Highlights

	THREE MONTHS ENDED JUNE 30, 2012	2011	SIX MONTHS ENDED JUNE 30, 2012	2011
Financial *($thousands, except per share amounts)*				
Petroleum and natural gas revenue	**31,571**	54,442	**70,036**	102,973
Funds generated from operations *(1)*	**12,898**	27,241	**30,960**	57,074
Per share – basic	**$0.12**	$0.27	**$0.30**	$0.56
Per share – diluted	**$0.12**	$0.26	**$0.30**	$0.55
Cash flow from operations (including changes in working capital) *(1)*	**11,972**	24,102	**30,428**	49,198
Per share – basic	**$0.12**	$0.24	**$0.30**	$0.48
Per share – diluted	**$0.12**	$0.23	**$0.30**	$0.47
Profit (loss) *(2)*	**(44,721)**	652	**(51,961)**	33,302
Per share – basic	**($0.44)**	$0.01	**($0.51)**	$0.33
Per share – diluted	**($0.44)**	$0.01	**($0.51)**	$0.32
Exploration and development expenditures	**3,939**	20,569	**45,516**	77,922
Marlboro gas plant expenditures	**–**	5,470	**–**	19,773
Total capital expenditures	**3,939**	26,039	**45,516**	97,695
Proceeds from the sale of petroleum and natural gas properties	**89,127**	17,920	**90,127**	141,380
Working capital (surplus) deficit (excluding convertible debentures)	**8,078**	(21,673)	**8,078**	(21,673)
Convertible debentures	**–**	98,706	**–**	98,706
Bank indebtedness	**183,105**	152,227	**183,105**	152,227
Total debt, including working capital	**191,183**	229,260	**191,183**	229,260
Operations				
Average production				
Natural gas *(Mcf per day)*	**70,485**	65,171	**73,653**	64,365
Crude oil *(bbls per day)*	**1,262**	2,287	**1,561**	2,497
Natural gas liquids *(bbls per day)*	**946**	766	**916**	892
Sulphur *(tonnes per day) (3)*	**7**	56	**27**	62
Total *(BOE per day)*	**13,962**	13,971	**14,779**	14,179
Average sales price *(4)*				
Natural gas *($ per Mcf)*	**2.02**	4.45	**2.16**	4.40
Crude oil *($ per bbl)*	**101.81**	94.13	**95.80**	87.47
Natural gas liquids *($ per bbl)*	**59.37**	63.75	**65.78**	58.60
Sulphur *($ per tonne)*	**167.39**	127.96	**122.75**	111.94
Netback per BOE *($ per BOE)*				
Petroleum and natural gas sales *(4)*	**23.60**	40.50	**25.28**	39.82
Other income	**0.79**	–	**0.37**	–
Royalties	**(1.73)**	(6.30)	**(2.25)**	(4.63)
Operating expenses	**(7.48)**	(8.89)	**(7.86)**	(9.14)
Transportation	**(1.24)**	(1.05)	**(1.09)**	(1.05)
Operating netback	**13.94**	24.26	**14.45**	25.00
Wells drilled *(gross)*	**1**	3	**12**	25
Undeveloped land *(net acres)*	**181,772**	228,272	**181,772**	228,272

(1) The calculation of funds generated from operations and cash flow from operations for the three months ended June 30, 2012 excludes $2.7 million (2011 – $3.7 million) of interest expense which is classified as finance expense. Similarly, for the six months ended June 30, 2012, $5.3 million (2011 – $7.8 million) of interest expense is classified as finance expense.
(2) Included in the net loss for the three and six months ended June 30, 2012 is an after-tax impairment of $34.4 million.
(3) A BOE conversion ratio has been calculated using a conversion rate of one tonne of sulphur to one barrel.
(4) Excludes the change in fair value of derivatives.

Management's Discussion and Analysis of Financial Condition and Results of Operations

The following Management Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") was prepared at, and is dated, August 7, 2012. This document is provided by the management of Fairborne Energy Ltd. ("Fairborne" or the "Company") to review second quarter 2012 activities and results as compared to the same period in the previous year, and should be read in conjunction with the unaudited interim consolidated financial statements including selected notes for the three and six months ended June 30, 2012 and the audited consolidated financial statements including notes for the years ended December 31, 2011 and 2010. The MD&A should be read in conjunction with the Company's MD&A for the year ended December 31, 2011, as disclosure which is unchanged from the December 31, 2011 MD&A has not been duplicated herein. Additional information relating to Fairborne, including Fairborne's annual information form, is available on SEDAR at www.sedar.com

Nature of Business: *Fairborne is a growth-oriented exploration and production company. The Company maintains its head office in Calgary and is engaged in the business of exploring for, developing, acquiring and producing crude oil and natural gas in Western Canada. Fairborne follows a strategy of balancing risk and reward by focusing on opportunities by geographic area and prospect type. Within the selected areas, the Company develops a portfolio of exploration and development prospects in conjunction with an active acquisition strategy.*

Forward Looking Statements: *This document contains forward-looking statements including management's assessment of future plans and operations and plans to review capital expenditures budgets in light of projected cash flows may constitute forward-looking statements under applicable securities laws and necessarily involve risks including, without limitation, risks associated with oil and gas exploration, development, exploitation, production, marketing and transportation, loss of markets, volatility of commodity prices, currency fluctuations, imprecision of reserve estimates, environmental risks, competition from other producers, inability to retain drilling rigs and other services, incorrect assessment of the value of acquisitions, failure to realize the anticipated benefits of acquisitions, delays resulting from or inability to obtain required regulatory approvals and ability to access sufficient capital from internal and external sources. As a consequence, the Company's actual results may differ materially from those expressed in, or implied by, the forward looking statements. Forward looking statements or information are based on a number of factors and assumptions which have been used to develop such statements and information but which may prove to be incorrect. Although Fairborne believes that the expectations reflected in such forward-looking statements or information are reasonable, undue reliance should not be placed on forward looking statements because the Company can give no assurance that such expectations will prove to be correct. In addition to other factors and assumptions which may be identified in this document and other documents filed by the Company, assumptions have been made regarding, among other things: the impact of increasing competition; the general stability of the economic and political environment in which Fairborne operates; the ability of the Company to obtain qualified staff, equipment and services in a timely and cost efficient manner; drilling results; the ability of the operator of the projects which the Company has an interest in to operate the field in a safe, efficient and effective manner; Fairborne's ability to obtain financing on acceptable terms; field production rates and decline rates; the ability to replace and expand oil and natural gas reserves through acquisition, development or exploration; the timing and costs of pipeline, storage and facility construction and expansion; the ability of the Company to secure adequate product transportation; future oil and natural gas prices; currency, exchange and interest rates; the regulatory framework regarding royalties, taxes and environmental matters in the jurisdictions in which the Company operates; and Fairborne's ability to successfully market its oil and natural gas products. Readers are cautioned that the foregoing list of factors is not exhaustive. Additional information on these and other factors that could affect the Company's operations and financial results are included in reports on file with Canadian securities regulatory authorities and may be accessed through the SEDAR website (www.sedar.com) or at the Company's website (www.fairborne-energy.com).*

Furthermore, the forward looking statements contained in this document are made as at the date of this document and the Company does not undertake any obligation to update publicly or to revise any of the included forward looking statements, whether as a result of new information, future events or otherwise, except as may be required by applicable securities laws.

Non-GAAP and Additional GAAP Measures: *This document contains funds generated from operations which is an additional GAAP measure presented in the consolidated financial statements. The Company uses funds generated from operations as a key measure to demonstrate the Company's ability to generate funds to repay debt and fund future capital investment. This document contains the terms "funds generated from operations per share", "cash flow from operations per share", "net debt" and "netbacks" which are non-GAAP financial measures. The Company uses these measures to help evaluate its performance. These non-GAAP financial measures do not have any standardized meaning prescribed by GAAP and are therefore unlikely to be comparable to similar measures presented by other issuers. The Company uses net debt (bank indebtedness plus negative working capital or less positive working capital, excluding convertible debentures) as an alternative measure of outstanding debt. The Company considers corporate netbacks a key measure as it demonstrates its profitability relative to current commodity prices. Netbacks which have no GAAP equivalent are calculated on a BOE basis by deducting royalties, operating costs, and transportation from petroleum and natural gas sales. Fairborne also presents funds generated from operations per share and cash flow from operations per share and such per share amounts are calculated using weighted average shares outstanding consistent with the calculation of profit (loss) per share.*

BOE Conversions: *Barrel of oil equivalent ("BOE") amounts may be misleading, particularly if used in isolation. A BOE conversion ratio has been calculated using a conversion rate of one tonne of sulphur to one barrel and six thousand cubic feet of natural gas to one barrel. This conversion ratio of six thousand cubic feet of natural gas to one barrel is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead. Given that the value ratio based on the current price of crude oil as compared to natural gas is significantly different from energy equivalency of 6:1; utilizing a conversion on a 6:1 basis may be misleading as an indication of value.*

Proposed Transactions

Strategic Review Process

On March 15, 2012, Fairborne announced that its Board of Directors had initiated a process to identify, examine and consider strategic alternatives with the view to enhancing shareholder value. Strategic alternatives may include, but are not limited to, sale of the corporation, merger or other business combination, recapitalization, sale of all or a portion of the Company's assets, or any combination thereof, continued execution of its business plan, among all other alternatives. The Company cautions that there are no assurances or guarantees that the process will result in a transaction or, if a transaction is undertaken, the terms or timing of such a transaction. In connection therewith, the Board of Directors has established a Special Committee comprised of independent directors to oversee the process. The Company has appointed financial advisors but has not yet set a definite schedule to complete its evaluation or process.

Property Dispositions

On May 16, 2012, Fairborne completed a disposition which included properties in the greater Sinclair area located in Manitoba and Saskatchewan for gross proceeds of $80 million, subject to closing adjustments. Production associated with the properties was approximately 700 bbls per day of oil. Proceeds from the disposition were initially used to reduce bank indebtedness. As a result of this disposition, Fairborne recorded a loss of $2.9 million in the statement of operations for the six months ended June 30, 2012.

On May 31, 2012, Fairborne completed a non-core asset divestiture of 85 barrels per day of oil production in central Saskatchewan for gross proceeds of $11 million, subject to closing adjustments. Proceeds from the disposition were initially used to reduce bank indebtedness. As a result of this disposition, Fairborne recorded a gain of $0.9 million in the statement of operations for the six months ended June 30, 2012.

During the second quarter of 2012, the previously announced disposition of the Company's Clive oil assets was terminated by the purchaser as it was unsuccessful in obtaining the required financing for the purchase. Fairborne remains committed to this innovative and economic CO_2 project and will evaluate its options to advance the project in the coming months.

Second Quarter 2012 Financial Results

Production

	Three months ended June 30,		Six months ended June 30,	
	2012	2011	**2012**	2011
Natural gas *(Mcf per day)*	**70,485**	65,171	**73,653**	64,365
Crude oil *(bbls per day)*	**1,262**	2,287	**1,561**	2,497
Natural gas liquids *(bbls per day)*	**946**	766	**916**	892
Sulphur *(tonnes per day)* (1)	**7**	56	**27**	62
Total *(BOE per day)*	**13,962**	13,971	**14,779**	14,179
Natural gas % of production	**84%**	78%	**83%**	76%

(1) A BOE conversion ratio has been calculated using a conversion rate of one tonne of sulphur to one barrel.

Second quarter production was impacted by two separate property dispositions completed in May 2012 with combined production of approximately 800 barrels per day of crude oil. In addition, production interruptions continued throughout the second quarter 2012 as approximately 1,000 BOE per day of natural gas remained shut in at Wild River in response to low natural gas prices. Despite production interruptions and property sales, production increases from drilling programs resulted in average production of 13,962 BOE per day in the second quarter of 2012, essentially unchanged from the comparative second quarter of 2011 (13,971 BOE per day).

Natural gas production of 70.5 MMcf per day during the second quarter of 2012 was 8% lower than the preceding first quarter of 2012 (76.8 MMcf per day) as a result of the shut in of natural gas production at the Company's Wild River property as well as typical decline rates for new wells that were brought on production in late 2011 and early 2012.

Crude oil and NGL production of 2,208 bbls per day for the second quarter of 2012 was 28% lower than the second quarter of 2011 (3,053 BOE per day) and 20% lower than preceding first quarter of 2012 (2,746 BOE per day) reflecting the impact of property dispositions completed in the second quarter. Despite an increase in NGL production from a successful drilling program, overall oil and NGL production volumes have also declined as a result of typical decline rates on the Company's other crude oil properties.

Sulphur production in the second quarter reflected the continued shut in of production on the Company's Wild River property.

Commodity Prices & Risk Management Activities

	THREE MONTHS ENDED JUNE 30,		SIX MONTHS ENDED JUNE 30,	
	2012	2011	**2012**	2011
Average Prices *(1)*				
Natural gas *($ per Mcf)*	**2.02**	4.45	**2.16**	4.40
Crude oil *($ per bbl)*	**101.81**	94.13	**95.80**	87.47
Natural gas liquids *($ per bbl)*	**59.37**	63.75	**65.78**	58.60
Sulphur *($ per tonne)*	**167.39**	127.96	**122.75**	111.94
BOE *($ per BOE)*	**23.52**	40.20	**25.20**	39.58
Benchmark Prices				
AECO Daily Index *(Cdn$ per Mcf)*	**1.84**	3.88	**2.00**	3.83
AECO Monthly Index *(Cdn$ per Mcf)*	**1.90**	3.74	**2.21**	3.76
Edmonton par *(Cdn$ per bbl)*	**84.39**	102.65	**88.25**	95.54
Nymex Calendar Average *(US$ per bbl)*	**93.49**	102.56	**98.21**	98.33

(1) Excludes the change in fair value of derivatives.

Risk Management – Physical Sales Contracts

Fairborne's risk management strategy is based on the following objectives:

- → protect shareholder return on investment;
- → reduce risk exposure in budgeted annual funds flow projections; and
- → help ensure transaction economics on acquisitions.

Financial instruments may be utilized by the Company to manage its exposure to commodity price fluctuations, foreign currency and interest rates. The Company's policy is not to utilize financial instruments for trading or speculative purposes.

Natural Gas

Fairborne's average realized natural gas price in the second quarter of 2012 was 10% higher than the AECO Daily benchmark reference price due to corporate hedging activities and the higher heat content of Fairborne's production. Compared to the prior year, Fairborne's realized natural gas price for the three months ending June 30, 2012 was 55% lower reflecting the 53% drop in market prices. An average of 28,780 Mcf per day was sold under fixed price physical sales and derivative contracts during the second quarter of 2012 representing 41% of the Company's natural gas production. Risk management activities increased the Company's natural gas revenue by an estimated $0.1 million in the second quarter of 2012 which had the effect of increasing Fairborne's realized natural gas price by $0.02 per Mcf to $2.02 per Mcf.

The following table summarizes the outstanding fixed price physical sales and derivative contracts for natural gas, including contracts outstanding at June 30, 2012 as well as contracts entered into after June 30, 2012:

	Q3/2012	Q4/2012
Participating Swaps		
Volume *(Mcf per day)*	**33,297**	**14,140**
Average Floor Price *($ per Mcf)*	**$2.06**	**$2.05**

Conversion factor: 1 Mcf = 1.135 GJ

At June 30, 2012, Fairborne had no natural gas contracts that were accounted for as derivative contracts.

Crude Oil

During the second quarter of 2012, Fairborne had an average of 230 bbls per day of crude oil under fixed price physical sales and derivative contracts representing 18% of crude oil production. Risk management activities, including option costs for puts purchased during the quarter, increased the Company's crude oil revenue by $1.4 million ($12.19 per bbl) in the second quarter. Fairborne's realized crude oil price of $101.81 per bbl in the second quarter of 2012 increased 8% from the same period in 2011 which reflected the impact of corporate hedging activities partially offset by a decrease in market prices.

The following table summarizes the outstanding fixed price physical sales and derivative contracts on crude oil, including contracts outstanding at June 30, 2012 as well as contracts entered into after June 30, 2012:

	Q3/2012	Q4/2012
Swaps		
Volume *(bbls per day)*	**300**	**300**
Average Price *($CDN per bbl)*	**$104.11**	**$104.11**

At June 30, 2012, Fairborne had one crude swap that was accounted for as derivative contract and the mark-to-market value of this contract was recorded as an asset of $1.1 million.

Sulphur

The Company's average realized sulphur price in the second quarter of 2012 was $167.39 per tonne, compared to $127.96 in the second quarter of 2011.

Petroleum and Natural Gas Revenue

($thousands except as noted)	Three months ended June 30, 2012	2011	Six months ended June 30, 2012	2011
Petroleum and natural gas sales:				
Natural gas	**12,975**	26,420	**29,019**	51,316
Crude oil	**11,689**	19,596	**27,214**	39,544
Natural gas liquids	**5,112**	4,441	**10,970**	9,459
Sulphur	**102**	657	**592**	1,248
Total	**29,878**	51,114	**67,795**	101,567
Per BOE	**$23.52**	$40.20	**$25.20**	$39.58
Other petroleum and natural gas revenue items:				
Change in fair value of derivatives	**590**	2,952	**1,023**	796
Other income	**1,000**	–	**1,000**	–
Royalty income	**103**	376	**218**	610
Total	**1,693**	3,328	**2,241**	1,406
Total petroleum and natural gas revenue	**31,571**	54,442	**70,036**	102,973
Per BOE	**$24.85**	$42.82	**$26.04**	$40.12

Fairborne reported petroleum and natural gas sales of $29.9 million for the second quarter of 2012, representing a decrease of 21% from the preceding first quarter of 2012 ($37.9 million) and a 42% decrease from the $51.1 million reported in the second quarter of 2011. The drop in petroleum and natural gas sales was primarily attributed to lower natural gas prices and the disposition of oil properties in the second quarter of 2012. Natural gas sales of $13.0 million were 19% lower than the first quarter of 2012 ($16.0 million) as a result of a 15% decline in natural gas market prices as well as lower natural gas production. Similarly, natural gas sales in the second quarter of 2012 were 51% lower than the same period in 2011 as the increase in production was offset by a 53% decrease in natural gas market prices. Crude oil sales of $11.7 million were 25% lower than the first quarter of 2012 ($15.5 million) as a result of the property dispositions in the quarter. Compared to the second quarter of the prior year, oil revenues decreased 40% as a result of property dispositions as well as a reduction in market prices. NGL sales have decreased by 13% compared to the first quarter of 2012 as increased production was offset by lower commodity prices. Compared to the second quarter of 2011, NGL sales have increased 15% as a result of successful drilling programs.

Other revenue items include royalty income, which decreased as a result of lower natural gas prices, and the change in fair value of derivatives, which represents the change in the mark-to-market value of derivative contracts. The $0.6 million increase recorded in the second quarter of 2012 (2011 - $3.0 million) reflected both the changes in the unrealized value of existing contracts as well as a reduction for amounts realized on contracts that settled during the period. Fairborne's risk management program, including derivative contracts and physical sales contracts, increased the Company's realized revenue by an estimated $1.5 million in the second quarter of 2012, compared to an increase of $0.7 million in the second quarter of 2011. Additionally, the Company recorded other income of $1.0 million in the second quarter of 2012 for a non-refundable deposit received in relation to the proposed Clive area disposition that was terminated by the purchaser during the quarter.

Royalties

($thousands except as noted)	Three months ended June 30, 2012	2011	Six months ended June 30, 2012	2011
Crown	2,142	5,767	4,271	7,494
Freehold and overriding	58	2,247	1,792	4,386
Total	2,200	8,014	6,063	11,880
Crown *(% of P&NG sales)*	7.2%	11.3%	6.3%	7.4%
Freehold and overriding *(% of P&NG sales)*	0.2%	4.4%	2.6%	4.3%
Total *(% of P&NG sales)*	7.4%	15.7%	8.9%	11.7%
Per BOE	$1.73	$6.30	$2.25	$4.63

Fairborne recorded $2.2 million of royalties during the second quarter of 2012, representing a royalty rate of 7.4%, lower than the 10.2% recorded in the preceding quarter as well as the 15.7% recorded in the second quarter of 2011. Second quarter royalties for both 2012 and 2011 include royalty adjustments resulting from the Crown's annual recalculation of allowable deductions and credits. These second quarter adjustments were $0.9 million in 2012 and $3.1 million in 2011 resulting in a lower royalty rate in 2012 compared to 2011. Freehold and overriding royalties in the second quarter of 2012 were reduced by an adjustment for prior years' royalties identified in a recent Indian Oil and Gas Canada royalty audit.

Production and Operating Costs

($thousands except as noted)	Three months ended June 30, 2012	2011	Six months ended June 30, 2012	2011
Operating costs				
Natural gas	7,796	8,800	16,101	17,508
Oil and NGLs	1,710	2,501	5,027	5,949
Transportation costs	1,578	1,339	2,933	2,691
Total	11,084	12,640	24,061	26,148
Operating costs, per BOE	$7.48	$8.89	$7.86	$9.14
Transportation costs, per BOE	$1.24	$1.05	$1.09	$1.05
Production and operating costs, per BOE	$8.72	$9.94	$8.95	$10.19

Fairborne's operating costs of $9.5 million ($7.48 per BOE) during the second quarter of 2012 were 9% lower than the preceding first quarter of 2012 ($8.19 per BOE) and 16% lower than the second quarter of 2011 ($8.89 per BOE). Compared to the prior year, operating cost reductions were attributed to the start up of the Company's Marlboro gas plant in May 2011 as well as the shut in and disposition of properties with operating costs in excess of the corporate average.

Transportation costs of $1.6 million ($1.24 per BOE) for the second quarter of 2012 include clean oil trucking, trucking of natural gas liquids, certain third party fuel charges and transportation and fuel costs associated with the usage of natural gas pipelines. Transportation costs in the second quarter of 2012 were higher when compared to the preceding first quarter of 2012 ($0.95 per BOE) and the second quarter of 2011 ($1.05 per BOE) due to higher fuel charges.

Operating Netbacks

($ per BOE)	Three months ended June 30, 2012	2011	Six months ended June 30, 2012	2011
Petroleum and natural gas sales (1)	**23.52**	40.20	**25.20**	39.58
Other income	**0.79**	–	**0.37**	–
Royalty income	**0.08**	0.30	**0.08**	0.24
Royalties	**(1.73)**	(6.30)	**(2.25)**	(4.63)
Operating costs	**(7.48)**	(8.89)	**(7.86)**	(9.14)
Transportation	**(1.24)**	(1.05)	**(1.09)**	(1.05)
Operating netback	**13.94**	24.26	**14.45**	25.00

(1) Excludes the change in fair value of derivatives

Fairborne's operating netback of $13.94 per BOE was 7% lower than the first quarter of 2012 ($14.94 per BOE) and 43% lower when compared to the second quarter of 2011 ($24.26 per BOE), reflecting property dispositions and the significant decrease in natural gas prices, partially offset by lower royalties and reduced operating costs.

General and Administrative ("G&A") Expenses

($thousands except as noted)	Three months ended June 30, 2012	2011	Six months ended June 30, 2012	2011
G&A expenses, net of recoveries	**4,799**	3,595	**7,929**	7,075
Compensation costs	**141**	648	**648**	1,362
Total G&A expenses	**4,940**	4,243	**8,577**	8,437
G&A expenses, net of recoveries, per BOE	**$3.79**	$2.83	**$2.95**	$2.76
Compensation costs, per BOE	**$0.11**	$0.51	**$0.24**	$0.53

Fairborne recorded $4.8 million ($3.79 per BOE) of G&A expenses, net of recoveries, in the second quarter of 2012, 71% higher than the preceding first quarter of 2012 and 34% higher than the second quarter of 2011. The increase in G&A expenses is a result of costs related to the strategic review process, including staff retention costs, professional services and special committee costs.

Compensation expense of $0.1 million in the second quarter of 2012 is lower than the preceding first quarter of 2012 ($0.5 million) and the second quarter of 2011 ($0.6 million) as a result of above average stock option forfeitures during the quarter.

Depreciation and Amortization ("D&A")

($thousands except as noted)	Three months ended June 30, 2012	2011	Six months ended June 30, 2012	2011
Depreciation and amortization	**21,974**	23,491	**46,635**	47,088
Impairment charges	**46,000**	–	**46,000**	–
Total depreciation and impairment	**67,974**	23,494	**92,635**	47,088
Depreciation and amortization per BOE	**$17.29**	$18.48	**$17.33**	$18.35
Impairment charges per BOE	**$36.21**	–	**$17.10**	–

Fairborne recorded $68.0 million in depreciation and amortization in the second quarter of 2012 including an impairment charge of $46.0 million. Impairments are recognized when an asset's or group of assets' carrying value exceeds their recoverable amount. During the second quarter of 2012, Fairborne recorded an impairment of $46.0 million on its Deep Basin asset. Impairments can reverse in the future if circumstances change. Not including the impairment, on a BOE basis, depreciation and amortization rates in 2012 are lower than 2011 as a result of the impairment loss recorded at the end of 2011 which reduced the carrying value of petroleum and natural gas assets.

Gain (Loss) on Disposition of Capital Assets

	Three months ended June 30,		Six months ended June 30,	
($thousands except as noted)	**2012**	2011	**2012**	2011
Gain (loss) on disposition of P&NG assets	**(1,740)**	–	**(1,919)**	47,167
Gain (loss) on recognition of non-monetary transactions	**–**	(411)	**295**	517
Total gain (loss) on disposition of capital assets	**(1,740)**	(411)	**(1,624)**	47,684
Per BOE	**($1.37)**	($0.32)	**($0.60)**	$18.59

Gains and losses are recognized in net income on the disposal of an item of petroleum and natural gas ("P&NG) assets. The amount of the gain or loss is determined by comparing the proceeds from disposal with the carrying amount of the item. This includes transactions such as sales of assets, farm-outs, asset swaps and other non-monetary transactions. Included in the loss on disposition of P&NG assets in the second quarter of 2012 is a net loss of $1.9 recorded on property dispositions during the quarter.

Finance Expense

	Three months ended June 30,		Six months ended June 30,	
($thousands except as noted)	**2012**	2011	**2012**	2011
Interest expense	**2,654**	3,656	**5,329**	7,827
Accretion of asset retirement obligation	**254**	233	**540**	458
Impairment loss on trade receivable	**322**	–	**322**	117
Accretion of convertible debentures	**–**	571	**–**	1,142
Total finance expense	**3,230**	4,460	**6,191**	9,544
Per BOE	**$2.54**	$3.51	**$2.30**	$3.72

Fairborne recorded $3.2 million in finance expense in the second quarter of 2012, comparable to the preceding quarter (Q1 2012 – $3.0 million) and 29% lower than the $4.5 million recorded in the second quarter of 2011. Compared to the second quarter of 2011, the decrease is consistent with lower debt levels as well as the maturation and repayment of the convertible debentures on December 31, 2011. The debentures were repaid with existing credit facilities that carry a lower interest rate than the convertible debentures.

Taxes

	Three months ended June 30,		Six months ended June 30,	
	2012	2011	**2012**	2011
Deferred taxes (reduction) *($thousands)*	**(14,876)**	531	**(17,154)**	14,258
Per BOE	**($11.71)**	$0.42	**($6.38)**	$5.55

Fairborne recorded a deferred tax reduction of $14.9 million in the second quarter of 2012 compared to deferred taxes of $0.5 million during the second quarter of 2011, both of which reflect a provision for future tax at tax rates expected to apply when the related temporary differences reverse.

Profit (Loss) and Funds Generated from Operations

($thousands except as noted)	Three months ended June 30, 2012	Three months ended June 30, 2011	Six months ended June 30, 2012	Six months ended June 30, 2011
Funds generated from operations	**12,898**	27,241	**30,960**	57,074
Per share – basic	**$0.12**	$0.27	**$0.30**	$0.56
Per share – diluted	**$0.12**	$0.26	**$0.30**	$0.55
Cash flow from operations (including changes in working capital)	**11,972**	24,102	**30,428**	49,198
Per share – basic	**$0.12**	$0.24	**$0.30**	$0.48
Per share – diluted	**$0.12**	$0.23	**$0.30**	$0.47
Profit (loss)	**(44,721)**	652	**(51,961)**	33,302
Per share – basic	**($0.44)**	$0.01	**($0.51)**	$0.33
Per share – diluted	**($0.44)**	$0.01	**($0.51)**	$0.32

BOE Analysis

Three months ended June 30,	2012		2011	
	($thousands)	*($ per BOE)*	*($thousands)*	*($ per BOE)*
Petroleum and natural gas revenue (1)	**31,571**	**24.85**	54,442	42.82
Royalties	**(2,200)**	**(1.73)**	(8,014)	(6.30)
Production and operating costs	**(11,084)**	**(8.72)**	(12,640)	(9.94)
Change in fair value of derivatives	**(590)**	**(0.46)**	(2,952)	(2.32)
General & administrative (2)	**(4,799)**	**(3.79)**	(3,595)	(2.83)
Funds generated from operations	**12,898**	**10.15**	27,241	21.43
Finance expense	**(3,230)**	**(2.54)**	(4,460)	(3.51)
Change in fair value of derivatives	**590**	**0.46**	2,952	2.32
Compensation expense – non-cash	**(141)**	**(0.11)**	(648)	(0.51)
Gain (loss) on disposition of capital assets	**(1,740)**	**(1.37)**	(411)	(0.32)
Depreciation and amortization	**(67,974)**	**(53.50)**	(23,491)	(18.48)
Deferred taxes (expense) reduction	**14,876**	**11.71**	(531)	(0.42)
Profit (loss)	**(44,721)**	**(34.20)**	652	0.51

(1) Including the change in fair value of derivatives (non-cash).
(2) Net of compensation expense (non-cash).

SIX MONTHS ENDED JUNE 30,	2012		2011	
	($thousands)	($ per BOE)	($thousands)	($ per BOE)
Petroleum and natural gas revenue (1)	70,036	26.04	102,973	40.12
Royalties	(6,063)	(2.25)	(11,880)	(4.63)
Operating expenses	(24,061)	(8.95)	(26,148)	(10.19)
Change in fair value of derivatives	(1,023)	(0.38)	(796)	(0.30)
General & administrative (2)	(7,929)	(2.95)	(7,075)	(2.76)
Funds generated from operations	30,960	11.51	57,074	22.24
Finance expense	(6,191)	(2.30)	(9,544)	(3.72)
Change in fair value of derivatives	1,023	0.38	796	0.30
Compensation expense – non-cash	(648)	(0.24)	(1,362)	(0.53)
Gain (loss) on disposition of capital assets	(1,624)	(0.60)	47,684	18.59
Depreciation and amortization	(92,635)	(34.43)	(47,088)	(18.35)
Deferred taxes (expense) reduction	17,154	6.38	(14,258)	(5.55)
Profit (loss)	(51,961)	(19.32)	33,302	12.98

(1) Including the change in fair value of derivatives (non-cash)
(2) Net of compensation expense.

Fairborne reported funds generated from operations of $12.9 million ($10.15 per BOE) for the second quarter of 2012, a decrease of 53% when compared to the second quarter of 2011 ($27.2 million). The decrease in funds generated from operations reflected higher natural gas production and lower royalties being offset by lower commodity prices and lower oil production as a result of property dispositions in the second quarter of 2012.

The loss of $44.7 million for the second quarter of 2012 (Q2 2011 – profit of $0.7 million) reflects the impairment loss of $46.0 million as well as the decrease in cash flows. The loss of $52.0 million ($19.32 per BOE) for the six months ended June 30, 2012 compared to the profit of $33.3 million for the same time period in 2011 reflects the impact of the gain recorded on the property disposition completed late in the first quarter of 2011.

Liquidity and Capital Resources

Capital Expenditures

P&NG assets have been divided into intangible exploration assets ("E&E assets") and petroleum and natural gas properties and equipment ("development assets").

Petroleum and Natural Gas Properties and Equipment

	Three months ended June 30,		Six months ended June 30,	
($thousands)	**2012**	2011	**2012**	2011
Development expenditures				
Land and property acquisitions	**250**	4,143	**797**	5,131
Geological and geophysical	**–**	1,421	**–**	4,241
Drilling and completions	**1,445**	8,490	**36,710**	58,180
Well equipment and facilities	**1,402**	9,834	**6,633**	27,925
Turnarounds and overhauls	**791**	489	**791**	489
Corporate assets	**71**	251	**144**	318
Total development expenditures	**3,959**	24,628	**45,075**	96,284
Acquisitions and Dispositions				
Proceeds from sale of petroleum and natural gas properties	**(86,591)**	(17,920)	**(87,591)**	(141,380)

During the second quarter of 2012, Fairborne's development expenditures totaled $4.0 million with capital expenditures financed through funds generated from operations. In the second quarter of 2012, $0.2 million of general and administrative costs were capitalized to development assets which included $0.3 million of directly attributable G&A costs and a recovery of $0.1 million related to stock based compensation costs as a result of the higher than average stock option forfeitures occurring in the quarter.

Fairborne spent $1.4 million on drilling and completion activities in the second quarter of 2012 with a total of one (0.7 net) gas well drilled on the Company's Marlboro property. Tangible development expenditures of $1.4 million during the three months ended June 30, 2012 included the tie-in of wells at the Company's Marlboro and Harlech properties.

In the second quarter of 2012, Fairborne completed two property dispositions which included properties located in Saskatchewan and Manitoba for total net proceeds of $90.1 million, including $2.5 million for intangible exploration assets included in the dispositions.

Intangible Exploration Assets

	Three months ended June 30,		Six months ended June 30,	
($thousands)	**2012**	2011	**2012**	2011
Exploration expenditures				
Land and seismic	**(20)**	1,177	**441**	1,177
Exploratory drilling and completions	**–**	234	**–**	234
Total exploration expenditures	**(20)**	1,411	**441**	1,411
Dispositions				
Proceeds from sale of exploration properties	**(2,536)**	–	**(2,536)**	–

E&E assets include projects that are pending determination of technical feasibility and economic viability.

Working Capital and Bank Indebtedness

At June 30, 2012, Fairborne had drawn $183.1 million (December 31, 2011 – $228.3 million) against its credit facilities and had a working capital deficit of $8.1 million (December 31, 2011 – $32.8 million). Property dispositions during the second quarter generated net proceeds of $90.1 million which were applied against outstanding bank debt. Year to date capital expenditures of $45.5 million have been financed from funds generated from operations of $31.0 million with the balance financed through bank debt.

Concurrent with the second quarter property dispositions and the annual borrowing base review, Fairborne's credit facilities were reduced to include a $205 million extendible revolving term credit facility and a $15 million demand operating credit facility for a total available facility of $220 million. The extendible revolving term facility is available on a revolving basis until May 15, 2013 (364 day facility) at which time it may be extended, at the lenders option. If the revolving period is not extended, the undrawn portion of the facility will be cancelled and the amount outstanding would convert to a 365 day nonrevolving term facility. The amounts outstanding under the non-revolving term facility are required to be repaid at the end of the term facility being May 16, 2014. Interest payable on amounts drawn under the facilities is at the prevailing bankers' acceptance rates plus stamping fees, lenders' prime rate or LIBOR rates plus applicable margins, depending on the form of borrowing by the Company. The margins and stamping fees vary from 1.00% to 3.75% depending on financial statement ratios and the form of borrowing. The credit facilities are secured by a general security agreement and a first ranking floating charge on the assets of the Company. The facility is subject to a semi-annual valuation of Fairborne's petroleum and natural gas assets. The Company anticipates it will have adequate liquidity to fund its financial liabilities as they come due. Fairborne has no defaults or breaches on its bank debt or any of its financial liabilities.

Fairborne actively manages its capital structure especially during periods of extreme volatility in both commodity and capital markets, such as experienced in 2011 and continuing in 2012. In order to reduce outstanding bank indebtedness in light of low natural gas prices, the Company completed several non-core property dispositions in 2011 and the second quarter of 2012. Proceeds from the 2012 dispositions were initially applied against bank indebtedness.

The Company's objective when managing capital is to maintain a flexible capital structure which will allow it to execute on its capital investment program, including investing in oil and gas activities which may or may not be successful. As well, through periods of extreme market fluctuations, the Company strives to maintain flexibility and liquidity in its capital structure. As a result, Fairborne continually works to balance the proportion of debt and equity in its capital structure to take into account the level of risk being incurred in its capital expenditures. With depressed share prices continuing into 2012, the ability to issue additional shares has been restricted.

In order to maintain or adjust the capital structure, Fairborne considers various factors including: its forecasted debt to forecasted funds from operations ratio while attempting to finance an acceptable investment program including incremental investment and acquisition opportunities; the current level of bank credit available from the banking syndicate; the level of bank credit that may be obtainable from the banking syndicate as a result of reserve growth; the availability of other sources of debt with different characteristics than the existing bank debt; the sale of assets; limiting the size of the investment program; and the availability of new common equity financing if available on acceptable terms. In the midst of financial uncertainty, the Company will continually re-evaluate its capital expenditure program in light of projected cash flows.

Shareholders' Equity

The Company is authorized to issue an unlimited number of common shares and an unlimited number of preferred shares, issuable in series.

The following table provides a summary of outstanding common shares and stock options at the dates indicated:

(thousands)	July 31, 2012	June 30, 2012	December 31, 2011
Common shares	**102,594**	**102,594**	102,594
Stock options	**7,396**	**7,480**	7,740
Weighted average common shares (1)			
Basic	**n/a**	**102,594**	102,563
Diluted	**n/a**	**102,594**	102,563

(1) Weighted average common shares outstanding are for the twelve months ended December 31, 2011 and for the six months ended June 30, 2012.

Off-Balance Sheet Arrangements

Fairborne has no off-balance-sheet arrangements.

Business Environment and Risk

The business risks the Company is exposed to are those inherent in the oil and gas industry as well as those governed by the individual nature of Fairborne's operations. Geological and engineering risks, the uncertainty of discovering commercial quantities of new reserves, commodity prices, interest rate and foreign exchange risks, competition and government regulations – all of these govern the businesses and influence the controls and management at the Company. Fairborne manages these risks by:

- attracting and retaining a team of highly qualified and motivated professionals who have a vested interest in the success of the Company;
- operating properties in order to maximize opportunities;
- employing risk management instruments to minimize exposure to volatility of commodity prices, interest rate and foreign exchange rates;
- maintaining a strong financial position; and
- maintaining strict environmental, safety and health practices.

Controls and Procedures

Disclosure Controls and Procedures

Fairborne's Chief Executive Officer and Chief Financial Officer have designed or caused to be designed under their supervision, disclosure controls and procedures to provide reasonable assurance that (i) material information relating to the Company is made known to Fairborne's Chief Executive Officer and Chief Financial Officer by others, particularly during the period in which the annual and interim filings are being prepared; and (ii) information required to be disclosed by the Company in its annual filings, interim filings or other reports filed or submitted by it under securities legislation is recorded, processed, summarized and reported within the time period specified in securities legislation.

Internal Controls over Financial Reporting

Fairborne's Chief Executive Officer and Chief Financial Officer have designed or caused to be designed under their supervision, internal controls over financial reporting to provide reasonable assurance regarding the reliability of the Company's financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles applicable to the Company.

No material changes in Fairborne's internal controls over financial reporting were identified during the three months ended June 30, 2012, that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

It should be noted that a control system, including Fairborne's disclosure and internal controls and procedures, no matter how well conceived, can provide only reasonable, but not absolute, assurance that the objectives of the control system will be met and it should not be expected that the disclosure and internal controls and procedures will prevent all errors or fraud.

Quarterly Financial Information

The following is a summary of select financial information for the quarterly periods indicated:

	Q2/2012	Q1/2012	Q4/2011	Q3/2011
Financial *($thousands, except per share amounts)*				
Petroleum and natural gas revenue	**31,571**	38,465	49,443	53,350
Funds generated from operations	**12,898**	18,062	27,050	31,504
Per share – basic	**$0.12**	$0.18	$0.26	$0.31
Per share – diluted	**$0.12**	$0.18	$0.26	$0.31
Cash flow from operations (including changes in working capital)	**11,972**	18,456	34,820	34,089
Per share – basic	**$0.12**	$0.18	$0.34	$0.33
Per share – diluted	**$0.12**	$0.18	$0.34	$0.33
Profit (loss)	**(44,721)**	(7,240)	(108,889)	1,323
Per share – basic	**($0.44)**	($0.07)	($1.06)	$0.01
Per share – diluted	**($0.44)**	($0.07)	($1.06)	$0.01
Total assets	**767,731**	928,885	918,287	1,050,898
Working capital deficit (excluding convertible debentures)	**8,078**	32,902	32,767	21,257
Convertible debentures	**–**	–	–	99,353
Bank indebtedness	**183,105**	253,541	228,341	125,196
Total debt, including working capital	**191,183**	286,443	261,108	245,806
Operations				
Average production				
Natural gas *(Mcf per day)*	**70,485**	76,821	75,803	72,303
Crude oil *(bbls per day)*	**1,262**	1,860	2,036	2,262
Natural gas liquids *(bbls per day)*	**946**	886	811	845
Sulphur *(tonnes per day)*	**7**	46	58	48
Total *(BOE per day)*	**13,962**	15,596	15,539	15,206

	Q2/2011	Q1/2011	Q4/2010	Q3/2010
Financial *($thousands, except per share amounts)*				
Petroleum and natural gas revenue	54,442	48,531	56,904	54,718
Funds generated from operations	27,241	29,833	34,372	32,532
Per share – basic	$0.27	$0.29	$0.34	$0.32
Per share – diluted	$0.26	$0.29	$0.34	$0.31
Cash flow from operations (including changes in working capital)	24,102	25,096	39,194	27,380
Per share – basic	$0.24	$0.24	$0.38	$0.27
Per share – diluted	$0.23	$0.24	$0.38	$0.26
Profit (loss)	652	32,650	(8,247)	3,201
Per share – basic	$0.01	$0.32	($0.08)	$0.03
Per share – diluted	$0.01	$0.31	($0.08)	$0.03
Total assets	1,052,932	1,039,135	1,072,064	1,071,759
Working capital deficit (surplus) (excluding convertible debentures)	(21,673)	47,175	17,743	22,622
Convertible debentures	98,706	98,135	97,564	97,058
Bank indebtedness	152,227	101,774	206,331	194,042
Total debt, including working capital	229,260	247,084	321,638	313,722
Operations				
Average production				
Natural gas *(Mcf per day)*	65,171	63,550	71,845	68,910
Crude oil *(bbls per day)*	2,287	2,710	2,946	2,916
Natural gas liquids *(bbls per day)*	766	1,020	1,028	1,036
Sulphur *(tonnes per day)*	56	67	62	66
Total (*BOE per day*)	13,971	14,388	16,010	15,503

Interim Consolidated Statements of Financial Position

(unaudited)

(thousands of Canadian dollars)		June 30, 2012	December 31, 2011
Assets			
Current assets			
Cash and cash equivalents		$ 242	$ 188
Accounts receivable		16,549	28,144
Derivative asset	*(Note 11)*	1,063	40
Prepaid expenses and deposits		4,824	4,906
Total current assets		22,678	33,278
Petroleum and natural gas properties and equipment	*(Note 2)*	713,461	851,322
Intangible exploration assets	*(Note 3)*	31,592	33,687
Total capital assets		745,053	885,009
		$ 767,731	$ 918,287
Liabilities			
Current liabilities			
Accounts payable and accrued liabilities		$ 30,756	$ 66,045
Total current liabilities		30,756	66,045
Bank indebtedness	*(Note 5)*	183,105	228,341
Provisions	*(Note 6)*	17,597	19,330
Deferred taxes		59,626	76,780
Total non-current liabilities		260,328	324,451
Total liabilities		291,084	390,496
Equity			
Common shares		537,116	537,116
Contributed surplus		39,013	38,196
Deficit		(99,482)	(47,521)
Total equity		476,647	527,791
		$ 767,731	$ 918,287

See accompanying notes which are an integral part of these interim consolidated financial statements.

Interim Consolidated Statements of Operations and Comprehensive Income (Loss)

(unaudited)

(thousands of Canadian dollars except per share amounts)		For the three months ended June 30, 2012	For the three months ended June 30, 2011	For the six months ended June 30, 2012	For the six months ended June 30, 2011
Revenue					
Petroleum and natural gas		$ 31,571	$ 54,442	$ 70,036	$ 102,973
Royalties		(2,200)	(8,014)	(6,063)	(11,880)
		29,371	46,428	63,973	91,093
Expenses					
Production and operating		11,084	12,640	24,061	26,148
General and administrative		4,940	4,243	8,577	8,437
Depreciation and amortization	*(Notes 2, 4)*	67,974	23,491	92,635	47,088
Results from operating activities		(54,627)	6,054	(61,300)	9,420
Gain (loss) on disposition of capital assets		(1,740)	(411)	(1,624)	47,684
Finance expense	*(Note 10)*	(3,230)	(4,460)	(6,191)	(9,544)
Profit (loss) before taxes		(59,597)	1,183	(69,115)	47,560
Deferred taxes (reduction)		(14,876)	531	(17,154)	14,258
Profit (loss) and comprehensive income (loss)		$ (44,721)	$ 652	$ (51,961)	$ 33,302
Profit (loss) per share	*(Note 7)*				
Basic		$ (0.44)	$ 0.01	$ (0.51)	$ 0.33
Diluted		$ (0.44)	$ 0.01	$ (0.51)	$ 0.32

See accompanying notes which are an integral part of these interim consolidated financial statements.

Interim Consolidated Statements of Changes in Equity

(unaudited)

FOR THE SIX MONTHS ENDED JUNE 30,		2012 NUMBER		2012 AMOUNT	2011 NUMBER		2011 AMOUNT
(thousands of Canadian dollars)		*(thousands)*			*(thousands)*		
Common shares							
Balance, beginning of period		102,594	$	537,116	102,506	$	536,812
Issued on exercise of stock options		–		–	66		189
Balance, end of period		102,594	$	537,116	102,572	$	537,001
Equity portion of convertible debentures							
Balance, beginning and end of period			$	–		$	2,964
Contributed surplus							
Balance, beginning of period			$	38,196		$	31,988
Equity based compensation	*(Note 8)*			817			1,859
Stock options exercised				–			(147)
Balance, end of period			$	39,013		$	33,700
Retained earnings (deficit)							
Balance, beginning of period			$	(47,521)		$	26,743
Profit (loss)				(51,961)			33,302
Balance, end of period			$	(99,482)		$	60,045
Total Equity							
Balance, end of period			$	476,647		$	633,710

See accompanying notes which are an integral part of these interim consolidated financial statements.

Interim Consolidated Statements of Cash Flows

(unaudited)

FOR THE SIX MONTHS ENDED JUNE 30,		2012	2011
(thousands of Canadian dollars)			
Operating activities			
Profit (loss)		$ (51,961)	$ 33,302
Adjustments for:			
Depreciation and amortization	*(Notes 2, 4)*	92,635	47,088
Deferred taxes (reduction)		(17,154)	14,258
Change in fair values of derivatives	*(Note 11)*	(1,023)	(796)
Finance expense (including accretion)	*(Note 10)*	6,191	9,544
(Gain) loss on disposition of capital assets		1,624	(47,684)
Stock based compensation	*(Note 8)*	648	1,362
Funds generated from operations		30,960	57,074
Change in non-cash working capital	*(Note 9)*	167	(7,743)
Asset retirement expenditures	*(Note 6)*	(699)	(133)
Net cash from operating activities		30,428	49,198
Financing activities			
Bank indebtedness		(45,236)	(54,104)
Interest paid		(5,072)	(7,582)
Issuance of common shares		–	42
Net cash used in financing activities		(50,308)	(61,644)
Investing activities			
Expenditures on petroleum and natural gas properties	*(Note 2)*	(45,075)	(96,284)
Expenditures on exploration assets	*(Note 3)*	(441)	(1,411)
Proceeds from sale of petroleum and natural gas properties		90,127	141,380
Change in non-cash working capital	*(Note 9)*	(24,677)	(31,080)
Net cash from investing activities		19,934	12,605
Change in cash and cash equivalents		54	159
Cash and cash equivalents, beginning of period		188	319
Cash and cash equivalents, end of period		$ 242	$ 478

See accompanying notes which are an integral part of these interim consolidated financial statements.

Selected Notes to the Interim Consolidated Financial Statements

FOR THE SIX MONTHS ENDED JUNE 30, 2012 *(unaudited)*
(tabular amounts are stated in thousands and thousands of Canadian dollars except per share amounts)

1. Basis of Presentation

Fairborne Energy Ltd. (the "Company" or "Fairborne") is a resource-based company engaged in the exploration for and the development and production of natural gas, natural gas liquids and crude oil in Western Canada.

These interim consolidated financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") applicable to the preparation of interim financial statements, including IAS 34. The Company has consistently applied the same accounting policies throughout all periods presented. These financial statements should be read in conjunction with the consolidated financial statements and notes thereto for the year ended December 31, 2011.

The consolidated financial statements were authorized by the Board of Directors on August 8, 2012.

2. Petroleum and Natural Gas Properties and Equipment

Resource Properties and Equipment		For the six months ended June 30, 2012	For the year ended December 31, 2011
Cost			
Balance, beginning of period		$ 1,176,362	$ 1,109,728
Additions		44,931	172,654
Non-monetary additions		300	6,164
Asset retirement obligation additions		150	3,640
Capitalized stock-based compensation		169	984
Non-monetary dispositions		(5)	(6,914)
Dispositions		(201,290)	(109,894)
Balance, end of period		$ 1,020,617	$ 1,176,362
Accumulated depreciation and impairment losses			
Balance, beginning of period		$ (327,179)	$ (99,519)
Depreciation		(46,429)	(98,633)
Dispositions		110,375	17,973
Impairment losses	*(Note 4)*	(46,000)	(147,000)
Balance, end of period		$ (309,233)	$ (327,179)
Net book value, end of period		$ 711,384	$ 849,183

Corporate Assets		FOR THE SIX MONTHS ENDED JUNE 30, 2012		FOR THE YEAR ENDED DECEMBER 31, 2011
Cost				
Balance, beginning of period	$	5,291	$	4,600
Additions		144		691
Balance, end of period	$	5,435	$	5,291
Accumulated depreciation and impairment losses				
Balance, beginning of period	$	(3,152)	$	(2,794)
Depreciation		(206)		(358)
Balance, end of period	$	(3,358)	$	(3,152)
Net book value, end of period	$	2,077	$	2,139

		JUNE 30, 2012		DECEMBER 31, 2011
Petroleum and natural gas properties and equipment – cost	$	1,026,052	$	1,181,653
Petroleum and natural gas properties and equipment – accumulated depreciation		(312,591)		(330,331)
Petroleum and natural gas properties and equipment – net book value	$	713,461	$	851,322

The depreciation and impairment of property plant and equipment, and any reversal thereof, are recognized in depreciation and amortization in the statement of operations.

3. Intangible Exploration Assets

		FOR THE SIX MONTHS ENDED JUNE 30, 2012		FOR THE YEAR ENDED DECEMBER 31, 2011
Cost				
Balance, beginning of period	$	33,687	$	15,732
Additions		441		16,005
Dispositions		(2,536)		–
Non-monetary additions		–		2,765
Non-monetary dispositions		–		(815)
Balance, end of period	$	31,592	$	33,687

4. Impairment of Assets

Fairborne is required to test a CGU for impairment if a triggering event occurs. At June 30, 2012, a triggering event arose on two of Fairborne's CGUs. The recoverable amount of the CGUs tested for impairment is based on the higher of the value in use and fair value less costs to sell. At June 30, 2012, Fairborne calculated the estimated value in use to complete the impairment test. Value in use was determined using the net present value of cash flows from proven and probable oil and gas reserves of the respective CGU with a discount rate of 10% for both the Manitoba/Saskatchewan and Deep Basin CGUs. Also included in the value in use calculation was an estimate of the fair value of Fairborne's undeveloped land holdings.

The following commodity price estimates were used in the fair value calculations:

July 1, 2012:

YEAR	WTI Oil (*$U.S./bbl*)	Foreign Exchange Rate	Edmonton Light Crude Oil (*$Cdn/bbl*)	AECO Gas (*$Cdn/mmbtu*)
2012	91.57	0.98	83.47	2.47
2013	90.00	0.98	86.73	3.44
2014	95.00	0.98	95.92	3.90
2015	100.00	0.98	101.02	4.36
2016	100.00	0.98	101.02	4.82
2017	100.00	0.98	101.02	5.28
2018	101.35	0.98	102.40	5.68
2019	103.38	0.98	104.47	5.80
2020	105.45	0.98	106.58	5.91
2021	107.56	0.98	108.73	6.03
Escalate thereafter 2.0% per year				

During the quarter ended June 30, 2012, using the estimated value in use, and given the decrease in estimated future natural gas prices from December 31, 2011 to June 30, 2012 it was determined the Deep Basin CGU had a book value that exceeded its value in use by $46.0 million. Accordingly, an impairment loss was recorded at June 30, 2012.

An increase in the assumed discount rate of 2% would have increased the total recorded impairment by approximately $24.1 million for the quarter ended June 30, 2012, while a 10% decrease to the prices used in the quarter impairment test would have increased the recorded impairment by approximately $34.7 million. Conversely, a decrease of 2% in the discount rate would have decreased the impairment by approximately $28.6 million and a 10% increase in assumed prices would have decreased it by approximately $34.3 million.

5. Bank Indebtedness

At June 30, 2012, the Company had a $205 million extendible revolving term credit facility and a $15 million demand operating credit facility available from a syndicate of Canadian chartered banks, subject to the banks' semi-annual valuation of Fairborne's petroleum and natural gas properties. The extendible revolving term facility is available on a revolving basis until May 15, 2013 (364 day facility) at which time it may be extended, at the lenders option. If the revolving period is not extended, the undrawn portion of the facility will be cancelled and the amount outstanding will convert to a 365 day non-revolving term facility. The amounts outstanding under the non-revolving term facility are required to be repaid at the end of the term facility being May 16, 2014. Interest payable on amounts drawn under the facilities is at the prevailing bankers' acceptance rates plus stamping fees, lenders' prime rate or LIBOR rates plus applicable margins, depending on the form of borrowing by the Company. The margins and stamping fees vary from 1.00% to 3.75% depending on financial statement ratios and the form of borrowing. The credit facilities are secured by a general security agreement and a first ranking floating charge on the assets of the Company. At June 30, 2012, letters of credit totaling $2.1 million were outstanding.

6. Provisions

A reconciliation of provisions is provided below:

	For the six months ended June 30, 2012	For the year ended December 31, 2011
Asset retirement obligation, beginning of period	$ 13,344	$ 12,730
Provisions made	150	891
Provisions used	(699)	(902)
Accretion	540	932
Change in estimate	–	3,468
Disposals	(1,405)	(3,775)
Asset retirement obligation, end of period	11,930	13,344
Other provisions	5,667	5,986
Balance, end of period	$ 17,597	$ 19,330

7. Profit (Loss) per Share

The following table summarizes the weighted average common shares used in calculating profit (loss) per share:

	Three months ended June 30, 2012	Three months ended June 30, 2011	Six months ended June 30, 2012	Six months ended June 30, 2011
Numerator				
Profit (loss) for the period – basic and diluted	$ (44,721)	$ 652	$ (51,961)	$ 33,302
Denominator				
Weighted average shares – basic	102,594	102,568	102,594	102,538
Stock options	–	962	–	1,085
Denominator for diluted profit (loss) per share	102,594	103,530	102,594	103,623
Basic profit (loss) per share	$ (0.44)	$ 0.01	$ (0.51)	$ 0.33
Diluted profit (loss) per share	$ (0.44)	$ 0.01	$ (0.51)	$ 0.32

Excluded from the diluted number of shares for the period ended June 30, 2012 is the effect of 7.5 million stock options as they are anti-dilutive to the net loss. Excluded from the diluted number of shares for the period ended June 30, 2011 is the effect of convertible debentures (7.4 million shares) and 1.2 million stock options.

8. Equity Based Compensation

Stock based compensation expense of $0.8 million (June 30, 2011 – $1.9 million) was recognized in the period. Of this amount, stock based compensation costs of $0.2 million (June 30, 2011 – $0.5 million) were capitalized during the period.

9. Supplemental Cash Flow Information

The following table sets forth the changes in non-cash working capital:

FOR THE SIX MONTHS ENDED JUNE 30,	2012	2011
Change in receivables	$ 11,595	$ (19,100)
Change prepaid expenses and deposits	82	168
Change in accounts payable and accrued liabilities	(36,187)	(19,891)
	$ (24,510)	$ (38,823)
Operating	$ 167	$ (7,743)
Investing	$ (24,677)	$ (31,080)

10. Finance Expense

	For the three months ended June 30, 2012	For the three months ended June 30, 2011	For the six months ended June 30, 2012	For the six months ended June 30, 2011
Interest on bank indebtedness	$ 2,654	$ 2,031	$ 5,329	$ 4,577
Accretion of asset retirement obligation	254	233	540	458
Impairment loss on trade receivables	322	–	322	117
Interest on convertible debentures	–	1,625	–	3,250
Accretion of convertible debentures	–	571	–	1,142
Finance expenses recognized in profit and loss	$ 3,230	$ 4,460	$ 6,191	$ 9,544

11. Commodity Contracts

Fairborne has a risk management program whereby the Company sells forward a portion of its future production through fixed price physical sales contracts with customers.

a) Commodity Contracts Recorded at Fair Value:

At June 30, 2012, certain contracts have been recorded on the statement of financial position at their estimated fair value as a $1.1 million asset (December 31, 2011 – asset of $40,000). The change in the fair value has been recorded in petroleum and natural gas revenue.

Crude Oil:

	Volume *(bbls per day)*	Price *(CDN$ per bbl)*
Swap		
July 1, 2012 – Dec 31, 2012	300	$104.11

b) Commodity Contracts not Recorded at Fair Value:

The following contracts outstanding at June 30, 2012 have been entered into for the purpose of physical delivery of a non-financial item; therefore, the physical delivery contracts are not fair valued. Settlements on these contracts are included in petroleum and natural gas revenue as they occur.

Natural Gas:

	Volume *(GJs per day)*	Price *(CDN$ per GJ)*	Settlement Index
Participating Swaps [(1)]			
July 1, 2012 – Oct 31, 2012	5,000	$1.840 + 50%	AECO C Monthly
July 1, 2012 – Oct 31, 2012	5,000	$1.835 + 50%	AECO C Monthly
July 1, 2012 – Oct 31, 2012	7,500	$1.850 + 50%	AECO C Monthly
July 1, 2012 – Oct 31, 2012	5,000	$1.805 + 50%	AECO C Monthly
July 1, 2012 – Oct 31, 2012	5,000	$1.850 + 50%	AECO C Monthly
July 1, 2012 – Oct 31, 2012	5,275	$1.760 + 50%	AECO C Monthly
July 1, 2012 – Dec 31, 2012	5,000	$1.780 + 50%	AECO C Monthly

(1) The settlement price for the participating swaps is the contract price plus 50% of any excess of market price over contract price.

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Reserve Evaluators

GLJ Petroleum Consultants Ltd.

Bankers

Royal Bank of Canada
National Bank of Canada
Alberta Treasury Branch
Union Bank

Legal Counsel

Burnet, Duckworth & Palmer LLP
McCarthy Tetrault LLP

Stock Exchange Listing

The Toronto Stock Exchange
Trading Symbol: **FEL**

Corporate Governance

A system of corporate governance for Fairborne has been established to provide the Board of Directors, management and shareholders of the Company with effective governance. A more detailed discussion of corporate governance is available in the Information Circular for the Annual Meeting of Shareholders.

Directors

Greg Bay
President and CEO
Cypress Capital Management Ltd.

Robert B. Hodgins
Investor and Corporate Director

Johannes J. Nieuwenburg
General Partner
KERN Partners Ltd.

Carl J. Tricoli
Founder, Co-President
and Managing Partner
Denham Capital Management LP

Steven R. VanSickle
President and CEO
Fairborne Energy Ltd.

Richard A. Walls
Investor and Corporate Director

Rodney D. Wimer
President
Mazama Capital Partners

General Information

Shareholders and interested investors are encouraged to visit our web site: http://www.fairborne-energy.com
Historical public documents, corporate information, latest presentation material and press releases are all available.
Filings also available at: www.sedar.com

Officers

Steven R. VanSickle
President
and Chief Executive Officer

David L. Summers
Chief Operating Officer

Aaron G. Grandberg
Chief Financial Officer

Jackie M. Cugnet
Vice President
Finance

David S. Cymbalisty
Vice President
Engineering

Scott W. Hadley
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Exploration

F. Tom Park
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