareholder of the Company owns shares. The amounts were recorded as share issuance costs.

These transactions are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

**Approach Energy Inc.**  
**Notes to Financial Statements**  
**December 31, 2001**

*(Information as at June 30, 2002 and for the six month periods ended June 30, 2002 and 2001 is unaudited)*

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7. Commitments

The Company is committed under a lease on a compressor expiring July 1, 2003 for future minimum lease payments in the amount of \$19,800 per month totalling \$237,600.

8. Financial instruments

(a) Fair values

The fair values of the Company's accounts receivable, bank overdraft, accounts payable and accrued liabilities are estimated to approximate their carrying values due to the immediate or short-term maturity of these financial instruments. The fair value of the Company's bank indebtedness approximates its carrying value as it bears interest at variable market rates.

(b) Delivery commitment

During the year ended December 31, 2001, the Company entered into fixed price contracts to deliver gas at various prices. The following physical sales commitment is outstanding at June 30, 2002:

| Commodity   | Notional Volume | Strike Price | Term                               |
|-------------|-----------------|--------------|------------------------------------|
| Natural gas | 1,500 GJ/day    | \$3.32/GJ    | October 1, 2001 - October 31, 2002 |

The physical contract price is based on an Alberta delivery point.

9. Subsequent event

Pursuant to a binding agreement (the "Agreement") dated July 18, 2002 between Terraquest Energy Corporation ("Terraquest") and the Company, Terraquest agreed to acquire all of the issued and outstanding Common Shares and Special Warrants of the Company (the "Offer") at a price of \$2.13 cash for each Common Share and Special Warrant outstanding.

If the Company fails to comply with the terms of the Agreement, a break fee of \$600,000 must be paid to Terraquest.

The Offer closed August 2, 2002 with the acquisition of 4,451,541 Common Shares and Special Warrants by Terraquest at a total price of \$9,481,782.

**INITIAL PROPERTIES**  
**STATEMENT OF REVENUE AND OPERATING EXPENSES**  
**THREE YEARS ENDED DECEMBER 31, 2001, 2000 AND 1999**



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## Auditors' Report

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To the Directors

Terraquest Energy Corporation

At the request of Terraquest Energy Corporation, we have audited the statement of revenue and operating expenses of the properties transferred to Terraquest Energy Corporation for each of the years in the three-year period ended December 31, 2001. This financial information is the responsibility of the vendor of the selected properties. Our responsibility is to express an opinion on this financial information based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial information is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial information. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of such financial information.

In our opinion, this statement of revenue and operating expenses presents fairly, in all material respects, the revenues and operating expenses of the properties transferred to Terraquest Energy Corporation, described in note 1, for each of the years in the three-year period ended December 31, 2001 in accordance with Canadian generally accepted accounting principles.

(signed) Collins Barrow Calgary LLP  
**CHARTERED ACCOUNTANTS**

Calgary, Alberta  
May 14, 2002

# Terraquest Energy Corporation

## Statement of Revenue and Operating Expenses

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|                                          | Years Ended December 31, |              |            |
|------------------------------------------|--------------------------|--------------|------------|
|                                          | 2001                     | 2000         | 1999       |
| Revenue                                  |                          |              |            |
| Petroleum, natural gas and liquids sales | \$ 2,592,440             | \$ 2,830,464 | \$ 954,413 |
| Less: Royalties                          | 649,552                  | 533,609      | 175,169    |
|                                          | 1,942,888                | 2,296,855    | 779,244    |
| Production expenses                      | 599,642                  | 423,123      | 299,106    |
| Net operating income                     | \$ 1,343,246             | \$ 1,873,732 | \$ 480,138 |

## **Terraquest Energy Corporation**

### **Notes to Statement of Revenue and Operating Expenses Three Years Ended December 31, 2001, 2000 and 1999**

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1. Basis of presentation

Pursuant to a Plan of Arrangement (the "Plan") effective January 16, 2002 between Richland Petroleum Corporation ("Richland"), Provident Energy Trust ("Provident") and Terraquest Energy Corporation ("Terraquest"), Richland shareholders received for each share of Richland held, one new share of Terraquest, which acquired certain assets from Richland in exchange for shares of Terraquest. This statement represents the operations of the properties purchased by Terraquest pursuant to the Plan.

This statement includes only those revenues and operating expenses which are directly related to the properties transferred to Terraquest, and does not include any expenses related to general and administrative costs, interest, income and capital taxes or any provisions related to depletion, depreciation or future site restoration and abandonments, nor any adjustments to revenues for hedging programs pursued by Richland.

2. Significant accounting policies

(a) Revenues

Oil, natural gas and liquids sales are recorded when the commodities are delivered to purchasers.

(b) Operating expenses

Operating expenses include all costs related to lifting, gathering, transporting and processing of oil and natural gas and related products.

**CERTIFICATE OF THE CORPORATION**

Dated: September 19, 2002

The foregoing constitutes full, true and plain disclosure of all material facts relating to the securities offered by this prospectus as required by Part 9 of the *Securities Act* (Alberta), Part VII of the *Securities Act* (Manitoba) and by Part XV of the *Securities Act* (Ontario) and by the respective regulations thereunder.

(signed) Kerry D. Lyons  
President and Chief Executive Officer

(signed) R. James Brown  
Vice-President Finance and Chief Financial Officer

On behalf of the Board of Directors

(signed) Lorenzo Donadeo  
Director

(signed) Bill Maslechko  
Director

**CERTIFICATE OF THE UNDERWRITERS**

Dated: September 19, 2002

To the best of our knowledge, information and belief, the foregoing constitutes full, true and plain disclosure of all material facts relating to the securities offered by this prospectus as required by Part 9 of the *Securities Act* (Alberta), Part VII of the *Securities Act* (Manitoba) and by Part XV of the *Securities Act* (Ontario) and by the respective regulations thereunder.

GRIFFITHS McBURNEY & PARTNERS

(signed) Thomas A. Budd

PETERS & CO. LIMITED

(signed) Christopher S. Potter