

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 **FOURTH REPORT OF THE MONITOR,  
HARDIE & KELLY INC.  
September 26, 2011**

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**FOURTH REPORT OF THE MONITOR  
HARDIE & KELLY INC.  
SEPTEMBER 26, 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 “CCAA”) 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 June 27, 2011, the Monitor prepared a report to the Court (the “Third Report”) in advance of the Company’s application for an extension of the Stay.
4. On June 29, 2011 the Court granted an order extending the Stay through to September 30, 2011.
5. The purpose of this Fourth report (the “Fourth 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 Third Report;
  - b. The Company’s financial performance since the date of the Third Report;
  - c. The Company’s revised cash flow forecast for the period September 19 – November 4, 2011;
  - d. The Company’s restructuring activities;
  - e. The Company’s request for an extension of the Stay through to October 31, 2011 and the Monitor’s recommendation with respect thereto; and
  - f. The Company’s request for a variation of the terms governing its ability to access the net proceeds from the sale of any shares of Terra Energy Corp. (the “Terra Shares”) and the Monitor’s recommendation with respect thereto.

### **TERMS OF REFERENCE**

6. In preparing this Fourth 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. The scheduled maintenance at the McMahon Gas Plant, through which Fortress processes its natural gas volumes, was successfully completed. Service at the plant resumed in July resulting in Fortress now achieving the previously anticipated production levels of 120 BOE/d.
8. Certain capital expenditure program initiatives have been deferred for the time being with a view to preserving cash in the short term.

### **FINANCIAL PERFORMANCE**

9. Concurrent with the Company's June 29, 2011 application for an extension of the Stay, Fortress filed a revised cash flow forecast through to the week ending September 30, 2011 which was attached as Exhibit "B" to the June 24, 2011 Affidavit of J. Cameron Bailey (the "Revised Forecast"). A variance analysis of the Company's actual receipts and disbursements over the period June 20 – September 16, 2011 versus the corresponding period in the Revised Forecast is set out in the following table:

June 20 – September 16, 2011				
	Actual	Forecast	Variance	Notes
<b><u>RECEIPTS</u></b>				
Petroleum and natural gas revenues	172,084	142,600	29,484	
Processing revenues	35,421	22,500	12,921	
Crown royalties	(7,000)	(11,000)	4,000	
	200,505	154,100	46,405	
Sale of Terra shares	-	500,000	(500,000)	(a)
Accounts receivable	73,237	-	73,237	(b)
	<b>273,742</b>	<b>654,100</b>	<b>(380,358)</b>	
<b><u>DISBURSEMENTS</u></b>				
<b><u>Oil and Gas Operations</u></b>				
Operating costs	(52,026)	(67,595)	15,569	
Capital expenditures	(230,038)	(365,000)	134,962	(c)
Payroll				
Employees & benefits	(107,913)	(96,000)	(11,913)	
Consultants	(119,589)	(178,200)	58,611	(d)
Lease Payments				
Premises	(12,600)	(12,600)	-	
Land and mineral lease rentals	(11,356)	(15,000)	3,644	
General and administrative	(86,434)	(45,500)	(40,934)	(e)
Professional fees	-	(35,750)	35,750	(f)
Restructuring costs	-	(100,000)	100,000	(f)
	<b>(619,956)</b>	<b>(915,645)</b>	<b>295,689</b>	
NET CASH FLOW	(346,214)	(261,545)	(84,669)	
OPENING – CASH	430,298	430,298	-	
CLOSING – CASH	<b>84,084</b>	<b>168,753</b>	<b>(84,669)</b>	

10. Fortress experienced a negative cash flow of approximately \$346,000 over the period June 20 – September 16, 2011 versus an anticipated deficit of approximately \$262,000 over the same period. Although the overall negative variance is only approximately \$85,000, we offer the following comments with respect to certain individual variances:

- a. Sale of Terra shares – given the factors discussed below, to date, it has not yet been necessary for Fortress to liquidate any of its holdings of the Terra Shares thereby creating a negative cash flow variance over the period of \$500,000;
- b. Accounts receivable – the positive variance includes an insurance premium refund of approximately \$30,000 that for cash flow forecasting purposes had been accounted for as an offset to the annual insurance premium payment in the Revised Forecast. A corresponding negative variance is reflected as part of the *General and Administrative* line item discussed below;

- c. Capital expenditures – with a view to preserving funds, Management has deferred certain capital expenditures and managed the timing of others creating a positive cash flow variance of approximately \$135,000;
  - d. Consultants – the positive variance of approximately \$59,000 can be attributed to the decreased level of activity with respect to capital expenditures and the vacation of the geologist engaged by the Company;
  - e. General and Administrative – as discussed above, the negative variance is primarily related to the payment of the annual insurance renewal premium that was originally accounted for in the Revised Forecast as an offset to the premium refund; and
  - f. Professional Fees and Restructuring Costs – given the effective holding pattern in respect of the CCAA proceedings over the course of the summer, the Company did not incur any additional expenses over and above those that had previously been provided for by way of retainers.
11. The Company maintained a cash balance of approximately \$84,000 as at September 16, 2011.
12. Given the recent turbulence in the equity markets, the estimated current market value of the Terra Shares has decreased to approximately \$2.5 Million.

#### **CASH FLOW FORECAST**

13. Management, with the assistance of the Monitor, has prepared an updated cash flow forecast for the period September 19 through to November 4, 2011 (the “September 19 Forecast”) which is attached as Appendix “A”. A summary of the September 19 Forecast is provided in the table below:

<u>September 19 – November 4, 2011</u>	
<u>Forecast</u>	
<b><u>RECEIPTS</u></b>	
P&NG revenues	215,000
Processing revenues	19,000
Less: royalties	<u>(27,000)</u>
	207,000
Sale of Terra shares	<u>250,000</u>
<b>Total Receipts</b>	<b><u>457,000</u></b>
<b><u>DISBURSEMENTS</u></b>	
Operating costs	(42,000)
Capital expenditures	(200,000)
Payroll	
Employees & Benefits	(60,500)
Consultants	(71,400)
Lease Payments	
Premises	(8,400)
Land/mineral leases	(7,500)
General and administrative	(19,425)
Professional fees	(21,000)
Restructuring costs	<u>(50,000)</u>
<b>Total Disbursements</b>	<b><u>(480,225)</u></b>
<b>Net Cash Flow</b>	<b><u>(23,225)</u></b>
<b>Opening Cash</b>	<b><u>84,084</u></b>
<b>Closing Cash</b>	<b><u>60,859</u></b>

14. The September 19 Forecast reflects a negative cash flow of approximately \$23,000 over the forecast period resulting in an anticipated cash balance of approximately \$61,000 as at November 4, 2011.
15. The Monitor is satisfied that the September 19 Forecast is reasonable in the circumstances. However, it should be highlighted that the Forecast contemplates the liquidation of approximately \$250,000 of its holdings of the Terra Shares by November 4, 2011. As mentioned above, the current market value of the Terra Shares is approximately \$2.5 Million such that Management anticipates Fortress will continue to have access to sufficient liquid assets through to the beginning of November. However, achieving the anticipated cash flow projection is likely to be dependent on the Company's ability to liquidate a significant volume of the Terra Shares on a timely basis.

16. On March 31, 2011, the Court granted the Company authorization to liquidate the Terra Shares upon the Monitor's written approval with the net proceeds to be held in trust by the Company's legal counsel pending further order of the Court. The Company intends on seeking the Court's approval to be able to immediately utilize the net proceeds from any sales of the Terra Shares, provided the Monitor approves of such use, rather than the funds being held in trust by the Company's counsel. The Monitor is supportive of this course of action given the imminent anticipated need to utilize the net proceeds to fund ongoing operating expenses.

### **RESTRUCTURING EFFORTS**

17. 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 "CRA Reassessment") issued by Canada Revenue Agency ("CRA").
18. Since the commencement of the proceedings, Management and the Company's legal counsel 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.
19. During the week of September 19, 2011, Fortress' counsel was advised by CRA's legal counsel that the CRA Reassessment would be vacated. CRA's counsel informed Fortress' counsel that CRA would be preparing a letter confirming same and describing the amounts that will be set out in the formal revised Notices of Reassessment (the "Revised Reassessments"). CRA's counsel has since informed Fortress' counsel that such letter has not yet been issued because CRA disputes certain matters relating to the taxation years 1997 – 1999 and additional time is required by CRA to complete its review.
20. On May 25, 2011, Alberta Finance and Enterprise ("Alberta Finance") issued reassessments on behalf of the Province of Alberta (the "Alberta Reassessment") for the 2004, 2005 and 2006 taxation years based on the original CRA Reassessment. Fortress also disputed the Alberta Reassessment. Management and its legal counsel are confident that the Alberta Reassessment will also be vacated upon the Revised Reassessments being issued by CRA.



21. Absent the claims arising from the CRA Reassessment and the Alberta Reassessment, Fortress is otherwise solvent. Upon receipt of the Revised Reassessments there will be no need for Fortress to remain under the protection provided for by the Stay. The Company will not have to wait for confirmation that the Alberta Assessment has been vacated as Alberta Finance does not have the ability to take collection action while the Alberta Reassessment is in dispute.
22. Given the above, the Company intends on seeking an extension of the Stay until October 31, 2011.

**RECOMMENDATION**

23. 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 through to October 31, 2011 is warranted.
24. The Monitor is supportive of the Company's request for authorization to utilize the net proceeds from the sale of any of the Terra Shares provided the Monitor approves of the use of such funds.

All of which is respectfully submitted this 26<sup>th</sup> day of September 2011.

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

Per: 

A. Ronald Hardie, CA • CIRP  
President

# APPENDIX "A"

Fortress Energy Inc.  
Forecast Cash Flow  
(unaudited)

	Notes	WEEK BEGINNING						PERIOD TOTAL
		19-Sep-11	26-Sep-11	3-Oct-11	10-Oct-11	17-Oct-11	24-Oct-11	
<b>RECEIPTS</b>								
Petroleum and natural gas revenues	1		109,000				106,000	215,000
Processing revenues	1		19,000					19,000
Less: Crown royalties	1		(12,000)					(27,000)
			116,000				106,000	207,000
Sale of Terra shares	2					250,000		250,000
Accounts Receivable								
Subtotal			116,000			250,000	106,000	457,000
<b>DISBURSEMENTS</b>								
Oil and Gas Operations	3		(21,000)					(42,000)
Operating Costs	4		(50,000)			(150,000)		(200,000)
Capital items								
Payroll	5		(15,500)		(15,500)		(29,500)	(60,500)
Employees & ben	5		(34,650)					(71,400)
Consultants								
Lease payments	6		(4,200)					(8,400)
Premises	6							(7,500)
Land lease rentals	6		(7,500)					(19,425)
General & administrative	7		(8,925)					(10,500)
Professional fees	8		(1,575)					(50,000)
Restructuring costs	9							
Subtotal			(9,075)	(144,775)		(15,500)	(29,500)	(480,225)
<b>NET CASH FLOW (DEFICIT)</b>			(9,075)	(28,775)		100,000	76,500	(23,225)
<b>OPENING CASH</b>	10		84,084	75,009	46,234	30,734	130,734	84,084
<b>CLOSING CASH</b>			75,009	46,234	46,234	130,734	207,234	60,859

Notes:

- 1 Revenues (net of transportation charges) and royalties have been estimated based on recent historical results and estimated
- 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 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 September 19, 2011