Oilsands Quest Files Form 10-Q Quarterly Report

09.03.2011 | CNW

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CALGARY, March 9 /CNW/ --
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CALGARY, March 9 /CNW/ - Oilsands Quest Inc. (NYSE Amex: BQI) ('Oilsands Quest', 'OQI' or 'the Company') has filed its Form 10-Q Quarterly Report for the quarter ended January 31, 2010 with the United States Securities and Exchange Commission. The full document is available online at www.sec.gov and www.sedar.com; the Management's Discussion and Analysis (MD&A) is presented below.

Commenting on the quarter and current operations, Oilsands Quest President and Chief Executive Officer Garth Wong said, 'We made both and operational and financial progress during the third quarter of our current fiscal year. We began our winter drilling program at Wallace Creek, where we hope to demonstrate the potential for a second 30,000 barrel-per-day commercial oil sands project in addition to our planned Axe Lake project. We also gained financial flexibility through the initiation of an 'At-The-Market' financing. We remain focused on maximizing value for our shareholders by advancing our development plans while we actively seek the best long-term option for the Company's future.'

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    Management's Discussion and Analysis
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The following discussion addresses material changes in our results of operations and capital resources and uses for the three and nine months ended January 31, 2011, compared to the three and nine months ended January 31, 2010, and our financial condition and liquidity since April 30, 2010. We presume that readers have read or have access to our 2010 Annual Report on Form 10-K/A, which includes disclosure regarding critical accounting policies and estimates as part of Management's Discussion and Analysis of Financial Condition and Results of Operation. Unless otherwise stated, all dollar amounts are expressed in U.S. dollars. All future payments in Canadian dollars have been converted to U.S. dollars using an exchange rate of $1.00 U.S. = $0.9978 CDN, which was the January 31, 2011 exchange rate.

Overview

Recent Events

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- As of February 1, 2011 the Board of Directors appointed Garth Wong as President and Chief Executive Officer, replacing Brian MacNeill who was in the role on an interim basis. Mr. MacNeill will remain on the Board of Directors and Chair of the Special Committee of the Board of Directors described below.

- As of February 1, 2011, the Board of Directors appointed Annie Lamoureux as Vice President and Controller.

- On March 31, 2011, T. Murray Wilson will be leaving his executive position with Oilsands Quest. Mr. Wilson will remain a member of the Company's Board of Directors and will continue to serve as a member of the Reserves and Resources Committee. Mr. Wilson joined Oilsands Quest in August of 2006 and served the Company in various capacities, most recently as the Executive Deputy Chairman.

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Three Months Ended January 31, 2010

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- On January 13, 2011 we provided an operational update and comprehensive review of the geology, reservoir characteristics, and potential development plans for all of our assets.

- We completed preparation for our 2011 winter drilling program at Wallace Creek, which seeks to confirm the potential for Wallace Creek to become Oilsands Quest's second commercial oil sands project after Axe Lake. We began drilling on February 13, 2011.

- We announced an 'At-The-Market' ('ATM') financing with Knight Capital America Group, Inc. on January 17, 2011. The ATM financing will provide us with funds for near-term operational priorities including the core hole re-abandonment program, as well as additional liquidity as we consider alternatives for enhancing shareholder value.

- We presented at TD Newcrest's Energy Conference on January 17, 2011 in London, England.

- In January we accompanied a delegation led by Saskatchewan Minister of Energy and Resources, the Honorable Bill Boyd, on a trade mission to China. While in China we met with a number of companies to promote the development of the oil sands assets in Saskatchewan.

- Effective January 12, 2011, we appointed Simon Raven to the position of Vice President, Exploration and Development from his previous position as our Chief Geologist.

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Nine Months Ended January 31, 2010

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- On August 17, 2010, we announced that we had initiated a process to explore strategic alternatives for enhancing shareholder value. The process is overseen by a Special Committee of the Board of Directors (the 'Special Committee') to consider all alternatives to increase shareholder value, including financing opportunities, asset divestitures, joint ventures and/or a corporate sale, merger or other business combination. We retained TD Securities Inc. as a financial advisor to assist us with this process.

- We confirmed that our Axe Lake reservoir can be likely produced using steam-assisted gravity drainage (SAGD), a proven oil sands recovery process, in spite of the different cap-rock characteristics at Axe Lake compared with similar projects further west. We completed laboratory testing of the glacial till overburden overlying the Axe Lake area. The results of the testing indicate that the glacial till has the characteristics required likely to act as a steam containment cap for an in-situ SAGD operation.

- We announced changes to the management team on September 2, 2010.

- We completed a re-abandonment program of 18 core holes at Axe Lake. 14 of the core holes were successfully re-abandoned. The re-abandonment of the 4 core holes that were not abandoned properly occurred early in the program.

- On November 5, 2010, we completed a financing for 20.8 million common shares at a price of $0.45 USD per share and 7.1 million common shares on a flow-through basis at a price of $0.51 CDN ($0.50 USD) per share for total gross proceeds of approximately $13.4 million CDN ($12.9 million USD).

- We also completed a non-brokered private financing May 10, 2010 for 10.5 million flow-through shares at $1.00 CDN ($0.995 USD) and 9.2 million common shares at $0.85 per share for gross proceeds of $18.6 million CDN ($18.1 million USD).

- We filed an application to the Saskatchewan Ministry of Environment (SME) for the approval of a 30,000 BPD commercial project at Axe Lake.

- We were granted a one year extension, to May 31, 2011, of our oil sands permits in northwest Saskatchewan.

- We announced an updated independent third party resource estimate for our properties.

- We completed the engineering design for a SAGD pilot project at Axe Lake, which modifies existing surface facilities. We also procured materials with certain long lead times for the facilities and horizontal wells.

- We drilled four additional delineation wells in the Axe Lake area in order to meet minimum commitments for certain permit retention as well as to increase resource understanding.

- We announced the cancellation of the proposed sale of our non-core assets at Pasquia Hills to Canshale Corp.

- We announced our intention to dispose of our non-core assets, the Eagles Nest oil sands lease and Pasquia Hills oil shale permits.

- We received approval from the Saskatchewan Ministry of Energy and Resources ('SMER') for a steam assisted gravity drainage (SAGD) pilot at Axe Lake's Test Site 1.

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Operations Summary

Exploration Programs

During the nine months ended January 31, 2011, we constructed access roads and leases in preparation for drilling up to 11 new core holes in the Wallace Creek area in February and March of 2011. This drilling program is a follow up to our successful drilling program of early 2010 and we expect to increase our resource base and qualify additional lands on this permit for a potential conversion to a lease.

We are planning to drill these core holes as part of a combined drilling program with an operator from an adjacent oil sands property. By combining our operations in the area, we expect to realize significant operating efficiencies and secure the rigs and services required to complete the program. The first well in this program commenced drilling on February 13, 2011 and we expect the program to be completed in mid-March 2011.

We filed for and received approval for the second of three one-year extensions of our Saskatchewan oil sands permits. We may seek and be granted an additional one year extension of each permit if the Company continues to meet its obligations under the terms of the permits and the Oil and Gas Conservation Regulations, 1985.

We also relinquished our two northernmost land permits in Saskatchewan (permits PS000213 and PS000215) as we focus our exploration and development opportunities to include only those lands that recent exploration activity have demonstrated to be prospective. The relinquishment of these permits did not impact our resource estimates or development plans. Please see below under the section titled 'Outlook' for a more detailed description of the Company's land strategy.

Axe Lake Area - Reservoir Development Activities

In July 2010, we drilled four wells to confirm the extent of the reservoir at Axe Lake and to satisfy our permit retention work obligations on the Saskatchewan permits. The objective of these wells was to provide additional information on the geology in the area and they will not have a significant impact on our assessment of the resource in the Axe Lake area.

During the nine months ended January 31, 2011 we completed testing of the steam containment characteristics of the glacial till. The laboratory tests indicate that the glacial till cap likely will support the proposed SAGD pilot at Axe Lake at chamber pressures of between 1,750 to 2,500 kPa.

We are continuing with the additional processing and interpretation of the 1,847 kilometres (1,149 miles) of 2-D and 3-D seismic data in order to correlate this information to the results of the overburden drilling program and the summer 2010 drilling program at Axe Lake. This interpretation of the seismic data and the correlation of the well information will be used to assist in the placement of the well pads for commercial development as well as mapping the glacial till overburden over areas where we currently lack well control.

We filed a proposal to the Saskatchewan Ministry of Environment (SME) for approval to produce up to 30,000 barrels per day of bitumen using SAGD. Filing with the SME is the first step in a two-stage process to apply for approval of a commercial lease for oil sands development. This proposal provides the complete vision for the project, giving the regulator helpful context when approving testing activity and giving all stakeholders clarity around the long-term development plans. The second stage of the process consists of an application for commercial project approval to SMER that will be submitted following the successful completion of the SAGD pilot.

The proposed project includes components typical of SAGD operations such as multi-well production pads of horizontal well pairs, and a central processing and bitumen treatment facility that includes produced fluid separation, water recycling, steam generation and tank storage facilities. Options for site access, utility service corridors, bitumen transportation, electricity and natural gas supplies are also being evaluated.

We received approval for a SAGD pilot at Test Site 1. The proposed pilot will consist of one 100 meter long horizontal well pair, with the upper well placed five meters below the glacial till cap, or overburden, and is designed to make use of the existing surface facilities. The SAGD pilot will demonstrate the steam containment properties of the glacial till cap and provide information essential for the front-end engineering design for the commercial development. Further activity on the pilot project has been suspended pending the necessary financing.

Development of a commercial project remains subject to financing, regulatory and other contingencies such as successful reservoir tests, board of directors' approvals, and other risks inherent in the oil sands industry (See 'Risk Factors' section of our Form 10-K/A for the year ended April 30, 2010).

Environmental and Regulatory

Our Saskatchewan oil sands permits were granted in 2004 and are for five year terms ending in 2009. Each permit allows for an option to request three additional year long extensions. On June 21, 2010, we received approval for the second of the possible three one-year extensions. The Company may elect to seek an additional one-year extension for the oil sands permits in May 2011, and may elect to convert these permits to lease prior to the expiry of these permits. While we expect that our application for extension will be granted, approval requires that certain conditions are met and that the Company is in compliance with the Oil and Gas Conservation Regulations, 1985. Please see below under the section titled 'Outlook' for further detail on the Company's land strategy.

The Company is in discussion with SME to assess a re-abandonment issue relating to the abandonment of early exploration core holes. We have drilled 355 exploration core holes in Saskatchewan and during a review of our development plans and well records, we determined that 223 of the early-year wells were not abandoned to a standard that meets our thermal development requirements or were not abandoned in accordance with the regulatory requirements.

We have applied for waivers on 99 core holes, the majority of which are located outside the current potential commercial development area and the regulator has indicated that they are willing to consider such waivers on a case by case basis. Our waiver applications are based on the fact that these core holes fall outside the current commercial development area and are therefore located in areas that are not expected to be economically recoverable. We have included approximately 124 core holes in our management best estimate of the re-abandonment costs as described in our financial statements.

During the nine months ended January 31, 2011, we completed an 18 hole re-abandonment program. We successfully re-abandoned 14 core holes and were only partially successful in our attempt to re-abandon the other four core holes. Those four core holes may still contain conduits which will require the Company to undertake further monitoring should a SAGD project be implemented within the vicinity of these core holes. The re-abandonment of these four core holes occurred early in the program, and we anticipate high success rates on the re-abandonments still to come.

The remaining 106 core holes are comprised of a combination of locations that are in or adjacent to the commercial development area plus a portion of the core holes for which we intend to seek waivers. Our best estimate of the cost to complete this program over the next four years is $21.2 million.

Pasquia Hills Oil Shale Area

A geologic assessment, including an estimate of Petroleum Initially-in-Place, of our permit lands based on the drill results to October 2009 and data obtained from legacy drilling was prepared by Norwest Corp.

On July 30, 2010, we cancelled a transaction to sell the Pasquia Hills assets to Canshale Corp. as Canshale was unable to meet the minimum financing requirement that was a condition for the transaction to close.

Corporate

On August 17, 2010, we announced that we had initiated a process to explore strategic alternatives for enhancing shareholder value. The Board's decision reflects careful consideration of our current financial position and the capital required to execute the business plan. In light of the significant incremental capital required to advance the exploration and development of the oil sands assets in Saskatchewan and Alberta, the Board determined that it is in the best interests of shareholders to engage financial advisors and formally explore all alternatives. The process of exploring and evaluating strategic alternatives is being overseen by a Special Committee chaired by Brian MacNeill, and including Ronald Blakely and Paul Ching.

The Special Committee is considering all alternatives to increase shareholder value, including strategic financing opportunities, asset divestitures, joint ventures and/or a corporate sale, merger or other business combination, and will ultimately recommend a course of action to the Company's full Board. We have retained TD Securities Inc. as a financial advisor to assist us with this process.

We also announced our intention to divest our Eagles Nest oil sands lease and Pasquia Hills oil shale permits. The Eagles Nest property is geographically distant from our other oil sands discoveries and is largely unexplored. We have also recognized for some time that retaining and developing the Pasquia Hills oil shale deposits would require considerable time, effort and financial resources while we are in the process of exploring and developing our significant portfolio of oil sands assets. We have no plans to develop the Pasquia Hills properties at this time. We have not yet received any offers under financial terms that are acceptable to the Company and have determined that it is in the best interests of the company to retain these assets until an adequate offer is received or additional funds are available for the development of these longer-term assets.

There can be no assurance that the review of strategic alternatives will result in a financing or a sale of the company or in any other transaction. There is no timetable for the review, and the Company does not intend to comment further regarding the evaluation of strategic alternatives unless the Board agrees to a definitive transaction or the process is concluded. The Company may continue to seek interim financing while the strategic alternatives process unfolds.

Outlook

Our reservoir development and exploration activities over the next few months will be focused on the Wallace Creek drilling program, preparing to execute the SAGD pilot at Axe Lake if financing becomes available and working with SMER to convert our Axe Lake permits to a long-term lease.

At Axe Lake, our activities will focus on retaining portions of PS00208 and PS00210 and converting them to leases. The permits are currently held under the Oil Shale Regulations, 1964 (1964 Regulations). We have requested that the Saskatchewan Minister of Energy and Resources convert permits PS00208 and PS00210 to licenses and then to leases under the terms of the Petroleum and Natural Gas Regulations, 1969 (1969 Regulations). The outcome of these discussions is not certain.

We expect to relinquish the balance of our Axe Lake lands in Saskatchewan as we do not believe that the lands to the south of the Axe Lake area are prospective, either due to the presence of interbedded water in the reservoirs that would not allow for commercial development or lack of bitumen in the reservoirs in the licenses in the southern portion of our Saskatchewan lands. Our assessment of the Saskatchewan Oil Sands Licenses has resulted in the recognition of an impairment of $2.5 million ($1.8 million net of tax) in the financial statements as of and for the nine months ended January 31, 2011. Further, we have found interbedded water areas in our East Raven Ridge area. Further analysis of these lands' prospectivity is underway and may result in relinquishment of certain of our East Raven Ridge lands in Alberta. The relinquishment of these lands will have no impact on the Company's current resource estimates or development plans.

Over the next twelve months, we plan to continue the analytical activities necessary to evaluate the recoverability of our oil sands resources at Axe Lake, Wallace Creek and Raven Ridge, including a SAGD pilot at Axe Lake. Further delineation drilling is required in the northern and eastern Wallace Creek area, and the southern Raven Ridge area in order to satisfy permit retention requirements. Whether or not the Company is able to complete this delineation drilling and retain certain portions of these permits not yet delineated is subject to the availability of capital and regulatory approvals.

Based on the delineation drilling results to date and our knowledge of the regional geology, we believe there is good potential for that project area to ultimately support an additional commercial project at Wallace Creek. This assessment is subject to a further delineation drilling, the availability of capital to complete this drilling and regulatory approvals.

Based on our review of publicly available drilling data and an analysis of our own delineation drilling to date, the reservoir in our West Raven Ridge area adjacent to Cenovus Energy Inc.'s ('Cenovus') Borealis Project appears to be similar geologically. Both reservoirs have relatively thick net bitumen pay and significant amounts of top and bottom water associated with them. Cenovus has submitted an application to the Energy Resources Conservation Board of Alberta to develop their property and, while we do not yet have the commercial or technical wherewithal to commercially develop our West Raven Ridge area, the reservoir may be developed using a similar recovery scheme as is planned by Cenovus.

Liquidity and Capital Resources

At January 31, 2011, the Company held cash and cash equivalents totaling $21.0 million.

On May 10, 2010, the Company issued 10.5 million flow-through shares at $1.00 CDN ($0.995 USD) and 9.2 million common shares at $0.85 USD per share for gross proceeds of $18.6 million CDN ($18.1 million USD) pursuant to a non-brokered private placement.

On November 5, 2010, we completed a financing for 20.8 million common shares at a price of $0.45 USD per share and 7.1 million common shares on a flow-through basis at a price of $0.51 CDN ($0.50 USD) per share for total gross proceeds of approximately $13.4 million CDN ($12.9 million USD).

On January 17, 2011, the Company entered into an equity distribution agreement ('Agreement') with Knight Capital Americas, L.P. ('KCA'), a subsidiary of Knight Capital Group, Inc. Under the terms of the Agreement, the Company may offer and sell shares of common stock by way of 'at-the-market' distributions on NYSE Amex, up to a maximum of US$20 million over a period of 12 months, through KCA as sales agent. The shares will be distributed at market prices prevailing at the time of each sale and the timing, price and number of shares sold are at our discretion. The number of shares sold on any given day is expected to be relatively small compared to the total volume of shares traded.

Funds raised from the ATM program will be used to finance a re-abandonment program of approximately 26 core holes in the Axe Lake area and general corporate purposes. The near term priorities at Axe Lake are to convert the existing oil sands permits to a long-term lease and to continue with the core hole re-abandonment program.

Management anticipates that the Company will be able to fund its activities through December 2011 with its cash and cash equivalents as at January 31, 2011. However, significant uncertainty remains about our ability to continue as a going concern and we may not be able to continue our operations beyond the next twelve months without additional financing. Additional financing will also be required if our activities are changed in scope or if actual costs differ from estimates of current plans.

There is no assurance that debt or equity financing or joint venture partner arrangements will be available to us on acceptable terms, if at all, to meet our requirements. The Company has no revenues, and its operating results, profitability and the future rate of growth depend solely on management's ability to successfully implement the business plans and on the ability to raise additional capital. See 'Outlook' above.

The consolidated financial statements have been prepared assuming that we will continue as a going concern.

Results of Operations

Net loss

Three months ended January 31, 2011 as compared to three months ended January 31, 2010. The Company experienced a net loss of $10.7 million or $0.03 per share for the three months ended January 31, 2011 as compared to a net loss of $23.7 million or $0.08 per share for the three months ended January 31, 2010. The decline in the net loss in the current period as compared to the prior period is primarily due to the reduction in exploration activity, a reduction in stock-based compensation expense, decreased corporate expenses due to a reduction in salary expenses resulting from downsizing activities, and partially offset by a decrease in the deferred income tax benefit and foreign exchange gain.

Nine months ended January 31, 2011 as compared to nine months ended January 31, 2010. The Company experienced a net loss of $35.8 million or $0.10 per share for the nine months ended January 31, 2011 as compared to a net loss of $41.7 million or $0.14 per share for the nine months ended January 31, 2010. The decrease in the net loss as compared to the prior year is caused by an overall reduction in exploration and drilling activity, a reduction in salary expenses as a result of downsizing activities and a reduction in stock based compensation costs. The decrease in the net loss during the nine month period ended January 31, 2011 compared to the prior year was partially offset by $8.5 million ($6.2 million net of tax) of cost revisions related to asset retirement obligations to re-abandon core holes in the Axe Lake area and reclaim the airstrip, camp site, access roads and reservoir test site at the Company's properties.

The Company also recognized an impairment of $2.5 million ($1.8 million net of tax) on the Saskatchewan Oil Sands Licenses due to the high likelihood of relinquishment as well as an additional allowance for impairment of $4.8 million ($3.5 million net of tax) on the Pasquia Hills property. In addition, the Company incurred $2.9 million of additional corporate expenses resulting from employee retention and termination costs and advisory costs incurred as part of the strategic alternatives review process. The decrease in the net loss the nine month period ended January 31, 2011 compared to the prior year was also partially offset by a reduction in deferred income tax benefit and by foreign exchange activity, whereas a gain of $3.9 million was recorded during the nine months ended January 31, 2010 as a result of holding Canadian funds with appreciation of the Canadian dollar value versus the US dollar, compared to a loss of $0.1 million during the current period.

The Company expects to continue to incur operating losses and will continue to be dependent on additional sales of equity or debt securities and/or property sales or joint ventures to fund its activities in the future.

Exploration costs

Three and nine months ended January 31, 2011 as compared to three and nine months ended January 31, 2010. Exploration costs for the three months ended January 31, 2011 were $2.8 million (2010 - $14.0 million). Exploration costs for the nine months ended January 31, 2011 were $16.2 million (2010 - $26.4 million). Exploration expenditures in the three months ended January 31, 2011 decreased due to a reduction in drilling and exploration activity during the period compared to the same period in the previous year.

The decrease in exploration costs during the nine month period ended January 31, 2011 is also due to a reduction in exploration and drilling activity during the nine months ended January 31, 2011 compared to the same period last year. This is partially offset by $8.5 million of cost revisions related to asset retirement obligations to re-abandon a certain number of wells in the Axe Lake area and reclaim the airstrip, camp site, access roads and reservoir test site at the Company's properties that were recorded in the nine month period ended January 31, 2011 compared to the same period last year. The Operations Summary above provides a summary of the exploration activities conducted in the three and nine months ended January 31, 2011.

General and administrative

Corporate

Three and nine months ended January 31, 2011 as compared to three and nine months ended January 31, 2010. General and administrative expenses settled with cash for the three months ended January 31, 2011 were $3.7 million (2010 - $5.7 million). General and administrative expenses settled with cash for the nine months ended January 31, 2011 were $12.8 million (2010 - $12.8 million). Expenditures in the three month period ended January 31, 2011 consist of salaries ($2.0 million), legal and other professional fees ($0.9 million) and general office costs ($0.8 million). Expenditures in the nine month period ended January 31, 2011 consist of salaries ($5.9 million), legal and other professional fees ($3.8 million) and general office costs ($3.1 million). General and administrative expenses in the three months ended January 31, 2010 consist of salaries ($3.8 million), legal and other professional fees ($0.5 million) and general office costs ($1.4 million). General and administrative expenses in the nine months ended January 31, 2010 consist of salaries ($7.3 million), legal and other professional fees ($1.9 million) and general office costs ($3.6 million). At January 31, 2011, there were 22 employees and no seasonal field employees, and at January 31, 2010, there were 62 employees including 17 seasonal field employees. The decrease in salaries and wages during the three and nine months ended January 31, 2011 is due to a reduction in salary expenses resulting from downsizing activities and a reduction in severances paid during the period compared to the same periods last year which were partially offset by the recognition of costs of $0.7 million for the three month period ended January 31, 2011 and $1.2 million for the nine month period ended January 31, 2011 for employee benefit arrangements related to a termination plan in connection with the review of strategic alternatives. The increase in professional fees during the three and nine months ended January 31, 2011 is related to additional costs incurred as part of the strategic alternatives review process. The decrease in general office costs during the three and nine months ended January 31, 2011 is mainly caused by downsizing activities.

Stock-based compensation

Three and nine months ended January 31, 2011 as compared to three and nine months ended January 31,

10. Stock-based compensation expense for the three months ended January 31, 2011 was $0.05 million (2010 - $1.9 million) and $1.0 million for the nine months ended January 31, 2011 (2010 - $4.7 million) and consists of stock-based compensation related to the issuance of options to directors, officers and employees. The decrease during the three and nine month period compared to the same periods in the prior year is due to fewer options remaining to vest including options forfeited caused by a reduction in the number of employees. A total of 5.7 million options were forfeited during the nine months ended January 31, 2011.

Foreign exchange loss (gain)

Three and nine months ended January 31, 2011 as compared to three and nine months ended January 31, 2010. A foreign exchange gain of $0.06 million (2010 - $0.8 million) during the three months ended January 31, 2011 resulted from holding less Canadian funds in the parent company during the current period as compared the same period last year when the value of the Canadian dollar appreciated slightly against the U.S dollar. For the nine months ended January 31, 2011, a foreign exchange loss of $0.1 million (2010 - gain of $3.9 million) resulted from holding fewer Canadian funds in the parent company during the current nine month period compared to the same period last year with increased volatility of the Canadian dollar against the U.S. dollar.

Depreciation and accretion

Three and nine months ended January 31, 2011 as compared to three and nine months ended January 31, 2010. Depreciation and accretion expense for the three months ended January 31, 2011 was $1.1 million (2010 - $0.8 million) and $3.3 million for the nine months ended January 31, 2011 (2010 - $1.8 million).

Depreciation expense relates to camp facilities, equipment and corporate assets which are being depreciated over their useful lives of three to five years. Accretion expense relates to the asset retirement obligation recognized on the re-abandonment of a certain number of wells in the Axe Lake area and on the airstrip, camp site, access roads and reservoir test sites which are being brought into income over a period of one to thirty years. The increase during the three and nine month period ended January 31, 2011 compared to the same periods last year is due to the additional accretion on asset retirement obligation resulting from the re-abandonment of a certain number of wells in the Axe Lake area that was identified in the previous fiscal year.

Impairment

Three and nine months ended January 31, 2011 as compared to three and nine months ended January 31, 2010. The impairment for the three months ended January 31, 2011 was $5.1 million (2010 - $5.6) and is mainly due to recognizing an additional $4.8 million impairment on the Pasquia Hills property. Due to the considerable time, effort and financial resources required to explore and develop the property and since the Company has no plan to move in that direction, management recognized a full impairment on the oil shale property and wrote down the remaining carrying value to zero at January 31, 2011. The impairment for the nine months ended January 31, 2011 was $7.3 million (2010 - $5.6 million) and is comprised of the additional $4.8 million impairment on the Pasquia Hills property as well as $2.5 million on the Saskatchewan Oil Sands Licenses due to their high likelihood of relinquishment which existed at January 31, 2011.

Interest and other income

Three and nine months ended January 31, 2011 as compared to three and nine months ended January 31, 2010. Interest income for the three months ended January 31, 2011 was $0.07 million (2010 - $0.05 million) and $0.1 million for the nine months ended January 31, 2011 (2010 - $0.1 million). Interest income is earned because the Company pre-funds its activities and the resulting cash on hand which is invested in short-term deposits. The increase during the three month period as compared to the same period last year reflects the increase in market interest rates over the intervening period. Interest income during the nine months ended January 31, 2011 compared to the same period in the prior year remained constant reflecting the decrease in short term investments offset by an increase in market interest rates over the intervening period.

Deferred income tax expense (benefit)

Three months ended January 31, 2011 as compared to three months ended January 31, 2010. The deferred income tax benefit for the three months ended January 31, 2011 was $1.9 million (2010 - $3.4 million). The decrease in the deferred tax benefit is due to a reduction in exploration activity and the renunciation of $5.4 million of flow through expenditures corresponding to a reduction of $0.6 million in tax benefit.

Nine months ended January 31, 2011 as compared to nine months ended January 31, 2010. The deferred income tax benefit for the nine months ended January 31, 2011 was $4.9 million (2010 - $5.6 million). The decrease in the deferred tax benefit is due to the reduction in exploration activity during the period, the renunciation of $8.6 million of flow through expenditures corresponding to a reduction of $1.0 million in tax benefit, and the recording of $4.4 million of asset retirement liabilities settled during the period and resulting in the reversal of $1.2 million of tax benefits previously recognized on asset retirement obligations. This decrease in the deferred tax benefit is partially offset by $2.3 million of tax benefits related to $8.5 million of additional asset retirement obligations that were recorded during the period. It also includes $2.0 million of tax benefits related to the $7.3 million impairment of the Saskatchewan Oil Sands Licenses and Pasquia Hills property.

The Company has generated deferred tax benefits by expensing all exploration costs for accounting purposes while capitalizing these costs for income tax purposes. This results in a higher tax basis for the Company's property and equipment when compared to their carrying value. The deferred tax liability reported on the balance sheet is mainly related to the excess book value of property compared to its tax basis.

Recently Issued Accounting Standards Not Yet Adopted

There are no relevant recently issued accounting standards that would impact the Company.

Off-Balance Sheet Arrangements

The Company has no off-balance sheet arrangements that have or are reasonably likely to have a current or further effect on its financial condition, changes in financial condition, revenues or expenses, results of operations liquidity, capital expenditures or capital resources that are material to investors.

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Cautionary statement about forward-looking statements

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The following includes certain statements that may be deemed to be 'forward-looking statements.' All statements, other than statements of historical facts, included in this Form 10-Q that address activities, events or developments that our management expects, believes or anticipates will or may occur in the future are forward-looking statements. Such forward-looking statements include discussion of such matters as:

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- the amount and nature of future capital, exploration and development expenditures;
- the extent and timing of exploration and development activities;
- business strategies and development of our business plan and exploration programs;
- potential relinquishment of certain of our oil sands permits and licenses;
- anticipated cost of our asset retirement obligations, including the extent and timing of our core hole re-abandonment program;
- our plans to negotiate with the Saskatchewan Ministry of Energy and Resources (SMER) respecting the transfer of our Saskatchewan oil sands permits from the Oil Shale Regulations to the Petroleum and Natural Gas Regulations; and the outcome of our process to explore strategic alternatives.

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Forward-looking statements also typically include words such as 'anticipate', 'estimate', 'expect', 'potential', 'could' or similar words suggesting future outcomes. Readers are cautioned that forward-looking statements are not guarantees of future performance and that actual results or developments may differ materially from those expressed or implied in the forward-looking statements. The Company is under no duty to update any of these forward-looking statements after the date of this report. You should not place undue reliance on these forward-looking statements.

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About Oilsands Quest

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Oilsands Quest Inc. (www.oilsandsquest.com) is exploring and developing oil sands permits and licences, located in Saskatchewan and Alberta, and developing Saskatchewan's first commercial oil sands discovery. It is leading the establishment of the province of Saskatchewan's emerging oil sands industry.

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