



**Canadian Energy**  
SERVICES LP

3<sup>rd</sup> Interim Report 2006  
for period ending September 30, 2006



## MANAGEMENT'S DISCUSSION AND ANALYSIS OF CANADIAN ENERGY SERVICES L.P.

The following management's discussion and analysis ("MD&A") of financial condition and results of operations should be read in conjunction with the unaudited financial statements and notes thereto of Canadian Energy Services L.P. ("CES" or the "Partnership") as at and for the period ended September 30, 2006 included elsewhere in this interim report. The information contained in this management's discussion and analysis was prepared on November 3, 2006 and incorporates all relevant considerations to that date.

Certain statements in this MD&A may constitute "forward-looking information" which involves known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of the Partnership, or industry results, to be materially different from any future results, performance or achievements expressed or implied by such forward-looking information. When used in this MD&A, such information uses such words as "may", "would", "could", "will", "intend", "expect", "believe", "plan", "anticipate", "estimate", and other similar terminology. This information reflects the Partnership's current expectations regarding future events and operating performance and speaks only as of the date of the MD&A. Forward-looking information involves significant risks and uncertainties, should not be read as a guarantee of future performance or results, and will not necessarily be an accurate indication of whether or not such results will be achieved. A number of factors could cause actual results to differ materially from the results discussed in the forward-looking information, including, but not limited to, the factors discussed below. Although the forward-looking information contained in this MD&A is based upon what management of the Partnership believes are reasonable assumptions, the Partnership cannot assure investors that actual results will be consistent with this forward-looking information. This forward-looking information is provided as of the date of this MD&A, and, subject to applicable securities laws, the Partnership assumes no obligation to update or revise such information to reflect new events, or circumstances.

In particular, this MD&A contains forward-looking information pertaining to the following: capital expenditure programs; supply and demand for drilling fluid systems and industry activity levels; commodity prices; treatment under governmental regulatory regimes; dependence on equipment suppliers and equipment improvements; dependence on personnel; collection of accounts receivable; operating risk liability; expectations regarding market prices and costs; expansion of services in Canada and the United States; development of new technology; acquisition of trucking capacity; and competitive conditions.

The Partnership's actual results could differ materially from those anticipated in the forward-looking information as a result of the following factors: general economic conditions in Canada, the United States and internationally; demand for oilfield services during drilling and completion of oil and natural gas wells; volatility in market prices for oil and natural gas and the effect of this volatility on the demand for oilfield services generally; competition; liabilities and risks, including environmental liabilities and risks, inherent in oil and natural gas operations; sourcing, pricing and availability of raw materials, consumables, component parts, equipment, suppliers, facilities, and skilled management, technical and field personnel; ability to integrate technological advances and match advances of competitors; availability of capital; uncertainties in weather and temperature affecting the duration of the oilfield service periods and the activities that can be completed; changes in legislation and the regulatory environment, including uncertainties with respect to implementing the Kyoto Protocol; fluctuations in foreign exchange and interest rates and the other factors considered under "Risk Factors" in the Partnership's final prospectus dated February 21, 2006 and "Risks and Uncertainties" in this MD&A.

Without limiting the foregoing, the forward-looking information contained in this MD&A is expressly qualified by this cautionary statement.



## Financial Highlights

Financial Results	Three Months Ended Sept 30, 2006	213-day Period Ended Sept 30, 2006 <sup>1</sup>
(\$000's except per unit amounts)		
Revenue	14,619	29,380
Gross margin <sup>2</sup>	4,194	8,278
Net earnings	2,500	4,454
per unit – basic <sup>4</sup>	0.27	0.49
per unit – diluted <sup>4</sup>	0.27	0.49
EBITDAC <sup>2</sup>	2,596	4,635
Cash flow from operations <sup>2</sup>	2,635	4,724
per unit – basic <sup>4</sup>	0.29	0.52
per unit – diluted <sup>4</sup>	0.29	0.52
Distributions declared		
per Class A Unit	0.2376	0.5544
per Subordinated Class B Unit	0.2376	0.5544

Financial Position	Sept 30, 2006
(\$000's)	
Working capital	11,539
Total assets	106,630
Long term financial liabilities <sup>3</sup>	1,208
Unitholders' equity	87,947

Partnership Units Outstanding <sup>4</sup>	Three Months Ended Sept 30, 2006	213-day Period Ended Sept 30, 2006 <sup>1</sup>
End of period	9,380,946	9,380,946
Weighted average – basic	9,244,805	9,053,470
Weighted average – diluted	9,244,898	9,053,549

### Notes:

<sup>1</sup> From commencement of operations on March 2, 2006.

<sup>2</sup> Refer to the "Non-GAAP Measures" on page 5 for further detail.

<sup>3</sup> Vehicle financing loans, excluding current portion and including due to related party.

<sup>4</sup> Includes Class A Units and Subordinated Class B Units (see "Unitholders' Equity" on page 11).



## Overview of Financial and Operational Results

### *Highlights of the three months ended September 30, 2006 for CES were:*

- Revenue of \$14.6 million increased \$6.8 million (86%) from the previous quarter following the traditional seasonal increase in activity. Activity was hampered in September due to wet weather conditions which resulted in delayed rig moves in areas where deeper wells are drilled. Geographic expansion into the far north with product shipped up to Fort Liard, N.W.T. for usage over the winter drilling season. Revenue will be recognized as the product is mixed.
- Gross margin of \$4.2 million or 29% of revenue was generated.
- Selling, general and administrative ("SG&A") costs were \$1.6 million reflecting the costs to prepare for growth and comply with heightened public entity reporting requirements.
- Net earnings of \$2.5 million, at 17% of revenue, was achieved following consistently strong field margins.
- The Partnership continued with its distribution policy and declared monthly distributions of \$0.0792 per unit to Class A unitholders. A quarterly distribution of \$0.2376 was declared to the Subordinated Class B unitholders of record on September 30, 2006. The target payout ratio on an annualized basis continues to be 80% of distributable cash. The actual payout ratio for the three months ended September 30, 2006 was 93% and 125% for the 213-day period ended September 30, 2006. The year to date period ended September 30th included six months of the lowest level of annual activity for oilfield services. Management believes the annual target level of distributions is achievable and appropriate for the Partnership's business.
- During the period \$3.75 million aggregate principal amount of unsecured convertible promissory notes outstanding were converted into 375,000 Class A Units at a conversion price of \$10.00 and \$500,000 aggregate principal amount of the unsecured promissory notes were repaid by the Partnership. At the end of the period, \$750,000 aggregate principal amount of the unsecured promissory notes remained outstanding.
- Long-term debt, excluding current portion and the unsecured promissory notes, at September 30, 2006 was \$458,000. To date the Partnership has not drawn on its \$3.0 million operating line of credit.

## Overview of the Partnership Formation and Corporate Structure

The Partnership is a limited partnership formed on January 13, 2006 under the Limited Partnerships Act (Ontario). The Partnership was organized in accordance with and is governed by the terms and conditions of a limited partnership agreement dated January 13, 2006 and amended and restated on March 2, 2006 (the "Partnership Agreement"). The Partnership's business and affairs are managed by Canadian Energy Services Inc. (the "General Partner") pursuant to the Partnership Agreement. A copy of the Partnership Agreement is available on the Partnership's SEDAR profile at [www.sedar.com](http://www.sedar.com).

The General Partner was incorporated on December 9, 2005 under the Business Corporations Act (Alberta). The General Partner is responsible for the administration and management of the Partnership and carries out the objects, purposes and business of the Partnership. The General Partner had not carried on any business prior to the date the Partnership commenced operations other than in connection with the Partnership's initial public offering ("IPO") and



the acquisition of the drilling fluid businesses and does not hold any material assets other than legal title to certain assets for the sole benefit of the Partnership. The General Partner holds a 0.01% general partnership interest in the Partnership.

The Partnership commenced business operations on March 2, 2006 following the acquisition of the businesses of two private drilling fluid service companies. See "Investing Activities – Business Acquisitions" on page 9. Immediately thereafter, the Partnership completed its IPO for net proceeds of approximately \$55.4 million. See "Financing Activities" on page 11. CES designs and implements drilling fluid systems for the oil and gas industry in particular relating to drilling medium to deep vertical and directional wells and horizontal wells in the Western Canadian Sedimentary Basin ("WCSB").

CES Operations Ltd., a wholly-owned subsidiary of the Partnership, was incorporated on September 22, 2006. Petro Services USA, LLC a Delaware limited liability company of which CES Operations Ltd. is the sole shareholder, was formed on September 29, 2006. Each of the foregoing companies were formed in connection with the Partnership's operational expansion strategy into the United States. To date, there has been no activity in either entity.

### 213-day Reporting Period and Comparative Information

The following financial information for CES is for the 213-day period from the commencement of operations on March 2, 2006 to the period ended September 30, 2006. Readers should note the 213-day period does not represent three complete quarters of operations.

No comparative information or analysis is provided, as financial results for the prior period are not available and would not be considered directly comparable due to the complexity of harmonizing the accounting periods and policies for the past financial information of the acquired businesses.

### Non-GAAP Measures

The financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP"). Certain supplementary information and measures not recognized under GAAP are also provided where management believes they assist the reader in understanding the Partnership's results and will be calculated on a consistent basis. These measures include:

**Cash flow or cash flow from operations** – means cash flow from operations before changes in non-cash working capital.

**Distributable cash** – means cash flow from operations less maintenance capital.

**EBITDAC** – means earnings before interest, taxes, amortization and unit-based compensation expense.

**Gross margin** – means revenue less cost of sales, which represents cost of product and field operating costs.

**Payout ratio** – means distributions declared as a percentage of distributable cash.

These measures are identified and presented, where appropriate, together with reconciliations to the equivalent GAAP measure, however, they should not be used as an alternative to GAAP measures, because they may not be consistent with calculations of other companies, trusts or partnerships.



## Results for the Interim Periods

	Three Months Ended Sept 30, 2006	213-day Period Ended Sept 30, 2006
(\$000's, except per unit amounts)		
Revenue	14,619	29,380
Cost of sales	10,425	21,102
Gross margin	4,194	8,278
% of revenue	29%	28%
Selling, general and administrative expenses	1,598	3,643
Amortization of property and equipment	107	204
Partnership unit-based compensation	28	66
Other income	(39)	(89)
Net earnings	2,500	4,454
per unit – basic	0.27	0.49
per unit – diluted	0.27	0.49

## Revenue and Operating Activities

Revenue for the three month period ended September 30, 2006 was \$14.6 million which was negatively impacted by lower than expected activity in the month of September largely due to wet weather conditions. This impacted operations in those areas where deeper wells are drilled.

The Partnership expanded its geographic area of operations into the far north with the bulk shipment of product to Fort Liard, N.W.T. in September for a drilling contractor providing turnkey services to an exploration company. The product has been staged for usage over the winter drilling season. Revenue will be recognized as the product is mixed.

The active rig count in Western Canada averaged 512 for the three months ended September based on Canadian Association of Oilwell Drilling Contractors ("CAODC") published active rig counts for Western Canada. CES estimated that it held a 12% market share during this period. CES determined market share by comparing, on a semi-weekly basis, active rigs where the Partnership was contracted to provide services to the total active rigs for Western Canada. Active rigs, in both cases, included operating rigs, rigs on standby (i.e. waiting on weather) and rigs that were moving.

The Partnership also tracked operating days. Operating days represents those days that CES was generating revenue (i.e. actual drilling days).

The Partnership estimated operating days as follows:

	Three Months Ended Sept 30, 2006	213-day Period Ended Sept 30, 2006
Operating Days	4,968	9,164

CES continued to focus on the medium to deep and horizontal wells which represented approximately 95% of revenue for the three month period ended September 30, 2006.

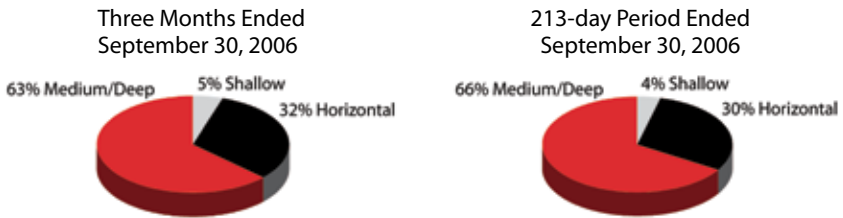


The Partnership classifies oil and natural gas wells by depth, as follows:

shallow wells:	generally less than 1,000 metres;
medium wells:	generally between 1,000 and 2,500 metres;
deep wells:	generally greater than 2,500 metres; and
horizontal wells:	drilled vertically then horizontally with often multiple lateral legs reaching out 500 to 1,500 metres each.

CES's experience has been that drilling fluid systems profitability increases significantly with the depth and complexity of the well drilled.

The following charts illustrate the Partnership's estimated revenue by well type. They demonstrate that activity continued in CES's targeted areas.



### Cost of Sales and Gross Margin

Gross margin of \$4.2 million, or 29% of revenue, was generated for the three months ended September 30, 2006. Gross margin represents the profit earned on revenue after deducting the cost of materials, field labour and all related field costs. Margins can vary due to a change in product mix.

We continued to identify products that provide opportunities to lower costs, either by sourcing through different suppliers or by buying in larger quantities and obtaining volume discounts. As activity increases in the winter drilling season, higher turnover can support volume purchasing.

Key input costs for CES's business include hydrocarbon base oil and labour costs. Labour costs are rising throughout the entire industry. The cost of base oil is passed through to the customer on a monthly price schedule. CES is working with its customers to recover labour cost increases through increases in the day rates for field engineering services.

### Selling, General and Administrative Expenses

Selling, general and administrative ("SG&A") costs for the three months ended September 30, 2006 were \$1.6 million. This included costs which continued to be slightly higher than anticipated as CES prepares for growth and complies with heightened public entity reporting requirements. SG&A for the 213-day period was 12% of revenue. On an annualized basis, the Partnership feels a target of SG&A at 10% of revenue is achievable.

In October, 2006, the Partnership converted to a new business information system that has harmonized the financial accounting and reporting systems inherited from the acquired businesses. See "Investing Activities – Capital Expenditures" on page 9.



## Other Expense (Income) Items

Amortization was \$107,000 for the three months ended September 30, 2006, largely related to vehicles which are amortized on a straight-line basis over 3 years.

Unit-based compensation was determined using the Black-Scholes option pricing model and expensed over the three year vesting period.

Other income largely represents interest income earned on short-term investments.

## Quarterly Financial Summary

	Three Months Ended Sept 30, 2006	Three Months Ended June 30, 2006	30 Day Period Ended March 31, 2006 <sup>1</sup>
<b>Financial Results</b>			
(\$000's except per unit amounts)			
Revenue	14,619	7,839	6,922
Gross margin <sup>2</sup>	4,194	2,315	1,769
Net earnings	2,500	675	1,279
per unit – basic <sup>3</sup>	0.27	0.08	0.14
per unit – diluted <sup>3</sup>	0.27	0.08	0.14
EBITDAC <sup>2</sup>	2,596	737	1,302
Cash flow from operations <sup>2</sup>	2,635	778	1,311
per unit – basic <sup>3</sup>	0.29	0.09	0.15
per unit – diluted <sup>3</sup>	0.29	0.09	0.15
<b>Partnership Units Outstanding <sup>3</sup></b>			
End of period	9,380,946	9,005,946	8,905,946
Weighted average – basic	9,244,805	8,907,045	8,905,946
Weighted average – diluted	9,244,898	8,912,539	8,905,946

### Notes:

<sup>1</sup> From commencement of operations on March 2, 2006.

<sup>2</sup> Refer to the "Non-GAAP Measures" on page 5 for further detail.

<sup>3</sup> Includes Class A Units and Subordinated Class B Units (see "Unitholders' Equity" on page 11).

## Liquidity and Capital Resources

At September 30, 2006, the Partnership had cash and cash equivalents of \$4.5 million. Working capital was positive at \$11.5 million.

Included in long-term liabilities at September 30, 2006 was an amount of \$750,000 owing to a related party in connection with the Partnership's acquisition of the drilling fluid businesses. See "Investing Activities – Business Acquisitions" on page 9 and "Transactions with Related Parties" on page 13. Management is satisfied that the Partnership has sufficient liquidity and capital resources to meet this long-term payment obligation.

In June 2006, CES entered into a revolving demand facility to borrow up to \$3.0 million for general operating purposes.

Financial instruments of CES include cash and cash equivalents, accounts receivable and accounts payable and accrued liabilities. As at September 30, 2006 there were no significant dif-





ferences between the carrying value of these amounts and their estimated fair market value.

## Cash Flow from Operating Activities and Distributions

	Three Months Ended Sept 30, 2006	213-day Period Ended Sept 30, 2006
(\$000's)		
Cash flow from operations, before changes in non-cash working capital items	2,635	4,724
Maintenance capital	245	692
Distributable cash <sup>1</sup>	2,390	4,032
Distributions declared	2,217	5,046
Payout ratio	93%	125%

**Note:**

<sup>1</sup> Refer to the "Non-GAAP Measures" on page 5 for further detail.

Distributable cash was \$2.4 million for the three months ended September 30, 2006. The Partnership declared monthly distributions of \$0.0792 per Class A Common limited partnership unit ("Class A Unit") during the period and a quarterly distribution of \$0.2376 per Class B subordinated limited partnership unit ("Subordinated Class B Unit") to Subordinated Class B unitholders of record on September 30, 2006. Distributions on the Subordinated Class B Units are paid on a quarterly basis, subject to the Partnership achieving certain distribution targets on the Class A Units.

The target payout ratio on an annualized basis continues to be 80% of distributable cash. The actual payout ratio for the three months ended September 30, 2006 was 93%. The actual payout ratio for the 213-day period ended September 30, 2006 was 125%. The target payout ratio level is the anticipated level for the twelve month calendar period. The actual payout ratio will vary with the seasonality of the Partnership's cash flow. Periods of higher activity will cause the payout ratio to decrease, likewise lower activity periods will cause the payout ratio to increase. The year to date period ended September 30th includes six months of the lowest level of annual activity for oilfield services. Management believes the annual target level of distributions is achievable and appropriate for the Partnership business.

Subsequent to the quarter end, CES declared a monthly distribution of \$0.0792 per Class A Unit to Class A unitholders of record on October 31, 2006.

## Investing Activities

### Capital Expenditures

The Partnership incurred \$472,000 in capital expenditures for the three months ended September 30, 2006. A significant portion of the expenditures (\$177,000) related to computer hardware and software for the new business information system being implemented by the Partnership. In addition, \$50,000 was spent on mud vans in Carlyle, Sask. used to transport products to stocking points and well locations. Both of these expenditures are classified as expansion capital. The Partnership also invested \$245,000 in maintenance capital which was largely comprised of vehicles for employees in the field operations.

### Business Acquisitions

On March 2, 2006, the Partnership completed the acquisition of the drilling fluid businesses from Impact Fluid Systems Inc. ("Impact") and Canadian Fluid Systems Ltd. ("CFS" and collectively with Impact the "Vendors") for an aggregate purchase price of \$80.7 million, plus an aggregate working capital adjustment of \$6.0 million.



The working capital adjustment was calculated based on a minimum working capital amount from each of Impact and CFS. Working capital in excess of this amount was added to the purchase price of the respective businesses. The working capital adjustment was determined by CES within a 120-day period from the acquisition date. At the time of closing of the acquisition, the minimum working capital amount was estimated to be \$700,000 for each of Impact and CFS, for a total of \$1.4 million. As a result of the increase in activity and the need to maintain a higher level of working capital in the Partnership, on May 10, 2006, the Vendors and the Partnership agreed to amend the acquisition agreements to provide for a maximum working capital adjustment of \$6.0 million rather than an \$8.8 million working capital adjustment that would have been otherwise payable under the acquisition agreements due to the strong performance of the businesses prior to closing.

The total purchase price of \$86.7 million was funded by the payment of \$50.6 million in acquisition notes, \$6.0 million payable to the Vendors, the issuance of 860,594 Class A Units and the issuance of 2,151,486 Subordinated Class B Units at the IPO price of \$10 per unit.

The acquisition of the drilling fluid businesses by the Partnership has been accounted for using the purchase method.

	Impact	CFS	Total
<b>Net assets acquired</b>	\$000's	\$000's	\$000's
Current assets	17,161	10,694	27,855
Property and equipment	659	16	675
Goodwill	37,621	38,345	75,966
Current liabilities	(11,860)	(5,694)	(17,554)
Long-term debt	(220)	-	(220)
	43,361	43,361	86,722
<b>Consideration</b>	\$000's	\$000's	\$000's
Acquisition notes	25,301	25,301	50,602
Due to Vendors	3,000	3,000	6,000
Class A Units	4,303	4,303	8,606
Subordinated Class B Units	10,757	10,757	21,514
	43,361	43,361	86,722

The acquisition notes were repaid with proceeds from the IPO. See "Financing Activities" on page 11.

The payable to the Vendors of \$6.0 million was satisfied by the issuance of an unsecured promissory note to each Vendor in the amount of \$3.0 million. Each note is for a term of 2 years from the March 2, 2006 closing of the acquisitions, and is non-interest bearing for the first year of the term but shall bear interest at the Royal Bank of Canada prime rate on the second year of the term.

On May 10, 2006 the Partnership agreed to grant an option in favour of the Vendors to convert the promissory notes arising from the working capital adjustment to Class A Units at \$10 per unit for a period of up to six months from March 2, 2006, the effective date of the acquisitions. On June 29, 2006 \$1.0 million aggregate principal amount of the promissory note held by Impact was assigned to a shareholder of Impact and was converted into 100,000 Class A Units at a conversion price of \$10.00 per Class A Unit and on July 19, 2006 the \$3.0 million aggregate principal amount of the promissory note held by CFS was converted into 300,000 Class A Units at a conversion price of \$10.00 per unit.

On September 18, 2006, the Partnership extended the conversion option on the unsecured promissory notes to September 30, 2006 and a further \$750,000 aggregate principal amount was converted into Class A Units at \$10.00 per Class A Unit. During the three month period ended September 30, 2006 an aggregate of \$500,000 of the outstanding notes were repaid in cash. The remaining amount payable of \$750,000 was assigned from the Vendors to a related party who is also an officer of the General Partner.

The above business acquisitions were transacted with certain individuals or entities controlled by them, who as a result of the acquisitions are significant unitholders of the Partnership. These individuals or persons related to them have continued in key management roles with the General Partner. These persons include Rodney L. Carpenter and Thomas J. Simons who are officers, directors, and significant direct or indirect shareholders of CFS and Impact, respectively, as well as officers and directors of the General Partner.

## Financing Activities

On March 2, 2006, the Partnership completed the IPO of 5,893,866 Class A Units at a price of \$10 per Class A Unit for aggregate gross proceeds of \$58.9 million before deducting \$3.5 million in underwriting commissions and approximately \$1.8 million in other costs relating to the IPO. Of the net proceeds, \$50.6 million was used to repay the acquisition notes issued to each of CFS and Impact in connection with the business acquisitions described under "Investing Activities – Business Acquisitions" on page 9 and the remaining \$3.0 million was retained in the Partnership to fund growth opportunities including the purchase of the Carlyle Facility (as defined herein). See "Transactions with Related Parties" on page 13.

## Unitholders' Equity

On March 2, 2006, the Partnership closed the IPO of 5,893,866 Class A Units at a price of \$10 per Class A Unit, for aggregate gross proceeds of \$58.9 million and net proceeds of approximately \$53.6 million after deducting offering expenses and underwriters' commission of approximately \$5.3 million.

In connection with the acquisition of the drilling fluid businesses, the Partnership issued an aggregate of 860,594 Class A Units and 2,151,486 Subordinated Class B Units to the Vendors as partial consideration for the acquired businesses. The Subordinated Class B Units issued to CFS and Impact in connection to the acquisitions are non-transferable (except to certain shareholders, associates or affiliates of the respective Vendors) and are only exchangeable into Class A Units on or after March 2, 2009, unless a take-over bid is made for the Class A Units and certain other limited circumstances. Distributions on the Subordinated Class B Units are paid quarterly subject to achieving certain distribution targets on the Class A Units.



The Partnership is authorized to issue an unlimited number of Class A Units and Subordinated Class B Units.

<b>Class A Units</b>	<b>Number of Units</b>	<b>Amount (\$000's)</b>
Class A Units issued pursuant to the IPO	5,893,866	\$ 58,939
Unit issue expenses	-	(5,336)
	5,893,866	53,603
Issued as consideration for acquired businesses	860,594	8,606
Issued on conversion of promissory notes (note 4)	100,000	1,000
Class A Units at June 30, 2006	6,854,460	\$ 63,209
Issued on conversion of promissory notes (note 4)	375,000	3,750
Class A Units at September 30, 2006	7,229,460	\$ 66,959

<b>Subordinated Class B Units</b>	<b>Number of Units</b>	<b>Amount (\$000's)</b>
Issued as consideration for acquired businesses	2,151,486	\$ 21,514
Subordinated Class B Units at September 30, 2006	2,151,486	\$ 21,514

## Unit Option Plan

The Partnership may provide additional compensation to employees, officers and directors of the General Partner and to certain other service providers by issuing options to acquire Class A Units under the Partnership's Unit Option Plan (the "Unit Option Plan"). As at September 30, 2006, 938,095 Class A Units were reserved for issuance under the Unit Option Plan, of which 306,595 Class A Units remain available for option grants. The 631,500 outstanding options vest as to one-third on each of the first, second and third anniversary dates of the grant and expire five years after the grant.

As part of an employee retention program and following regulatory approval, on October 6, 2006 the Partnership adjusted the exercise price of 196,500 of the outstanding Unit Options held by certain office and field employees from a weighted average exercise price of \$9.87 to \$7.79. The new exercise price reflected the current market price of the Class A Units. The incremental value due to the reduction in the exercise price is \$50,000, which will be recognized as unit-based compensation over the remaining vesting period. The exercise price was not adjusted for any of the options held by directors, officers and other insiders of the General Partner. The option repricing was effected solely as an incentive to employees in recognition of robust labor market conditions.

## Commitment/Contractual Obligations

The Partnership has the following financial commitments with payments due for the periods ending September 30 as follows:

<b>(\$000's)</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>Total</b>
Vehicle financing loans	\$ 336	\$ 270	\$ 162	\$ 26	\$ 794
Operating leases	106	55	3	-	164
Office rent	294	-	-	-	294
<b>Total</b>	<b>\$ 736</b>	<b>\$ 325</b>	<b>\$ 165</b>	<b>\$ 26</b>	<b>\$ 1,252</b>

Given its current financial condition, the Partnership anticipates it will be able to meet these commitments as necessary.

## Off-Balance Sheet Arrangements

The Partnership does not have off-balance sheet arrangements.



## Transactions with Related Parties

The amount due to the related party of \$750,000 represents the amount owing to one of the principals of Impact in respect of the Partnership's acquisition of the assets of Impact. The amount was originally determined based on a working capital adjustment pursuant to the respective agreements, as amended. This amount is represented by an unsecured promissory note in favor of the related party that is for a two year term from March 2, 2006 the closing date of the acquisitions, is non-interest bearing for the first year of the term but shall bear interest at the Royal Bank of Canada prime rate on the second year of the term. See "Investing Activities – Business Acquisitions" on page 9.

On March 2, 2006, the Partnership acquired certain land, building and related equipment (the "Carlyle Facility") from persons who are non-arms length with CES. The Carlyle Facility was acquired from a corporation that was owned by Rodney L. Carpenter, Kenneth D. Zandee and a third party. Mr. Carpenter is an officer and director of the General Partner and a significant shareholder of CFS. Mr. Zandee is an officer of the General Partner and a significant shareholder of CFS. The Carlyle facility was acquired for \$260,000 which represented fair market value.

## Critical Accounting Policies and Estimates

CES prepares its financial statements in accordance with Canadian generally accepted accounting principles ("GAAP"). There were no new accounting policies announced during the period presented which would be expected to materially impact on the Partnership's financial statements.

As a routine element of the financial statement preparation process, management is required to make estimates and assumptions based on information available as at the financial statement date. These estimates and assumptions affect the reported amounts of assets and liabilities, the possible disclosure of contingent assets and liabilities at the date of the financial statements and the amount of revenue and expense reported for the period.

Although estimates and assumptions must be made during the financial statement preparation process, it is management's opinion that none of the estimates or assumptions were highly uncertain at the time they were made. The most significant estimate in CES's financial statements is the amortization period for property and equipment.

## Initial Adoption of Accounting Policies

The Partnership has adopted the following significant accounting policies:

### **(a) Consolidation:**

These consolidated financial statements include the accounts of the Partnership and its wholly-owned subsidiaries. All inter-company balances and transactions are eliminated on consolidation.

### **(b) Cash and cash equivalents:**

The Partnership considers deposits in banks, certificates of deposit and short-term investments with original maturities of three months or less from the acquisition date as cash and cash equivalents.

### **(c) Inventory:**

Inventory is stated at the lower of cost, determined on a first-in, first-out basis, and net realizable value.



**(d) Property and equipment:**

Property and equipment are recorded at cost less accumulated amortization. Property and equipment are amortized using the straight-line method over their estimated useful lives at the following rates:

Computer equipment and software	3 years	straight-line method
Vehicles	3 years	straight-line method
Field equipment	5 years	straight-line method
Furniture and fixtures	5 years	straight-line method
Buildings	10 years	straight-line method

The Partnership regularly reviews its property and equipment to account for impairment.

**(e) Goodwill:**

Goodwill is the residual amount that results when the purchase price of an acquired business exceeds the sum of the amounts allocated to the assets acquired, less liabilities assumed, based on their fair values.

Goodwill is not amortized and is tested for impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired. The impairment test is carried out in two steps. In the first step, the carrying amount of the reporting unit is compared with its fair value. When the fair value of a reporting unit exceeds its carrying amount, goodwill of the reporting unit is considered not to be impaired and the second step of the impairment test is unnecessary.

The second step is necessary when the carrying amount of a reporting unit exceeds its fair value, in which case, the implied fair value of the reporting unit's goodwill is compared with its carrying amount to measure the amount of the impairment loss, if any. The implied fair value of goodwill is determined in the same manner as the value of goodwill is determined in a business combination, using the fair value of the reporting unit as if it was the purchase price. When the carrying amount of goodwill exceeds the implied fair value of the goodwill, an impairment loss is recognized in an amount equal to the excess. Impairment provisions are not reversed if there is a subsequent increase in the fair value of goodwill.

**(f) Revenue recognition:**

The Partnership's revenue is primarily comprised of the sale of products and the provision of services. Revenue on sales of product is recognized based on fixed or determinable prices when the product has been delivered to the well site and the product has been mixed. For sales that are invoiced upon shipment of the product, deferred revenue is recorded for the portion of the product that has not been mixed. Revenue from field service charges is recognized based upon agreed daily, hourly or job rates, when the service is performed. Revenue will only be recognized when collection is reasonably assured.

**(g) Unit-based compensation:**

The Partnership uses the fair value method to account for options granted to employees, officers and directors of the General Partner and certain service providers. Under the fair value method, the fair value of the options is estimated at the grant date using the Black-Scholes option pricing method, and such fair value is expensed over the vesting period, with a corresponding increase in contributed surplus. The amount of compensation expense and contributed surplus is reduced for options that are cancelled prior to vesting. Any consideration received upon the exercise of the unit-based compensation together with the amount of non-cash compensation expense recognized in contributed surplus is recorded as an increase in unitholders' capital.

**(h) Income taxes:**

The income of the Partnership is taxed at the partner level. As a result, provisions for income and capital taxes are not made by the Partnership. These consolidated financial statements include the assets, liabilities, and operations of the Partnership and its subsidiaries and do not include the assets, liabilities, including income tax, of the partners.

**(i) Measurement uncertainty:**

The preparation of consolidated financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amount of assets and liabilities, disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the period. Such estimates include providing for amortization of property and equipment. Actual results could differ from these estimates.

**(j) Earnings per unit:**

Basic earnings per unit are computed by dividing net earnings by the weighted average number of units outstanding during the period. The Partnership uses the treasury stock method for calculating diluted earnings per unit. Diluted earnings per unit are computed similar to basic earnings per unit except that the weighted average units outstanding are increased to include additional units from the assumed exercise of unit options, if dilutive. The number of additional units is calculated by assuming that outstanding unit options were exercised and that the proceeds from such exercises were used to acquire Class A Units at the average market price during the year.

Management of the Partnership is not aware of any recent accounting pronouncements or developments that will affect the Partnership's financial statements. Management will continue to monitor and assess the impact of accounting pronouncements on the Partnership's financial statements as they become available.

## Financial Instruments

The net carrying value of accounts receivable approximates fair value due to the short-term nature of these instruments. The Partnership has a large number of diverse customers, which minimizes overall accounts receivable credit risk.

The carrying value of accounts payable and accrued liabilities and distributions payable approximates the fair value of these financial instruments due to their short-term nature.

The Partnership is exposed to minimal interest rate risk due to limited long-term liabilities outstanding.

## Risk and Uncertainties

The drilling industry is cyclical and the business of CES is directly affected by fluctuations in the level of oil and natural gas exploration and development activity carried on by its clients. Drilling activity is seasonal and, in turn, is directly affected by a variety of factors, including weather, oil and natural gas prices, access to capital markets and government policies including environmental regulations. Any prolonged or significant decrease in energy prices or economic activity, or adverse change in government regulations could have a significant negative impact on exploration and development drilling activity in Canada.

The oil and natural gas drilling season is affected by weather. The industry is generally more active during the winter months of November through March, as the movement of heavy equipment is easier over the frozen ground. Wet weather, traditionally in the spring and sum-



mer, can hamper the movement of drilling rigs which has a direct impact upon generating revenue. Conversely, a longer colder winter as well as a dry spring and summer strengthen drilling operations and therefore serve to enhance CES's revenue generation. Mitigation of weather risk is difficult and costly as effective derivative products do not yet exist to successfully manage this risk.

The ability of the Partnership to expand its services will depend upon the ability to attract qualified personnel as needed. The demand for skilled oilfield employees and drilling fluid technicians is high, and the supply is limited. The unexpected loss of the Partnership's key personnel or the inability to retain or recruit skilled personnel could have an adverse effect on the Partnership's results. CES addresses this risk by:

- attracting well trained and experienced professionals;
- offering competitive compensation at all levels;
- ensuring a safe working environment with clearly defined standards and procedures; and
- offering its employees both internal and external training programs

CES takes its environmental responsibilities seriously and has instituted standards, policies and procedures to address this risk area. In addition, the Partnership maintains insurance policies with respect to its operations providing coverage of all material insurable risks.

A concentration of credit risk exists in CES's trade accounts receivable since they are exclusively from companies in the western Canadian oil and gas industry. Significant changes in the oil and gas industry including economic conditions, environmental regulations, government policy and other geopolitical factors may adversely affect CES's ability to realize the full value of its accounts receivable. It is not possible to predict the likelihood or magnitude of this risk. CES attempts to mitigate this risk by performing credit checks on key customers, managing the amount and timing of exposure to individual customers and by review of its credit policies on a regular basis. There were no bad debts in the three month period ended September 30, 2006.

Reference should be made to the final prospectus of the Partnership dated February 21, 2006 in respect of the Partnership's IPO, and in particular to the heading "Risk Factors" for further risks associated with the business, operations and structure of the Partnership.

## Outlook

The industry outlook continues to remain robust for drilling activity and related services in the areas that CES is focused on.

- Operators continue to direct resources to deeper/longer life gas reserves/production and to light and heavy oil reserves/production. The CAODC recently announced a 15% decline in anticipated number of wells drilled in the WCSB next year, however, they have attributed virtually all of the decline to activity cutbacks at shallow or low-deliverability gas areas, as well as coalbed methane, as reported in the Daily Oil Bulletin. The Partnership has virtually no participation in these areas of expected activity reductions.
- The Partnership's Envirobond and Invert product lines continue to be leading technologies in the deeper, long life gas market. The unique improvement to Invert through its Patent-Pending technology, Seal-AX, positions the Partnership with a value added proposition for its customers in this attractive market.
- Although natural gas commodity prices had declined from recent highs, CES antici-





pates strong activity levels and sustained margins through the balance of 2006 and into the first quarter of 2007. The Partnership's diverse client base and strong value adding products enable CES to sustain activity levels despite reductions in the capital programs of some of the Partnership's clients. CES anticipates its client mix will change as operators with more counter cyclical strategies expand their capital spending to take advantage of increased rig and oilfield service availability.

- Conventional horizontal drilling for oil is very active, driven by high commodity prices. CES's Liquidrill technology remains a leading drilling fluid in the oil drilling industry segment.
- CES is well positioned in both southeast Saskatchewan and across the United States border to participate in the Bakken oil field play (the "Bakken"). The Bakken formation, which expands from southeast Saskatchewan into South Dakota and west into Montana, was recently reported in the National Post as potentially being the largest light-oil pool discovered in Western Canada since 1957 and one of the top onshore fields found in the United States in the last half century.
- Oilsands drilling activity is increasing as drilling contractors build out new rigs that have been specially built for steam assisted gravity drainage ("SAGD") type drilling and the commercial phases of these projects will provide significant opportunities. We expect programs to "kick off" during the next six months.
- Technology is constantly evolving when it comes to recovering maximum production from the bitumen deposits of northeast Alberta and northwest Saskatchewan. SAGD is currently the primary recovery method. CES is well positioned to maintain/increase its market share in the bitumen production segment with its Liquidrill/Tarbreak system regardless of the recovery method utilized. The problems encountered while drilling in these areas are the same regardless of the post drilling recovery method used and Liquidrill/Tarbreak will continue to offer value to operators in this area.
- On October 31, 2006, the Federal Government of Canada announced a proposed Tax Fairness Plan to begin taxing the income before distributions of publicly traded flow through vehicles such as income trusts and limited partnerships. The plan provides for a four-year transition period for existing entities. Given the information available at this time, the financial impact on the Partnership and the unitholders cannot be reasonably estimated.

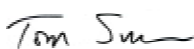


**CONSOLIDATED BALANCE SHEET**

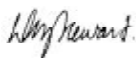
as at September 30, 2006 (stated in thousands of dollars) (unaudited)

	2006
<b>ASSETS</b>	
Current assets	
Cash and cash equivalents (note 5)	\$ 4,494
Accounts receivable	22,586
Inventory	1,766
Prepaid expenses	168
	29,014
Property and equipment (note 6)	1,650
Goodwill (note 4)	75,966
	\$ 106,630
<b>LIABILITIES AND UNITHOLDERS' EQUITY</b>	
Current liabilities	
Accounts payable and accrued liabilities	\$ 15,278
Distributions payable	1,084
Deferred revenue	777
Current portion of vehicle financing loans (note 7)	336
	17,475
Vehicle financing loans (note 7)	458
Due to related party (notes 4 and 14)	750
	18,683
Unitholders' equity	
Class A Units (note 8)	66,959
Subordinated Class B Units (note 8)	21,514
Contributed surplus	66
Deficit	(592)
	87,947
	\$ 106,630
Commitments (note 12)	
Subsequent Events (note 16)	

APPROVED ON BEHALF OF THE BOARD:


**Thomas J. Simons**

President &amp; Chief Executive Officer and Director


**D. Michael G. Stewart**

Director &amp; Chairman, Audit Committee

*The accompanying notes are an integral part of these consolidated financial statements.*

## CONSOLIDATED STATEMENTS OF OPERATIONS AND RETAINED EARNINGS (DEFICIT)

From commencement of operations on March 2, 2006 to September 30, 2006  
(stated in thousands of dollars except per unit amounts) (unaudited)

	Three Months Ended Sept 30, 2006	213-day Period Ended Sept 30, 2006
Revenue	\$ 14,619	\$ 29,380
Cost of sales	10,425	21,102
Gross margin	4,194	8,278
Expenses		
Selling, general and administrative expenses	1,598	3,643
Amortization of property and equipment	107	204
Partnership unit-based compensation (note 9)	28	66
	1,733	3,913
Other income	39	89
Net earnings for the period	2,500	4,454
Retained earnings, beginning of period	(875)	-
Unitholders' distributions declared (note 11)	(2,217)	(5,046)
<b>Deficit, end of period</b>	<b>\$ (592)</b>	<b>\$ (592)</b>
<b>Net earnings per Partnership unit (note 10)</b>		
Basic	\$ 0.27	\$ 0.49
Diluted	\$ 0.27	\$ 0.49

*The accompanying notes are an integral part of these consolidated financial statements.*



**CONSOLIDATED STATEMENTS OF CASH FLOW**

From commencement of operations on March 2, 2006 to September 30, 2006  
(stated in thousands of dollars) (unaudited)

	Three Months Ended Sept 30, 2006	213-day Period Ended Sept 30, 2006
<b>CASH PROVIDED BY (USED IN):</b>		
<b>OPERATING ACTIVITIES:</b>		
Net earnings for the period	\$ 2,500	\$ 4,454
Items not involving cash:		
Amortization of property and equipment	107	204
Partnership unit-based compensation	28	66
Change in non-cash operating working capital (note 15)	(3,114)	2,020
	(479)	6,744
<b>FINANCING ACTIVITIES:</b>		
Units issued for cash, net of issue costs	-	53,603
Repayment of vehicle financing loans	(68)	(134)
Distributions to unitholders	(2,187)	(3,962)
	(2,255)	49,507
<b>INVESTING ACTIVITIES:</b>		
Repayment of acquisition notes (note 4)	-	(50,602)
Repayment of promissory notes (note 4)	(500)	(500)
Purchase of property and equipment	(220)	(655)
	(720)	(51,757)
<b>INCREASE IN CASH AND CASH EQUIVALENTS</b>	<b>(3,454)</b>	<b>4,494</b>
Cash and cash equivalents, beginning of period	7,948	-
Cash and cash equivalents, end of period (note 5)	\$ 4,494	\$ 4,494
<b>SUPPLEMENTARY CASH FLOW DISCLOSURE</b>		
Interest paid	\$ -	\$ -
Taxes paid	\$ -	\$ -

*The accompanying notes are an integral part of these consolidated financial statements.*



## Canadian Energy Services L.P.

From commencement of operations on March 2, 2006 to September 30, 2006 (unaudited)

### 1. The Limited Partnership

Canadian Energy Services L.P. (the "Partnership") is a limited partnership formed on January 13, 2006, pursuant to the Limited Partnerships Act (Ontario). The Partnership is a "Canadian partnership" as defined in subsection 102(1) of the Income Tax Act (Canada) (the "Act") and the terms of a limited partnership agreement dated January 13, 2006, and amended and restated on March 2, 2006 (the "Partnership Agreement"), prohibit the issuance of units to, and the admittance as partners of, persons who are non-resident of Canada for the purposes of the Act.

On March 2, 2006, the Partnership commenced business operations when it acquired the businesses of two private drilling fluid companies. Consideration for the acquisition was comprised of acquisition notes, the issuance of Class A Common limited partnership units ("Class A Units") and Class B subordinated limited partnership units ("Subordinated Class B Units"). On March 2, 2006 the acquisition notes were repaid with the proceeds from the Partnership's initial public offering of 5,893,866 Class A Units for aggregate gross proceeds of \$58.9 million and net proceeds of \$53.6 million after deducting underwriting commissions and certain other expenses of the initial public offering.

Canadian Energy Services Inc., the general partner of the Partnership (the "General Partner"), was incorporated on December 9, 2005 under the Business Corporations Act (Alberta). The General Partner is authorized to carry on the business of the Partnership and has full power and exclusive authority to administer, manage, control, and operate the business of the Partnership. The Partnership reimburses the General Partner for all direct costs and expenses incurred in the performance of those duties.

CES Operations Ltd., a wholly-owned subsidiary of the Partnership, was incorporated on September 22, 2006. Petro Services USA, LLC, a Delaware limited liability company of which CES Operations Ltd. is the sole shareholder, was formed on September 29, 2006. As of September 30, 2006, there has been no activity in either entity.

The Partnership designs and implements drilling fluid systems for the oil and gas industry, in particular relating to drilling medium to deep vertical and directional wells and horizontal wells in the Western Canadian Sedimentary Basin. The oil and natural gas drilling season is affected by weather. The industry is generally more active during the winter months of November through March, as the movement of heavy equipment is easier over the frozen ground. Wet weather in the spring and summer can hamper the movement of drilling rigs which has a direct impact upon generating revenue. Conversely, a longer colder winter as well as a dry spring and summer strengthen drilling operations.

### 2. Basis of Presentation

The consolidated financial statements have been prepared by management of the Partnership in accordance with Canadian generally accepted accounting principles.

### 3. Significant Accounting Policies

#### (a) Consolidation:

These consolidated financial statements include the accounts of the Partnership and its wholly-owned subsidiaries. All inter-company balances and transactions are eliminated on consolidation.



**(b) Cash and cash equivalents:**

The Partnership considers deposits in banks, certificates of deposit and short-term investments with original maturities of three months or less from the acquisition date as cash and cash equivalents.

**(c) Inventory:**

Inventory is stated at the lower of cost, determined on a first-in, first-out basis, and net realizable value.

**(d) Property and equipment:**

Property and equipment are recorded at cost less accumulated amortization. Property and equipment are amortized using the straight-line method over their estimated useful lives at the following rates:

Computer equipment and software	3 years	straight-line method
Vehicles	3 years	straight-line method
Field equipment	5 years	straight-line method
Furniture and fixtures	5 years	straight-line method
Buildings	10 years	straight-line method

The Partnership regularly reviews its property and equipment to account for impairment.

**(e) Goodwill:**

Goodwill is the residual amount that results when the purchase price of an acquired business exceeds the sum of the amounts allocated to the assets acquired, less liabilities assumed, based on their fair values.

Goodwill is not amortized and is tested for impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired. The impairment test is carried out in two steps. In the first step, the carrying amount of the reporting unit is compared with its fair value. When the fair value of a reporting unit exceeds its carrying amount, goodwill of the reporting unit is considered not to be impaired and the second step of the impairment test is unnecessary.

The second step is necessary when the carrying amount of a reporting unit exceeds its fair value, in which case, the implied fair value of the reporting unit's goodwill is compared with its carrying amount to measure the amount of the impairment loss, if any. The implied fair value of goodwill is determined in the same manner as the value of goodwill is determined in a business combination, using the fair value of the reporting unit as if it were the purchase price. When the carrying amount of goodwill exceeds the implied fair value of the goodwill, an impairment loss is recognized in an amount equal to the excess. Impairment provisions are not reversed if there is a subsequent increase in the fair value of goodwill.

**(f) Revenue recognition:**

The Partnership's revenue is primarily comprised of the sale of products and the provision of services. Revenue on sales of product is recognized based on fixed or determinable prices when the product has been delivered to the well site and the product has been mixed. For sales that are invoiced upon shipment of the product, deferred revenue is recorded for the portion of the product that has not been mixed. Revenue from field service charges is recognized based upon agreed daily, hourly or job rates, when the service is performed. Revenue will only be recognized when collection is reasonably assured.

**(g) Unit-based compensation:**

The Partnership uses the fair value method to account for options granted to employees, officers and directors of the General Partners and certain service providers. Under the fair value method, the fair value of the options is estimated at the grant date using the Black-Scholes option pricing method, and such fair value is expensed over the vesting period, with a corresponding increase in contributed surplus. The amount of compensation expense and contributed surplus is reduced for options that are cancelled prior to vesting. Any consideration received upon the exercise of the unit-based compensation together with the amount of non-cash compensation expense recognized in contributed surplus is recorded as an increase in unitholders' capital.

**(h) Income taxes:**

The income of the Partnership is taxed at the partner level. As a result, provisions for income and capital taxes are not made by the Partnership. These consolidated financial statements include the assets, liabilities, and operations of the Partnership and its subsidiaries and do not include the assets, liabilities, including income tax, of the partners (see note 16 – Subsequent Events).

**(i) Measurement uncertainty:**

The preparation of consolidated financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amount of assets and liabilities, disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the period. Such estimates include providing for amortization of property and equipment. Actual results could differ from these estimates.

**(j) Earnings per unit:**

Basic earnings per unit are computed by dividing net earnings by the weighted average number of units outstanding during the period. The Partnership uses the treasury stock method for calculating diluted earnings per unit. Diluted earnings per unit are computed similar to basic earnings per unit except that the weighted average units outstanding are increased to include additional units from the assumed exercise of unit options, if dilutive. The number of additional units is calculated by assuming that outstanding unit options were exercised and that the proceeds from such exercises were used to acquire Class A Units at the average market price during the year.

**(k) Financial instruments:**

The net carrying value of accounts receivable approximates fair value due to the short-term nature of these instruments. The Partnership has a large number of diverse customers, which minimizes overall accounts receivable credit risk.

The carrying value of accounts payable and accrued liabilities and distributions payable approximate the fair value of these financial instruments due to their short-term nature.

The Partnership is exposed to minimal interest rate risk due to limited long-term liabilities outstanding.



## 4. Business Acquisitions

On March 2, 2006, the Partnership completed the acquisition of the drilling fluid businesses from Impact Fluid Systems Inc. ("Impact") and Canadian Fluid Systems Ltd. ("CFS" and collectively with Impact, the "Vendors") for an aggregate purchase price of \$80.7 million, plus a working capital adjustment of \$6.0 million. The purchase price was funded by the payment of \$50.6 million in acquisition notes payable, \$6.0 million payable to the Vendors, the issuance of 860,594 Class A Units and the issuance of 2,151,486 Subordinated Class B Units at the initial public offering (the "IPO") price of \$10.00 per unit. The working capital adjustment was determined by the Partnership within a 120-day period from the acquisition date. The acquisition has been accounted for using the purchase method.

	Impact	CFS	Total
Net assets acquired	\$	\$	\$
Current assets	17,161	10,694	27,855
Property and equipment	659	16	675
Goodwill	37,621	38,345	75,966
Current liabilities	(11,860)	(5,694)	(17,554)
Long-term debt	(220)	-	(220)
	43,361	43,361	86,722
<b>Consideration</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>
Acquisition notes	25,301	25,301	50,602
Due to Vendors	3,000	3,000	6,000
Class A Units	4,303	4,303	8,606
Subordinated Class B Units	10,757	10,757	21,514
	43,361	43,361	86,722

The acquisition notes were repaid with proceeds from the initial public offering (note 8).

The payable to the Vendors was satisfied by the issuance of an unsecured promissory note that is for a term of two years from March 2, 2006, at such time they become payable on demand, and are non-interest bearing for the first year of the term but shall bear interest at the Royal Bank of Canada prime rate on the second year of the term. The promissory notes carried a conversion option in favour of the holders thereof to convert the amounts payable into Class A Units at a conversion price of \$10.00 per Class A Unit for a period of up to six months from March 2, 2006, the date of the acquisitions. On September 18, 2006, the Partnership extended the conversion option on the unsecured promissory notes to September 30, 2006. During the 213-day period ended September 30, 2006, \$4.75 million aggregate principal amount of the unsecured promissory notes were converted into Class A Units at a conversion price of \$10.00 per Class A Unit and \$500,000 was repaid in cash. (note 8).

The above business acquisitions were transacted with certain individuals, or entities controlled by them, who as a result of the acquisitions are significant unitholders of the Partnership. These individuals or persons related to them have continued in key management roles with the General Partner. These individuals include Rodney L. Carpenter and Thomas J. Simons who are officers, directors, and significant shareholders of CFS and Impact, respectively, as well as officers and directors of the General Partner.



## 5. Cash and Cash Equivalents

The major components of cash and cash equivalents are as follows:

Cash	\$ 644
Temporary investments	3,850
	<u>\$ 4,494</u>

## 6. Property and Equipment

	Cost	Accumulated Amortization	Net Book Value Sept 30, 2006
Computer equipment and software	\$ 281	\$ 29	\$ 252
Vehicles	974	127	847
Field equipment	298	30	268
Furniture and fixtures	70	5	65
Buildings	222	13	209
Land	9	-	9
	<u>\$ 1,854</u>	<u>\$ 204</u>	<u>\$ 1,650</u>

## 7. Credit Facilities and Vehicle Financing Loans

In June 2006, the Partnership entered into a revolving demand facility with a commercial bank that permits the Partnership to borrow up to \$3.0 million at the bank's prime rate of interest plus 0.50%. The facility is secured by a general security agreement containing a first ranking security interest over all personal property of the Partnership and the General Partner. It is also secured by a guarantee provided by the General Partner for the full amount outstanding at any one time under the credit facility.

The carrying values of vehicle financing loans are approximately equal to fair value and are comprised of:

Vehicle financing loans, repayable in monthly payments of \$0.8- \$1.7, maturing from September 2007 to September 2010	\$ 794
Less current portion	(336)
	<u>\$ 458</u>

Principal payments are as follows for the periods ending September 30:

2007	\$ 336
2008	270
2009	162
2010	26



## 8. Unitholders' Equity

The Partnership is authorized to issue an unlimited number of Class A Units and Subordinated Class B Units.

<b>Class A Units</b>	<b>Number of Units</b>	<b>Amount</b>
Issued pursuant to initial public offering	5,893,866	\$ 58,939
Less unit issue expenses	-	(5,336)
	5,893,866	53,603
Issued as consideration for acquired businesses	860,594	8,606
Issued on conversion of promissory notes (note 4)	100,000	1,000
Class A Units at June 30, 2006	6,854,460	\$ 63,209
Issued on conversion of promissory notes (note 4)	375,000	3,750
Class A Units at September 30, 2006	7,229,460	\$ 66,959

<b>Subordinated Class B Units</b>	<b>Number of Units</b>	<b>Amount</b>
Issued as consideration for acquired businesses	2,151,486	\$ 21,514
Subordinated Class B Units at September 30, 2006	2,151,486	\$ 21,514

On March 2, 2006, the Partnership closed the IPO of 5,893,866 Class A Units at a price of \$10 per Class A Unit, for gross proceeds of \$58.9 million or net proceeds of \$53.6 million after offering expenses and underwriters' commission of approximately \$5.3 million.

In connection with the acquisition of the drilling fluid businesses, the Partnership issued an aggregate of 860,594 Class A Units and 2,151,486 Subordinated Class B Units to the Vendors as partial consideration for the acquired businesses. The Subordinated Class B Units issued to CFS and Impact in connection with the acquisition are non-transferable (except to certain shareholders, associates or affiliates of the respective Vendors) and are only exchangeable into Class A Units on or after March 2, 2009, unless a take-over bid is made for the Class A Units and certain other limited circumstances. Distributions on the Subordinated Class B Units are paid quarterly subject to achieving certain distribution targets on the Class A Units.

## 9. Partnership Unit Option Plan

The Partnership may provide additional compensation to the employees, officers and directors of the General Partner and certain service providers by issuing options to acquire Class A Units under the Partnership's unit option plan (the "Unit Option Plan"). As at September 30, 2006, 938,095 Class A Units were reserved for issuance under the Unit Option Plan, of which 306,595 Class A Units remain available for grant. The 631,500 outstanding options vest as to one-third on each of the first, second and third anniversary dates of the grant and expire five years after grant.

The following table summarizes information about the Unit Option Plan as at September 30, 2006.

	Options	Average Exercise Price
Outstanding, beginning of period	-	\$ -
Granted at March 2, 2006	575,500	10.00
Outstanding, end of period, March 31, 2006	575,500	\$ 10.00
Granted, April 1 – June 30, 2006	24,000	9.49
Outstanding, end of period, June 30, 2006	599,500	\$ 9.98
Granted, July 1 – September 30, 2006	55,000	8.74
Cancelled, July 1 – September 30, 2006	(23,000)	9.56
Outstanding, end of period, September 30, 2006	631,500	\$ 9.89
Exercisable, end of period, September 30, 2006	-	-

The fair value of the options granted during the three month period ended September 30, 2006 was \$45,000 and the fair value of the options cancelled was \$19,000. During the same period, unit-based compensation costs of \$28,000 were recorded in the statement of operations. The compensation costs were calculated using the Black-Scholes option pricing model, assuming a risk-free interest rate of 4.5%, a dividend yield of 11%, an expected volatility of 31% and expected lives of unit options of 5 years (see note 16 – Subsequent Events).

## 10. Earnings Per Unit

The computations for basic and diluted earnings per unit are as follows:

	Three Months Ended Sept 30, 2006	213-day Period Ended Sept 30, 2006
Net earnings	\$ 2,500	\$ 4,454
Weighted average number of units outstanding:		
Basic	9,244,805	9,053,470
Effect of unit options	93	79
Diluted	9,244,898	9,053,549
Earnings per unit:		
Basic	\$ 0.27	\$ 0.49
Diluted	\$ 0.27	\$ 0.49

## 11. Cash Distributions

The Partnership declares monthly distributions of cash to Class A unitholders of record as at the close of business on each monthly distribution record date. In addition, the Partnership pays quarterly distributions on the Subordinated Class B Units to unitholders of record at the close of business on each quarterly distribution record date, subject to achieving certain distribution targets on the Class A Units. Such distributions are recorded as reductions of equity upon declaration of the distribution. The Partnership has paid distributions to holders of Class A Units and Subordinated Class B Units for the period ended September 30, 2006 as follows:



Distribution Period 2006	Distribution Record Date	Date of Distribution	Per Class A Unit	Per Subordinated Class B Unit	Total
Mar 2 - 31	Mar 31	Apr 13	\$0.0792	\$0.0792	\$ 705
Apr 1 - 30	Apr 30	May 15	0.0792	-	535
May 1 - 31	May 31	Jun 15	0.0792	-	535
Jun 1 - 30	Jun 30	Jul 14	0.0792	-	543
Apr 1 - Jun 30	Jun 30	Jul 14	-	0.2376	511
Jul 1 - 31	Jul 31	Aug 15	0.0792	-	567
Aug 1 - 31	Aug 31	Sep 15	0.0792	-	567
Sep 1 - 30	Sep 30	Oct 13	0.0792	-	572
Jul 1 - Sep 30	Sep 30	Oct 13	-	0.2376	511
<b>Total Distributions</b>					<b>\$ 5,046</b>

## 12. Commitments

- (a) The Partnership has an agreement regarding a sublease for office space until April 30, 2007 and expects to pay approximately \$294,000 of rent and operating costs to that date.
- (b) The Partnership has numerous operating vehicle leases and the lease payments due for the periods ending September 30 are as follows:

2007	\$ 106
2008	55
2009	3

## 13. Payments to the General Partner

The General Partner will be allocated 0.01% of the taxable income of the Partnership for each fiscal year and 99.9% of the taxable income of the Partnership will be allocated to the holders of Class A Units and Subordinated Class B Units.

## 14. Related Party Transactions

The amount due to the related party of \$750,000 represents the balance owing to one of the principals of Impact in respect of the Partnership's acquisition of the assets of Impact. The amount was originally determined based on a working capital adjustment pursuant to the respective acquisition agreements, as amended. This amount is represented by an unsecured promissory note that is for a two year term from March 2, 2006, the closing date of the acquisitions, and is non-interest bearing for the first year of the term but shall bear interest at the Royal Bank of Canada prime rate on the second year of the term. Of the \$6.0 million aggregate principal amount of the unsecured promissory notes issued, \$4.75 million in aggregate principal amount of unsecured promissory notes were converted into Class A units and \$500,000 was repaid in cash (note 4).

On March 2, 2006, the Partnership acquired certain land, building and related equipment (the "Carlyle Facility") from persons who are non-arms length with the Partnership. The Carlyle Facility was acquired from a corporation that was owned by Rodney L. Carpenter, Kenneth D. Zandee and a third party. Mr. Carpenter is an officer and director of the General Partner and a significant shareholder of CFS. Mr. Zandee is an officer of the General Partner and a significant shareholder of CFS. The Carlyle Facility was acquired for \$260,000 which represented fair market value.



## 15. Supplemental Information

Components of change in non-cash working capital balances:	Three Months Ended Sept 30, 2006	213-day Period Ended Sept 30, 2006
Operating:		
Accounts receivable	\$ (7,845)	\$ 4,207
Inventory	(456)	(727)
Prepaid expenses	59	(145)
Accounts payable and accrued liabilities	4,351	(2,092)
Deferred revenue	777	777
	\$ (3,114)	\$ 2,020

## 16. Subsequent Events

As part of an employee retention program on October 6, 2006, the Partnership adjusted the exercise price of 196,500 of the outstanding Unit Options held by certain office and field employees from a weighted average exercise price of \$9.87 to \$7.79. The new exercise price reflected the current market price of the Class A Units. The incremental value due to the reduction in the exercise price is \$50,000, which will be recognized as unit-based compensation over the remaining vesting period. The exercise price was not adjusted for any of the options held by directors, officers and other insiders of the General Partner.

On October 23, 2006, the Partnership declared a monthly distribution of \$0.0792 per Class A Unit to unitholders of record on October 31, 2006.

On October 31, 2006, the Federal Government of Canada announced a proposed Tax Fairness Plan to begin taxing the income before distributions of publicly traded flow through vehicles such as income trusts and limited partnerships. The plan provides for a four-year transition period for existing entities. Given the information available at this time, the financial impact on the Partnership and the unitholders cannot be reasonably estimated.



**BOARD OF DIRECTORS**

Kyle D. Kitagawa <sup>1</sup>  
Chairman

Alan D. Archibald <sup>2</sup>

Colin D. Boyer <sup>1,2</sup>

John M. Hooks <sup>2</sup>

D. Michael G. Stewart <sup>1</sup>

Thomas J. Simons

Rodney L. Carpenter

**OFFICERS**

Thomas J. Simons  
President and Chief  
Executive Officer

Laura A. Cillis  
Chief Financial Officer

Kenneth E. Zinger  
Chief Operating Officer

Rodney L. Carpenter  
Vice President, Business  
Development

A. David Rosenthal  
Vice President, Operations

Kenneth D. Zandee  
Vice President, Marketing

Scott R. Cochlan  
Corporate Secretary

**AUDITORS**

Deloitte & Touche LLP  
Chartered Accountants, Calgary, AB

**BANKERS**

Royal Bank of Canada, Calgary, AB

**SOLICITORS**

Blake, Cassels & Graydon LLP  
Calgary, AB

**REGISTRAR & TRANSFER AGENT**

Computershare Investor Services Inc.,  
Calgary, AB and Toronto, ON

**STOCK EXCHANGE LISTING**

The Toronto Stock Exchange  
Trading Symbol: CEU.UN

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*1 Member of the Audit Committee*

*2 Member of the Governance and Compensation Committee*