



**Terra Energy Corp.  
Consolidated Interim Financial Statements  
For the period ended March 31, 2004  
(Unaudited – prepared by management)**

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## **UNAUDITED CONSOLIDATED INTERIM FINANCIAL STATEMENTS**

In accordance with National Instrument 51-102 released by the Canadian Securities Administrators, the Corporation discloses that its auditors have not reviewed the unaudited financial statements for the period ended March 31, 2004.

	<b>Terra Energy Corp.</b>	
	<b>Balance Sheet</b>	
	<b>March 31</b>	<b>December 31</b>
	<b>2004</b>	<b>2003</b>
	<b>(unaudited)</b>	<b>(audited)</b>
		<b>(Note 1)</b>
<b>Assets</b>		
<b>Current</b>		
Cash and cash equivalents	682,287	512,051
Accounts receivable	1,552,139	1,651,014
Inventory	328,120	303,048
Income taxes receivable	135,428	231,450
Current portion of promissory note	-	559,726
Prepaid expenses	273,140	124,124
	<u>2,971,114</u>	<u>3,381,413</u>
<b>Oil and gas properties</b>	<b>15,796,949</b>	<b>12,224,115</b>
<b>Incorporation costs</b>	<b>3,417</b>	<b>3,417</b>
<b>Due from related party (Note 5)</b>	<b>-</b>	<b>15,000</b>
	<u>18,771,480</u>	<u>15,623,945</u>
<b>Liabilities and Shareholders' Equity</b>		
<b>Current</b>		
Revolving line of credit	6,730,749	7,567,154
Accounts payable	2,531,636	3,003,452
Due to related party (Note 5)	46,150	-
	<u>9,308,535</u>	<u>10,570,606</u>
<b>Asset retirement obligations</b>	<b>801,150</b>	<b>742,568</b>
<b>Future income taxes</b>	<b>1,569,123</b>	<b>1,758,923</b>
<b>Preferred shares (Note 6)</b>	<b>1,148,641</b>	<b>1,148,641</b>
	<u>12,827,449</u>	<u>14,220,738</u>
<b>Shareholders' Equity</b>		
<b>Share capital (Note 7)</b>	<b>8,174,853</b>	<b>3,429,753</b>
<b>Contributed Surplus</b>	<b>18,800</b>	<b>-</b>
<b>Deficit</b>	<b>(2,249,622)</b>	<b>(2,026,546)</b>
	<u>5,944,031</u>	<u>1,403,207</u>
	<b>\$ 18,771,480</b>	<b>\$ 15,623,945</b>
<b>Commitments and Contingencies (Note 8)</b>		

**Terra Energy Corp.**  
**Statements of Income and Retained Earnings (Deficit)**  
**(Unaudited – prepared by Management)**

**For the three month period ended March 31**

	2004	2003
<b>Revenue</b>		
Petroleum and natural gas revenues	3,598,950	2,880,068
Royalties and production taxes	(684,760)	(686,134)
	<b>\$ 2,914,190</b>	<b>\$ 2,193,934</b>
<b>Expenses</b>		
Production	736,260	679,259
Amortization and depletion	673,000	512,000
General & Administrative	528,419	287,773
Interest on revolving line of credit	72,771	106,638
Accretion	20,000	11,581
	<b>2,030,450</b>	<b>1,597,251</b>
<b>Income from operations before other items and income taxes</b>	<b>883,740</b>	<b>596,683</b>
<b>Other item</b>		
Unrealized foreign exchange gain	-	112,753
	<b>883,740</b>	<b>709,436</b>
<b>Income Taxes</b>		
Current provision	100,800	458,000
Future provision (recovery)	235,200	(178,000)
	<b>336,000</b>	<b>280,000</b>
<b>Income for the period</b>	<b>547,740</b>	<b>429,436</b>
<b>Retained earnings (deficit), beginning of period</b>	<b>(2,026,546)</b>	<b>522,135</b>
<b>Dividends (Note 5)</b>	<b>(770,816)</b>	
<b>Retained earnings (deficit), end of period</b>	<b>(2,249,622)</b>	<b>951,571</b>
<b>Earnings per common share - basic</b>	<b>\$ 0.02</b>	<b>\$ 0.02</b>
<b>Earnings per common share - diluted</b>	<b>0.02</b>	<b>0.02</b>
<b>Weighted average number of shares outstanding - basic</b>	<b>24,429,913</b>	<b>22,500,000</b>
<b>Weighted average number of shares outstanding - diluted</b>	<b>26,972,668</b>	<b>22,500,000</b>

**Terra Energy Corp.**  
**Statements of Cashflows**  
(Unaudited – Prepared by Management)

**For the three month period ended March 31**

**2004**                      **2003**

**Cash Flows from Operating Activities**

Net income	\$ 547,740	\$ 429,436
Items not affecting cash:		
Amortization and depletion	673,000	512,000
Future income taxes	235,200	(178,000)
Accretion	20,000	11,581
Stock based compensation	18,800	-
Unrealized foreign exchange gain	-	(112,753)
	<b>1,494,740</b>	<b>662,264</b>

Net Change in non-cash working capital balances	(459,713)	574,592
	<b>\$ 1,035,027</b>	<b>\$ 1,236,856</b>

**Cash Flows from Financing Activities**

Proceeds from revolving line of credit	(836,405)	50,000
Repayment of long-term debt	-	(273,767)
	<b>(836,405)</b>	<b>(223,767)</b>

**Cash Flows from Investing Activities**

Investment in oil and gas properties	(2,473,305)	(1,060,183)
Interest on note receivable	(72,540)	(26,088)
Due from related party	15,000	-
Payments received from related companies	-	190,030
Cash assumed on acquisition of Rhodes Resources Corp.	2,502,459	-
	<b>(28,386)</b>	<b>(896,241)</b>

<b>Increase in cash and cash equivalents</b>	<b>170,236</b>	<b>116,848</b>
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<b>Cash and cash equivalents, beginning of period</b>	<b>512,051</b>	<b>43,219</b>
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<b>Cash and cash equivalents, end of period</b>	<b>\$ 682,287</b>	<b>\$ 160,067</b>
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**March 31, 2004**

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## **1. NATURE OF OPERATIONS**

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Terra Energy Corp. (the "Corporation") was formed on January 30, 2004 as a result of the amalgamation of Rhodes Resources Corp. ("Rhodes"), Terrapet Energy Corp. ("Terrapet"), and Terra Energy Corp. ("Terra") pursuant to the Business Corporations Act of Alberta. The amalgamated Corporation operates under the name Terra Energy Corp. The Corporation's principal business is the exploration, development, and production of oil and natural gas.

The amalgamation has been recorded as a reverse takeover by Terrapet and the comparative financial statements represent a continuation, for accounting purposes, of the financial statements of Terrapet and its subsidiaries ("Terrapet Consolidated").

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## **2. SIGNIFICANT ACCOUNTING POLICIES**

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The interim consolidated financial statements of Terra Energy Corp. have been prepared by management in accordance with Canadian generally accepted accounting principles. The interim consolidated financial statements have been prepared following the same accounting policies and methods of computation as the financial statements for Terrapet Energy Corp. the year ended December 31, 2003. The interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements of Terrapet Energy Corp. and the notes thereto for the year ended December 31, 2003.

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## **3. CHANGE IN ACCOUNTING POLICY**

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Effective January 1, 2003, the Corporation prospectively adopted the new Canadian accounting standard relating to stock-based compensation. Under this standard, the Corporation accounts for stock options granted to non-employees using the fair-value based method. Compensation cost is measured at fair value on the date of grant and recognized over the vesting period by a charge to general and administrative expenses and an equal credit to contributed surplus. For stock options granted to employees compensation expense of \$18,800 has been recorded for the period ending March 31, 2004 with the offsetting charge to contributed surplus.

Under the transitional provisions of the standard, the Corporation is required to record compensation expense in the statement of income and deficit for options issued on or after January 1, 2003. As no options had been granted at March 31, 2003, the prior year amounts have not been restated. However, options were granted on October 31, 2003 and later comparative interim periods will be restated.

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**March 31, 2004**

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#### **4. BUSINESS ACQUISITION**

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On January 30, 2004, Terrapet Energy Corp. ("Terrapet"), Rhodes Resources Corp. ("Rhodes"), and Terra Energy Corp. ("Terra") amalgamated to form Terra Energy Corp.

The shareholders of Rhodes received 5,345,944 common shares of the Corporation based on a five to one share consolidation of their existing shareholdings at January 30, 2004. The common shareholder of Terrapet received 18,547,304 common shares of Corporation in exchange for 22,500,000 common shares of Terrapet. The Series VI preferred shareholders of Terrapet received 3,429,752 common shares of the Corporation in exchange for 3,429,752 Series VI preferred shares of Terrapet.

The amalgamation transaction has been recorded as a reverse takeover by Terrapet and these consolidated financial statements represent a continuation, for accounting purposes, of the financial statements of Terrapet and its subsidiaries Terragrande Energy Corp. and Constar Resources Ltd. The comparative amounts presented are those of Terrapet Consolidated.

Prior to January 30, 2004 Terrapet and Rhodes were related as a result of common ownership and management. The amalgamation transaction has been recorded at the exchange value as there was a substantive change in the ownership interest by non-related parties of Rhodes. The purchase price allocation has also been supported by independent evidence.

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#### **5. RELATED PARTY TRANSACTIONS**

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During the period January 1 through to March 31 of each 2003 and 2004, Terrapet and/or the Corporation entered into the following related party transactions:

(a) Related Parties:

Capital Strategies Canada Corp., controlled by officers of the Corporation  
Rhodes Resources Corp., related due to common ownership  
Terra Capital Corp., parent company  
Forterra Properties Inc., related due to common control  
Rhodes Petroleum Corp., related due to common control

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March 31, 2004

Terra Energy Corp.  
Notes to Consolidated Interim Financial Statements  
(Unaudited -Prepared by Management)

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5. RELATED PARTY TRANSACTIONS (Continued)

(b) Transactions:

	<b>Three Month Period Ended March 31, 2004</b>	Three Month Period Ended March 31, 2003
Interest revenue – Rhodes Resources Inc.	<u>\$ -</u>	<u>\$ 11,454</u>
Expenses		
Management fee – Terra Capital Corp.	<u>327,883</u>	<u>203,808</u>

- (i) Revenue and expense transactions are in the normal course of operations and have been valued in these consolidated financial statements at the exchange amount which is the amount of consideration established and agreed to by the related parties.
- (ii) Management fees have been paid to Terra Capital Corp in respect of management, personnel service, vehicle, office furniture, and equipment leasing for the periods ending March 31, 2003 and 2004.
- (iii) During 2003, the Corporation purchased all the outstanding shares of Rhodes Resources Inc., a corporation under common control with Terrapet. The assets consisted of oil and gas properties with a net book value of \$100,000. A note payable for \$100,000 was issued by Terrapet to Rhodes Petroleum Corp for consideration of this transaction. Rhodes Resources Inc. was immediately wound up into Terrapet.
- (iv) Prior to the amalgamation with Rhodes Resources Corp., and Terra Energy Corp., Terrapet paid a dividend of \$770,816 to Terra Capital Corp. The dividend resulted in the elimination of a promissory note receivable at December 31, 2003.

(c) Due from (to) related parties

	<b>March 31, 2004</b>	December 31, 2003
Terra Capital Corp.	<u>\$ (46,150)</u>	<u>\$ -</u>

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March 31, 2004

**Terra Energy Corp.**  
**Notes to Consolidated Interim Financial Statements**  
**(Unaudited -Prepared by Management)**

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**5. RELATED PARTY TRANSACTIONS (Continued)**

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Included in accounts payable and accrued liabilities at December 31, 2003 are \$39,456 owing to Rhodes Resources Corp. This amount is due for the working interest share of expenses related to wells operated by the Corporation.

Included in accounts receivable at December 31, 2003 is \$228,497 due from Rhodes Resources Corp. to Terrapet in connection with a farm-in arrangement between the two companies.

As a result of the amalgamation with Rhodes Resources Corp., no amount is owed or owing at March 31, 2004.

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**6. PREFERRED SHARES**

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The Corporation had issued and outstanding Series I to V, 8% cumulative preferred shares which are redeemable and retractable at \$1 per share. The number of shares outstanding at March 31, 2004 was 1,148,641 (December 31, 2003 – 1,148,641). All dividends have been paid to December 31, 2003. As these shares are redeemable at the option of the holder and retractable at the option of the Corporation, a liability in the amount of \$1,148,641 (December 31, 2003 - \$1,148,641) has been reflected in the Corporation's consolidated financial statements. The holder of the preferred shares has waived his right to redeem these shares prior to April 1, 2005. As a result, the liability has been classified as long-term.

March 31, 2004

**7. SHARE CAPITAL**

a) Authorized:

- i) Unlimited number of common voting shares
- ii) Unlimited number of preferred shares

b) Common Shares Issued:

	Number	Amount
Balance, December 31, 2003	22,500,000	1
Share reduction as a result of amalgamation	(3,952,696)	-
Issued for preferred Series VI share conversion	3,429,752	3,429,752
Issued on acquisition of Rhodes Resources Corp. (note 3)	5,345,944	4,495,100
Issued as consideration for certain oil and gas properties	200,000	250,000
Balance, March 31, 2004	27,523,000	8,174,853

On October 31, 2003 Terrapet completed a 220,588:1 stock split. All number of shares and per share amounts has been restated to reflect the stock split for 2003.

Series VI Preferred Shares Issued:

	Number	Amount
Balance December 31, 2003	3,429,752	3,429,752
Reduction due to conversion to common shares	(3,429,752)	(3,429,752)
Balance, March 31, 2004	-	-

March 31, 2004

**7. SHARE CAPITAL (continued)**

c) Stock Options:

- (i) The Corporation has a stock option plan whereby officers, directors, employees, and consultants may be granted options to purchase common shares of the Corporation. At March 31, 2004 options have been granted to purchase 2,429,000 common shares (December 31, 2003 – nil) ranging at prices between \$0.75 and \$1.00 with expiry dates ranging from December 31, 2006 to February 13, 2009.

Details of the options outstanding are as follows:

	Number	Weighted Average Exercise Price
Balance December 31, 2003	-	-
Granted on acquisition of Rhodes Resources Corp. (note 3) under stock option plan	<b>312,000</b>	<b>0.75</b>
Granted under the stock option plan	<b>2,117,000</b>	<b>1.00</b>
Balance, March 31, 2004	<b>2,429,000</b>	<b>\$0.97</b>

  

Options Exercise Price	Outstanding March 31, 2004	Weighted Average Remaining Contract Life	Exercisable March 31, 2004	Weighted Average Remaining Contract Life
\$0.75	312,000	3.58 years	312,000	3.58 years
1.00	2,117,000	4.88 years	403,400	4.88 years
	2,429,000	4.71 years	715,400	4.71 years

- (ii) Prior to amalgamation, Terrapet has also issued 400,000 options that were converted to 329,730 options post amalgamation. The options are exercisable at \$1.21 per common share and expire December 31, 2006.
- (iii) The Corporation has also granted 217,400 agent options issued under Rhodes Resources Corp. prior to acquisition. These options are exercisable at \$1.00 per common share and expire on December 31, 2005.

**March 31, 2004**

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**7. SHARE CAPITAL (Continued)**

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d) Stock-based compensation:

Effective January 1, 2003, the Corporation prospectively adopted the new Canadian accounting standard relating to stock-based compensation. Under this standard, the Corporation accounts for stock options granted to non-employees using the fair-value based method. Compensation cost is measured at fair value on the date of grant and recognized over the vesting period by a charge to general and administrative expenses and an equal credit to contributed surplus. For stock options granted to employees compensation expense of \$18,800 has been recorded for the period ending March 31, 2004 with the offsetting charge to contributed surplus.

The fair value of share options was estimated using the Black-Scholes option-pricing model with the following assumptions: Dividend yield (Nil); expected volatility at 1%; risk-free interest rate of 3.5%; weighted average life of 5 years.

e) Warrants

The Corporation issued in exchange for warrants previously granted by Rhodes Resources Corp., the following warrants:

- i) 60,000 warrants exercisable to purchase a common share at \$1.00 per common share expiring on July 9, 2004.
- ii) 1,066,667 warrants exercisable to purchase a common share at \$1.00 per common share with 424,000 expiring December 31, 2004, 332,000 expiring March 7, 2005, and 310,667 expiring October 28, 2005.
- iii) 687,500 warrants exercisable to purchase a common share at \$1.10 per share until December 31, 2004, and \$1.20 per share until December 31, 2005 when these warrants will expire.

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March 31, 2004

**Terra Energy Corp.**  
**Notes to Consolidated Financial Statements**  
**(Unaudited -Prepared by Management)**

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**8. COMMITMENTS AND CONTINGENCIES**

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- (a) The Corporation is subject to various regulatory and statutory requirements relating to the protection of the environment. These requirements, in addition to contractual agreements and management decisions, result in the accrual of estimated future removal and site restoration costs. Any changes in these estimates will affect future earnings.

Costs attributable to these commitments and contingencies are expected to be incurred over an extended period of time and are to be funded mainly from the Corporation's cash provided by operating activities. Although the ultimate impact of these matters on net earnings cannot be determined at this time, it could be material for any one quarter or year.

- (b) The Corporation had outstanding letters of credit to various parties for a total of \$155,900. These letters of credit will expire in the next year.
- (c) The Corporation is currently involved in litigation with an industry participant who is claiming \$685,850 in respect of breach of contract related to payment on account of Authorizations for Expenditures related to the development of certain lands and pipelines. The Corporation is contesting this claim and issued a counterclaim. It is management's opinion that an adequate provision has been recorded in these consolidated financial statements. Additional amounts, if any, required to resolve these matters, will be recorded in the period of settlement.
- (d) The Corporation is currently involved in litigation with three registered landowners who are claiming \$85,000 in respect of breach of contract and trespass related to activities on or near land owned by the plaintiffs. The Corporation is contesting this claim. No provision has been recorded in these consolidated financial statements. Additional amounts, if any, required to resolve these matters, will be recorded in the period of settlement.
- (e) Constar Resources Ltd. ("Constar"), a subsidiary of the Corporation, was also involved in litigation with a vendor for \$51,239 resulting from unpaid amounts by Constar. The entire liability had been accrued in the accounts at December 31, 2003. The matter has been resolved during the current period without any additional amounts being recorded.
- (f) The Corporation is currently involved in litigation brought by an industry participant relating to a claim of ownership or equitable ownership in a natural gas lease covering a one-quarter Section of land. The Corporation is contesting this claim. No provision has been recorded in these financial statements.
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**March 31, 2004**

**8. COMMITMENTS AND CONTINGENCIES – (Continued)**

(g) The Corporation has entered into contracts to hedge commodity prices and deliver petroleum and natural gas. The terms of the contracts are summarized as follows:

Contract Type	Buy Price	Sales Price	Remaining Volume	Contract Term
Physical	N/A	\$5.87 per GJ	214,000GJ	November 1, 2003 to October 31, 2004
Physical	\$5.55 per GJ at AECO	N/A	214,000 GJ	November 1, 2003 to October 31, 2004
Physical	N/A	\$33.67 per bbl	9,000bbl	January 1, 2004 to December 31, 2004
Physical	N/A	\$34.30 per bbl	9,000bbl	January 1, 2004 to December 31, 2004
Physical	N/A	\$36.89 per bbl	2,730bbl	January 1, 2004 to June 30, 2004
Physical	N/A	\$33.38 per bbl	6,000bbl	July 1, 2004 to December 31, 2004
Financial	N/A	\$35.35 per bbl	36,000bbl	January 1, 2005 to December 31, 2005
Financial	N/A	\$36.65 per bbl	36,000bbl	January 1, 2005 to December 31, 2005

N/A – not applicable

The amount that the Corporation would be required to pay if all the contracts were cancelled at March 31, 2004 would approximate \$268,000 (March 31, 2003 - \$1,288,000).

(h) The Corporation has available a financial swap facility of up to \$2.5 million. The Corporation may enter commodity swap contracts with terms of less than one year and may not exceed 2/3 of the Corporation's average daily production, net of royalties, for the fiscal quarter prior to the date the contract is entered into. The facility is secured by a general security agreement; a floating charge debenture in the amount of \$35 million and an unlimited liability guarantee by the Corporation and its subsidiaries. At March 31, 2004 there were no outstanding swap contracts.