FOREST OIL CORP
Form 10-Q
November 09, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2006

Or

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission File Number 1-13515

FOREST OIL CORPORATION

(Exact name of registrant as specified in its charter)

New York	**25-0484900**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
707 17th Street, Suite 3600 Denver, Colorado	**80202**
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code: **(303) 812-1400**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. x Yes o No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer x Accelerated filer o Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). o Yes x No

As of October 31, 2006 there were 62,931,547 shares of the registrant s common stock, par value $.10 per share, outstanding.

FOREST OIL CORPORATION
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September 30, 2006

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PART I - FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

FOREST OIL CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(In Thousands, Except Share Data)

	September 30, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 11,402	7,231
Accounts receivable	119,918	178,124
Derivative instruments	37,499	941
Deferred tax assets		77,346
Other current assets	34,588	52,283
Total current assets	203,407	315,925
Property and equipment, at cost:		
Oil and gas properties, full cost method of accounting:		
Proved, net of accumulated depletion of $2,220,480 and $3,059,031	2,435,869	2,898,774
Unproved	259,842	275,684
Net oil and gas properties	2,695,711	3,174,458
Other property and equipment, net of accumulated depreciation and amortization of $31,329 and $32,527	31,850	25,560
Net property and equipment	2,727,561	3,200,018
Derivative instruments	19,413	
Goodwill	86,880	87,072
Other assets	34,108	42,531
	$ 3,071,369	3,645,546
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 231,150	312,076
Accrued interest	18,242	4,260
Derivative instruments	14,781	151,678
Asset retirement obligations	1,800	33,329
Deferred income taxes	4,183	
Other current liabilities	14,745	21,573
Total current liabilities	284,901	522,916
Long-term debt	1,096,076	884,807
Asset retirement obligations	58,948	178,225
Other liabilities	43,436	45,691
Deferred income taxes	180,800	329,385
Total liabilities	1,664,161	1,961,024
Shareholders equity:		
Preferred stock, none issued		
Common stock, 62,927,258 and 64,548,229 shares issued and outstanding	6,293	6,455
Capital surplus	1,211,519	1,529,102
Retained earnings	106,947	217,293
Accumulated other comprehensive income (loss)	82,449	(18,220)
Treasury stock, at cost, 1,861,143 shares held in 2005		(50,108)
Total shareholders equity	1,407,208	1,684,522
	$ 3,071,369	3,645,546

See accompanying Notes to Condensed Consolidated Financial Statements.

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FOREST OIL CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
	(In Thousands, Except Per Share Amounts)			
Revenue:				
Oil and gas sales:				
Natural gas	$ 90,296	156,070	312,102	470,711
Oil, condensate, and natural gas liquids	110,624	110,080	318,137	323,664
Total oil and gas sales	200,920	266,150	630,239	794,375
Marketing, processing, and other	1,919	2,086	5,899	5,207
Total revenue	202,839	268,236	636,138	799,582
Operating expenses:				
Lease operating expenses	34,963	51,576	115,823	145,219
Production and property taxes	8,974	10,914	30,699	31,358
Transportation costs	5,494	4,597	15,865	14,352
General and administrative (including stock-based compensation)	10,548	9,847	38,755	31,694
Depreciation and depletion	62,505	91,029	203,426	284,554
Accretion of asset retirement obligations	1,226	4,352	5,879	12,951
Impairments and other		4,002	2,078	6,926
Spin-off and merger costs			5,416	
Total operating expenses	123,710	176,317	417,941	527,054
Earnings from operations	79,129	91,919	218,197	272,528
Other income and expense:				
Interest expense	19,122	15,664	51,613	46,224
Unrealized (gains) losses on derivative instruments, net	(77,914)	72,095	(68,178)	74,365
Realized losses (gains) on derivative instruments, net	12,883	38	30,496	(280)
Unrealized foreign currency exchange loss	766		766	
Other (income) expense, net	(950)	341	(200)	4,251
Total other income and expense	(46,093)	88,138	14,497	124,560
Earnings before income taxes and discontinued operations	125,222	3,781	203,700	147,968
Income tax expense:				
Current	(743)	(203)	2,078	1,971
Deferred	49,031	719	66,391	51,660
Total income tax expense	48,288	516	68,469	53,631
Earnings from continuing operations	76,934	3,265	135,231	94,337
Income from discontinued operations, net of tax			2,422	
Net earnings	$ 76,934	3,265	137,653	94,337
Basic earnings per common share:				
Earnings from continuing operations	$ 1.24	.05	2.17	1.54
Income from discontinued operations, net of tax			.04	
Net earnings per common share	$ 1.24	.05	2.21	1.54
Diluted earnings per common share:				
Earnings from continuing operations	$ 1.21	.05	2.13	1.50
Income from discontinued operations, net of tax			.04	
Net earnings per common share	$ 1.21	.05	2.17	1.50

See accompanying Notes to Condensed Consolidated Financial Statements.

FOREST OIL CORPORATION
CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY
(Unaudited)

	Common Stock Shares (In Thousands)	Amount	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive (Loss) Income	Treasury Stock	Total Shareholders Equity
Balances at January 1, 2006	64,548	$ 6,455	1,529,102	217,293	(18,220)	(50,108)	1,684,522
Exercise of stock options	218	22	4,649	(8)		27	4,690
Tax benefit of stock options exercised			40				40
Employee stock purchase plan	20	2	553				555
Restricted stock issued, net of forfeitures	1						
Retirement of treasury stock	(1,860)	(186)	(49,895)			50,081	
Amortization of stock-based compensation			17,017				17,017
Tax benefit of acquired net operating losses			8,405				8,405
Pro rata distribution of MERI common stock to shareholders (Note 2)			(298,352)	(247,991)	7,549		(538,794)
Comprehensive earnings:							
Net earnings				137,653			137,653
Unrealized gain on effective derivative instruments, net of tax					77,074		77,074
Amortization of deferred hedging loss, net of tax					2,411		2,411
Decrease in unfunded pension liability, net of tax					83		83
Foreign currency translation					13,552		13,552
Total comprehensive earnings							230,773
Balances at September 30, 2006	62,927	$ 6,293	1,211,519	106,947	82,449		1,407,208

See accompanying Notes to Condensed Consolidated Financial Statements.

FOREST OIL CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Nine Months Ended September 30, 2006 (In Thousands)	2005
Operating activities:		
Net earnings	$ 137,653	94,337
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and depletion	203,426	284,554
Accretion of asset retirement obligations	5,879	12,951
Stock-based compensation	11,384	426
Impairments	2,078	2,924
Unrealized (gains) losses on derivative instruments, net	(68,178)	74,365
Amortization of deferred derivative losses	15,204	
Unrealized foreign currency exchange loss	766	
Deferred income tax expense	67,617	51,660
Other, net	(2,565)	1,883
Changes in operating assets and liabilities, net of effects of acquisitions and divestitures:		
Accounts receivable	966	(645)
Other current assets	(23,330)	(3,956)
Accounts payable	(1,131)	(6,859)
Accrued interest and other current liabilities	(3,153)	6,792
Net cash provided by operating activities	346,616	518,432
Investing activities:		
Capital expenditures for property and equipment:		
Exploration, development, and acquisition costs	(741,495)	(548,133)
Other fixed assets	(9,718)	(9,659)
Proceeds from sales of assets	1,367	23,668
Other, net	120	(4,273)
Net cash used by investing activities	(749,726)	(538,397)
Financing activities:		
Proceeds from bank borrowings	2,444,963	1,630,000
Repayments of bank borrowings	(2,055,924)	(1,663,000)
Repayments of bank debt assumed in acquisition		(35,000)
Proceeds from Spin-off (Note 2)	21,670	
Proceeds from the exercise of options and warrants and employee stock purchases	5,246	41,806
Other, net	(8,599)	(1,723)
Net cash provided (used) by financing activities	407,356	(27,917)
Effect of exchange rate changes on cash	(75)	(780)
Net increase (decrease) in cash and cash equivalents	4,171	(48,662)
Cash and cash equivalents at beginning of period	7,231	55,251
Cash and cash equivalents at end of period	$ 11,402	6,589
Cash paid during the period for:		
Interest	$ 42,819	35,235
Income taxes	5,243	5,128

See accompanying Notes to Condensed Consolidated Financial Statements.

FOREST OIL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

(1) BASIS OF PRESENTATION

The Condensed Consolidated Financial Statements included herein are unaudited and include the accounts of Forest Oil Corporation and its consolidated subsidiaries (collectively, Forest or the Company). In the opinion of management, all adjustments, consisting of normal recurring accruals, have been made which are necessary for a fair presentation of the financial position of Forest at September 30, 2006, the results of its operations for the three and nine months ended September 30, 2006 and 2005, and its cash flows for the nine months ended September 30, 2006 and 2005. Interim results are not necessarily indicative of expected annual results because of the impact of fluctuations in prices received for liquids (oil, condensate, and natural gas liquids) and natural gas and other factors.

In the course of preparing the Condensed Consolidated Financial Statements, management makes various assumptions, judgments, and estimates to determine the reported amount of assets, liabilities, revenue, and expenses, and in the disclosures of commitments and contingencies. Changes in these assumptions, judgments, and estimates will occur as a result of the passage of time and the occurrence of future events and, accordingly, actual results could differ from amounts initially established.

The more significant areas requiring the use of assumptions, judgments, and estimates relate to volumes of oil and gas reserves used in calculating depletion, the amount of future net revenues used in computing the ceiling test limitations, and the amount of future capital costs and abandonment obligations used in such calculations. Assumptions, judgments, and estimates are also required in determining impairments of undeveloped properties, valuing deferred tax assets, and estimating fair values of derivative instruments.

Certain amounts in the prior year financial statements have been reclassified to conform to the 2006 financial statement presentation.

For a more complete understanding of Forest s operations, financial position, and accounting policies, reference is made to the consolidated financial statements of Forest, and related notes thereto, filed with Forest s annual report on Form 10-K for the year ended December 31, 2005, previously filed with the Securities and Exchange Commission.

(2) ACQUISITIONS AND DIVESTITURES

Acquisitions

On March 31, 2006, Forest completed the acquisition of oil and gas properties located primarily in the Cotton Valley trend in East Texas. Forest paid approximately $255 million, as adjusted to reflect an economic effective date of February 1, 2006, for properties with an estimated 110 Bcfe of estimated proved reserves at the time the acquisition was announced in February 2006 and production that averaged 13 MMcfe per day in January 2006. Forest acquired approximately 26,000 net acres in the fields, of which approximately 14,000 net acres were undeveloped. Forest funded this acquisition utilizing its bank credit facilities.

Divestitures

Spin-off and Merger of Offshore Gulf of Mexico Operations

On March 2, 2006, Forest completed the spin-off of its offshore Gulf of Mexico operations by means of a special dividend, which consisted of a pro rata spin-off (the Spin-off) of all outstanding shares of Forest Energy Resources, Inc. (hereinafter known as Mariner Energy Resources, Inc. or MERI), a total

(2) ACQUISITIONS AND DIVESTITURES (Continued)

of 50,637,010 shares of common stock, to holders of record of Forest common stock as of the close of business on February 21, 2006. Immediately following the Spin-off, MERI was merged with a subsidiary of Mariner Energy, Inc. (Mariner) in a stock for stock transaction (the Merger). Mariner s common stock commenced trading on the New York Stock Exchange on March 3, 2006.

The Spin-off was a tax-free transaction for federal income tax purposes. Prior to the Merger, as part of the Spin-off, MERI paid Forest approximately $176.1 million. The $176.1 million was drawn on a newly created bank credit facility established by MERI immediately prior to the Spin-off. This credit facility and associated liability was included in the Spin-off. Subsequent to the closing, Forest received additional net cash proceeds of $21.7 million from MERI for a total of $197.8 million. As of October 31, 2006, in accordance with the transaction agreements, Forest and MERI had submitted post-closing adjustments from which Forest has determined it owes MERI approximately $5.8 million, which is subject to further adjustment.

The table below sets forth the effect of the Spin-off on the Company s balance sheet:

	Change in Balance Sheet Accounts (In Thousands)		
Assets (Increase/(Decrease))			
Cash	$	(10	)
Accounts receivable Due from MERI		15,953	
Accounts receivable third parties		(54,078	)
Other current assets		(44,837	)
Proved oil and gas properties, net of accumulated depletion		(1,033,289	)
Unproved oil and gas properties		(38,523	)
Other assets		(7,919	)
Liabilities and Shareholders Equity ((Increase)/Decrease)			
Current liabilities		96,142	
Derivative instruments		17,087	
MERI credit facility		176,102	
Asset retirement obligations		150,182	
Deferred income taxes		184,396	
Accumulated other comprehensive income		(7,549	)
Net decrease to capital surplus and retained earnings	$	(546,343	)

Sale of ProMark Discontinued Operations

On March 1, 2004, the Company sold the assets and business operations of Producers Marketing, Ltd. (ProMark) to Cinergy Canada, Inc. (Cinergy) for $11.2 million CDN. As a result of the sale, ProMark s results of operations were reported as discontinued operations in the historical financial statements. Under the terms of the purchase and sale agreement, Forest may receive additional contingent consideration over a period of five years through February 2009. During the nine months ended September 30, 2006, Forest recognized an additional $3.6 million contingent payment ($2.4 million net of tax), which has been reflected as income from discontinued operations in the Condensed Consolidated Statements of Operations.

(3) EARNINGS PER SHARE AND COMPREHENSIVE EARNINGS (LOSS)

Earnings per Share

Basic earnings per share is computed by dividing net earnings attributable to common stock by the weighted average number of common shares outstanding during each period, excluding treasury shares.

Diluted earnings per share is computed by adjusting the average number of common shares outstanding for the dilutive effect, if any, of stock options, unvested restricted stock grants, unvested phantom stock units, and warrants. The following sets forth the calculation of basic and diluted earnings per share:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	**2005**	**2006**	**2005**
	(In Thousands, Except Per Share Amounts)			
Earnings from continuing operations	$76,934	3,265	135,231	94,337
Income from discontinued operations, net of tax			2,422	
Net earnings	$76,934	3,265	137,653	94,337
Weighted average common shares outstanding during the period	62,250	61,946	62,187	61,198
Add dilutive effects of stock options, unvested restricted stock grants, and unvested phantom stock units	1,234	1,194	1,194	1,077
Add dilutive effects of warrants				432
Weighted average common shares outstanding, including the effects of dilutive securities	63,484	63,140	63,381	62,707
Basic earnings per share:				
From continuing operations	$1.24	.05	2.17	1.54
From discontinued operations			.04	
Basic earnings per share	$1.24	.05	2.21	1.54
Diluted earnings per share:				
From continuing operations	$1.21	.05	2.13	1.50
From discontinued operations			.04	
Diluted earnings per share	$1.21	.05	2.17	1.50

Comprehensive Earnings (Loss)

Comprehensive earnings (loss) is a term used to refer to net earnings plus other comprehensive income (loss). Other comprehensive income (loss) is comprised of revenues, expenses, gains, and losses that under generally accepted accounting principles are reported as separate components of shareholders equity instead of net earnings. Items included in Forest s other comprehensive income (loss) for the three and nine months ended September 30, 2006 and 2005 are foreign currency gains related to the translation of the assets and liabilities of Forest s Canadian operations, changes in the unfunded pension liability, and net hedging losses.

The components of comprehensive earnings (loss) are as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	**2005**	**2006**	**2005**
	(In Thousands)			
Net earnings	$76,934	3,265	137,653	94,337
Other comprehensive income (loss):				
Foreign currency translation gains	294	18,257	13,552	11,367
Unfunded pension liability, net of tax			83	(149)
Unrealized gain (loss) on derivative instruments, net of tax	1,381	(56,454)	79,485	(104,713)
Total comprehensive earnings (loss)	$78,609	(34,932)	230,773	842

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(4) STOCK-BASED COMPENSATION

Prior to January 1, 2006, the Company accounted for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. Under APB Opinion No. 25, no compensation expense was recognized for stock options issued to employees if the grant price equaled or was above the market price on the date of the option grant. Effective January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 123 (Revised), *Share-Based Payment* (SFAS 123(R)) using the modified prospective method. Under this method, compensation cost is recorded for all unvested stock options, restricted stock, and phantom stock units beginning in the period of adoption and prior period financial statements are not restated. Under the fair value recognition provisions of SFAS 123(R), stock-based compensation is measured at the grant date based on the value of the awards and the value is recognized on a straight-line basis over the requisite service period (usually the vesting period).

The table below sets forth total stock-based compensation recorded during the three and nine months ended September 30, 2006 under the provisions of SFAS 123(R), the remaining unamortized amounts and the weighted average amortization period remaining as of September 30, 2006. Approximately $9.7 million of the $18.7 million of total stock-based compensation for the nine months ended September 30, 2006 was attributable to a partial settlement of the Company s restricted stock awards and phantom stock unit awards in connection with the Spin-off.

	Stock Options	Restricted Stock	Phantom Stock Units	Total (1)
	(In Thousands)			
Three months ended September 30, 2006:				
Total stock-based compensation costs	$ 961	1,305	162	2,428
Less: stock-based compensation costs capitalized	(425)	(398)	(96)	(919)
Stock-based compensation costs expensed	$ 536	907	66	1,509
Nine months ended September 30, 2006:				
Total stock-based compensation costs	$ 3,983	12,827	1,682	18,492
Less: stock-based compensation costs capitalized	(1,135)	(4,684)	(944)	(6,763)
Stock-based compensation costs expensed	$ 2,848	8,143	738	11,729
Unamortized stock-based compensation costs as of September 30, 2006	$ 7,021	13,680	2,456 (2)	23,157
Weighted average amortization period remaining	1.1 years	2.1 years	2.3 years	1.8 years

(1) The Company also maintains an employee stock purchase plan (which is not included in the table above) under which $.1 million and $.2 million of compensation cost was recognized for the three and nine months ended September 30, 2006, respectively under the provisions of SFAS 123(R).

(2) Based on the closing price of the Company s common stock on September 30, 2006.

SFAS 123(R) required the Company to estimate forfeitures in calculating the cost related to stock-based compensation as opposed to recognizing forfeitures and the corresponding reduction in expense as the forfeitures occur. The cumulative adjustment recorded related to this change of approximately $.1 million was recorded as a reduction in general and administrative expense and capitalized oil and gas properties in the first quarter of 2006 and was not presented separately in the Condensed Consolidated Statement of Operations. The impact of adopting SFAS 123(R) as of January 1, 2006 resulted in a decrease to net income of approximately $1.9 million, or $.03 per basic and diluted share for the nine month period ending September 30, 2006.

(4) STOCK-BASED COMPENSATION (Continued)

Equity Incentive Plans

In 2001, the Company adopted the Forest Oil Corporation 2001 Stock Incentive Plan (the 2001 Plan) under which non-qualified stock options, incentive stock options, restricted stock, phantom stock units, and other awards may be granted to employees, consultants, and non-employee directors. In 2003, the Company amended the 2001 Plan to increase the number of shares of the Company s common stock, at par value $.10 per share (Common Stock), reserved for issuance. The aggregate number of shares of Common Stock that the Company may issue under the 2001 Plan may not exceed 5,012,074 shares. Options have historically been granted at an exercise price equal to the fair market value of one share of Common Stock on the date of grant. Options granted to employees under the 2001 Plan generally vest in increments of 25% on each of the first four anniversary dates of the date of grant and have a term of ten years. Options granted to non-employee directors vest immediately and have a term of ten years. In connection with the Spin-off, the shares available for grant and outstanding stock options under the 2001 Plan were adjusted to reflect the economic effect of the Spin-off by reducing the exercise price and increasing the number of underlying shares. As of September 30, 2006, the Company had 649,728 shares available for issuance under the 2001 Plan.

The Company also had a Stock Incentive Plan (the 1996 Plan) that expired on March 5, 2002 under which non-qualified stock options and restricted stock were granted to employees and director stock awards were granted to non-employee directors. Options granted under the 1996 Plan generally vested in increments of 20% commencing on the date of grant and on each of the first four anniversaries of the date of the grant and generally had a term of ten years.

The Company has historically issued new shares of Common Stock or treasury stock to settle its equity-based awards. In May 2006, Forest retired the Company s treasury stock. As a result of the retirement, settlements on equity-based awards subsequent to May 2006 will be from issuances of new shares of Common Stock.

(4) STOCK-BASED COMPENSATION (Continued)

Stock Options

The following table summarizes stock option activity in the Company s stock-based compensation plans for the nine months ended September 30, 2006. The number of shares and the exercise price of the outstanding stock options were adjusted so that the fair value of each award was the same immediately before and after the Spin-off, in accordance with the anti-dilution provisions in the 2001 Plan and 1996 Plan.

	Number of Options	Weighted Average Exercise Price Per Share	Aggregate Intrinsic Value (In Thousands)(1)	Number of Shares Exercisable
Outstanding at January 1, 2006	2,578,235	$ 27.78	$ 45,889	1,348,599
Granted				
Exercised	(58,337)	28.71	1,255	
Cancelled	(98,587)	30.91		
Outstanding at March 2, 2006	2,421,311	27.63	55,723	
Adjustment to give effect to Spin-off	1,176,804			
Granted	50,000	36.95		
Exercised	(160,837)	18.75	2,536	
Cancelled	(74,979)	20.87		
Outstanding at September 30, 2006	3,412,299	18.80	43,771	2,205,889

(1) The intrinsic value of a stock option is the amount by which the current market value of the underlying stock exceeds the exercise price of the option.

Stock options are granted at the fair market value of one share of Common Stock on the date of grant. Options granted to non-employee directors vest immediately and options granted to officers and other employees vest ratably over four years. All outstanding options had a term of ten years at the date of grant.

The fair value of stock options granted during 2006 was estimated using the Black-Scholes option pricing model. The following weighted average assumptions were used to compute the fair market value of stock options granted in the nine months ended September 30, 2006 and 2005:

	Nine Months Ended September 30,	
	2006	2005
Expected life of options	10 years	5 years
Risk free interest rates	5.13%	3.64% to 4.28%
Estimated volatility	45%	31% to 35%
Dividend yield	0.0%	0.0%
Weighted average fair market value of options granted during the period	$23.60	$9.34

The expected life of the options is based, in part, on historical exercise patterns of the holders of options with similar terms, with consideration given to how historical patterns may differ from future exercise patterns based on current or expected market conditions and employee turnover. The risk free interest rate was based on the U.S. Treasury yield curve in effect at the time of grant. The expected volatility was based on the historical volatility of the Company s stock.

(4) STOCK-BASED COMPENSATION (Continued)

The following table summarizes information about options outstanding at September 30, 2006:

	Stock Options Outstanding				Stock Options Exercisable		
Range of Exercise Prices	**Number of Options**	**Weighted Average Remaining Contractual Life (Years)**	**Weighted Average Exercise Price**	**Aggregate Intrinsic Value (In Thousands)**	**Number Exercisable**	**Weighted Average Exercise Price**	**Aggregate Intrinsic Value (In Thousands)**
$8.41 16.55	685,952	5.95	$ 14.82	$ 11,547	536,330	$ 14.66	$ 9,056
16.74 16.85	815,318	6.83	16.84	12,072	524,833	16.83	7,726
16.88 20.02	709,335	4.92	18.91	9,022	671,450	18.98	8,444
20.19 20.47	28,606	7.52	20.32	323	12,261	20.35	137
20.60 36.95	1,173,088	7.96	22.40	10,807	461,015	23.60	3,666
$8.41 36.95	3,412,299	6.65	18.80	$ 43,771	2,205,889	18.39	$ 29,029

Restricted Stock and Phantom Stock Units

The following table summarizes the restricted stock and phantom stock unit activity during the nine months ended September 30, 2006. The grant date fair value of the restricted stock and phantom stock units was determined by reference to the average of the high and low stock price of a share of Common Stock as published by the NYSE on the date of grant.

	Restricted Stock		**Phantom Stock Units**	
	Number of Shares	**Weighted Average Grant Date Fair Value**(1)	**Number of Shares**	**Weighted Average Grant Date Fair Value**(1)
Unvested at January 1, 2006	634,000	$ 43.72	72,350	$ 46.07
Granted	32,500	40.45	13,700	46.72
Vested	(200)	46.07		
Forfeited	(31,950)	46.03	(8,300)	46.07
Unvested at September 30, 2006	634,350	43.44	77,750	46.18

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(1) These per-share fair values represent the actual grant date fair value and have not been adjusted to give effect to the Spin-off. In connection with the Spin-off, holders of restricted stock awards received .8093 unrestricted shares of MERI for each share of restricted stock. Accordingly, compensation cost of approximately $8.4 million was recorded in the first quarter of 2006 as a partial settlement of the restricted stock award, or approximately $13.00 per share. In addition, cash bonuses totaling $1.2 million were paid to Canadian employees in the first quarter of 2006 who held phantom stock units on that date representing the per-share value of the MERI shares received by each holder of restricted stock.

During the year ended 2005, Forest granted 72,350 phantom stock units valued at $3.3 million as compensation exclusively to Canadian employees. The phantom stock units can be settled in cash, shares of Common Stock, or a combination of both. The phantom stock units have been accounted for as a liability within the Condensed Consolidated Financial Statements. As of September 30, 2006, the Company s fair value liability for the phantom stock units totaled $2.5 million.

The restricted stock and phantom stock units generally vest on the third anniversary of the date of the award, but may vest earlier upon a qualifying disability, death, retirement, or a change in control of the Company in accordance with the term of the underlying agreement.

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(4) STOCK-BASED COMPENSATION (Continued)

Employee Stock Purchase Plan

The Company has a 1999 Employee Stock Purchase Plan (the ESPP), under which it is authorized to issue up to 300,000 shares of Common Stock. Employees who are regularly scheduled to work more than 20 hours per week and more than five months in any calendar year may participate in the ESPP. Under the terms of the ESPP, employees may elect each quarter to have up to 15% of their annual base earnings withheld to purchase shares of Common Stock, up to a limit of $25,000 of Common Stock per calendar year. The ESPP currently provides for four offering periods during the year which coincide with the calendar quarters. The purchase price of a share of Common Stock purchased under the ESPP is equal to 85% of the lower of the beginning-of-quarter or end-of-quarter market price. ESPP participants are restricted from selling the shares of Common Stock purchased under the ESPP for a period of six months after purchase. As of September 30, 2006, the Company had 168,816 shares available for issuance under the ESPP.

Pro Forma Effects

Had Forest recognized compensation expense for all stock-based awards based upon the estimated fair value on the grant date under the fair value methodology prescribed by SFAS 123, as amended by SFAS 148 and SFAS 123(R), its pro forma net earnings and earnings per common share for the three and nine month periods ended September 30, 2005 would have been as follows:

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
	(In Thousands, Except Per Share Amounts)	
Net earnings, as reported	$ 3,265	94,337
Add: Stock-based compensation included in reported net income, net of tax	78	252
Deduct: Total stock-based compensation expense determined under fair value based method for all awards, net of tax	(637)	(2,095)
Pro forma net earnings	$ 2,706	92,494
Basic earnings per common share:		
As reported	$ .05	1.54
Pro forma	$ .04	1.51
Diluted earnings per common share:		
As reported	$ .05	1.50
Pro forma	$ .04	1.48

(5) LONG-TERM DEBT

Components of long-term debt are as follows:

	September 30, 2006				December 31, 2005			
	Principal (In Thousands)	Unamortized Premium (Discount)	Other(1)	Total	Principal	Unamortized Premium (Discount)	Other(1)	Total
U.S. Credit Facility	$ 280,000			280,000	97,000			97,000
Canadian Credit Facility	89,470			89,470	56,806			56,806
8% Senior Notes Due 2008	265,000	(171)	3,932	268,761	265,000	(244)	5,652	270,408
8% Senior Notes Due 2011	285,000	6,781	4,365	296,146	285,000	7,750	4,992	297,742
73⁄4% Senior Notes Due 2014	150,000	(1,810)	13,509	161,699	150,000	(1,990)	14,841	162,851
	$ 1,069,470	4,800	21,806	1,096,076	853,806	5,516	25,485	884,807

(1) Represents the unamortized portion of gains realized upon termination of interest rate swaps that were accounted for as fair value hedges. The gains are being amortized as a reduction of interest expense over the terms of the notes.

(6) PROPERTY AND EQUIPMENT

Forest uses the full cost method of accounting for oil and gas properties. Separate cost centers are maintained for each country in which Forest has operations. During the periods presented, Forest s primary oil and gas operations were conducted in the United States and Canada. All costs incurred in the acquisition, exploration, and development of properties (including costs of surrendered and abandoned leaseholds, delay lease rentals, dry holes, and overhead related to exploration and development activities) and the fair value of estimated future costs of site restoration, dismantlement, and abandonment activities are capitalized.

Investments in unproved properties, including related capitalized interest costs, are not depleted pending determination of the existence of proved reserves. Unproved properties are assessed periodically to ascertain whether impairment has occurred. Unproved properties whose costs are individually significant are assessed individually by considering the primary lease terms of the properties, the holding period of the properties, and geographic and geologic data obtained relating to the properties. Where it is not practicable to assess individually the amount of impairment of properties for which costs are not individually significant, such properties are grouped for purposes of assessing impairment. The amount of impairment assessed is added to the costs to be amortized, or is reported as a period expense, as appropriate. During the second quarter of 2006, the Company recorded an impairment of $2.1 million related to Gabon. The Gabon impairment was related to historical costs impaired to reflect a drilled dry hole. In the first quarter of 2005, the Company recorded an impairment of $2.9 million related to various international properties, principally related to its properties in Romania.

Pursuant to full cost accounting rules, the Company must perform a ceiling test each quarter on its proved oil and gas assets. The ceiling test provides that capitalized costs less related accumulated depletion and deferred income taxes for each cost center may not exceed the sum of (1) the present value of future net revenue from estimated production of proved oil and gas reserves using current prices, including the effects of derivative instruments but excluding the future cash outflows associated with settling asset retirement obligations that have been accrued on the balance sheet, at a discount factor of 10%; plus (2) the cost of properties not being amortized, if any; plus (3) the lower of cost or estimated fair value of unproved properties included in the costs being amortized, if any; less (4) income tax effects related to differences in the book and tax basis of oil and gas properties. Gain or loss is not recognized on the sale of oil and gas properties unless the sale significantly alters the relationship between capitalized costs and estimated proved oil and gas reserves attributable to a cost center. Should the net capitalized costs for a cost center exceed the sum of the components noted above, an impairment charge would be recognized to the extent of the excess capitalized costs. There were no ceiling test impairments of oil and gas properties in 2006 or 2005, although the Company s Canadian full cost pool, in particular, could be adversely impacted by moderate declines in commodity prices.

At September 30, 2006, the spot price that Forest used for its Canadian natural gas in computing its cost center ceiling was temporarily depressed to a level at which Forest s capitalized costs in its Canadian cost center would have exceeded the cost center ceiling, as described above, by approximately $66.9 million. Subsequent to September 30, 2006 and before the release of these quarterly financial statements, the spot price of Canadian natural gas increased to levels such that Forest s Canadian cost center ceiling exceeded its capitalized costs. As such, no impairment adjustment to the Canadian cost center was necessary as of September 30, 2006.

Depletion of proved oil and gas properties is computed on the units-of-production method, whereby capitalized costs, as adjusted for future development costs and asset retirement obligations, are amortized over the total estimated proved reserves. Furniture and fixtures, computer hardware and software, and

(6) PROPERTY AND EQUIPMENT (Continued)

other equipment are depreciated on the straight-line or declining balance method, based upon estimated useful lives of the assets ranging from three to 12 years.

(7) ASSET RETIREMENT OBLIGATIONS

Forest records estimated future asset retirement obligations pursuant to the provisions of Statement of Financial Accounting Standards No. 143, *Accounting for Asset Retirement Obligations* (SFAS No. 143). SFAS No. 143 requires entities to record the fair value of a liability for an asset retirement obligation in the period in which it is incurred with a corresponding increase in the carrying amount of the related long-lived asset. Subsequent to initial measurement, the asset retirement liability is required to be accreted each period to its present value. Capitalized costs are depleted as a component of the full cost pool using the units-of-production method. Forest s asset retirement obligations consist of costs related to the plugging of wells, the removal of facilities and equipment, and site restoration on oil and gas properties.

The following table summarizes the activity for Forest s asset retirement obligations for the nine months ended September 30, 2006 and 2005:

	Nine Months Ended September 30,	
	2006	**2005**
	(In Thousands)	
Asset retirement obligations at beginning of period	$ 211,554	210,176
Accretion expense	5,879	12,951
Liabilities incurred	1,231	4,181
Liabilities assumed	1,009	705
Liabilities included in the Spin-off	(150,182)	
Liabilities settled	(6,647)	(19,599)
Revisions of estimated liabilities	(2,585)	3,002
Impact of foreign currency exchange rate	489	433
Asset retirement obligations at end of period	60,748	211,849
Less: Current asset retirement obligations	(1,800)	(34,733)
Long-term asset retirement obligations	$ 58,948	177,116

(8) EMPLOYEE BENEFITS

The following table sets forth the components of the net periodic cost of Forest s defined benefit pension plans and postretirement benefits in the United States for the three and nine months ended September 30, 2006 and 2005:

	Pension Benefits Three Months Ended September 30,		**Postretirement Benefits Three Months Ended September 30,**		**Pension Benefits Nine Months Ended September 30,**		**Postretirement Benefits Nine Months Ended September 30,**	
	2006	**2005**	**2006**	**2005**	**2006**	**2005**	**2006**	**2005**
	(In Thousands)							
Service cost	$		137	167			443	501
Interest cost	548	581	101	113	1,644	1,743	320	339
Curtailment gain(1)							(1,851)	
Expected return on plan assets	(607)	(586)			(1,823)	(1,758)		
Recognized actuarial loss	227	188			682	564		
Total net periodic expense	$ 168	183	238	280	503	549	(1,088)	840

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(1) Forest recognized a $1.9 million curtailment gain in connection with the Spin-off on March 2, 2006. This gain was recorded as a reduction in general and administrative expense for the nine months ended September 30, 2006.

(9) FINANCIAL INSTRUMENTS

Forest periodically enters into derivative instruments such as swap, basis swap, and collar agreements in order to provide a measure of stability to Forest s cash flows in an environment of volatile oil and gas prices and to manage the exposure to commodity price risk. Forest s commodity derivative instruments generally serve as effective economic hedges of commodity price exposure; however, various circumstances can cause commodity hedges to not qualify for cash flow hedge accounting either at the inception of the hedge or during the term of the hedge. When the criteria for cash flow hedge accounting are not met or when cash flow hedging is not elected, realized gains and losses (i.e., cash settlements) are recorded in other income and expense in the Condensed Consolidated Statements of Operations. Similarly, changes in the fair value of the derivative instruments are recorded as unrealized gains or losses in the Condensed Consolidated Statements of Operations. In contrast, cash settlements for derivative instruments that qualify for hedge accounting are recorded as additions to or reductions of oil and gas revenues while changes in fair value of cash flow hedges are recognized, to the extent the hedge is effective, in other comprehensive income until the hedged item is recognized in earnings.

Discontinuance of Hedge Accounting

As a result of production deferrals experienced in the Gulf of Mexico related to hurricanes Katrina and Rita, Forest was required to discontinue cash flow hedge accounting on some of its natural gas and oil hedges during the third and fourth quarters of 2005. Additionally, as a result of the Spin-off on March 2, 2006, additional commodity swaps and collars formerly designated as cash flow hedges of offshore Gulf of Mexico production also no longer qualified for hedge accounting.

Because a significant portion of the Company s derivatives no longer qualified for hedge accounting and to increase clarity in its financial statements, the Company elected to discontinue hedge accounting prospectively for all of its remaining commodity derivatives beginning in March 2006. This change in reporting has not impacted the Company s reported cash flows, although the results of operations have been affected by mark-to-market gains and losses, which fluctuate with volatile oil and gas prices. Subsequent to March 2006, the Company has recognized all mark-to-market gains and losses in earnings, rather than deferring such amounts in accumulated other comprehensive income included in shareholders equity.

The net mark-to-market loss on the Company s remaining swaps and collars that qualified for cash flow hedge accounting at the date the decision was made to discontinue hedge accounting were deferred in accumulated other comprehensive income and were amortized into oil and gas revenues as the original forecasted hedged oil and gas production occurred in 2006. Amortization of the remaining $3.2 million of net deferred losses will be recorded in the fourth quarter of 2006.

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(9) FINANCIAL INSTRUMENTS (Continued)

The table below summarizes the realized and unrealized losses (gains) Forest incurred related to its derivative instruments for the periods indicated.

	Three Months Ended September 30, 2006 (In Thousands)	2005	Nine Months Ended September 30, 2006	2005
Realized losses on derivatives designated as cash flow hedges(1)	$ 2,250	64,313	40,607	118,663
Realized losses (gains) on derivatives not designated as cash flow hedges(2)	12,883	38	30,496	(280)
Ineffectiveness recognized on derivatives designated as cash flow hedges(2)		6,296	(5,573)	5,504
Unrealized (gains) losses on derivatives not designated as cash flow hedges(2)	(77,914)	65,799	(62,605)	68,861
Total realized and unrealized (gains) losses recorded	$ (62,781)	136,446	2,925	192,748

(1) Included in oil and gas sales in the Condensed Consolidated Statements of Operations.

(2) Included in other income and expense in the Condensed Consolidated Statements of Operations.

The tables below set forth Forest s outstanding commodity swaps and collars as of September 30, 2006:

	Swaps Natural Gas (NYMEX HH) Bbtu per Day	Weighted Average Hedged Price per MMBtu	Oil (NYMEX WTI) Barrels per Day	Weighted Average Hedged Price per Bbl
Fourth Quarter 2006	10.0	$ 5.51	7,500	$ 51.18
Fiscal 2007			3,500	73.16
Fiscal 2008			3,000	73.02
Fiscal 2009			2,500	73.02
Fiscal 2010			2,000	73.15

	Costless Collars Natural Gas (NYMEX HH) Bbtu per Day	Weighted Average Hedged Floor and Ceiling Price per MMBtu	Oil (NYMEX WTI) Barrels per Day	Weighted Average Hedged Floor and Ceiling Price per Bbl
Fourth Quarter 2006	50.0	$ 7.43/11.88	5,500	$ 46.73/65.87
Fiscal 2007	35.0	8.76/11.70	4,000	65.81/87.18

The Company also uses basis swaps in connection with natural gas swaps in order to fix the price differential between the NYMEX price and the index price at which the natural gas production is sold. At September 30, 2006, there was a basis swap in place covering 15.0 Bbtu per day in 2007.

(9) FINANCIAL INSTRUMENTS (Continued)

At September 30, 2006, the fair value of Forest s commodity derivative contracts was a current liability of $14.8 million and a derivative asset of $56.9 million (of which $37.5 million was classified as current). Forest is exposed to risks associated with swap and collar agreements arising from movements in the prices of oil and natural gas and from the unlikely event of non-performance by the counterparties to the swap and collar agreements.

In October 2006, the Company entered into two additional swap agreements. The table below sets forth the weighted average terms of the agreements.

	Swaps	
	Natural Gas (NYMEX HH)	
	Bbtu per Day	Weighted Average Hedged Price per MMBtu
Fiscal 2007	20.0	$ 8.10

In October 2006, the Company entered into an additional basis swap agreement covering 10.0 Bbtu per day for 2007.

(10) BUSINESS AND GEOGRAPHICAL SEGMENTS

Segment information has been prepared in accordance with Statement of Financial Accounting Standards No. 131, *Disclosures About Segments of an Enterprise and Related Information*. At September 30, 2006, Forest conducts operations in one industry segment, that being the oil and gas exploration and production industry, and had three reportable geographical business segments: United States, Canada and International. Forest s remaining activities are not significant and therefore are not reported as a separate segment, but are included as a reconciling item in the information below. The segments were determined based upon the type of operations in each business segment and the geographical location of each. The segment data presented below was prepared on the same basis as the Condensed Consolidated Financial Statements. Effective in the first quarter of 2006, Forest ceased allocating general and administrative expenses to the business segments to correspond with its decision to monitor and evaluate general and administrative expenses at the corporate level. Effective in the third quarter of 2006, Forest decreased the number of reportable segments from five to three to correspond to the same number of cost centers under the full cost accounting rules. Segment information previously reported has been modified to conform to the current presentation.

	Oil and Gas Operations Three Months Ended September 30, 2006				Nine Months Ended September 30, 2006			
	U.S.	Canada	International	Total Company	U.S.	Canada	International	Total Company
	(In Thousands)							
Revenue	$ 157,452	43,468		200,920	498,187	132,052		630,239
Expenses:								
Lease operating expenses	27,237	7,726		34,963	94,420	21,403		115,823
Production and property taxes	8,248	726		8,974	28,520	2,179		30,699
Transportation costs	2,624	2,870		5,494	8,908	6,957		15,865
Depletion	43,884	17,750		61,634	144,650	56,237		200,887
Accretion of asset retirement obligations	951	263	12	1,226	5,069	776	34	5,879
Impairments and other							2,078	2,078
Earnings (loss) from operations	$ 74,508	14,133	(12)	88,629	216,620	44,500	(2,112)	259,008
Capital expenditures	$ 143,194	43,471	774	187,439	676,032	118,286	6,337	800,655
Goodwill	$ 71,377	15,503		86,880	71,377	15,503		86,880

(10) BUSINESS AND GEOGRAPHICAL SEGMENTS (Continued)

A reconciliation of segment earnings (loss) from operations to consolidated earnings before income taxes and discontinued operations is as follows:

	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2006
	(In Thousands)	
Earnings from operations for reportable segments	$ 88,629	259,008
Marketing, processing, and other	1,919	5,899
General and administrative expense (including stock-based compensation)	(10,548)	(38,755)
Administrative asset depreciation	(871)	(2,539)
Spin-off and merger costs		(5,416)
Interest expense	(19,122)	(51,613)
Unrealized gains on derivative instruments, net	77,914	68,178
Realized losses on derivative instruments, net	(12,883)	(30,496)
Unrealized foreign currency exchange loss	(766)	(766)
Other income, net	950	200
Earnings before income taxes and discontinued operations	$ 125,222	203,700

	Oil and Gas Operations							
	Three Months Ended September 30, 2005				Nine Months Ended September 30, 2005			
	U.S.	Canada	International	Total Company	U.S.	Canada	International	Total Company
	(In Thousands)							
Revenue	$ 218,192	47,958		266,150	677,215	117,160		794,375
Expenses:								
Lease operating expenses	46,767	4,809		51,576	130,687	14,532		145,219
Production and property taxes	10,355	559		10,914	29,354	2,004		31,358
Transportation costs	3,252	1,345		4,597	9,883	4,469		14,352
Depletion	73,648	16,349		89,997	236,482	45,354		281,836
Accretion of asset retirement obligations	4,105	236	11	4,352	12,255	675	21	12,951
Impairments and other	4,002			4,002	4,002		2,924	6,926
Earnings (loss) from operations	$ 76,063	24,660	(11)	100,712	254,552	50,126	(2,945)	301,733
Capital expenditures	$ 117,092	31,684	1,135	149,911	575,860	77,539	2,389	655,788
Goodwill	$ 86,081	15,509		101,590	86,081	15,509		101,590

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(10) BUSINESS AND GEOGRAPHICAL SEGMENTS (Continued)

A reconciliation of segment earnings (loss) from operations to consolidated earnings before income taxes and discontinued operations is as follows:

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
	(In Thousands)	
Earnings from operations for reportable segments	$ 100,712	301,733
Marketing, processing, and other	2,086	5,207
General and administrative expense (including stock-based compensation)	(9,847)	(31,694)
Administrative asset depreciation	(1,032)	(2,718)
Interest expense	(15,664)	(46,224)
Unrealized losses on derivative instruments, net	(72,095)	(74,365)
Realized (losses) gains on derivative instruments, net	(38)	280
Other expense, net	(341)	(4,251)
Earnings before income taxes and discontinued operations	$ 3,781	147,968

(11) RECENT ACCOUNTING PRONOUNCEMENTS

Financial Accounting Standards Board (FASB) Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109* , was issued in July 2006 and will be effective for the Company on January 1, 2007. FIN 48 defines the threshold for recognizing the benefits of uncertain tax return positions in the financial statements. The Company has not yet determined the impact this Interpretation will have on its financial position, results of operations or cash flows.

In September 2006, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements* (SFAS No. 157). This statement clarifies the definition of fair value, establishes a framework for measuring fair value, and expands the disclosures on fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. We have not determined the effect, if any, the adoption of this statement will have on our results of operations or financial position.

In September 2006, the FASB adopted SFAS No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 106, and 132(R).* SFAS No. 158 requires companies to recognize a net liability or asset and an offsetting adjustment to accumulated other comprehensive income to report the funded status of defined benefit pension and other postretirement benefit plans. SFAS No. 158 requires prospective application, and the recognition and disclosure requirements are effective for the Company s fiscal year ending December 31, 2006. Additionally, SFAS No. 158 requires companies to measure plan assets and obligations at their year-end balance sheet date. This requirement is effective for our fiscal year ending December 31, 2008. We have not determined the effect, if any, the adoption of this statement will have on our results of operations or financial position.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108). SAB 108 provides guidance on how prior year misstatements should be taken into consideration when quantifying misstatements in current year financial statements for purposes of determining whether the current year s financial statements are materially misstated. SAB 108 becomes effective during our 2007 fiscal year. We do not expect the adoption of SAB 108 to have a material impact on our financial statements.

Item 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Forest is an independent oil and gas company engaged in the acquisition, exploration, development, and production of natural gas and liquids in North America and selected international locations. Forest was incorporated in New York in 1924, as the successor to a company formed in 1916, and has been a publicly held company since 1969.

The following discussion and analysis should be read in conjunction with Forest s Condensed Consolidated Financial Statements and Notes thereto, the information under the heading Forward-Looking Statements below, and the information included in Forest s 2005 Annual Report on Form 10-K under the heading Risk Factors , and Management s Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies, Estimates, Judgments, and Assumptions. Unless the context otherwise indicates, references in this quarterly report on Form 10-Q to Forest, we, ours, us, or like terms refer to Forest Oil Corporation and its subsidiaries.

2006 OVERVIEW

Spin-off of Offshore Gulf of Mexico Operations

On March 2, 2006, Forest completed the spin-off of its offshore Gulf of Mexico operations by means of a stock dividend, which consisted of a pro rata spin-off (the Spin-off) of all outstanding shares of Forest Energy Resources, Inc. (hereinafter known as Mariner Energy Resources, Inc. or MERI), a total of 50,637,010 shares of common stock, to holders of record of Forest common stock as of the close of business on February 21, 2006. Immediately following the Spin-off, MERI was merged with a subsidiary of Mariner Energy, Inc. (Mariner) in a stock for stock transaction (the Merger). Mariner s common stock commenced trading on the New York Stock Exchange on March 3, 2006.

The Spin-off was completed without the payment of consideration by Forest shareholders and consisted of a special dividend of .8093 shares of MERI for each outstanding share of Forest common stock. The Merger was accomplished by the exchange of all issued and outstanding shares of MERI for shares of common stock of Mariner, with each whole share of MERI exchanged for one share of Mariner common stock. The Spin-off was a tax-free transaction for federal income tax purposes. Prior to the Merger, as part of the Spin-off, MERI paid Forest an initial cash amount equal to approximately $176.1 million. Subsequent to the closing, Forest received additional net cash proceeds of $21.7 million from MERI for a total of $197.8 million. As of October 31, 2006, in accordance with the transaction agreements, Forest and MERI had submitted post-closing adjustments from which Forest has determined it owes MERI approximately $5.8 million, which is subject to further adjustment.

Cotton Valley Acquisition

On March 31, 2006, Forest completed the acquisition of oil and gas properties located primarily in the Cotton Valley trend in East Texas. Forest paid approximately $255 million, as adjusted to reflect an economic effective date of February 1, 2006, for properties with an estimated 110 Bcfe of estimated proved reserves at the time the acquisition was announced in February 2006 and production that averaged 13 MMcfe per day in January 2006. Forest obtained approximately 26,000 net acres in the fields, of which approximately 14,000 net acres were undeveloped. This acquisition is expected to provide another core area of growth and add significant onshore activity to the Southern business unit. Forest funded this acquisition utilizing its bank credit facilities.

Katy Field

Effective August 1, 2006, Forest took over as operator of the Katy field. Gross field production increased 31% to 17 MMcfe per day during the third quarter of 2006 from 13 MMcfe per day achieved through the first six months of the year. The field has 33,000 gross acres and a six well shallow Frio drilling program is planned for the fourth quarter along with two deeper Wilcox tests. The capital activity in this field is expected to increase as 31 development locations have been identified. Forest is undertaking a field study including all 131 existing wellbores with a goal to propose a recompletion, workover and drilling program in 2007.

Barnett Shale

In July 2006, Forest entered into a joint exploration agreement with a third party which increases its gross acreage position in the Barnett Shale to approximately 20,000 acres. The joint exploration agreement involved approximately 14,000 acres in Hill County, Texas. Each party will participate with approximately 50% working interest in this joint area. The first horizontal well commenced drilling in the third quarter of 2006.

Production Increase

Production from the Retained Properties (see definition below) increased 17% during the three months ended September 30, 2006 from the corresponding period in 2005 and increased 14% during the nine months ended September 30, 2006 from the same period in 2005. The production increase is discussed further in Results of Operations, *Oil and Gas Production and Revenues*, below.

Formation of New Subsidiary and Plans for Related Financing

As of October 31, 2006, Forest transferred the majority of the assets associated with its Alaska business unit to a new subsidiary, Forest Alaska Operating LLC (Alaska). Alaska holds the oil and gas interests of Forest in the Cook Inlet region of the State of Alaska and it will enter into a service agreement with Forest for the operation of those assets. The activities of Alaska are intended to focus on the exploitation of its assets and participation in the proposed development program in the McArthur River Field over the next several years.

The new subsidiary intends to attempt to obtain $375 million of term loan financing to fund a $350 million distribution to Forest and provide initial working capital for Alaska s operations. Forest indirectly owns 100% of the interests in the new subsidiary, and the term loans will be secured by the subsidiary s assets and will be non-recourse to Forest.

RESULTS OF OPERATIONS

As a result of the Spin-off discussed above, the revenues and expenses associated with our offshore Gulf of Mexico operations are only included in our consolidated results of operations through February 28, 2006. As a result, the operational results for the three and nine month periods of 2006 presented are not comparable to the corresponding periods in 2005.

Our reported earnings of $76.9 million for the third quarter of 2006, or $1.21 per diluted share, were $73.7 million higher than net earnings of $3.3 million, or $.05 per diluted share, for the same period in 2005. Reported earnings for the nine months ended September 30, 2006 of $137.7 million, or $2.17 per diluted share, were $43.3 million higher than net earnings of $94.3 million, or $1.50 per diluted share, for the same period in 2005. The three and nine month period increases in net earnings were primarily attributable to changes in the mark-to-market value of our derivatives offset by decreased oil and gas sales as a result of the Spin-off transaction discussed above.

In the following discussions, revenues and expenses directly attributable with the properties included in the Spin-off (the Spin-off Properties) and those retained (the Retained Properties) are discussed separately.

Oil and Gas Production and Revenues

Production volumes, oil and gas sales revenue, and average sales prices for the three months ended September 30, 2006 and 2005 were as follows:

	Three Months Ended September 30,							
	2006				**2005**			
	Gas (MMcf)	**Oil (MBbls)**	**NGLs (MBbls)**	**Total (MMcfe)**	**Gas (MMcf)**	**Oil (MBbls)**	**NGLs (MBbls)**	**Total (MMcfe)**
Production volumes:								
Retained Properties:								
United States	10,838	1,264	431	**21,008**	8,404	1,308	281	**17,938**
Canada	6,075	185	100	**7,785**	4,821	203	103	**6,657**
Total Retained Properties	16,913	1,449	531	**28,793**	13,225	1,511	384	**24,595**
Spin-off Properties					11,444	525	150	**15,494**
Totals	16,913	1,449	531	**28,793**	24,669	2,036	534	**40,089**
Revenues (in thousands):								
Retained Properties:								
United States	$ 59,721	85,067	14,914	**159,702**	59,955	78,451	8,566	**146,972**
United States hedging gains (losses)	2,445	(4,695)		**(2,250)**	(8,587)	(12,583)		**(21,170)**
Canada	28,130	10,785	4,553	**43,468**	33,558	10,359	4,041	**47,958**
Total Retained Properties	90,296	91,157	19,467	**200,920**	84,926	76,227	12,607	**173,760**
Spin-off Properties					99,411	31,136	4,986	**135,533**
Spin-off Properties hedging losses					(28,267)	(14,876)		**(43,143)**
Total Spin-off Properties					71,144	16,260	4,986	**92,390**
Totals	$ 90,296	91,157	19,467	**200,920**	156,070	92,487	17,593	**266,150**
Average sales price:								
Retained Properties:								
United States	$ 5.51	67.30	34.60	**7.60**	7.13	59.98	30.48	**8.19**
United States hedging gains (losses)	.23	(3.71)		**(.11)**	(1.02)	(9.62)		**(1.18)**
Canada	4.63	58.30	45.53	**5.58**	6.96	51.03	39.23	**7.20**
Total Retained Properties	5.34	62.91	36.66	**6.98**	6.42	50.45	32.83	**7.06**
Spin-off Properties					8.69	59.31	33.24	**8.75**
Spin-off Properties hedging losses					(2.47)	(28.34)		**(2.78)**
Total Spin-off Properties					6.22	30.97	33.24	**5.97**
Totals	$ 5.34	62.91	36.66	**6.98**	6.33	45.43	32.95	**6.64**

Production volumes, oil and gas sales revenue, and average sales prices for the nine months ended September 30, 2006 and 2005 were as follows:

	Nine Months Ended September 30,							
	2006				2005			
	Gas (MMcf)	Oil (MBbls)	NGLs (MBbls)	Total (MMcfe)	Gas (MMcf)	Oil (MBbls)	NGLs (MBbls)	Total (MMcfe)
Production volumes:								
Retained Properties:								
United States	31,632	3,786	1,116	**61,044**	24,822	4,047	816	**54,000**
Canada	17,768	557	304	**22,934**	13,676	638	318	**19,412**
Total Retained Properties	49,400	4,343	1,420	**83,978**	38,498	4,685	1,134	**73,412**
Spin-off Properties	6,378	193	82	**8,028**	41,442	1,845	628	**56,280**
Totals	55,778	4,536	1,502	**92,006**	79,940	6,530	1,762	**129,692**
Revenues (in thousands):								
Retained Properties:								
United States	$ 188,996	244,707	36,482	**470,185**	154,336	208,903	22,075	**385,314**
United States hedging losses	(2,549)	(15,738)		**(18,287)**	(12,456)	(22,365)		**(34,821)**
Canada	88,606	29,561	13,885	**132,052**	79,733	26,564	10,863	**117,160**
Total Retained Properties	275,053	258,530	50,367	**583,950**	221,613	213,102	32,938	**467,653**
Spin-off Properties	53,975	11,614	3,020	**68,609**	296,124	95,887	18,553	**410,564**
Spin-off Properties hedging losses	(16,926)	(5,394)		**(22,320)**	(47,026)	(36,816)		**(83,842)**
Total Spin-off Properties	37,049	6,220	3,020	**46,289**	249,098	59,071	18,553	**326,722**
Totals	$ 312,102	264,750	53,387	**630,239**	470,711	272,173	51,491	**794,375**
Average sales price:								
Retained Properties:								
United States	$ 5.97	64.63	32.69	**7.70**	6.22	51.62	27.05	**7.14**
United States hedging losses	(.08)	(4.16)		**(.30)**	(.50)	(5.53)		**(.64)**
Canada	4.99	53.07	45.67	**5.76**	5.83	41.64	34.16	**6.04**
Total Retained Properties	5.57	59.53	35.47	**6.95**	5.76	45.49	29.05	**6.37**
Spin-off Properties	8.46	60.18	36.83	**8.55**	7.15	51.97	29.54	**7.30**
Spin-off Properties hedging losses	(2.65)	(27.95)		**(2.78)**	(1.13)	(19.95)		**(1.49)**
Total Spin-off Properties	5.81	32.23	36.83	**5.77**	6.02	32.02	29.54	**5.81**
Totals	$ 5.60	58.37	35.54	**6.85**	5.89	41.68	29.22	**6.13**

Net oil and gas production from the Retained Properties in the third quarter of 2006 was 28.8 Bcfe or an average of 313 MMcfe per day, a 17% increase from 24.6 Bcfe or an average of 267 MMcfe per day in the third quarter of 2005. Net oil and gas production from the Retained Properties in the first nine months of 2006 was 84.0 Bcfe or an average of 308 MMcfe per day, a 14% increase from 73.4 Bcfe or an average of 269 MMcfe per day in the same period of 2005. The net increase in oil and gas production in each period was primarily attributable to increases at the Buffalo Wallow field and the recently acquired East Texas properties in the United States and the Wild River field in Canada.

Oil and natural gas revenues from the Retained Properties were $200.9 million during the three months ended September 30, 2006, a 16% increase as compared to $173.8 million for the same period in the prior year. The increase in oil and natural gas revenues for the three month period was due to a 17% increase in production offset by a 1% decrease in the average realized sales price per Mcfe from $7.06 in 2005 to $6.98 in 2006. Oil and natural gas revenues from the Retained Properties were $584.0 million during the nine months ended September 30, 2006, a 25% increase as compared to $467.7 million for the same period in the prior year. The increase in oil and natural gas revenues for the nine month period was due to a 14% increase in production as well as a 9% increase in the average realized sales price per Mcfe to $6.95 in 2006 from $6.37 in 2005.

No oil and gas production or revenue was recognized in the third quarter of 2006 related to the Spin-off Properties as a result of the completion of the Spin-off transaction on March 2, 2006. Oil and gas production from the Spin-off Properties during the third quarter of 2005 was 15.5 Bcfe or an average of 168.4 MMcfe per day. Net oil and gas production from the Spin-off Properties in the nine month period of 2006 was 8.0 Bcfe compared to 56.3 Bcfe in the same period in 2005. The decrease in total production was primarily due the fact that the nine month period of 2006 only includes two months of offshore production from the Spin-off properties. During the quarter ended September 30, 2005 oil and gas revenues from the Spin-off Properties totaled $92.4 million resulting in an average price per Mcfe of $5.97. Oil and natural gas revenues from the Spin-off Properties totaled $46.3 million, or $5.77 per Mcfe, during the nine months ended September 30, 2006, as compared to $326.7 million, or $5.81 per Mcfe, for the same period in the prior year. The decrease in total oil and gas revenues was due to the fact that the nine month period of 2006 includes only two months of offshore production from the Spin-off properties.

The average realized sales prices for the periods presented include losses that we recognized on our derivative instruments designated as cash flow hedges. For the three months ended September 30, 2006, Forest recognized hedging losses of $2.3 million compared to hedging losses of $64.3 million during the same period in the prior year. For the nine months ended September 30, 2006, Forest recognized hedging losses of $40.6 million compared to hedging losses of $118.7 million during the same period in the prior year. The recognized losses in the first nine months of 2006 include $15.2 million in hedge losses settled in the fourth quarter of 2005 but recognized in the first quarter of 2006 to correspond with the timing of the production that was deferred by hurricanes Katrina and Rita. See *Realized and Unrealized Gains and Losses on Derivative Instruments* below for information on gains and losses recognized on derivative instruments not designated as cash flow hedges during the three and nine months ended September 30, 2006 and 2005.

Oil and Gas Production Expense

The tables below set forth the detail of oil and gas production expense, for the three and nine months ended September 30, 2006 and 2005:

	Three Months Ended September 30,					
	2006			**2005**		
	Retained Properties	**Spin-off Properties**	**Total**	**Retained Properties**	**Spin-off Properties**	**Total**
	(In Thousands, Except per Mcfe Data)					
Lease operating expenses (LOE):						
Direct operating expense and overhead	$ 31,382		**31,382**	26,578	17,149	**43,727**
Workover expense	3,581		**3,581**	3,391	3,539	**6,930**
Hurricane repairs					919	**919**
Total LOE	$ 34,963		**34,963**	29,969	21,607	**51,576**
LOE per Mcfe	$ 1.21		**1.21**	1.22	1.39	**1.29**
Production and property taxes	$ 8,974		**8,974**	10,249	665	**10,914**
Production and property taxes per Mcfe	$ .31		**.31**	.42	.04	**.27**
Transportation costs	$ 5,494		**5,494**	3,974	623	**4,597**
Transportation costs per Mcfe	$ .19		**.19**	.16	.04	**.11**

Nine Months Ended September 30,			
2006			**2005**
Retained Properties	**Spin-off Properties**	**Total**	