

COURT FILE NUMBER 1101-02781

COURT COURT OF QUEEN'S BENCH OF ALBERTA

JUDICIAL CENTRE CALGARY

IN THE MATTER OF THE *COMPANIES'*
CREDITORS ARRANGEMENT ACT, R.S.C.
1985, c. C-36, AS AMENDED

AND IN THE MATTER OF FORTRESS
ENERGY INC.

DOCUMENT **THIRD REPORT OF THE MONITOR,
HARDIE & KELLY INC.
June 27, 2011**

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**THIRD REPORT OF THE MONITOR
HARDIE & KELLY INC.
JUNE 27, 2011**

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INTRODUCTION

1. On March 2, 2011, Fortress Energy Inc. (“Fortress” or the “Company”) made application for and obtained protection from its creditors under the *Companies’ Creditors Arrangement Act*, R.S.C. 1985 c. C-36 as amended (the “CCA”) pursuant to an order (the “Initial Order”) of the Court of Queen’s Bench of Alberta (the “Court”). The Court granted an initial stay of proceedings (the “Stay”) through to March 31, 2011.
2. Pursuant to the Initial Order, Hardie & Kelly Inc. was appointed as monitor (the “Monitor”) of the Company.
3. On May 24, 2011, the Monitor prepared a report to the Court (the “Second Report”) in advance of the Company’s application for an extension of the Stay.
4. On May 26, 2011, the Court granted an order extending the Stay through to June 30, 2011.
5. The purpose of this third report (the “Third Report”) is to provide an update to this Honourable Court with respect to the following:
 - a. The Company’s operations since the date of the Second Report;
 - b. The Company’s financial performance since the date of the Second Report;
 - c. The Company’s revised cash flow forecast for the period June 20 – September 30, 2011;
 - d. The Company’s restructuring activities; and
 - e. The Company’s request for an extension of the Stay through to September 30, 2011 and the Monitor’s recommendation with respect thereto.

TERMS OF REFERENCE

6. In preparing this Third Report, the Monitor has relied upon unaudited financial information, records of the Company and discussions with the Company's management ("Management"). The Monitor has not performed an audit, review or other verification of such information. An examination of the financial forecast as outlined in the Canadian Institute of Chartered Accountants Handbook has not been performed. Future-oriented financial information relied upon in this report is based on Management's assumptions regarding future events and actual results achieved may vary from this information and the variations may be significant.

OPERATIONAL UPDATE

7. In the Second Report, the Monitor advised that due to spring break up and adverse weather conditions the Company had not yet completed its budgeted \$262,500 capital expenditure program intended to increase production and to preserve the value of its remaining oil and gas assets (the "Capital Program"). The Capital Program is now essentially complete although certain of the obligations incurred are still to be paid.
8. Due to scheduled maintenance at the McMahon Gas Plant, through which Fortress processes its natural gas volumes, production was curtailed beginning June 8, 2011 and shut in on June 15, 2011. Service at the plant is scheduled to resume on July 8, 2011 at which time Fortress anticipates production will return to upwards of 120 BOE/d. Forecasted cash receipts in July, in respect of June production, have been adjusted to reflect the temporary decrease in production.

FINANCIAL PERFORMANCE

9. Concurrent with the Company's May 26, 2011 application for an extension of the Stay, Fortress filed a revised cash flow forecast through to the week ending June 27, 2011 which was attached as Exhibit "B" to the May 20, 2011 Affidavit of J. Cameron Bailey (the "Revised Forecast"). A variance analysis of the Company's actual receipts and disbursements over the period May 16 – June 17, 2011 versus the corresponding period in the Revised Forecast is set out in the following table:

| May 16 – June 17, 2011 | | | | |
|--------------------------------------|------------------|------------------|------------------|-------|
| | Actual | Forecast | Variance | Notes |
| <u>RECEIPTS</u> | | | | |
| Petroleum and natural gas revenues | 54,610 | 24,375 | 30,235 | |
| Processing revenues | 7,442 | 7,500 | (58) | |
| | 62,052 | 31,875 | 30,177 | |
| Sale of Terra shares | - | 187,500 | (187,500) | (a) |
| Accounts receivable | 80,542 | 70,966 | 9,576 | |
| | 142,594 | 290,341 | (147,747) | |
| <u>DISBURSEMENTS</u> | | | | |
| <u>Oil and Gas Operations</u> | | | | |
| Operating costs | (17,464) | (28,773) | 11,309 | |
| Capital expenditures | (26,660) | (135,416) | 108,756 | (b) |
| Payroll | | | | |
| Employees & benefits | (36,249) | (32,601) | (3,648) | |
| Consultants | (42,771) | (87,282) | 44,511 | |
| Lease Payments | | | | |
| Premises | (4,200) | (4,200) | - | |
| Land and mineral lease rentals | (1,066) | (10,000) | 8,934 | |
| General and administrative | (36,913) | (33,019) | (3,894) | |
| Professional fees | (8,687) | (24,437) | 15,750 | |
| | (174,010) | (355,728) | 181,718 | |
| NET CASH FLOW | (31,416) | (65,387) | 33,971 | |
| OPENING – CASH | 461,714 | 461,714 | - | |
| CLOSING – CASH | 430,298 | 396,327 | 33,971 | |

10. Fortress experienced a negative cash flow of approximately \$31,000 over the period May 16 – June 17, 2011 versus an anticipated deficit of approximately \$65,000 over the same period. Although the overall positive variance is only approximately \$34,000, we offer the following comments with respect to certain individual variances:
- a. Sale of Terra shares – primarily as a result of the timing difference discussed below it has not yet been necessary for Fortress to liquidate any of its holdings of the shares of Terra Energy Corp. (the “Terra Shares”) creating a negative cash flow variance over the period of \$187,500; and
 - b. Capital expenditures – the positive cash flow variance of approximately \$109,000 is a result of a timing difference in respect of the payment of expenses incurred Capital Program as discussed above. Payment of these expenses has been included in the further revised cash flow forecast as discussed below.
11. The Company maintained a cash balance of approximately \$430,000 as at June 17, 2011.

12. The estimated current market value of the Terra Shares remains at approximately \$3.6 Million.

CASH FLOW FORECAST

13. Management, with the assistance of the Monitor, has prepared a revised cash flow forecast for the period June 20 – September 30, 2011 (the “June 20 Forecast”) which is attached as Appendix “A”. A summary of the June 20 Forecast is provided in the table below:

| June 20 – September 30, 2011 | | |
|-------------------------------------|---------------------------|--------------|
| | Forecast | Notes |
| <u>RECEIPTS</u> | | |
| P&NG revenues | 231,600 | |
| Processing revenues | 22,500 | |
| Less: royalties | <u>(15,000)</u> | |
| | 239,100 | |
| Sale of Terra shares | <u>500,000</u> | a) |
| Total Receipts | <u>739,100</u> | |
| <u>DISBURSEMENTS</u> | | |
| Operating costs | (91,595) | |
| Capital expenditures | (365,000) | b) |
| Payroll | | |
| Employees & Benefits | (112,000) | |
| Consultants | (214,950) | |
| Lease Payments | | |
| Premises | (16,800) | |
| Land/mineral leases | (15,000) | |
| General and administrative | (56,000) | |
| Professional fees | (45,750) | |
| Restructuring costs | <u>(150,000)</u> | c) |
| Total Disbursements | <u>(1,067,095)</u> | |
| Net Cash Flow | <u>(327,995)</u> | |
| Opening Cash | <u>430,298</u> | |
| Closing Cash | <u>102,303</u> | |

14. The June 20 Forecast reflects a negative cash flow of approximately \$328,000 over the forecast period resulting in an estimated cash balance of approximately \$102,000 as at September 30, 2011. Noteworthy observations with respect to the June 20 Forecast are as follows:

- a. *Sale of Terra shares* - Fortress anticipates liquidating approximately \$500,000 of its holdings of the Terra Shares by September 30, 2011. On March 31, 2011, the Court granted the Company authorization to liquidate the Terra Shares with the Monitor's written approval. As mentioned above, the current market value of the Terra Shares is approximately \$3.6 Million such that Management anticipates Fortress will continue to have access to sufficient liquid assets as at the end of September;
- b. *Capital expenditures* – capital expenditures are reflected in the amount of \$365,000. This is comprised of approximately \$108,000 in respect of the payment of the balance of the expenses incurred as part of the Capital Program and a further \$260,000 associated with the addition of booster compression and the recompletion of a well in the Buick Creek area; and
- c. *Restructuring costs* - the Company has assumed that certain of the costs of its legal counsel, the Monitor and the Monitor's legal counsel will continue to be satisfied from funds previously issued as retainers to legal counsel over the forecast period; however, provision has now been made for additional retainers that may be required by the end of September.

15. The Monitor is satisfied that the June 20 Forecast is reasonable in the circumstances.

RESTRUCTURING EFFORTS

16. The Monitor previously reported that, on March 28, 2011, the Company had filed Notices of Objection to the Notices of Reassessment (collectively referred to as the "Reassessment") issued by Canada Revenue Agency ("CRA").
17. Since the date of the Second Report, Management and the Company's legal counsel have continued to have written and verbal communications with CRA and CRA's legal counsel regarding the status of the Notices of Objection with a view to expediting the appeal process.

18. Management has advised the Monitor that CRA's head office in Ottawa is continuing with its review process, but that at this time CRA is not in a position to provide a definitive deadline as to when they will provide the Company with a formal response to the Notices of Objection. However; CRA has provided some guidance by advising that a response should not be expected before late July or the beginning of August at the earliest.
19. The Monitor, Management and the Company's legal counsel have held discussions in regard to potential courses of action and restructuring alternatives in the event the Company's objection to the Reassessment is dismissed by CRA; however, Management and the Monitor are of the opinion that, at this time, incurring the expenses associated with a potential restructuring scenario would be premature pending further feedback from CRA in respect of the Notices of Objection.

RECOMMENDATION

20. The Monitor is satisfied that Management continues to act with due diligence and in good faith and the Monitor is of the view that a further extension of the Stay is warranted to allow the appeal process in respect of the Reassessment to be concluded.
21. Given CRA's advice that their review process is unlikely to be concluded before the end of July at the earliest, the Monitor is supportive of the Stay being extended to the end of September.

All of which is respectfully submitted this 27th day of June 2011.

Hardie & Kelly Inc., in its capacity as
Monitor of Fortress Energy Inc.
and not in its personal capacity

Per: 

Marc Kelly, CA•CIRP
Senior Vice President

APPENDIX “A”

Fortress Energy Inc.
Forecast Cash Flow
(unaudited)

| Notes | WEEK BEGINNING | | | | | | | | | | | | PERIOD TOTAL | | |
|--------------------------------------|----------------|-----------|----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|--------------|-----------|-------------|
| | 20-Jun-11 | 27-Jul-11 | 4-Aug-11 | 11-Aug-11 | 18-Aug-11 | 25-Aug-11 | 1-Sep-11 | 8-Sep-11 | 15-Aug-11 | 22-Aug-11 | 29-Aug-11 | 5-Sep-11 | | 12-Sep-11 | 19-Sep-11 |
| RECEIPTS: | | | | | | | | | | | | | | | |
| 1 Petroleum and natural gas revenues | | 65,000 | 7,500 | 21,600 | 7,500 | 7,500 | 7,500 | 7,500 | 56,000 | 7,500 | 7,500 | 7,500 | 7,500 | 89,000 | 231,600 |
| 1 Processing revenues | | (4,000) | | (5,000) | | | | | (4,000) | | | | | (4,000) | (22,500) |
| 1 Less: Crown royalties | | 61,000 | 7,500 | 18,600 | 7,500 | 7,500 | 7,500 | 7,500 | 52,000 | | | | | 85,000 | 239,100 |
| 2 Sale of Terra shares | | 61,000 | 7,500 | 18,600 | 7,500 | 7,500 | 7,500 | 7,500 | 52,000 | | | | | 85,000 | 500,000 |
| DISBURSEMENTS | | | | | | | | | | | | | | | |
| Oil and Gas Operations | | | | | | | | | | | | | | | |
| 3 Operating Costs | (9,829) | (10,100) | (15,666) | (10,000) | (10,000) | (10,000) | (10,000) | (10,000) | (22,000) | (10,000) | (10,000) | (10,000) | (10,000) | (24,000) | (91,593) |
| 4 Capital items | | (103,000) | | (60,000) | | | | (190,000) | | | | | | | (565,000) |
| 5 Payroll | | (16,000) | | (16,000) | | | | (16,000) | (16,000) | (16,000) | (16,000) | (16,000) | (16,000) | (16,000) | (112,000) |
| 5 Consultants | (18,900) | (48,000) | | (36,750) | | | | (18,900) | (36,750) | (16,000) | (16,000) | (16,000) | (16,000) | (36,750) | (214,950) |
| 6 Lease payments | | (4,200) | | (4,200) | | | | (4,200) | (4,200) | (4,200) | (4,200) | (4,200) | (4,200) | (4,200) | (16,800) |
| 6 Land lease rentals | | (10,500) | | (10,500) | | | | (10,500) | (10,500) | (10,500) | (10,500) | (10,500) | (10,500) | (10,500) | (15,000) |
| 7 Professional fees | (7,000) | (15,750) | | (10,000) | | | | (10,000) | (10,000) | (10,000) | (10,000) | (10,000) | (10,000) | (10,000) | (45,750) |
| 9 Restructuring costs | | | | (50,000) | | | | (50,000) | | | | | | (50,000) | (150,000) |
| Subtotal | (35,729) | (209,550) | (15,666) | (116,000) | (117,450) | (117,450) | (117,450) | (117,450) | (211,000) | (211,000) | (211,000) | (211,000) | (211,000) | (31,000) | (1,067,095) |
| NET CASH FLOW (DEFICIT) | (35,729) | (148,550) | (8,166) | (16,000) | (128,950) | (128,950) | (128,950) | (128,950) | (205,000) | (205,000) | (205,000) | (205,000) | (205,000) | (35,000) | (337,995) |
| OPENING CASH | 430,298 | 394,569 | 346,019 | 237,853 | 409,853 | 281,003 | 269,603 | 269,603 | 308,603 | 310,603 | 311,153 | 311,153 | 311,153 | 168,753 | 430,298 |
| CLOSING CASH | 394,569 | 246,019 | 237,853 | 221,853 | 281,003 | 269,603 | 269,603 | 269,603 | 310,603 | 311,153 | 311,153 | 311,153 | 311,153 | 203,753 | 102,303 |

Notes

- 1 Revenues (net of transportation charges) and royalties have been estimated based on recent historical results and estimated pricing.
- 2 Disposition of a portion of the Terra shares held as a result of the property disposition in 2010.
- 3 Field operating costs have been estimated based on recent historical operations and anticipated projects.
- 4 Includes ongoing capital projects required to maintain existing operations.
- 5 It is assumed that wages, benefits and consulting fees will continue to be paid in the ordinary course.
- 6 It is assumed lease obligations will be paid in the ordinary course.
- 7 Estimated general and administrative costs based on recent historical values.
- 8 IFRS conversion & general legal fees.
- 9 Costs associated with restructuring including those of the company's legal counsel, the Monitor and counsel for the Monitor. Certain costs will continue to be paid from retainers previously issued.
- 10 Balance forward as at June 20, 2011.