

INTERIM REPORT FOR THE NINE MONTHS ENDED  
(UNAUDITED)

September 30, 2004

Q3  
highlights

| (\$ thousands, unless otherwise indicated)         | Three months ended September 30 |           |          | Nine months ended September 30 |           |          |
|--|---------------------------------|-----------|----------|--------------------------------|-----------|----------|
|  | 2004                            | 2003      | % Change | 2004                           | 2003      | % Change |
| <b>FINANCIAL</b>                                   |                                 |           |          |                                |           |          |
| Revenue, net of royalties                          | \$ 13,986                       | \$ 5,924  | 136      | \$ 37,174                      | \$ 15,122 | 146      |
| Cash flow from operations <sup>(1)</sup>           | \$ 10,155                       | \$ 4,008  | 153      | \$ 26,821                      | \$ 10,527 | 155      |
| Cash flow from operations per share <sup>(1)</sup> |                                 |           |          |                                |           |          |
| Basic  | \$ 0.39                         | \$ 0.17   | 129      | \$ 1.04                        | \$ 0.50   | 108      |
| Diluted  | \$ 0.38                         | \$ 0.17   | 124      | \$ 1.01                        | \$ 0.49   | 106      |
| Net earnings                                       | \$ 3,594                        | \$ 1,789  | 101      | \$ 8,223                       | \$ 3,737  | 120      |
| Earnings per share                                 |                                 |           |          |                                |           |          |
| Basic  | \$ 0.14                         | \$ 0.08   | 75       | \$ 0.32                        | \$ 0.18   | 78       |
| Diluted  | \$ 0.14                         | \$ 0.07   | 100      | \$ 0.31                        | \$ 0.17   | 82       |
| Capital expenditures, net of dispositions          | \$ 11,860                       | \$ 11,319 | 5        | \$ 36,784                      | \$ 42,542 | -14      |
| Total assets                                       |                                 |           |          | \$122,416                      | \$ 84,703 | 45       |
| Bank debt  |                                 |           |          | \$ 17,450                      | \$ 2,650  | 558      |
| Working capital deficiency, excluding bank debt    |                                 |           |          | \$ 3,122                       | \$ 1,228  | 154      |
| Bank debt, net of working capital                  |                                 |           |          | \$ 20,572                      | \$ 3,878  | 430      |
| Shareholders' equity                               |                                 |           |          | \$ 72,939                      | \$ 62,276 | 17       |
| <b>OPERATIONS <sup>(2)</sup></b>                   |                                 |           |          |                                |           |          |
| Production   |                                 |           |          |                                |           |          |
| Oil (bbls/d)                                       | 2,396                           | 1,270     | 89       | 2,331                          | 904       | 158      |
| Natural gas (mcf/d)                                | 8,086                           | 5,161     | 57       | 7,838                          | 4,642     | 69       |
| Combined (BOE/d)                                   | 3,744                           | 2,130     | 76       | 3,637                          | 1,678     | 117      |
| Production per million shares (BOE/d)              | 145                             | 92        | 58       | 141                            | 80        | 76       |
| Realized sales prices                              |                                 |           |          |                                |           |          |
| Oil (\$/bbl)                                       | \$ 53.06                        | \$ 35.78  | 48       | \$ 47.36                       | \$ 37.18  | 27       |
| Natural gas (\$/mcf)                               | \$ 6.91                         | \$ 6.17   | 12       | \$ 6.91                        | \$ 7.26   | -5       |
| Combined (\$/BOE)                                  | \$ 48.86                        | \$ 36.27  | 35       | \$ 45.23                       | \$ 40.13  | 13       |
| Operating netbacks                                 |                                 |           |          |                                |           |          |
| Oil (\$/bbl)                                       | \$ 34.58                        | \$ 22.48  | 54       | \$ 31.02                       | \$ 23.00  | 35       |
| Natural gas (\$/mcf)                               | \$ 4.12                         | \$ 3.78   | 9        | \$ 3.96                        | \$ 4.51   | -12      |
| Combined (\$/BOE)                                  | \$ 31.02                        | \$ 22.56  | 38       | \$ 28.42                       | \$ 24.87  | 14       |
| Drilling activity                                  |                                 |           |          |                                |           |          |
| Total wells  | 16                              | 10        | 60       | 42                             | 23        | 83       |
| Working interest wells                             | 9.1                             | 6.9       | 32       | 28.0                           | 12.91     | 117      |
| Success rate on working interest wells             | 78%                             | 86%       |          | 88%                            | 68%       |          |
| Undeveloped land                                   |                                 |           |          |                                |           |          |
| Gross acres  |                                 |           |          | 182,481                        | 145,700   | 25       |
| Net acres  |                                 |           |          | 103,259                        | 70,736    | 46       |

(1) See cautionary statement relating to Non-GAAP Financial Measures at the front of Management's Discussion and Analysis.

(2) See cautionary statement relating to Other Measurements at the front of Management's Discussion and Analysis.

## message to shareholders

Celtic Exploration Ltd. ("Celtic" or the "Company") is pleased to report to shareholders on the activities of the Company during the third quarter of 2004.

The Company drilled 16 (9.1 net) wells during the third quarter, resulting in eight (4.6 net) oil wells, two (1.4 net) natural gas wells and four (1.1 net) coal bed methane wells, for an overall success rate of 78 percent. As at September 30, 2004, Celtic's undeveloped land position increased to 103,259 net (182,481 gross) acres.

In southern Alberta, Celtic drilled two oil wells, one natural gas well and four coal bed methane wells in the third quarter. The coal bed methane wells were the first wells drilled as part of the previously announced farm-out of 31 (19.5 net) sections of Celtic land in the Richdale/Michichi area. Under the terms of the farm-out agreement, Celtic retains a 50 percent working interest after drilling and completion operations. Two additional coal bed methane wells have been drilled subsequent to September 30, 2004.

In west central Alberta, the Company drilled two oil wells. A new discovery well was drilled at Fox Creek and a second horizontal re-entry well was drilled in the 80-percent-owned Morse River Unit. In late October 2004, Celtic experienced a pipeline break in its water injection line at Fox Creek. As a result, production in the Fox Creek area is expected to be down by approximately 800 to 900 BOE/d, for two weeks.

In northern Alberta, Celtic drilled five wells. At Ogston, two successful oil wells were drilled into the Granite Wash formation and, nearby at Otter, a Banff natural gas well was drilled and tested. A new prospect was tested at Kidney, resulting in a Keg River oil pool discovery well. This well has created several potential follow-up locations on existing Celtic lands.

The Company continues to add to its drilling inventory by participating at Crown land sales and by entering into farm-in agreements in order to lock up larger tracts of land.

## management's discussion and analysis

### ADVISORY REGARDING FORWARD-LOOKING STATEMENTS

Certain information with respect to Celtic contained in this interim report, including management's assessment of future plans and operations, contains forward-looking statements. These forward-looking statements are based on assumptions and are subject to numerous risks and uncertainties, some of which are beyond Celtic's control, including the impact of general economic conditions, industry conditions, volatility of commodity prices, currency exchange rate fluctuations, imprecision of reserve estimates, environmental risks, competition from other explorers, stock market volatility and ability to access sufficient capital. Celtic's actual results, performance or achievement could differ materially from those expressed in, or implied by, these forward-looking statements and, accordingly, no assurance can be given that any events anticipated by the forward-looking statements will transpire or occur. In addition, the reader is cautioned that historical results are not necessarily indicative of future performance.

## INTRODUCTION

The following management's discussion and analysis ("MD&A") should be read in conjunction with the Company's unaudited interim financial statements for the nine months ended September 30, 2004 and the audited financial statements and MD&A for the year ended December 31, 2003. The accompanying unaudited interim financial statements of Celtic for the nine months ended September 30, 2004 have been prepared by management and approved by the Company's Audit Committee and Board of Directors. These financial statements have not been reviewed by Celtic's external auditors. Additional information relating to Celtic can be found on the SEDAR website at [www.sedar.com](http://www.sedar.com).

## NON-GAAP FINANCIAL MEASURES

The financial data contained herein have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP"). Cash flow from operations, which is determined before changes in non-cash working capital, is used in the oil and gas industry as a key measure of performance. Cash flow from operations, as used by Celtic, does not have a standardized meaning prescribed by Canadian GAAP and, therefore, may not be comparable with the calculation of similar measures by other companies. Cash flow from operations, as presented, is not intended to represent operating profits, nor should it be viewed as an alternative to cash flow provided by operating activities, net earnings or other measures of financial performance calculated in accordance with GAAP. The Company calculates cash flow from operations per share using the same method and shares outstanding which are used in the determination of earnings per share.

## OTHER MEASUREMENTS

All dollar amounts are referenced in Canadian dollars, except when noted otherwise. Where amounts are expressed on a barrel of oil equivalent ("BOE") basis, natural gas volumes have been converted to oil equivalence at six thousand cubic feet per barrel. The term BOE may be misleading, particularly if used in isolation. A BOE conversion ratio of six thousand cubic feet per 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. References to oil in this discussion include crude oil and natural gas liquids ("NGLs"). NGLs include condensate, propane, butane and ethane.

## ACCOUNTING POLICIES AND ESTIMATES

Management is required to make judgements, assumptions and estimates in the application of generally accepted accounting principles that have a significant impact on the financial results of the Company. Details outlining Celtic's accounting policies are contained in the notes to the audited financial statements for the year ended December 31, 2003. In addition, details outlining changes in accounting policies and practices are contained in Note 2 to the accompanying unaudited interim financial statements for the nine months ended September 30, 2004.

## RELATED-PARTY TRANSACTIONS

Celtic has retained the law firm of Borden Ladner Gervais LLP to provide the Company with legal services. William C. Guinan, a director, chairman and corporate secretary of Celtic, is a partner of this law firm.

## GROWTH STRATEGY

Celtic expects to continue to grow at a rapid pace by implementing its dual-prong strategy to acquire assets with exploitation potential and, at the same time, implement its full-cycle exploration program. To complement this strategy, the Company has assembled a team of experienced and qualified personnel and is well positioned financially to act quickly on new opportunities. Celtic believes that its growth strategy will continue to increase cash flow per share, net asset value per share and production per million shares outstanding.

## RESULTS OF OPERATIONS

### Selected Quarterly Information

(\$ thousands, unless otherwise indicated)

|                                       | 2004<br>Q3 | 2004<br>Q2 | 2004<br>Q1 | 2003<br>Q4 |
|---------------------------------------|------------|------------|------------|------------|
| Revenue, net of royalties             | \$ 13,986  | \$ 11,976  | \$ 11,212  | \$ 7,307   |
| Cash flow from operations             | \$ 10,155  | \$ 8,472   | \$ 8,195   | \$ 4,787   |
| Per share – basic (\$/share)          | \$ 0.39    | \$ 0.33    | \$ 0.32    | \$ 0.19    |
| Per share – diluted (\$/share)        | \$ 0.38    | \$ 0.32    | \$ 0.31    | \$ 0.18    |
| Net earnings                          | \$ 3,594   | \$ 2,582   | \$ 2,047   | \$ 961     |
| Per share – basic (\$/share)          | \$ 0.14    | \$ 0.10    | \$ 0.08    | \$ 0.04    |
| Per share – diluted (\$/share)        | \$ 0.14    | \$ 0.10    | \$ 0.08    | \$ 0.04    |
| Total assets                          | \$ 122,416 | \$ 114,246 | \$ 106,166 | \$ 94,980  |
| Bank debt, net of working capital     | \$ 20,572  | \$ 19,023  | \$ 15,372  | \$ 10,785  |
| Production (BOE/d)                    | 3,744      | 3,543      | 3,623      | 2,726      |
| Production per million shares (BOE/d) | 145        | 137        | 140        | 105        |
| Realized sales price (\$/BOE)         | \$ 48.86   | \$ 45.07   | \$ 41.59   | \$ 35.55   |
| Operating netback (\$/BOE)            | \$ 31.02   | \$ 27.98   | \$ 26.13   | \$ 20.54   |

(\$ thousands, unless otherwise indicated)

|                                       | 2003<br>Q3 | 2003<br>Q2 | 2003<br>Q1 | 2002<br>Q4 |
|---------------------------------------|------------|------------|------------|------------|
| Revenue, net of royalties             | \$ 5,924   | \$ 4,582   | \$ 4,617   | \$ 1,055   |
| Cash flow from operations             | \$ 4,008   | \$ 3,088   | \$ 3,433   | \$ 550     |
| Per share – basic (\$/share)          | \$ 0.17    | \$ 0.14    | \$ 0.19    | \$ 0.08    |
| Per share – diluted (\$/share)        | \$ 0.17    | \$ 0.14    | \$ 0.18    | \$ 0.08    |
| Net earnings                          | \$ 1,789   | \$ 810     | \$ 1,139   | \$ 34      |
| Per share – basic (\$/share)          | \$ 0.08    | \$ 0.04    | \$ 0.06    | \$ 0.00    |
| Per share – diluted (\$/share)        | \$ 0.07    | \$ 0.04    | \$ 0.06    | \$ 0.00    |
| Total assets                          | \$ 84,703  | \$ 75,986  | \$ 53,159  | \$ 44,359  |
| Bank debt, net of working capital     | \$ 3,878   | \$ 11,299  | \$ 5,747   | \$ 3,399   |
| Production (BOE/d)                    | 2,130      | 1,551      | 1,342      | 375        |
| Production per million shares (BOE/d) | 92         | 72         | 72         | 26         |
| Realized sales price (\$/BOE)         | \$ 36.27   | \$ 39.08   | \$ 47.61   | \$ 36.50   |
| Operating netback (\$/BOE)            | \$ 22.56   | \$ 23.77   | \$ 29.86   | \$ 19.38   |

### *Production*

For the three months ended September 30, 2004, Celtic's production averaged 3,744 BOE/d, comprised of 2,396 barrels per day of oil and 8.1 million cubic feet per day of natural gas. This represents a 76 percent improvement from the average production of 2,130 BOE/d in the third quarter of 2003. For the nine months ended September 30, 2004, production averaged 3,637 BOE/d, made up of 2,331 barrels per day of oil and 7.8 million cubic feet per day of natural gas, resulting in a 117 percent increase from 1,678 BOE/d average production for the same period in 2003. Celtic's growth in production volumes, compared to the previous year, reflects the successful results from the Company's exploration and development drilling program. With additional new production coming on-stream as a result of recent drilling success, and wells that were delayed from being brought on production due to wet weather conditions in the summer, Celtic expects to show further production growth in the fourth quarter of 2004.

### *Commodity Prices*

Average prices received during the three-month period ended September 30, 2004 were \$53.06 per barrel for oil sales and \$6.91 per thousand cubic feet for natural gas sales. During the three-month period ended September 30, 2003, average prices received for sales were \$35.78 per barrel for oil and \$6.17 per thousand cubic feet for natural gas. During the nine months ended September 30, 2004, average selling prices were \$47.36 per barrel for oil and \$6.91 per thousand cubic feet for natural gas. In comparison, average selling prices for the same period in the previous year were \$37.18 per barrel for oil and \$7.26 per thousand cubic feet for natural gas. Higher commodity prices in the third quarter of 2004 contributed to increases in revenue and cash flow from operations for the period. Celtic is forecasting oil prices to average \$49.60 per barrel and natural gas prices to average \$6.40 per thousand cubic feet in the fourth quarter of 2004. However, recent strength in both oil and gas prices may result in higher than forecasted prices for the remainder of the year.

### *Revenue and Royalties*

Oil and gas revenue, before royalties, for the three months ended September 30, 2004 was \$16.9 million, up 138 percent from \$7.1 million during the same period of the previous year. Royalties during the third quarter of 2004 were \$2.9 million, averaging 17.1 percent of sales. During the same period of 2003, royalties were \$1.2 million, averaging 16.9 percent of sales. Oil and gas revenue, before royalties, for the nine months ended September 30, 2004 was \$45.1 million, up 145 percent from \$18.4 million during the same period of the previous year. Royalties during the first nine months of 2004 were \$8.0 million, averaging 17.7 percent of sales. During the same period of 2003, royalties were \$3.3 million, averaging 17.9 percent of sales. Celtic has been able to achieve lower royalties than industry standard through its participation in royalty incentive programs available for deep drilling and horizontal reactivation wells.

### *Expenses*

For the three-month period ended September 30, 2004, production expenses were \$3.1 million (\$8.98 per BOE), transportation and selling expense was \$0.2 million (\$0.60 per BOE), general and administrative expenses were \$0.5 million (\$1.35 per BOE), interest expense was \$0.1 million, and depletion, depreciation and amortization expenses were \$4.8 million (\$13.84 per BOE). In the previous year, for the three-month period ended September 30, 2003, production expenses were \$1.4 million (\$6.89 per BOE), transportation and selling expense was \$0.2 million (\$0.78 per BOE), general and administrative expenses were \$0.2 million (\$1.19 per BOE), interest expense was \$0.1 million, and depletion, depreciation and amortization expenses were \$2.6 million (\$13.02 per BOE).

For the nine months ended September 30, 2004, production expenses were \$8.2 million (\$8.21 per BOE), transportation and selling expense was \$0.7 million (\$0.67 per BOE), general and administrative expenses were \$1.1 million (\$1.14 per BOE), interest expense was \$0.3 million, and depletion, depreciation and amortization expenses were \$14.0 million (\$14.03 per BOE). In the previous year, for the nine months ended September 30,

2003, production expenses were \$3.3 million (\$7.12 per BOE), transportation and selling expense was \$0.4 million (\$0.98 per BOE), general and administrative expenses were \$0.6 million (\$1.25 per BOE), interest expense was \$0.2 million, and depletion, depreciation and amortization expenses were \$6.2 million (\$13.45 per BOE).

#### *Taxes*

For the nine months ended September 30, 2004, capital taxes were \$0.03 million, compared to \$0.12 million in the corresponding period of the previous year. As at September 30, 2004, Celtic had sufficient tax deductions available allowing the Company to not record any current income tax expense. However, a provision for future income taxes in the amount of \$1.6 million and \$4.0 million was recorded for the three-month period and nine-month period ended September 30, 2004, respectively. An analysis of the future income tax provision is included in the notes to the interim financial statements.

#### *Cash Flow from Operations and Net Earnings*

Cash flow from operations for the three months ended September 30, 2004 was \$10.2 million (\$29.48 per BOE) or \$0.39 per share (\$0.38 per share diluted). During the same period in the previous year, cash flow from operations was \$4.0 million (\$20.45 per BOE) or \$0.17 per share (\$0.17 per share diluted). Cash flow from operations for the nine months ended September 30, 2004 was \$26.8 million (\$26.91 per BOE) or \$1.04 per share (\$1.01 per share diluted). During the same period of 2003, cash flow from operations was \$10.5 million (\$22.99 per BOE) or \$0.50 per share (\$0.49 per share diluted).

The Company recorded net earnings of \$3.6 million or \$0.14 per share (basic and diluted) during the three-month period ended September 30, 2004. During the same period in the previous year, net earnings were \$1.8 million or \$0.08 per share (basic) and \$0.07 per share (diluted). Net earnings for the nine months ended September 30, 2004 were \$8.2 million or \$0.32 per share (basic) and \$0.31 per share (diluted), an increase of 120 percent from \$3.7 million in earnings for the same period in 2003.

The significant increase in cash flow from operations and net earnings in the first nine months of 2004, compared to the same period in 2003, was primarily due to the 117 percent growth in production and the 13 percent higher realized sales price per barrel of oil equivalent.

Weighted average common shares outstanding as at September 30, 2004 used to compute per-share amounts were 25.8 million basic and 26.4 million diluted.

#### *Capital Expenditures*

During the three-month period ended September 30, 2004, Celtic incurred \$11.9 million in capital expenditures, after proceeds from minor property dispositions. Approximately \$8.6 million was spent on drilling and completing wells, \$2.6 million on well equipment and facilities and the balance on land, seismic and other.

The Company's capital expenditure program, including acquisitions and dispositions, for the nine months ended September 30, 2004 is summarized in the following table:

| (\$ thousands)                          | Nine months ended<br>September 30, 2004 | Nine months ended<br>September 30, 2003 | Percent<br>Change |
|---|---|---|-------------------|
| Lease acquisitions and retention        | \$ 1,800                                | \$ 1,391                                | 29                |
| Geological and geophysical activity     | 1,713                                   | 738                                     | 132               |
| Drilling and completion of wells        | 24,349                                  | 13,033                                  | 87                |
| Facilities, pipeline and well equipment | 8,123                                   | 3,326                                   | 144               |
| Office furniture and equipment          | 191                                     | 154                                     | 24                |
| Property and equipment expenditures     | \$ 36,176                               | \$ 18,642                               | 94                |
| Property and equipment acquisitions     | 3,555                                   | 23,918                                  | -85               |
| Property and equipment dispositions     | (2,947)                                 | (18)                                    | 16,272            |
| Capital expenditures                    | \$ 36,784                               | \$ 42,542                               | -14               |

Celtic is committed to future growth through its dual-prong strategy to augment strategic oil and gas asset acquisitions with exploration and development drilling activity. As a result, the Company has recently increased its capital budget for 2004 to \$55.0 million, of which \$18.2 million is expected to be incurred during the fourth quarter of the year. The majority of these fourth-quarter expenditures are planned for exploration and development activity, whereby Celtic will drill 15 to 20 wells.

#### LIQUIDITY AND CAPITAL RESOURCES

Capital expenditures for the nine months ended September 30, 2004 were funded by cash flow from operations and bank debt.

The Company currently has a revolving demand loan facility with a Canadian chartered bank, with an authorized borrowing amount of \$36.0 million. At September 30, 2004, Celtic had \$17.5 million outstanding under this facility. Bank debt, including working capital deficiency at September 30, 2004, was \$20.6 million. As a result, the Company has significant unutilized bank lines, and remains in a strong financial position to implement its growth strategy in the near future.

Celtic expects to fund future capital expenditures through the use of a combination of cash flow from operations and bank debt, supplemented by new equity financings, if required and subject to market conditions.

## OUTLOOK

Celtic's Board of Directors has approved an initial capital expenditure budget of \$60 million for 2005. This capital program will be financed by cash flow from operations and bank credit lines.

After forecasting risked production discoveries, timing of production on-stream dates resulting from the Company's planned capital expenditures for 2005, and estimated decline rates on existing volumes, Celtic expects production in 2005 to average 5,500 BOE/d (60 percent oil and 40 percent gas). This represents a 43 percent increase from estimated average production of 3,850 BOE/d in 2004.

World oil demand has shown resilient growth in 2004. The response in world oil supply has left major oil exporting nations with limited spare productive capacity. As a result, Celtic expects oil prices to remain strong in 2005. In addition, natural gas demand in North America has also expanded in 2004, resulting in record natural gas drilling in Canada and the United States. However, natural gas prices in North America are expected to remain strong until supply increases significantly with the introduction of additional volumes of liquefied natural gas ("LNG") expected in two to four years. The Company's commodity price assumptions for 2005 are US\$41.50 per barrel for WTI oil, US\$6.25 per MMBTU for natural gas, and a US/Canadian exchange rate of US\$0.80.

As a result, cash flow from operations for 2005 is forecasted to be approximately \$51.6 million or \$2.00 per share. Bank debt, net of working capital, is estimated to reach \$28.0 million by the end of 2004 or 0.5 times 2005 cash flow from operations.

Celtic's capital expenditure budget for 2005 will see the Company participate at high working interests in the drilling of approximately 75 wells during the year. Celtic continues to pursue property acquisitions that would complement its existing asset base, and completion of such acquisitions would be over and above the Company's planned capital expenditure budget. Celtic is excited about its internally-generated growth prospects and remains optimistic about the Company's ability to deliver continued per-share growth in production, cash flow from operations and earnings.

On behalf of the Board of Directors,



David J. Wilson  
*President and Chief Executive Officer*  
November 12, 2004

## balance sheet

| (\$ thousands)  | As at<br>September 30 | As at<br>December 31       |
|---|-----------------------|----------------------------|
|   | 2004                  | 2003                       |
|   | <i>(Unaudited)</i>    | <i>(Restated – Note 2)</i> |
| <b>ASSETS</b>   |                       |                            |
| <b>Current assets</b>                                   |                       |                            |
| Cash and cash equivalents                               | \$ 45                 | \$ 37                      |
| Accounts receivable                                     | 10,113                | 6,593                      |
| Prepaid expenses  | 388                   | 19                         |
| Other   | 203                   | 204                        |
|   | 10,749                | 6,853                      |
| <b>Property and equipment</b> <i>(Note 3)</i>           | 111,667               | 88,127                     |
|   | \$ 122,416            | \$ 94,980                  |
| <b>LIABILITIES</b>                                      |                       |                            |
| <b>Current liabilities</b>                              |                       |                            |
| Accounts payable and accrued liabilities                | \$ 13,871             | \$ 14,191                  |
| Bank debt <i>(Note 4)</i>                               | 17,450                | 3,447                      |
|   | 31,321                | 17,638                     |
| <b>Asset retirement obligation</b> <i>(Notes 2a, 5)</i> | 2,956                 | 2,045                      |
| <b>Future income taxes</b>                              | 15,200                | 11,179                     |
|   | 49,477                | 30,862                     |
| <b>SHAREHOLDERS' EQUITY</b>                             |                       |                            |
| <b>Share capital</b> <i>(Note 6)</i>                    | 59,415                | 59,211                     |
| <b>Contributed surplus</b>                              | 576                   | 182                        |
| <b>Retained earnings</b>                                | 12,948                | 4,725                      |
|   | 72,939                | 64,118                     |
|   | \$ 122,416            | \$ 94,980                  |

The accompanying notes form an integral part of these financial statements.

## statement of operations and retained earnings

| (\$ thousands, except per-share amounts)                     | Three months ended September 30 |  | Nine months ended September 30 |  |
|--|---------------------------------|--|--------------------------------|--|
|  | 2004<br><i>(Unaudited)</i>      | 2003<br><i>(Restated –<br/>Note 2)<br/>(Unaudited)</i> | 2004<br><i>(Unaudited)</i>     | 2003<br><i>(Restated –<br/>Note 2)<br/>(Unaudited)</i> |
| <b>Revenue</b>   |                                 |  |                                |  |
| Petroleum and natural gas                                    | \$ 16,864                       | \$ 7,095   | \$ 45,137                      | \$ 18,379  |
| Royalties  | (2,878)                         | (1,171)  | (7,963)                        | (3,286)  |
|  | 13,986                          | 5,924  | 37,174                         | 15,093   |
| Other  | –                               | –  | –                              | 29   |
|  | \$ 13,986                       | \$ 5,924   | \$ 37,174                      | \$ 15,122  |
| <b>Expenses</b>  |                                 |  |                                |  |
| Production   | \$ 3,094                        | \$ 1,351   | \$ 8,182                       | \$ 3,260   |
| Transportation and selling <i>(Note 2b)</i>                  | 205                             | 153  | 667                            | 449  |
| General and administrative                                   | 467                             | 231  | 1,135                          | 570  |
| Interest   | 131                             | 131  | 338                            | 198  |
| Depletion and depreciation                                   | 4,766                           | 2,554  | 13,995                         | 6,157  |
| Stock-based compensation <i>(Note 2c)</i>                    | 130                             | 42   | 423                            | 126  |
| Accretion of asset retirement obligation <i>(Note 5)</i>     | 55                              | 32   | 137                            | 51   |
|  | \$ 8,848                        | \$ 4,494   | \$ 24,877                      | \$ 10,811  |
| <b>Earnings before taxes</b>                                 | \$ 5,138                        | \$ 1,430   | \$ 12,297                      | \$ 4,311   |
| Capital tax  | (66)                            | 50   | 31                             | 118  |
| Future income taxes <i>(Note 8)</i>                          | 1,610                           | (409)  | 4,043                          | 456  |
| <b>Net earnings</b>  | \$ 3,594                        | \$ 1,789   | \$ 8,223                       | \$ 3,737   |
| <b>Retained earnings, beginning of period</b>                |                                 |  |                                |  |
| As previously reported                                       | 9,354                           | 1,976  | 4,692                          | 28   |
| Retroactive adjustment for<br>changes in accounting policies | –                               | –  | 33                             | –  |
| As restated <i>(Note 2)</i>                                  | 9,354                           | 1,976  | 4,725                          | 28   |
| <b>Retained earnings, end of period</b>                      | \$ 12,948                       | \$ 3,765   | \$ 12,948                      | \$ 3,765   |
| <b>Earnings per share</b>                                    |                                 |  |                                |  |
| Basic  | \$ 0.14                         | \$ 0.08  | \$ 0.32                        | \$ 0.18  |
| Diluted  | 0.14                            | 0.07   | 0.31                           | 0.17   |

The accompanying notes form an integral part of these financial statements.

## statement of cash flows

| (\$ thousands)   | Three months ended September 30 |   | Nine months ended September 30 |   |
|--|---------------------------------|---|--------------------------------|---|
|  | 2004<br>(Unaudited)             | 2003<br>(Restated –<br>Note 2)<br>(Unaudited) | 2004<br>(Unaudited)            | 2003<br>(Restated –<br>Note 2)<br>(Unaudited) |
| <b>Operating activities</b>                            |                                 |   |                                |   |
| Net earnings   | \$ 3,594                        | \$ 1,789                                      | \$ 8,223                       | \$ 3,737                                      |
| Items not affecting cash:                              |                                 |   |                                |   |
| Depletion and depreciation                             | 4,766                           | 2,554   | 13,995                         | 6,157   |
| Stock-based compensation                               | 130                             | 42  | 423                            | 126   |
| Accretion of asset retirement obligation               | 55                              | 32  | 137                            | 51  |
| Future income taxes                                    | 1,610                           | (409)   | 4,043                          | 456   |
|  | \$ 10,155                       | \$ 4,008                                      | \$ 26,821                      | \$ 10,527                                     |
| Change in non-cash operating working capital (Note 10) | 2,499                           | (536)   | (7,304)                        | (2,550)                                       |
| <b>Cash provided by operating activities</b>           | <b>\$ 12,654</b>                | <b>\$ 3,472</b>                               | <b>\$ 19,517</b>               | <b>\$ 7,977</b>                               |
| <b>Financing activities</b>                            |                                 |   |                                |   |
| Increase in bank debt                                  | \$ 250                          | \$ (7,750)                                    | \$ 14,003                      | \$ 1,100                                      |
| Issue of common shares, net of costs                   | 156                             | 14,738  | 174                            | 31,553  |
| <b>Cash provided by financing activities</b>           | <b>\$ 406</b>                   | <b>\$ 6,988</b>                               | <b>\$ 14,177</b>               | <b>\$ 32,653</b>                              |
| <b>Investing activities</b>                            |                                 |   |                                |   |
| Property and equipment expenditures                    | \$ (12,146)                     | \$ (6,460)                                    | \$ (36,176)                    | \$ (18,642)                                   |
| Property and equipment acquisitions                    | 7                               | (4,859)                                       | (3,555)                        | (23,918)                                      |
| Property and equipment dispositions                    | 279                             | –   | 2,947                          | 18  |
| Site restoration and abandonment expenditures          | –                               | (4)   | –                              | (17)  |
| Change in non-cash investing working capital (Note 10) | (1,165)                         | 892   | 3,097                          | 999   |
| <b>Cash used in investing activities</b>               | <b>\$ (13,025)</b>              | <b>\$ (10,431)</b>                            | <b>\$ (33,687)</b>             | <b>\$ (41,560)</b>                            |
| <b>Net change in cash and cash equivalents</b>         | <b>\$ 35</b>                    | <b>\$ 29</b>                                  | <b>\$ 7</b>                    | <b>\$ (930)</b>                               |
| <b>Cash and cash equivalents, beginning of period</b>  | <b>10</b>                       | <b>2</b>                                      | <b>37</b>                      | <b>960</b>                                    |
| <b>Cash and cash equivalents, end of period</b>        | <b>\$ 45</b>                    | <b>\$ 31</b>                                  | <b>\$ 44</b>                   | <b>\$ 30</b>                                  |

The accompanying notes form an integral part of these financial statements.

## notes to the interim financial statements

*Interim period ended September 30, 2004  
(Unaudited)*

### 1. BASIS OF PRESENTATION

The interim financial statements of the Company have been prepared following the same accounting policies and methods of computation as the financial statements of the Company for the year ended December 31, 2003. The disclosure provided below is incremental to that included in the annual financial statements. In this regard, these interim financial statements should be read in conjunction with the financial statements and notes thereto for the year ended December 31, 2003, included in the Company's annual report.

### 2. CHANGES IN ACCOUNTING POLICIES AND PRACTICES

#### *(a) Asset retirement obligations*

The Company has retroactively adopted the Canadian accounting standard outlined in the CICA Handbook Section 3110, "Asset Retirement Obligations." This new section requires liability recognition for retirement obligations associated with oil and gas well sites and facilities, at fair value. The asset retirement cost, equal to the fair value of the retirement obligation, is capitalized as part of the cost of the related asset. These capitalized costs are amortized on a unit-of-production basis, consistent with depletion and depreciation.

The Company previously estimated future site restoration and abandonment costs and recorded them into earnings on a unit-of-production basis over the remaining life of proved reserves and accumulated a liability on the Balance Sheet. Prior year financial statements have been restated to reflect the change in accounting treatment. In summary, net earnings for the nine months ended September 30, 2003 increased by \$0.019 million, property and equipment assets at September 30, 2003 increased by \$1.246 million and liabilities increased by \$1.227 million.

#### *(b) Transportation and selling expenses*

The Company has retroactively adopted the accounting practice to classify transportation and selling expenses incurred to bring petroleum and natural gas production to market as an expense on the Statement of Operations. The Company's previous practice was to reduce petroleum and natural gas revenue. This change does not impact earnings. Information provided for prior periods has been reclassified to conform to the presentation adopted in 2004.

#### *(c) Stock-based compensation*

The Company has adopted the Canadian accounting standard outlined in the CICA Handbook Section 3870, "Stock-based Compensation and Other Stock-based Payments." This policy has been adopted prospectively effective January 1, 2003. This new section provides for the fair-value method to record stock-based compensation expense with respect to stock options granted. The fair value of each option granted is estimated on the date of grant using the Black-Scholes option pricing model.

Prior year financial statements have been restated to reflect the change in accounting treatment. In summary, net earnings for the nine months ended September 30, 2003 decreased by \$0.081 million, liabilities at September 30, 2003 decreased by \$0.045 million and contributed surplus increased by \$0.126 million.

### 3. PROPERTY AND EQUIPMENT

| At September 30, 2004 (\$ thousands)               | Cost              | Accumulated<br>depletion and<br>depreciation | Net book<br>value |
|--|-------------------|--|-------------------|
| Petroleum and natural gas properties and equipment | \$ 135,881        | \$ 24,558                                    | \$ 111,323        |
| Other assets                                       | 445               | 101  | 344               |
|  | <b>\$ 136,326</b> | <b>\$ 24,659</b>                             | <b>\$ 111,667</b> |

  

| At December 31, 2003 (as restated) (\$ thousands)  | Cost             | Accumulated<br>depletion and<br>depreciation | Net book<br>value |
|--|------------------|--|-------------------|
| Petroleum and natural gas properties and equipment | \$ 98,515        | \$ 10,595                                    | \$ 87,920         |
| Other assets                                       | 254              | 47   | 207               |
|  | <b>\$ 98,769</b> | <b>\$ 10,642</b>                             | <b>\$ 88,127</b>  |

At September 30, 2004, petroleum and natural gas properties with a cost of \$7.7 million (December 31, 2003 – \$6.2 million) relating to undeveloped properties have been excluded from the depletion and depreciation calculation. Future capital costs required to develop proved reserves in the amount of \$1.7 million (2003 – \$1.2 million) are included in the depletion and depreciation calculation.

Celtic does not capitalize any interest or general and administrative expenses that are not directly related to exploration and development activities. During the nine months ended September 30, 2004, the Company capitalized \$0.2 million (2003 – \$0.1 million) with respect to employee salaries directly relating to exploration and development activities.

### 4. BANK DEBT

| (\$ thousands)        | September 30, 2004 | December 31, 2003 |
|-----------------------|--------------------|-------------------|
| Demand operating loan | \$ 7,450           | \$ 3,447          |
| Bankers' acceptances  | 10,000             | –                 |
| Bank debt             | <b>\$ 17,450</b>   | <b>\$ 3,447</b>   |

Celtic has a demand revolving credit facility with a Canadian chartered bank. The authorized borrowing amount under this facility is \$36.0 million. Interest is payable monthly for borrowings through direct advances. Interest rates fluctuate based on a pricing grid and range from bank prime to bank prime plus 1.5%, depending upon the Company's then current debt-to-cash-flow ratio of between less than one times to greater than three times. Currently, interest is payable at bank prime. Under the credit facility, borrowings through the use of bankers' acceptances are also available. The Company has a fixed-rate bankers' acceptance in the amount of \$10.0 million, maturing on May 27, 2005 at an aggregate interest rate of 3.6%. Repayments of principal under the credit facility are not required, provided that the aggregate borrowings do not exceed the authorized borrowing amount and the Company is in compliance with all covenants, representations and warranties. The credit facility revolves until May 1, 2005, at which time the bank will conduct its annual review.

## 5. ASSET RETIREMENT OBLIGATION

The following table provides a reconciliation of the carrying amount of the obligation associated with the retirement of oil and gas properties:

| (\$ thousands)                                    | September 30, 2004 | December 31, 2003 |
|---|--------------------|-------------------|
| Asset retirement obligation, beginning of year    | \$ 2,045           | \$ 947            |
| Liabilities incurred, net of liabilities disposed | 774                | 1,010             |
| Accretion expense                                 | 137                | 88                |
| <b>Asset retirement obligation, end of period</b> | <b>\$ 2,956</b>    | <b>\$ 2,045</b>   |

## 6. SHARE CAPITAL

### *Authorized:*

Unlimited number of common shares.

Unlimited number of preferred shares.

### *Issued:*

| (thousands)  | Common shares | Amount           |
|--|---------------|------------------|
| Balance, December 31, 2003   | 25,790        | \$ 59,211        |
| Issued for cash on exercise of stock options                                       | 33            | 176              |
| Amount relating to exercised options<br>previously recorded as contributed surplus | –             | 29               |
| Share issue costs  | –             | (1)              |
| <b>Balance, September 30, 2004</b>   | <b>25,823</b> | <b>\$ 59,415</b> |

## 7. STOCK OPTIONS

Celtic has a stock option plan that provides for granting of stock options to directors, officers, employees and consultants. Stock options granted under the stock option plan have a maximum term of five years to expiry. Vesting is determined by the Company's Board of Directors. However, the majority of the options granted vest equally over a three-year period commencing on the first anniversary date of the grant. The exercise price of each stock option granted is determined as the closing market price of the common shares on the Toronto Stock Exchange on the day of grant. Each stock option granted permits the holder to purchase one common share of the Company at the stated exercise price.

The following table summarizes the changes in stock options outstanding during the year, up to September 30, 2004:

| (thousands, except per unit amounts) | Stock options | Average exercise price |
|--------------------------------------|---------------|------------------------|
| Balance, December 31, 2003           | 1,642         | \$ 4.66                |
| Granted                              | 406           | 7.69                   |
| Cancelled                            | (105)         | 6.22                   |
| Exercised                            | (33)          | 5.28                   |
| <b>Balance, September 30, 2004</b>   | <b>1,910</b>  | <b>\$ 5.21</b>         |

As at September 30, 2004, stock options representing 7.4% of the Company's issued common shares are outstanding. The following table summarizes information regarding stock options outstanding at September 30, 2004:

| Range of exercise prices per share | Number of options outstanding<br>(thousands) | Weighted average remaining term in years | Weighted average exercise price per share for options outstanding | Number of options exercisable<br>(thousands) | Weighted average exercise price per share for options exercisable |
|------------------------------------|--|--|---|--|---|
| \$2.01 to \$3.50                   | 588  | 3.0                                      | \$ 3.02   | 25   | \$ 2.90   |
| \$3.51 to \$5.00                   | 140  | 3.4                                      | \$ 4.06   | 43   | 4.06  |
| \$5.01 to \$6.50                   | 781  | 4.1                                      | \$ 5.79   | 45   | 5.21  |
| \$6.51 to \$8.00                   | 401  | 4.9                                      | \$ 7.70   | –  | –   |
| Total                              | 1,910  | 3.9                                      | \$ 5.21   | 113  | \$ 4.26   |

## 8. INCOME TAXES

The provision for future income taxes differs from the expected amount calculated by applying the combined federal and provincial corporate income tax rate as a result of the following:

| (\$ thousands)  | Nine months ended<br>September 30, 2004 |
|---|---|
| Earnings before taxes                                     | \$ 12,297                               |
| Statutory combined federal and provincial income tax rate | 38.87%                                  |
| Expected income taxes                                     | \$ 4,780                                |
| Increase (decrease) resulting from:                       |   |
| Non-deductible Crown payments                             | 1,596                                   |
| Non-taxable provincial royalty credits (ARTC)             | (132)                                   |
| Allowable resource allowance deduction                    | (2,205)                                 |
| Other adjustments   | 4                                       |
| Provision for future income taxes                         | \$ 4,043                                |

## 9. EARNINGS PER SHARE

The Company uses the treasury stock method to determine the dilutive effect of stock options and other dilutive instruments. Under this method, only "in-the-money" dilutive instruments impact the calculations in computing diluted earnings per share.

For the nine-month period ended September 30, 2004, in computing diluted earnings per share, 0.6 million shares were added to the 25.8 million weighted average number of common shares outstanding during the period for the dilutive effect of stock options.

## 10. SUPPLEMENTAL CASH FLOW INFORMATION

Changes in non-cash working capital, excluding bank debt:

| (\$ thousands)                            | Nine months ended<br>September 30, 2004 |
|---|---|
| Accounts receivable                       | \$ (3,519)                              |
| Prepaid expenses                          | (369)                                   |
| Other current assets                      | 1                                       |
| Accounts payable and accruals             | (320)                                   |
| <b>Change in non-cash working capital</b> | <b>\$ (4,207)</b>                       |
| Relating to:                              |   |
| Operating activities                      | \$ (7,304)                              |
| Investing activities                      | 3,097                                   |
| <b>Change in non-cash working capital</b> | <b>\$ (4,207)</b>                       |

Other cash flow information:

| (\$ thousands)          | Nine months ended<br>September 30, 2004 |
|-------------------------|---|
| Cash interest paid      | \$ 569                                  |
| Cash capital taxes paid | \$ 210                                  |

## 11. RELATED-PARTY TRANSACTIONS

The Company has retained the law firm of Borden Ladner Gervais LLP to provide Celtic with legal services. William C. Guinan, a director, chairman and corporate secretary of Celtic, is a partner of this law firm. During the nine months ended September 30, 2004, the Company paid a total of \$0.06 million to this firm for legal fees and disbursements (including GST). The Company expects to continue using the services of this law firm from time to time.

## corporate information

### BOARD OF DIRECTORS

Robert J. Dales <sup>(2)(3)(4)(5)</sup>  
*President, Valhalla Ventures Inc.*

William C. Guinan <sup>(1)(4)(5)</sup>  
*Partner, Borden Ladner Gervais LLP*

Eldon A. McIntyre <sup>(2)(3)</sup>  
*President, Jarrod Oils Ltd.*

Neil G. Sinclair <sup>(2)(4)</sup>  
*President, Sinson Investments Ltd.*

David J. Wilson <sup>(3)(5)</sup>  
*President & CEO, Celtic Exploration Ltd.*

- <sup>(1)</sup> Chairman of the Board
- <sup>(2)</sup> Member of the Audit Committee
- <sup>(3)</sup> Member of the Reserves Committee
- <sup>(4)</sup> Member of the Compensation Committee
- <sup>(5)</sup> Member of the Corporate Governance Committee

### OFFICERS

David J. Wilson  
*President & Chief Executive Officer*

Sadiq H. Lalani  
*Vice President, Finance & Chief Financial Officer*

Alan G. Franks  
*Vice President, Operations*

Michael R. Shea  
*Vice President, Land*

### HEAD OFFICE

Suite 500  
505 Third Street SW  
Calgary, Alberta  
T2P 3E6

### REGISTRAR AND TRANSFER AGENT

Valiant Trust Company  
Suite 510  
550 Sixth Avenue SW  
Calgary, Alberta  
T2P 0S2

### LEGAL COUNSEL

Borden Ladner Gervais LLP  
1000 Canterra Tower  
400 Third Avenue SW  
Calgary, Alberta  
T2P 4H2

### BANKERS

National Bank of Canada  
401 Eighth Avenue SW  
Calgary, Alberta  
T2P 1E4

### AUDITORS

PricewaterhouseCoopers LLP  
Suite 3100  
111 Fifth Avenue SW  
Calgary, Alberta  
T2P 5L3

### EVALUATION ENGINEERS

Sproule Associates Limited  
Suite 900  
140 Fourth Avenue SW  
Calgary, Alberta  
T2P 3N3

### STOCK EXCHANGE LISTING

Toronto Stock Exchange  
Trading symbol "CLT"