

**Terra Energy Corp.  
Consolidated Interim Financial Statements  
For the period ended September 30, 2004  
(Unaudited – prepared by management)**

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**Terra Energy Corp.**  
**Consolidated Balance Sheet**  
(Unaudited – prepared by management)

	September 30, 2004 (unaudited)	December 31, 2003 (audited) (Note 1)
<b>Assets</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$ 14,577	\$ 512,051
Accounts receivable	2,131,599	1,651,014
Inventory	470,575	303,048
Income taxes receivable	349,380	231,450
Current portion of promissory note	-	559,726
Prepaid expenses	408,743	124,124
	<b>3,374,874</b>	<b>3,381,413</b>
<b>Non Current Assets</b>		
Oil and gas properties	22,370,796	12,224,115
Incorporation costs	3,417	3,417
Due from related party (Note 5)	-	15,000
	<b>\$ 25,749,087</b>	<b>\$ 15,623,945</b>
<b>Liabilities and Shareholders' Equity</b>		
<b>Current Liabilities</b>		
Revolving line of credit (Note 6)	\$ -	\$ 7,567,154
Accounts payable and accrued liabilities	2,260,310	3,003,452
Accrued petroleum and natural gas property acquisition	750,000	-
	<b>3,010,310</b>	<b>10,570,606</b>
<b>Non Current Liabilities</b>		
Revolving line of credit (Note 6)	6,933,296	-
Asset retirement obligations	1,478,279	742,568
Future income taxes	2,682,395	1,758,923
Preferred shares (Note 7)	1,148,641	1,148,641
	<b>15,252,921</b>	<b>14,220,738</b>
<b>Shareholders' Equity</b>		
Share capital (Note 8)	11,651,262	3,429,753
Contributed Surplus (Note 3(a) and 4)	1,376,042	-
Deficit	(2,531,138)	(2,026,546)
	<b>10,496,166</b>	<b>1,403,207</b>
	<b>\$ 25,749,087</b>	<b>\$ 15,623,945</b>
<b>Commitments and Contingencies (Note 9)</b>		

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

	For the three months ended September 30		For the nine months ended September 30	
	2004	2003	2004	2003
<b>Revenue</b>				
Petroleum and natural gas	\$ 3,777,336	\$ 3,185,791	\$ 11,771,608	\$ 8,614,419
Royalties and production taxes (Note 11)	(884,557)	(921,708)	(2,382,685)	(1,994,217)
	<b>2,892,779</b>	2,264,083	<b>9,388,923</b>	6,620,202
<b>Expenses</b>				
Production	1,147,349	807,395	3,110,589	2,429,325
Amortization and depletion	1,083,000	446,000	2,700,000	1,392,000
General & administrative	522,012	531,036	1,523,774	1,054,670
Stock based compensation	103,000	-	434,000	-
Interest on revolving line of credit	61,358	-	203,083	-
Accretion	25,500	11,581	69,000	34,743
Interest on long term debt	20,388	101,212	61,164	312,020
	<b>2,962,607</b>	1,887,224	<b>8,101,610</b>	5,222,758
<b>Income (loss) from operations before other items and income taxes</b>	<b>(69,828)</b>	366,859	<b>1,287,313</b>	1,397,444
<b>Other income items</b>				
Unrealized foreign exchange gain	-	13,285	-	240,377
<b>Income (loss) before income taxes</b>	<b>(69,828)</b>	380,144	<b>1,287,313</b>	1,637,821
<b>Income taxes (recovery) (Note 13)</b>				
Current provision	(285,500)	-	(180,000)	86,600
Future provision	480,500	161,800	985,300	565,700
	<b>195,000</b>	161,800	<b>805,300</b>	652,300
<b>Net Income (loss) for the period</b>	<b>\$ (264,828)</b>	\$ 218,344	<b>\$ 482,013</b>	\$ 985,521
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<b>Earnings (loss) per common share – basic and diluted</b>	<b>\$ (0.01)</b>	\$ 0.01	<b>\$ 0.02</b>	\$ 0.04
<hr/>				
<b>Weighted average number of shares outstanding - basic</b>	<b>26,897,337</b>	22,500,000	<b>26,897,337</b>	22,500,000
<b>Weighted average number of shares outstanding - diluted</b>	<b>27,478,343</b>	22,500,000	<b>27,478,343</b>	22,500,000

**Terra Energy Corp.**  
**Interim Consolidated Statements of Retained Earnings (Deficit)**  
**(Unaudited – Prepared by Management)**

	For the three months ended September 30		For the nine months ended September 30	
	2004	2003	2004	2003
<b>Retained earnings (deficit), beginning of period</b>	<b>\$ (2,234,881)</b>	\$ 1,289,312	<b>\$ (2,026,546)</b>	\$ 522,135
<b>Net Income (loss) for the period</b>	<b>(264,828)</b>	218,344	<b>482,013</b>	985,521
<b>Purchase of common shares exceeding carrying value (Note 8 (b))</b>	<b>(31,429)</b>	-	<b>(215,789)</b>	-
<b>Dividends (Note 5)</b>	-	(55,000)	<b>(770,816)</b>	(55,000)
<b>Retained earnings (deficit), end of period</b>	<b>\$ (2,531,138)</b>	\$1,452,656	<b>\$ (2,531,138)</b>	\$ 1,452,656

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

	For the three month period ended September 30		For the nine month period ended September 30	
	2004	2003	2004	2003
<b>Cash flows from operating activities</b>				
Net income for the period	\$(264,828)	\$218,344	\$482,013	\$985,521
Items not affecting cash:				
Amortization and depletion	1,083,000	446,000	2,700,000	1,392,000
Future income taxes	480,500	161,800	985,300	565,700
Stock based compensation	103,000	-	434,000	-
Accretion	25,500	11,581	69,000	34,743
Unrealized foreign exchange gain	-	(13,285)	-	(240,377)
	<u>1,427,172</u>	<u>824,440</u>	<u>4,670,313</u>	<u>2,737,587</u>
Net change in non-cash working capital balances	(1,734,847)	(408,865)	(2,331,654)	(879,317)
	<u>(307,675)</u>	<u>415,575</u>	<u>2,338,659</u>	<u>1,858,270</u>
<b>Cash flows from financing activities</b>				
Issuance of share capital	4,541,881	-	4,556,881	-
Proceeds from (payment of) revolving line of credit	(127,141)	800,000	(633,858)	600,000
Repurchase of share capital	(41,524)	-	(289,858)	-
Repayment of long-term debt	-	(443,874)	-	(960,429)
Payment of dividends [Note 5(b)iv]	(105,000)	(55,000)	(105,000)	(55,000)
	<u>4,268,216</u>	<u>301,126</u>	<u>3,528,165</u>	<u>(415,429)</u>
<b>Cash flows from investing activities</b>				
Acquisition of oil and gas properties	(4,625,805)	(113,565)	(9,979,803)	(1,265,744)
Proceeds from disposal of oil and gas properties	1,276,678	240,750	1,276,678	240,750
Interest on note receivable	-	-	(72,540)	(26,088)
Due from related party	-	-	15,000	-
Payments paid to related companies	(106,092)	(205,500)	(106,092)	(205,500)
Cash assumed on acquisition of Rhodes Resources Corp.	-	-	2,502,459	-
	<u>(3,455,219)</u>	<u>(78,315)</u>	<u>(6,364,298)</u>	<u>(1,256,582)</u>
<b>Increase (decrease) in cash and cash equivalents</b>	<b>505,322</b>	<b>638,386</b>	<b>(497,474)</b>	<b>186,259</b>
<b>Cash and cash equivalents, beginning of period</b>	<b>(490,745)</b>	<b>(408,908)</b>	<b>512,051</b>	<b>43,219</b>
<b>Cash and cash equivalents, end of period</b>	<b>\$14,577</b>	<b>\$229,478</b>	<b>\$14,577</b>	<b>\$229,478</b>

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September 30, 2004

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

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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. CHANGES IN ACCOUNTING POLICIES**

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- (a) Effective January 1, 2004, the Corporation 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 \$434,000 has been recorded for the period ending September 30, 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 for options issued on or after January 1, 2003. As no options had been granted at September 30, 2003, the prior year amounts have not been restated.

- (b) The Canadian Institute of Chartered Accountants has issued a new accounting guideline on Hedging Relationships (AcG 13), which is effective for 2004. This guideline, in addition to supplementing and interpreting existing hedging requirements under Canadian GAAP, establishes certain other conditions required before hedge accounting may be applied. It is management's opinion that all outstanding commodity price derivative contracts satisfy the necessary requirements to be designated a hedging relationship.
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September 30, 2004

**Terra Energy Corp.**  
**Notes to Consolidated Interim Financial Statements**  
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**4. BUSINESS ACQUISITION (AMALGAMATION)**

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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 5,417,374 common shares of the Corporation based on a five to one share exchange ratio for their existing shareholdings at January 30, 2004. The common shareholder of Terrapet received 18,547,304 common shares of the 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 determination has also been supported by independent appraisals and evidence.

The determination of purchase price and the preliminary allocation to assets and liabilities is shown below. The purchase price determination is preliminary because certain items such as determination of the final tax bases and fair values of the assets and liabilities as of the acquisition date have not been entirely completed.

**Fair values of net assets acquired:**

Current assets	<b>\$ 2,502,459</b>
Other current assets	<b>160,000</b>
Future income tax asset	<b>725,000</b>
Oil and gas properties	<b>2,337,108</b>
Current liabilities assumed	<b>(317,299)</b>
Asset retirement obligations	<b>(37,168)</b>
	<b><u>\$ 5,370,100</u></b>

**Consideration given:**

Share capital issued, net of issuance costs	<b>\$ 4,495,100</b>
Stock options and warrants issued value recorded to Contributed Surplus	<b>875,000</b>
	<b><u>\$ 5,370,100</u></b>

The fair value for 536,400 share options and 1,884,167 warrants was estimated using the Black-Scholes option-pricing model with the following assumptions: Dividend yield (Nil); expected volatility at 30%; risk-free interest rate of 3.5%; with varying lives between 6 months and 3.75 years.

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September 30, 2004

**Terra Energy Corp.**  
**Notes to Consolidated Interim Financial Statements**  
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**5. RELATED PARTY TRANSACTIONS**

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During January 1 through to September 30 of each of fiscal periods 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

(b) Transactions:

	<b>Nine Month Period Ended September 30, 2004</b>	<b>Nine Month Period Ended September 30, 2003</b>
Interest revenue – Rhodes Resources Inc.	\$ -	\$ 11,454
Management fee – Terra Capital Corp. (ii)	<b>\$ 385,977</b>	\$ 463,349

- 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 September 30, 2003 and 2004.
  - iii During 2003, the Terrapet Energy Corp. 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 fair market value of \$100,000. A note payable for \$100,000 was issued by Terrapet to Rhodes Petroleum Corp for consideration of this transaction. Upon acquisition, 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. A promissory note receivable in the amount of \$665,816 was eliminated as part of the dividend amount as well as payment of other items.
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September 30, 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 September 30, 2004 \$nil (December 31, 2003 - \$39,456) owing to Rhodes Resources Corp. This amount was due for the working interest share of expenses related to wells operated by the Corporation prior to amalgamation.

Included in accounts receivable at September 30, 2004 \$nil (December 31, 2003 \$228,497) due from Rhodes Resources Corp. to Terrapet in connection with a farm-in arrangement between the two companies prior to amalgamation.

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**6. REVOLVING LINE OF CREDIT**

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The Corporation has available a revolving line of credit of up to \$10 million, which bears interest at prime plus 0.25%, and is repayable on demand with one year's notice. The facility is secured by a general security agreement, a floating charge debenture in the amount of \$35 million and an unlimited guarantee by Terra Energy Partnership and Constar Resources Ltd. At September 30, 2004, the Corporation was indebted on the revolving line of credit for the amount of \$6,933,296.

During the period ended September 30, 2004 the Corporation renegotiated its credit facility to require repayment with at least one year's notice from the bank. As a result the liability has been classified as non-current liabilities.

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**7. PREFERRED SHARES**

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Terrapet had issued an outstanding Series I to V, 8% cumulative preferred shares which were redeemable and retractable at \$1 per share. Upon amalgamation the Corporation issued Series I to V, 8% cumulative preferred share which were redeemable and retractable at \$1 per share in exchange for the Terrapet issued shares. The number of shares outstanding at September 30, 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 October 1, 2005. As a result, the liability has been classified as long-term.

During the nine month period ended September 30, 2004, dividends of \$61,164 (September 30, 2003 - \$nil) have been accrued on these shares. These amounts have been recorded as part of interest on long term debt.

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September 30, 2004

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

**8. 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 (amalgamation) of Rhodes Resources Corp. (note 4)	5,417,374	4,495,100
Issued as consideration for certain oil and gas properties	200,000	250,000
Issued on exercise of warrants	126,150	126,150
Issued on exercise of options	55,000	41,250
Issued pursuant to a flow through share agreement, net of tax effected share issuance costs	3,450,000	4,170,981
Income tax effect of flow through share renoucement related to flow shares issued through the Corporation and its predecessors		(787,900)
Shares repurchased	(249,400)	(74,072)
Balance, September 30, 2004	30,976,180	\$ 11,651,262

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.

The Corporation obtained permission from the TSX Venture Exchange for a Normal Course Issuer Bid to repurchase for cancellation up to 250,000 common shares to April 22, 2005. During the period ended September 30, 2004, 249,400 common shares were purchased.

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, September 30, 2004	-	\$ -

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September 30, 2004

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

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**8. SHARE CAPITAL (continued)**

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Pursuant to an escrow agreement and the policies of the TSX Venture Exchange, 19,731,522 common shares of the Corporation were deposited in escrow at the amalgamation date. The shares have been released as follows:

- (i) 4,636,826 on February 12, 2004
- (ii) 236,844 on March 20, 2004
- (iii) 4,636,826 on August 12, 2004
- (iv) 236,844 on September 20, 2004

The remaining escrowed common shares shall be released as follows:

- (i) 4,636,826 on February 12, 2005.
- (ii) 236,844 on March 20, 2005.
- (iii) 4,636,826 on August 12, 2005
- (iv) 236,844 on September 20, 2005
- (v) 236,842 on March 20, 2006.

No additional shares have been released subsequent to September 30, 2004.

c) Stock Options:

The Corporation has adopted an Employee Stock Option Plan whereby officers, directors, employees, and consultants may be granted options to purchase common shares of the Corporation subject to various vesting periods and other terms and conditions specified in the stock option plan. At September 30, 2004 options have been granted to purchase 2,838,000 common shares (December 31, 2003 - nil) ranging at prices between \$0.75 and \$1.00 with expiry date of February 11, 2009.

As part of the flow through share issuance during the three month period ended September 30, 2004, \$67,042 has been recorded to contributed surplus to reflect the estimated fair value of these options. The fair value for 241,500 share options was estimated using the Black-Scholes option-pricing model with the following assumptions: Dividend yield (Nil); expected volatility at 30%; risk-free interest rate of 3.5%; with varying lives between 6 months and 2.0 years.

September 30, 2004

Terra Energy Corp.  
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8. SHARE CAPITAL (continued)

c) Stock Options:

Details of all options outstanding are as follows:

	Number	Weighted Average Exercise Price
<b>Employee Stock Options</b>		
Balance December 31, 2003	-	\$ -
Granted on acquisition (amalgamation) of Rhodes Resources Corp. under stock option plan	312,000	0.75
Granted under the stock option plan in the current year	2,647,000	1.00
Exercised during the current period	(55,000)	(0.75)
Expired during the current period	(66,000)	(0.75)
<b>Employee Stock Options Balance, September 30, 2004</b>	<b>2,838,000</b>	<b>0.97</b>
<b>Agent Options</b>		
Balance December 31, 2003	-	-
Granted on acquisition (amalgamation) of Rhodes Resources Corp. These options expire between December 2005 and January 2006.	224,400	1.00
Granted as part of flow through share issuance. These options will expire August 29, 2006	241,500	1.40
<b>Balance September 30, 2004</b>	<b>465,900</b>	<b>1.21</b>
<b>Other Options</b>		
Balance December 31, 2003	400,000	1.00
Cancelled upon amalgamation with Terra Energy Corp. and Rhodes Resources Corp.	(400,000)	(1.00)
Granted as part of amalgamation of Terra Energy Corp. and Rhodes Resources Corp. These options expire December 31, 2006.	329,730	1.21
<b>Total Options Balance September 30, 2004</b>	<b>3,633,630</b>	<b>1.02</b>

September 30, 2004

Terra Energy Corp.  
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**8. SHARE CAPITAL (Continued)**

c) Stock Options:

Options Exercise Price	Weighted Average Remaining Contract Life	Outstanding September 30, 2004	Weighted Average Share Price for Outstanding Options	Exercisable September 30, 2004	Weighted Average Share Price for Exercisable Options
\$0.75	4.38 years	241,000		241,000	
1.00	4.38 years	2,597,000		403,400	
1.00	1.25 years	224,400		224,400	
1.21	2.25 years	329,730		329,730	
1.40	1.92 years	241,500		241,500	
	3.83 years	3,633,630	\$1.03	1,440,030	\$1.07

d) Stock-based compensation:

For stock options granted to employees compensation expense of \$434,000 has been recorded for the period ending September 30, 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 50%; 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) 1,066,667 warrants exercisable to purchase one 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.
- ii) 687,500 warrants exercisable to purchase one common share at \$1.10 per share until December 31, 2004, and at \$1.20 per share until December 31, 2005 at which time these warrants will expire.
- iii) 70,000 warrants exercised to purchase one common share at \$1.10 per share until January 29, 2005 and \$1.20 until January 29, 2006.

## 9. 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 asset retirement obligations. 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 may in the future be material for any one quarter or year.

- (b) The Corporation had outstanding letters of credit to various parties for a total of \$250,000 (December 31, 2003 - \$126,400). These letters of credit will expire in 2005.
- (c) The Corporation is currently involved in litigation with an industry participant who is claiming \$685,850 in respect of an alleged breach of contract arising from a failure to pay on account of Authorizations for Expenditures relating to the development of certain lands and pipelines. The Corporation is contesting this claim and has issued a counterclaim in respect of the same subject. 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 or when management changes its estimate of an adequate provision.
- (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 arising from pipeline construction and related operation and carried on by the Corporation 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 or when management can reasonably assess the likelihood and balance of amounts owing, if any.
- (e) 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 consolidated financial statements. Additional amounts, if any, required to resolve these matters will be recorded in the period of settlement or when management changes its estimate of an adequate provision.
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**Terra Energy Corp.**  
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**9. COMMITMENTS AND CONTINGENCIES – (Continued)**

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

Contract Type	Sales or Floor Price	Ceiling Price	Remaining Volume	Contract Term
Physical	\$5.80 per GJ	N/A	15,500 GJ	April 1, 2004 to October 31, 2004
Physical	\$33.67 per bbl	N/A	3,000bbl	January 1, 2004 to December 31, 2004
Physical	\$34.30 per bbl	N/A	3,000bbl	January 1, 2004 to December 31, 2004
Physical	\$33.38 per bbl	N/A	3,000bbl	July 1, 2004 to December 31, 2004
Financial	\$6.05 per GJ	N/A	123,000GJ	April 1, 2004 to October 31, 2004
Financial	\$6.15 per GJ	N/A	61,500GJ	April 1, 2004 to October 31, 2004
Financial	\$6.00 per GJ Floor with Protection of \$1.00 per GJ	8.95 per GJ	365,000GJ	November 1, 2004 to October 31, 2005
Financial	\$35.35 per bbl	N/A	36,500bbl	January 1, 2005 to December 31, 2005
Financial	\$36.65 per bbl	N/A	36,500bbl	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 September 30, 2004 would approximate \$1,414,110 (December 31, 2003 - \$219,000).

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September 30, 2004

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

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

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- (g) The Corporation has available a financial swap facility of up to \$3 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 September 30, 2004 (December 31, 2003 - \$nil) there were no outstanding swap contracts.
- (h) The Corporation is required to incur exploration and development activities of approximately \$2,300,000 as a result of flow through shares issued by Rhodes Resources Corp. As at September 30, 2004, the Corporation has incurred all required qualifying expenditures.
- (i) During August, 2004 the Corporation is required to incur exploration and development activities of approximately \$4,485,000 as a result of flow through shares issued in August, 2004. As at September 30, 2004, the Corporation has incurred qualifying expenditures of approximately \$58,000.
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**10. NON-CASH TRANSACTIONS**

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- (a) In lieu of settlement, dividends of \$665,816 (2003 - \$1,065,012) were declared for balances due to related parties.
- (b) During the current year, certain properties were purchased from an unrelated party for \$1 million. As part of the consideration, 200,000 common shares valued at an estimated fair market value \$250,000 were issued by the Corporation to the vendor.
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**11. ROYALTIES AND PRODUCTION TAXES**

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As a result of post amalgamation internal reviews, the Corporation has identified \$297,050 of unpaid production royalties to industry partners. In accordance with Generally Accepted Accounting Principles, the recognition of these revised estimates have been recorded in the current period.

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September 30, 2004

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

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**12. SUBSEQUENT EVENT**

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Subsequent to the period end, the Corporation entered into a commitment to amalgamate with Fossil Bay Resources Ltd. through a wholly owned subsidiary, Terra Resources Inc. The amalgamation is expected to be completed before December 31, 2004 and is expected to result in the issuance of as many as 681,510 common shares by the Corporation.

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**13. INCOME TAXES**

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The income tax provision for the nine month period ended September 30, 2004 is explained as follows:

Net Income before income taxes	<u>\$1,287,313</u>
Expected income tax provision at 39%	502,000
Adjustment for opening income tax pool balances	180,000
Non deductible stock based compensation expense	169,300
Adjustment for net resource deductions	<u>(46,000)</u>
Income tax provision as reported	<u><u>805,300</u></u>

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