

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 **FIFTH REPORT OF THE MONITOR,
HARDIE & KELLY INC.
October 25, 2011**

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**FIFTH REPORT OF THE MONITOR
HARDIE & KELLY INC.
OCTOBER 25, 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 September 26, 2011, the Monitor prepared a report to the Court (the “Fourth Report”) in advance of the Company’s application for a further extension of the Stay.
4. On September 29, 2011 the Court granted an order extending the Stay through to October 31, 2011.
5. The purpose of this report (the “Fifth 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 Fourth Report;
 - b. The Company’s financial performance since the date of the Fourth Report;
 - c. The Company’s revised cash flow forecast for the period October 24 – December 2, 2011;
 - d. The Company’s restructuring activities; and
 - e. The Company’s request for an extension of the Stay through to November 30, 2011 and the Monitor’s recommendation with respect thereto.

TERMS OF REFERENCE

6. In preparing this Fifth 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. Fortress has maintained average production levels of approximately 128 BOE/d thus far in the month of October.
8. The Company continues to defer its capital expenditure program initiatives with a view to preserving cash in the short term.

FINANCIAL PERFORMANCE

9. Concurrent with the Company's September 29, 2011 application for an extension of the Stay, Fortress filed a revised cash flow forecast through to the week of October 31, 2011 which was attached as Exhibit "B" to the September 26, 2011 Affidavit of J. Cameron Bailey (the "September 19 Forecast"). A variance analysis of the Company's actual receipts and disbursements over the period September 19 – October 21, 2011 versus the corresponding period in the September 19 Forecast is set out in the following table:

| September 19 – October 21, 2011 | | | | |
|------------------------------------|------------------|------------------|----------------|-------|
| | Actual | Forecast | Variance | Notes |
| <u>RECEIPTS</u> | | | | |
| Petroleum and natural gas revenues | 87,983 | 109,000 | (21,017) | |
| Processing revenues | - | 19,000 | (19,000) | |
| Crown royalties | - | (12,000) | 12,000 | |
| | 87,983 | 116,000 | (28,017) | |
| Sale of Terra shares | 284,206 | 250,000 | 34,206 | (a) |
| Accounts receivable | 72,841 | - | 72,841 | (b) |
| | 445,030 | 366,000 | 79,030 | |
| <u>DISBURSEMENTS</u> | | | | |
| Operating costs | (12,635) | (21,000) | 8,365 | |
| Capital expenditures | (103,972) | (200,000) | 96,028 | (c) |
| Payroll | | | | |
| Employees & benefits | (30,752) | (31,000) | 248 | |
| Consultants | (5,265) | (34,650) | 29,385 | (d) |
| Lease Payments | | | | |
| Premises | (4,200) | (4,200) | - | |
| Land and mineral lease rentals | (10,290) | (7,500) | (2,790) | |
| General and administrative | (16,459) | (10,500) | (5,959) | |
| Professional fees | - | (10,500) | 10,500 | |
| | (183,573) | (319,350) | 135,777 | |
| NET CASH FLOW | 261,457 | 46,650 | 214,807 | |
| OPENING – CASH | 84,084 | 84,084 | - | |
| CLOSING – CASH | 345,541 | 130,734 | 214,807 | |

10. Fortress experienced a positive cash flow of approximately \$261,000 over the period September 19 – October 21, 2011 versus an anticipated surplus of approximately \$47,000 over the same period. We offer the following comments with respect to the individual significant variances giving rise to the overall positive cash flow variance of approximately \$215,000:

- a. *Sale of Terra Shares* – The Company sold 500,000 of its holdings of the shares of Terra Energy Corp. (“Terra Shares”). The September 19 Forecast assumed an unspecified quantity of Terra Shares would be sold to realize approximately \$250,000 of net proceeds; however, given the pricing and bid lots at the dates of sale, net proceeds of approximately \$284,000 were realized;
- b. *Accounts receivable* – the positive variance with respect to accounts receivable, of approximately \$73,000, can be attributed to the unanticipated receipt of amounts due from joint venture partners as well as the inclusion of the receipt of processing revenues as accounts receivable collections rather than as a separate line item;

- c. Capital expenditures – the positive variance, of approximately \$96,000, with respect to capital expenditures can be attributed to timing differences with respect to the payment of expenses associated with the recent work at the McMahon Gas Plant. Payment of these expenses has been accounted for in the updated cash flow projection discussed below; and
- d. Consultants – a timing difference in respect of the payment of certain consulting fees resulted in a positive cash flow variance of approximately \$29,000. Payment of these expenses has been carried forward to the updated cash flow forecast.
11. The Company maintained a cash balance of approximately \$346,000 as at October 21, 2011.
12. Fortress now maintains 3,164,444 Terra Shares with a market value totaling approximately \$1.9 Million.

CASH FLOW FORECAST

13. Management, with the assistance of the Monitor, has prepared an updated cash flow forecast for the period October 24 through to December 2, 2011 (the “October 24 Forecast”) which is attached as Appendix “A”. A summary of the October 24 Forecast is provided in the table below:

| <u>October 24 – December 2, 2011</u> | |
|--------------------------------------|-------------------------|
| <u>Forecast</u> | |
| <u>RECEIPTS</u> | |
| P&NG revenues | 160,000 |
| Less: royalties | <u>(30,000)</u> |
| | 130,000 |
| Accounts receivable | <u>20,000</u> |
| Total Receipts | <u>150,000</u> |
| <u>DISBURSEMENTS</u> | |
| Operating costs | (30,000) |
| Capital expenditures | (89,865) |
| Payroll | |
| Employees & Benefits | (46,128) |
| Consultants | (124,581) |
| Lease Payments | |
| Premises | (8,400) |
| Land/mineral leases | (5,000) |
| General and administrative | (61,052) |
| Professional fees | <u>(10,000)</u> |
| Total Disbursements | <u>(375,026)</u> |
| Net Cash Flow | <u>(225,026)</u> |
| Opening Cash | <u>345,541</u> |
| Closing Cash | <u>120,515</u> |

14. The October 24, 2011 Forecast reflects a negative cash flow of approximately \$225,000 over the forecast period resulting in an anticipated cash balance of approximately \$121,000 as at December 2, 2011.
15. The Monitor is satisfied that the October 24 Forecast is reasonable in the circumstances. It should be noted that the Forecast does not contemplate the need to liquidate any further holdings of Terra Shares over the forecast period; however, in the event Fortress is required to make a further application for an extension of the Stay through to the New Year, it is likely the Company would then have to liquidate additional holdings of its Terra Shares.

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 “CRA Reassessment”) issued by Canada Revenue Agency (“CRA”).
17. In the Fourth Report, the Monitor reported that 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 subsequently informed Fortress’ counsel that such letter has not yet been issued because CRA disputes certain matters relating to the taxation years 1997 – 1999 (the “Earlier Claim”) and additional time is required by CRA to complete its review. This led to the Company seeking and the Court granting a further extension of the Stay to October 31, 2011.
18. As of the date of this Fifth Report, the Earlier Claim has not been resolved such that the Revised Assessments have yet to be issued. The Monitor has been advised that Management and Fortress’ tax counsel object to CRA’s proposed resolution of the Earlier Claim on the basis that CRA’s proposal would give rise to a contingent liability that would further impair the Company’s reputation and its ability to conduct business.

19. Management, Fortress' tax counsel, CRA and the Department of Justice, on behalf of CRA, are continuing their discussions with a view to resolving the matter.
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 ultimately 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 will be seeking an extension of the Stay until November 30, 2011, with the intention that Fortress would make an earlier application for its discharge from the CCAA proceedings if the Revised Assessments are issued in advance of November 30, 2011.

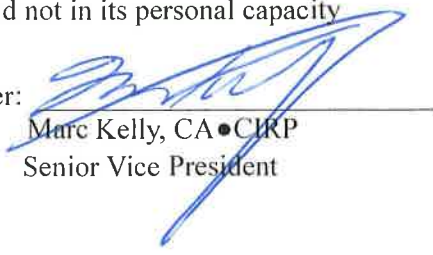
RECOMMENDATION

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 November 30, 2011 is warranted.

All of which is respectfully submitted this 25th day of October 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 |
|------------------------------------|-------|------------------|-----------------|-----------------|-----------------|----------------|------------------|
| | | 24-Oct-11 | 31-Oct-11 | 7-Nov-11 | 14-Nov-11 | 21-Nov-11 | |
| RECEIPTS | | | | | | | |
| Petroleum and natural gas revenues | 1 | 80,000 | | | | | 80,000 |
| Processing revenues | 1 | | | | | | (30,000) |
| Less: Crown royalties | 1 | 80,000 | | | | | 50,000 |
| Sale of Terra shares | 2 | | | | | | 20,000 |
| Accounts Receivable | | | | | | | 20,000 |
| Subtotal | | 80,000 | - | - | - | 20,000 | 50,000 |
| DISBURSEMENTS | | | | | | | |
| Oil and Gas Operations | | | | | | | |
| Operating Costs | 3 | (3,651) | (11,349) | | | | (15,000) |
| Capital Items | 4 | (89,865) | | | | | (89,865) |
| Payroll | | | | | | | |
| Employees & ben | 5 | (15,376) | | (15,376) | | | (15,376) |
| Consultants | 5 | (84,581) | | | | | (40,000) |
| Lease payments | | | | | | | (4,200) |
| Premises | 6 | | (4,200) | | | | (8,400) |
| Land lease rentals | 6 | | | | | (5,000) | (5,000) |
| General & administrative | 7 | (31,052) | | | | | (30,000) |
| Professional fees | 8 | | | | | | (10,000) |
| Restructuring costs | 9 | | | | | | - |
| Subtotal | | (224,525) | (15,549) | (15,376) | (15,376) | (5,000) | (114,576) |
| NET CASH FLOW (DEFICIT) | | (144,525) | (15,549) | (15,376) | (15,376) | 15,000 | (64,576) |
| OPENING CASH | 10 | 345,541 | 201,016 | 185,467 | 185,467 | 170,091 | 185,091 |
| CLOSING CASH | | 201,016 | 185,467 | 185,467 | 170,091 | 185,091 | 120,515 |

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 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 October 24, 2011