



**Wavefront Energy and Environmental Services Inc.**

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<input type="checkbox"/>	<b>Third Quarter Report</b>
<input type="checkbox"/>	For the nine month
<input checked="" type="checkbox"/>	period ended
<input type="checkbox"/>	<b>May 31, 2005</b>

#### **NOTICE OF AUDITOR REVIEW OF INTERIM FINANCIAL STATEMENTS**

The accompanying unaudited interim financial statements of the Corporation have been prepared by and are the responsibility of the Corporation's management.

The Corporation's independent auditor has not performed a review of these financial statements in accordance with standards established by the Canadian Institute of Chartered Accountants for a review of interim financial statements by an entity's auditor.



**Wavefront Energy and Environmental Services Inc.**

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**TO THE SHAREHOLDERS:**

On behalf of the Board of Directors, we would like to thank all stakeholders for their continued support as we endeavour to make the Corporation's DeepWave stimulation process an industry standard for secondary oil production and groundwater remediation.

As anticipated, the Corporation's financial performance has rebounded from that of the previous year with revenues dramatically up for the third quarter. For the third quarter ending May 31, 2005, the Corporation generated revenues of \$1,210,897 resulting in a net loss of \$1,162,105 versus revenues of \$409,827 and loss of \$1,368,845 for comparative period of last year. Coupled with the revenue growth, the Corporation continues to make significant in roads in the commercialization of its DeepWave stimulation process.

The implementation of the Corporation's three point strategy of licensing DeepWave to industry leaders, selling and implementing the technology directly with end users and acquiring undervalued oilfields to implement DeepWave is well underway and has been well received. Each of the strategic initiatives not only supports the other initiatives but also encourages an accelerated adoption of the technology. To that end with Halliburton Energy Services Inc., we have successfully designed a new DeepWave pulsing system that is deployed on coiled tubing for use in the well intervention market. In a 2002 equity research report by Raymond James and Associates, this market alone was estimated to be in the order of \$2 billion annually. Additionally, the Corporation has closed the acquisition of mineral property interest in Milam County, Texas and Rogers County, Oklahoma. The intent of the mineral property interests acquisition is to have permanently installed DeepWave systems to showcase the Corporation's technology to its customers, licensed agents and financial markets.

On behalf of the Board of Directors

Brett C. Davidson  
President & CEO

## **MANAGEMENT'S DISCUSSION AND ANALYSIS FOR THE NINE MONTHS ENDED MAY 31, 2005**

The following discussion and analysis of financial results should be read in conjunction with the unaudited financial statements and the accompanying notes for the period ended May 31, 2005 and is based on information available to July 26, 2005. The interim financial statements have not been audited or reviewed by Wavefront Energy and Environmental Services Inc.'s (the "Corporation" or "Wavefront") auditors. Additional information on Wavefront is available on SEDAR at [www.Sedar.com](http://www.Sedar.com).

### **OVERVIEW**

The principal business of the Corporation is the development and commercialization of innovative technologies for improved oil production and groundwater remediation.

#### DeepWave Technology

At the core of Wavefront's strategic value proposition is its patented DeepWave technology (formerly Pressure Pulsing Technology or PPT). DeepWave is an injection technology where with each impulse a volume of liquid is introduced through a casing or tubing and is forced at high accelerations via downhole devices into the reservoir. The intent of each impulse being the injected fluid increases the porosity, pressure, permeability, saturation, and homogenization of an ever-increasing coherent volume of the porous media.

More specifically DeepWave has been proven to be an effective method of increasing oil production and recovery of original oil in place through both a well intervention technique and a stimulation technique in water injectors during secondary recovery. It has also been a verified strategy by Environment and Industry Canada to accelerating ground water remediation by 250%.

There are no limits to the type of oil viscosity to which DeepWave can be applied, just as there are no geographical or depth limitations. The physical principles on which DeepWave is based are fundamental, and its physics are valid everywhere, all the time. DeepWave is applicable to production enhancement from conventional oilfields, to waterfloods in light oils, to deeper wells, to shallower wells, in vertical, inclined or horizontal wells. The method of implementation, however, will have to be modified to suit the physical situation and to meet design goals in individual wells and fields. As an analogy, consider the internal combustion engine: it powers mobile power plants, motorcycles, automobiles, caterpillar tractors, and 350 ton diesel-electric mine haulers, yet the physics are the same. As such, the method of implementation may result in certain circumstances as uneconomical. DeepWave can be modified to increase flow rates, production well efficiency, and oil recovery ratios in a wide variety of configurations.

The optimization of DeepWave is dependant upon, among other things, the frequency and amplitude of the pulse created. Thus, part of Wavefront's value proposition is to monitor and model DeepWave outcomes. Wavefront's intellectual property strategy is to maintain absolute control over its DeepWave modeling software internally known as the "DeepWave Analyzer". The software enables Wavefront to evaluate reservoir characteristics and provides key insights into the frequency and amplitude of the pulse required for the desired outcome in any given oil reservoir or groundwater aquifer.

#### Energy Sector Application of DeepWave Stimulation Process

Given limited financial, engineering design and implementation resources, Wavefront entered into Collaboration and Technology Licensing Agreements with Halliburton Energy Services Inc. The Collaboration Agreement allows Wavefront to jointly research, develop and manufacture additional DeepWave systems for the



improvement or enhancement of oil recovery, oil well stimulation and oilfield disposal methodologies. The License Agreement provides Halliburton non-exclusive rights in Canada and the United States to market DeepWave and exclusive rights outside of Canada and the United States. The Halliburton agreements were also sought to help address the rate of adoption on DeepWave throughout the world.

Oil producers worldwide are under competitive pressure to maximize their production levels and reduce production costs. To increase production efficiencies, producers require real time information on the behavior of the reservoir so that immediate production decisions can be drawn. Throughout the industry, down hole monitoring has emerged as a significant tool for reservoir surveillance so as to reduce costs and to maximize oil recovery for producers. As such, and as a result of developing such technologies to monitor pulse waves, Wavefront has vertically integrated to supply various monitoring systems.

Wavefront offers two types of monitoring systems: permanent systems specifically designed for placement within the cemented well casing for continuous monitoring throughout the life of the well; and reusable systems (production tubing and coil tubing) to external customers – some of which are also DeepWave customers or potential customers. Additionally, these monitoring products are sold to monitor the frequency and amplitude of the pressure pulse created. The revenue from the well monitoring business has provided cash flows to allow Wavefront to attend to its infrastructure whilst marketing DeepWave.

#### Environmental Sector Applications of the DeepWave Stimulation Process

With the negative net present value of environmental remediation projects and the long sales cycles, Wavefront, in parallel fashion, has also licensed Environmental Resource Management (“ERM”) non-exclusive rights to market DeepWave to the environmental sector. Wavefront also has two sales agents in the United States and one sales agent in Finland promoting the technology to the user sector. Licensing and securing outside agents has allowed Wavefront to gain market exposure for DeepWave while limiting the resources required to build a revenue stream from the environmental sector.

The sales cycle, with regards to energy DeepWave, is averaging 18 months from first discussions with a client to implementation. With customer acceptance of the technology, management expects that this should decrease. For example, in the oilfield monitoring sector, the sales cycle is approximately 4-6 months.

## **RESULTS OF OPERATIONS**

The Corporation no longer manages its operations using separate operating segments; as such, all results are reported on a consolidated basis. The Corporation however, still provides DeepWave to the energy and environmental sectors and integrated monitoring to internal and external customers.

### **Consolidated Results – nine months ended May 31, 2005**

Revenues for the nine months ended May 31, 2005 were \$1,120,897, an increase of more than three fold the revenue of \$409,827 that was recognized for comparative period (the nine months ending May 31, 2004).

Revenues for the quarter were primarily generated from sales of integrated monitoring products and services to an external customer in Alberta. Environmental DeepWave pulsing revenues however, continue to grow and generate recurring revenues through licensed agents. Gross profit as a percentage of revenue was 27.9% for the quarter and is lower than that for the comparative period of last year of 42.0%. The decrease in gross profit is due to the increase in integrated monitoring sales in the Corporation’s product mix, price discounts to recapture market share, and undertaking one large specialty design monitoring project that had higher than normal budgeted costs. The gross margin for the nine



months ended is also lower than that for the three months ending February 28, 2005 as the projects' cost and revenue relate to larger projects than those recognized for the first quarter of fiscal 2005, which also had a higher cost component relative to the revenue stream.

The Corporation's general and administrative expenses for the third quarter of fiscal 2005 were \$1,432,435, reduced from the \$1,544,337 incurred for the same period of the comparative period (the nine months ending May 31, 2004). The change is primarily due to decreases in professional fees of \$104,900, listing and public company fees of \$39,764 and office expenses of \$23,102 associated with not maintaining a sales office in Calgary, Alberta. Other notable changes included increases in wage expense by \$65,427 and consulting expense of \$33,163, that were both related to the efforts to locate and secure an oilfield to showcase DeepWave.

In the previous reporting quarter there was a write down of inventory of \$59,125 related to sensors that the Corporation acquired in a prior fiscal year but now does not believe will be utilized internally or sold to an external customer.

The net loss for the quarter was \$1,162,105 (\$0.05 per share), a decrease from the net loss of \$1,368,845 (\$0.07 per share) for comparative period (the nine months ending May 31, 2004). The decrease in the net loss is due to the increase of sales, albeit not proportionately to the increase in revenue. The disproportionate decrease in the net loss is due to a lower gross margin and increased expenses associated with acquiring mineral right interests in the United States and DeepWave tool collaboration initiatives with Halliburton Energy Services Inc.

### **Consolidated Results – three months ended May 31, 2005**

Revenues for the three months ended May 31, 2005 were \$469,616, an increase of more than 1.7 times the revenue of \$279,469 that was recognized for comparative period (the three months ending May 31, 2004).

Revenues for the quarter were primarily generated from the sale of integrated monitoring products and services to an external customer in Alberta. The gross profit as a percentage of revenue was 14.8% for the quarter and is lower than that for the comparative period of last year of 32.0% due to the same reason noted previously. The trend to lower gross margins was reported in the Corporations MD&A for the second quarter 2005.

The Corporation's general and administrative expenses of \$461,943 for the third quarter of fiscal 2005 was marginally reduced from the \$486,595 incurred for the same period of the comparative period (the three months ending May 31, 2004). The decrease was primarily due to decreases in travel expenses of \$20,124, professional fees of \$24,835, research and development expenses of \$18,469 and listing and public company fees of \$9,379. Other notable changes included increases in wage expenses of \$37,350 and consulting expenses of \$29,740 to the efforts to locate and secure an oilfield to showcase DeepWave.

The net loss for the quarter was \$400,202 (\$0.02 per share), a marginal increase from the net loss of \$392,709 (\$0.02 per share) for comparative period (the three months ending May 31, 2004). The relative unchanged results is primarily due to the increased resources being allocated to securing a working interest in an oilfield and efforts related to collaborating of new and additional DeepWave system developments. These costs were, however, offset by the increase in sales.

## **LIQUIDITY AND CAPITAL RESOURCES**

### **Liquidity**

During the reporting period ending May 31, 2005 the Corporation lost \$358,377 in cash from operations, compared to losing \$216,084 for the nine months ending May 31, 2004. The primary reasons for the increase in the use of cash



from operations are the lower gross margins, increased costs associated with securing a working interest in an oilfield, and efforts related to collaborating of new and additional DeepWave systems.

Given the large proportion of external costs, including direct materials, required in implementing integrated monitoring projects or fabricating DeepWave systems, the Corporation continued its policy of requiring clients to provide a deposit upon execution of a purchase order, allowance for expenditure or contract. This assisted the Corporation in better managing its cash flow with little external working capital financing.

The Corporation will be required to obtain financing, as required, through the exercise of stock options, share purchase warrants or the issuance of new share capital, as well as other financing opportunities such as strategic partnering arrangements or conventional debt. However, there can be no assurance that any of these methods will be successful in the future. Due to the stage of the Corporation's business, the market prices of the Corporation's shares have been subject to significant volatility. The ability of the Corporation to raise funds from the additional share capital or from the exercise of share options and warrants will depend upon the strength of the equity markets, which are always uncertain.

The solvency of the Corporation is directly related to its ability to continue to generate and increase the cash generated from operations or obtain conventional or further loans from its Board of Directors or securing additional equity financings. There is no guarantee that any of these alternatives will occur or continue to occur.

As at the end of the quarter the Corporation had a negative working capital of \$973,338. Working capital will continue to come from profits generated from current and future work, royalty revenues and financing efforts. Net tangible assets however, changed from negative \$291,497 for the current reporting period from a negative \$320,864 as reported at year-end.

Liquidity risk associated with financial instruments, is generally related to accounts receivable, and is believed to be very low based on the Corporation's history and the clients generally serviced.

The Corporation has not defaulted nor is in arrears on any lease interest or principal payments. Interest on notes payable is due and payable on demand. Interest has generally been accrued and has not been paid during the quarter; however, interest of \$64 was paid with the repayment of one note payable during the reporting period.

### **Capital Resources**

Currently the Corporation has no firm commitments for capital expenditures. However, the Corporation has recently announced it closed the acquisition of a 30% working interest in the existing production, equipment, and mineral lease of an oilfield in Rogers County, Oklahoma from an arms length party for total consideration of US \$15,000. The remaining working interest include 10% being held by an arms length party and 60% by a Michigan based Limited Liability Company. Of the 12 membership units in the Limited Liability Company a director and a related party to a director and senior officer of Wavefront holds 5 and 1 membership units respectively (or 50% of the Limited Liability Company's membership units).

There are no known trends or expected fluctuations in the Corporation's capital resources.

The Corporation has fully utilized its lines of credit and as the lines have not fluctuated from positive to negative they are recorded as bank indebtedness. As of July 26, 2005 the Corporation had cash on hand of \$95,452 with its lines of credit balance at \$168,567 (maximum available \$250,000).



## CAPITAL ASSETS AND EXPENDITURES

### Assets

Total assets decreased by \$547,931 from year-end. Much of the decrease stems from a reduction in accounts receivable and inventory levels, as the Corporation completed and recognized the revenue and costs associated with the completion of major monitor projects during the reporting period.

Cash has remained relatively stable. The Corporation continues to carefully manage its cash flow to ensure it will continue to meet its short-term cash requirements.

Capital additions are from environmental DeepWave systems amounting to \$25,347 and intangible assets of \$13,350, both net of amortization, were also made during the reporting quarter.

### Liabilities

Total liabilities decreased by \$598,359, principally resulting from a shares-for-debt transaction that reduced notes payable and due to shareholders by \$595,848 and by a decrease in unearned revenue of \$96,497 to \$117,701. The decreases however, were offset by increases in bank indebtedness of \$46,289 to \$228,880 and the addition of notes payable from the previous quarter of \$75,686 that were advanced from related parties.

## SHARE CAPITAL

### Description of share capital

During the quarter ending May 31, 2005, share capital increased to \$6,354,595 from \$5,220,000 at the end of fiscal 2004 as a result of closing a non-brokered private placement for gross proceeds of \$539,416 in the prior reporting quarter, and the closing of a shares-for-debt transaction settling \$595,527 in gross liabilities in the first quarter. The non-brokered private placement that closed during the prior reporting period resulted in the issuance of 2,345,225 units at a price of \$0.23 per unit, each unit consisting of one common share and one share purchase warrant, each full share purchase warrant entitling the holder to an additional common share with an exercise price of \$0.40 for a period of one year from the date of closing. Directors of the Corporation acquired 637,104 units of the non-brokered private placement for gross proceeds of approximately \$146,534.

Of the shares issued and outstanding, 9,678,220 shares are subject to a value escrow agreement, and 5,323,021 value escrow shares have been released. In addition, 323,078 shares are subject to seed share matrix restrictions that are similar to escrow restrictions, of which 177,693 seed shares have been released.

### Options outstanding

Date Granted	Expiry date	Number of incentive stock options	Price per share
October 5 '04	October 5 '09	470,000	\$0.45
April 30 '04	April 30 '09	495,455	\$0.44
January 15 '04	January 15 '09	57,500	\$0.50
November 30 '03	November 30 '08	125,000	\$0.55
September 30 '03	September 30 '08	<u>670,000</u>	\$0.50
		<u>1,817,955</u>	

**Warrants outstanding**

Date Granted	Expiry date	Number of shares purchase warrants	Price per share
May 31 '05	May 31 '06	220,224	\$0.35
February 28 '05	February 28 '06	2,345,225	\$0.40
May 31 '04	August 31 '05	1,370,501 <sup>(1)</sup>	\$0.55
September 30 '03	September 30 '05	937,364 <sup>(2)</sup>	\$0.55
		<u>4,873,314</u>	

(1) During the reporting period, the TSX Venture Exchange approved a reduction in the exercise price of 1,238,171 warrants to \$0.40 with no change to the exercise price of the remaining 132,330 warrants held by insiders. In addition, the TSX Venture Exchange approved an extension of the expiry dates of all 1,370,501 warrants from May 31, 2005 to August 31, 2005.

(2) In a prior reporting period, the TSX Venture Exchange approved a reduction in the exercise price of 912,664 warrants to \$0.55 with no change to the exercise price of the remaining 24,700 warrants held by insiders. In addition, the TSX Venture Exchange approved an extension of the expiry dates of all 937,364 warrants from September 30, 2004 to September 30, 2005.

**Options granted during the period**

Date of Grant	Number of Shares	Optionee	Exercise Price	Expiry Date
N/A				

Subsequent to the reporting period the Corporation issued 232,500 incentive stock options pursuant to its Stock Option Plan. These stock options were issued with an exercise price of \$0.40 and expire on June 1, 2010.

**TRANSACTIONS WITH RELATED PARTIES**

Expenses in the form of wages, employee benefits, contract employees and consultants, paid to insiders and related parties, during the period ended May 31, 2005 totaled \$218,778 (2004 - \$211,896). The amounts were paid as part of the normal course of business and are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

Notes payable of \$75,686 represents the advance of funds from directors and a related party of a director of the Corporation. The advances are unsecured, bear 14% interest and are repayable with 30 days notice. Interest expense as at May 31, 2005 is \$494 (2004 - \$897), of which \$64 has been paid and \$431 is included in Accounts Payable and Accrued Liabilities (2004 - \$897).

**PROPOSED TRANSACTIONS**

The Corporation acquired the mineral property interests in Milam County, Texas and Rogers County, Oklahoma. As the Rogers County mineral property interests includes production equipment and is currently producing oil, initial efforts will be focused on working over all existing producing oil wells, then implementing and measuring waterflood results to establish a baseline before installing the Corporation's DeepWave systems. With the Corporation having a 30% interest in the Rogers County oilfield, it will be responsible for 30% of the costs required to meet the previously noted objectives and the capitalization of the requisite DeepWave systems.



The intent of the mineral property interests acquisition is to have permanently installed DeepWave systems to showcase the Corporation's technology to its customers, licensed agents and financial markets. The acquisition completes the Corporation's three point strategy of licensing the DeepWave stimulation process to industry leaders, sell and implement the technology within Canada and the United States and acquire undervalued oilfields to implement the technology. Management believes that each of the strategic initiatives will support the other initiatives and accelerate overall technology adoption.

Additionally, the Corporation is negotiating the installation of several DeepWave systems for use in a commercial waterflood in California, Texas, and in western Canada. The successful implementation will augment efforts with Halliburton and may, upon agreement of the definition of success, lead to the implementation of multiple DeepWave systems for the long term.

## **CHANGES IN ACCOUNTING POLICIES**

### **Stock-based compensation**

As noted in the first full MD&A issued for the first quarter ended November 30, 2004, the Corporation adopted revisions to Section 3870 of the Canadian Institute of Chartered Accountants Handbook with respect to the accounting and disclosure of stock-based compensation. The revised section requires that the fair value of stock options be recorded in the financial statements. The Corporation applied these provisions retroactively with restatement of the prior year.

### **Segmented reporting**

Effective December 1, 2004 the Corporation will no longer report its financial results based on operating segments, as the Corporation no longer distinguished between operating segments nor does it assess operating results independently.

## **FINANCIAL AND OTHER INSTRUMENTS**

There are no changes, since the first quarter's MD&A, in significant financial or other instruments consisting of accounts receivable, interest rates or foreign currency risks.

## **RISK FACTORS**

The Corporation's business risks are the same as disclosed in its first full MD&A issued for the first quarter ended November 30, 2004. The most significant risk facing the Corporation, at present, is the ability to secure financing or to generate earnings sufficient to cover its working capital deficit and ongoing obligations.

## **FORWARD-LOOKING INFORMATION**

Statements in this Management's Discussion and Analysis relating to matters that are not historical facts are forward-looking statements. Such forward-looking statements involve known and unknown risks and uncertainties which may cause the actual results, performance or achievements of the Corporation to be materially different from any future results implied by such forward-looking statements. Such factors include fluctuations in acceptance rates of our technology, demand for products and services of both integrated monitoring and the DeepWave stimulation process, political and economic conditions globally and other factors that are described in further detail in Wavefront's continuous disclosure filings.