

# Echo Energy Canada Inc.

## Management's Discussion and Analysis of Financial Statements For the nine months ended September 30, 2005

November 18, 2005

### **Overall Performance**

Echo Energy Canada Inc. (the "Company") is in the business of exploring for, developing and operating natural gas and hydro-carbon properties.

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries, 1490564 Ontario Limited, Pecho Pipelines Inc. ("Pecho") and Echo Energy Inc. ("EEI"). Its investment in Echo Power Generation Inc. ("EPG") is accounted for under the equity method.

On August 27, 2004 the Company completed a three cornered amalgamation with EEI and 1593485 Ontario Inc ("Subco"), with the result that EEI and Subco amalgamated under the Business Corporations Act (Ontario) to form a new corporation wholly owned by the Company called Echo Energy Inc. The three cornered amalgamation was recorded as a reverse takeover under Canadian generally accepted accounting principles. In accordance with those principles, the Company's financial statements are shown as a continuation of Echo Energy Inc., including the comparative financial statements. By articles of amendment dated October 13, 2004, the Company changed its name from Pifher Resources Inc. to Echo Energy Canada Inc and split its common shares on a 3 for 1 basis.

The Company recorded earnings of \$4,175 for the period ended September 30, 2005 compared to a net loss of \$366,521 for the same period in 2004. Operating earnings of \$685,669 for the period ended September 30, 2005 were offset by equity in losses of EPG totaling \$557,194. Cumulative exploration expenses as at September 30, 2005 were \$42,455,876 including expenditures of \$539,275 for the nine months ended September 30, 2005 offset by \$233,711 of depletion for the period. The Company also incurred expenditures of \$738,334 in the construction of a gas pipeline and distribution system through its subsidiary Pecho and \$59,360 to acquire automotive equipment.

### **Selected Annual Information**

	December 31, 2004	December 31, 2003	December 31, 2002
	\$	\$	\$
Total revenues	504,184	31,171	24,866
Net income (loss)	(2,158,686)	(202,370)	(151,289)
Basic income (loss) per share	(0.13)	(0.02)	(0.02)
Diluted income (loss) per share	(0.13)	(0.02)	(0.02)
Total assets	49,768,621	8,592,907	5,178,779
Total long term financial liabilities	5,000,000	—	—

The above selected information and the summary of quarterly results presented below have been prepared by management, in Canadian currency, in accordance with Canadian generally accepted accounting principles and following the same accounting principles and methods of computation as the audited consolidated financial statements for the fiscal years ended December 31, 2003 and 2004 unless otherwise disclosed. The disclosures provided below are incremental to those included with the annual audited consolidated financial statements. This discussion and analysis should be read in conjunction with the consolidated financial statements and the notes thereto for the year ended December 31, 2004.

## **Results of Operations**

With the continuation of commercial operations, which commenced in the fourth quarter of 2004, the Company reflected gross sales of natural gas in the amount of \$3,071,017 for the first nine months of 2005 offset by royalties of \$191,342. Interest income decreased 52% from \$13,093 for the period ended September 30, 2004 to \$6,299 for the same period in 2005 as a result of lower term deposit balances.

Expenses directly related to gas sales amounted to \$179,512 for transportation, \$577,670 for operations and \$261,181 for depletion. Interest costs, in the amount of \$226,807, related to financing of the gathering system were also expensed. As the Company was in the development stage in the comparative period, no such costs were expensed and, specifically, prior interest charges related to bank financing had been capitalized as part of the cost of the gathering system.

Administrative expenses increased 167% from \$82,435 for the period ended September 30, 2004 to \$220,275 for the same period in 2005 due in part to increased activity and in part to the fact that comparative figures reflect only the costs incurred by Echo Energy Inc for the first eight months of 2004. Similarly, professional fees also increased by 200% from \$243,760 for the period ended September 30, 2004, including eight months of EEI only, to \$731,827 for the consolidated Company results for the same period in 2005. Increases were expected due to support for the activity on the Company's oil and gas leases, expenses related to the startup of gas operations and expenses related to the business combination involving the Company and its subsidiaries. Significant legal fees were also incurred during the first six months in regard to pursuit of an injunction designed to control possible interference caused by the activities of another company on lands under lease. The Company was unsuccessful in its application.

During the period ended September 30, 2005, the Company recorded its share of losses in EPG of \$557,194 (2004 – \$166,380). EPG is an Ontario corporation engaged in the business of exploring for wind power resources in Ontario. EPG has entered into license and easement option agreements with several land owners in Houghton and Bayham Townships. EPG has also entered into a strategic partnership regarding a renewable energy bid as discussed below.

## **Summary of Quarterly Results**

	For the three month period ended,							
	Sept 30, 2005	June 30, 2005	March 31, 2005	Dec 31, 2004	Sept 30, 2004	June 30, 2004	March 31, 2004	Dec 31, 2003
Revenues	1,093,607	1,078,696	898,714	491,091	3,303	1,221	8,569	11,088
Income from continuing operations	58,229	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Net income (loss)	58,229	(24,904)	(29,150)	(1,792,165)	(96,186)	(189,538)	(80,797)	(216,990)
Net income per share - basic (loss)	0.001	(0.000)	(0.001)	(0.04) <sup>1</sup>	(0.01)	(0.02)	(0.01)	(0.02)
Net income per share - fully diluted (loss)	0.001	(0.000)	(0.001)	(0.04) <sup>1</sup>	(0.01)	(0.02)	(0.01)	(0.02)

Notes:

- (1) Fluctuation in net income, net income per share basic and diluted due primarily to recognition of share compensation expense in the amount of \$1,514,000.

## **Liquidity**

### **[a] Shareholder Financing**

On October 28, 2004 the Company granted a total of 4,700,000 stock options to certain of its directors, officers and employees exercisable at a price of \$2.00 per share prior to October 28, 2007.

In August 2005, the Company received subscriptions for 397,600 flow-through common shares by private placement, which will result in gross proceeds of \$497,000.

### **[b] Bank Financing**

During the year ended December 31, 2004, the Company secured a credit facility of \$5,000,000 consisting of an interim construction loan and a demand revolving reducing term line of credit with a maturity date of March 10, 2005. Interest was charged at a rate of prime plus 1% for the interim construction loan and prime plus .5% on the demand revolving term facility. The Company also obtained from the lender, backing for letters of credit and stand-by letters of guarantee for up to \$500,000 with an interest rate of 2.5% per annum. The credit facilities assisted in the construction of the natural gas gathering system as discussed below.

During the period ended March 31, 2005, in replacement of the foregoing credit facilities, the Company secured a \$6,000,000 revolving production facility which was fully drawn as at January 28, 2005. \$5,000,000 of the facility was used to repay the interim construction loan and demand revolving reducing term loan. The revolving period extended to January 25, 2006 at which time the facility was to be extended or converted to a one year term with quarterly principal payments, if necessary, commencing April 25, 2006.

In October 2005, the facility credit limit was increased to \$6,500,000 and the revolving period was extended from January 25, 2006 to July 31, 2006 at which time the facility will be extended for a further 364 day period or converted to a one year term with quarterly principal payments of \$325,000, if necessary, commencing October 31, 2006.

Interest is charged at a rate of prime plus 0.5% and paid monthly during the revolving period. The credit facility has been classified as long-term debt consistent with terms of repayment.

The credit facility is subject to various covenants and is secured by an \$8,000,000 debenture representing a first floating charge on all assets and undertakings from the Company.

### **[c] Working Capital**

As at September 30, 2005, the Company had a working capital surplus of \$1,408,257 compared to a December 31, 2004 surplus of \$300,602. The Company reasonably expects to fund 2005 operations through cash flow from deliveries of gas.

#### [d] Commitments

The Company has entered into a number of exclusive lease rights with land owners related to its oil and gas properties. Under the terms of the leases, the minimum lease payments are as follows:

<i>Year</i>	<i>\$</i>
2005	186,400
2006	155,200
2007	143,600
2008	134,300
2009	134,100

#### **Capital Resources**

##### [a] Oil and Gas Leases

As at September 30, 2005, the Company's cumulative expenditures on oil and gas exploration were \$7,573,485 plus \$34,882,391 of value acquired on the business combination with EEI in 2004. The Company's oil and gas properties, located in Southwestern Ontario, include approximately 49,586 acres of leased lands located in Houghton and Middleton Townships in Norfolk County and Bayham and Malahide Townships in Elgin County. The Company has completed drilling of 70 gas wells and has purchased 2 existing wells. The Company expects to drill a further 14 wells to drain the probable acreage assignment. As at March 12, 2005, the Company reported reserves as follows:

Reserves Category	Gross Gas Reserves (BCF)	Net Gas Reserves (BCF)
Proved developed	35.23	32.76
Additional probable	43.72	41.46
Proved plus probable	78.95	74.22

Most of the currently producing wells are being restricted while the company continues to focus its efforts on stimulating existing wells, extracting fluids and bringing additional wells onstream in a controlled manner.

##### [b] Gas Gathering System

The gathering pipeline and compressor system consists of three sales points for gas produced from the Company's properties: sales through the Talisman Energy operated Lakeview Compressor, sales through the Union Gas system near the village of Mabees Corners, and sales through the Union Gas system just east of the city of Tillsonburg. Gas deliveries through the Talisman Lakeview compressor station commenced on June 24, 2004. Initially, 5 Echo gas wells were brought on stream. Prior to December 31, 2004, an additional 27 wells commenced production and 17 more wells commenced production in 2005 to date.

Drilling and fracing had been curtailed during the year ended December 31, 2004, to allow for the intensive effort and capital costs required to construct the pipeline and compression systems. A more aggressive drilling and fracing schedule is underway in the final quarter of 2005.

Gas deliveries through the Talisman Lakeview compressor station and the Tillsonburg station have been stored using the Union Gas storage system in southwestern Ontario. Gas is sold directly to Union Gas through the Mabees station. The storage purchased by the Company allows for storage of gas on an ongoing basis, with restrictions on maximum storage volumes and the rates at which gas can be put in or removed from the storage account. The Company began selling gas from its storage account in September. Gas deliveries during the first nine months of 2005 totaled 302,808 thousand cubic feet ("mcf") and 323,939 mcf were sold. Deliveries during the year ended December 31, 2004 totalled 119,866 mcf of which 90,591 mcf was sold.

**[c] Investment in Echo Power Generation Inc. (“EPG”)**

At September 30, 2005, the Company held a 43.62% interest in EPG for an initial investment of \$150,000. During the period from its initial investment to September 30, 2004 the Company recorded its share of losses in EPG of \$150,000 resulting in a nil net investment in EPG as at August 26, 2004. As a result of the business combination completed on August 27, 2004, the Company recorded an increase in asset value for its interest in EPG of \$1,830,608 and a corresponding future tax liability of \$330,608 to reflect an independent appraiser’s opinion of value. For the period from August 27, 2004 to December 31, 2004, the Company recorded its share of losses of EPG of \$262,150 bringing the 2004 share of losses to \$363,640 (2003 \$48,510). For the nine months ended September 30, 2005, the Company recorded its share of losses of EPG of \$557,194.

On August 22, 2005, the Company announced that it had been notified by EPG that EPG and Twenty-Two Degree Energy Corp. (“22DEG”) (in which EPG holds an approximate 22% equity interest) had entered into a Share Purchase Agreement with Enbridge Inc. which enabled EPG and 22DEG’s wind power projects to be bid into the Ontario Government’s Request for Proposal (RFP) for renewable energy announced April 19th, 2005.

If EPG or 22DEG is successfully awarded a contract under the Ontario Ministry of Energy’s Request for Proposals for up to 1000 MW of renewable energy to be announced in November 2005, Enbridge Inc. would acquire the awarded project(s). EPG and 22DEG would continue to provide assistance and support to the partner for the project(s).

**Merger with EEI**

On August 27, 2004, the Company issued 10,412,901 common shares effectively acquiring all of the outstanding common shares of Echo Energy Inc. As a result, shareholders of Echo Energy Inc. owned 61% of the outstanding shares of Echo Energy Canada Inc. Accordingly, reverse takeover principles were applied to account for the transaction.

The acquisition was effected through the amalgamation of Echo Energy Inc. and 1593485 Ontario Inc. (“Subco”), a wholly owned special purpose subsidiary of the Company, pursuant to an amended and restated pre-amalgamation agreement among the Company, EEI and Subco dated June 11, 2004. Pursuant to the terms of the amalgamation, EEI and Subco amalgamated to form one continuing corporation named Echo Energy Inc. (“Amalco”). The Company previously owned approximately 19.1% of EEI’s outstanding common shares, all of which were cancelled in the amalgamation. EEI shareholders other than the Company received 1.2575 newly issued common shares of the Company in exchange for each of their EEI common shares and the Company received 100 common shares of Amalco which continued as Echo Energy Inc. As a result, Echo Energy Inc. is now a wholly-owned subsidiary of the Company. The share exchange ratio was determined through negotiations between an independent committee of the board of the Company and the board of EEI. Amongst other aspects, the parties considered a valuation and fairness opinion prepared by Dundee Securities Corporation (“Valuator”) dated March 4, 2004.

The transaction was accounted for by the purchase method. The net asset valuation of oil and gas leases, investment in Echo Energy Inc. and Echo Power Generation Inc. were derived by the Valuator from a discounted cash flow analysis based on operating models and long-term business plans provided by management of the Company for the development of the oil and gas leases. The transaction is a related party transaction and the purchase consideration has been recorded at the exchange amount. Details of the Company’s net assets acquired and the assigned fair values of net assets at acquisition are presented in the notes to the consolidated financial statements for the year ended December 31, 2004.

## **Significant Accounting Policies**

### **[a] Stock Based Compensation**

The Canadian Institute of Chartered Accountants [CICA] has amended CICA 3870, Stock-based Compensation and Other Stock-based payments, recommending the recognition of an expense for option awards using the fair value method of accounting. The Company adopted the fair value recommendations of CICA 3870 prospectively for new awards granted on or after January 1, 2003 and recognized stock compensation expense for the year ended December 31, 2004 in accordance with the recommendations.

### **[b] Oil and gas leases**

The Company follows the full cost method of accounting for natural gas leases, whereby all costs associated with the acquisition of, exploration for and development of gas reserves are capitalized. Costs capitalized include lease acquisition costs, geological and geophysical expenditures, drilling of productive and non-productive wells and related plan and production equipment costs. General and administrative expenses are not capitalized other than to the extent of the Company's interest in Company operated capital expenditure programs to which operation's fees have been charged in accordance with standard industry operating agreements. While in the development stage, revenues derived from the sale of gas were presented as a reduction of capitalized cost. Proceeds from the sale of gas properties would reduce capitalized costs with recognition of a gain or loss if such a sale would significantly alter the rate of depletion and depreciation.

During the operational stage, capitalized costs plus estimated future development costs of proven reserves are depleted and depreciated using the unit-of-production method based upon estimated proven developed and undeveloped gas reserves before royalties as determined by independent consulting engineers.

In applying the full cost method, the Company performs an impairment test, which restricts the net capitalized costs from exceeding an amount equal to the estimated undiscounted value of future net revenues from proven oil and gas reserves based on current prices and costs, after deducting estimated future general and administrative expenses, financing costs, income taxes and site restoration costs.

## **Outstanding Share Data**

As at November 18, 2005, the Company had 51,599,515 common shares outstanding.

## **Risks and Uncertainties**

### **[a] Operations**

The Company's operations are subject to all of the risks normally incidental to the operation and development of natural gas properties and the drilling of natural gas wells, including encountering unexpected formations or pressures, blow-outs, premature decline of reservoirs, invasion of water into producing formations, craterings and fires and explosions, all of which could result in personal injuries, loss of life and damage to property of the Company and others. The Company conducts its activities in accordance with customary industry practice and, in accordance with such practice, will not be fully insured against all such risks, nor are all such risks insurable and, as a result, liability arising from these risks could have a material adverse effect upon its financial condition. Business interruption insurance may also be purchased for selected facilities, to the extent that such insurance is available. The Company may become liable for damages arising from such events against which it cannot insure or against which it may elect not to insure because of high premium costs or other reasons.

The marketability of natural gas acquired or discovered will be affected by numerous factors beyond the control of the Company. These factors include reservoir characteristics, market fluctuations, the proximity and capacity of natural gas pipelines and processing equipment and government regulation. Natural gas operations (exploration, production, pricing, marketing and transportation) are subject to extensive controls

and regulations imposed by various levels of government which may be amended from time to time. Natural gas operations are affected in varying degrees by government regulation such as restrictions on production, price controls, tax increases, expropriation of property, environmental and pollution controls or changes in conditions under which natural gas may be marketed. The Company's natural gas operations may also be subject to compliance with federal, provincial and local laws and regulations controlling the discharge of materials into the environment or otherwise relating to the protection of the environment.

The Company may experience growth through acquisitions. Its continued profitability and growth will depend in part upon its ability to successfully integrate its acquired assets with its existing business. There is no assurance that the Company will be able to successfully assimilate its acquisitions and its failure to do so could have a material adverse affect on its business, operating results and prospects.

Although satisfactory title reviews are conducted in accordance with industry standards, such reviews do not guarantee or certify that a defect in the chain of title may not arise to defeat the claim of the Company to certain properties. In addition, the success of the Company will be largely dependent upon the performance of its key officers and employees and consultants.

#### **[b] Natural Gas Prices**

The Company's results of operations and financial condition are dependent on the prices received for its natural gas production. Natural gas prices have fluctuated widely during recent years and are determined by supply and demand factors, including weather and general economic conditions as well as conditions in other natural gas producing regions, which are beyond the control of the Company. Any decline in natural gas prices could have a material adverse effect on the Company's operations, financial condition, natural gas reserves and the level of expenditures of the development of its natural gas reserves. The Company may manage the risk associated with changes in commodity prices and foreign exchanges rates from time to time, by entering into natural gas price hedges and forward foreign exchange contracts. To the extent that the Company engages in risk management activities related to commodity prices and foreign exchange rates, it will be subject to credit risks associated with counterparties with which it contracts. The Company has not engaged in such activities during 2005.

#### **[c] Delay in Cash Payments**

In addition to the usual delays in payment by purchasers of and natural gas to the operators of the properties, payments between any of such parties may also be delayed by restrictions imposed by lenders, delays in the sale or delivery of products, delays in the connection of wells to a gathering system, blowouts or other accidents, recovery by the operator of expenses incurred in the operation of the properties or the establishment by the operator of reserves for such expenses.

#### **[d] Reserve Estimates**

The reserve and recovery information contained in reserve estimations on the Company's properties, as evaluated by an independent engineer, are only estimates and no assurance can be given that the indicated levels of reserves will be produced. Probable Reserves estimated for properties may require revision based on the actual development strategies employed to prove such reserves.

#### **[e] Environmental Concerns**

The oil and natural gas industry is subject to environmental regulation pursuant to local, provincial and federal legislation. A breach of such legislation may result in the imposition of fines or issuance of clean up orders in respect of the Company or its properties. Such legislation may be changed to impose higher standards and potentially more costly obligations on the Company. There can be no assurance that the Company will be able to satisfy its actual future environmental and reclamation obligations.

#### **[f] Key Personnel Factors**

The Company is highly dependent on the services of members of senior management. The loss of the services of any of these individuals may adversely affect the Company's leadership and direction, which may impact its business, financial condition and results of operation.

**Additional Information**

Additional information relating to the Company is available on SEDAR at [www.sedar.com](http://www.sedar.com).