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Rally Energy Achieves Record Production, Revenues, Cash Flow and Income in 2005

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Rally Energy Corp. ("Rally") is pleased to announce record 2005 year-end operational and financial results. Highlights include:

- Record production of 2,579 boe/d, an increase of 30% over 2004 production of 1,978 boe/d;
- Record revenue of \$34.9 million, an increase of 56% over 2004 revenue of \$22.4 million;
- Record cash flow from operations of \$11.9 million, an increase of 43% over 2004 cash flow of \$8.3 million; and
- Record net income of \$1.5 million, an increase of 24% over 2004 net income of \$1.2 million

Rally's 2005 capital program of \$22.7 million included the drilling of 22 (18.03 net) wells. This program resulted in 14 (14 net) oil wells in Egypt, two (0.45 net) gas wells in Pakistan and one (0.38 net) oil well in Canada. A total of five wells were dry and abandoned, one (1.0 net) in Egypt and four (2.2 net) in Canada.

The successful drilling program and steam pilot results in Egypt, combined with a major gas discovery in Pakistan, resulted in a 466% increase in 2005 proved and probable oil and gas reserves to 45.6 million boe. The following production metrics were also achieved:

- Finding and development cost of \$3.20/boe (proved and probable basis);
- Proved reserves replacement ratio 16; and
- Operating costs of \$7.14/boe.

The Corporation ended the year with no long-term debt and a fully-available US\$7.0 million credit facility.

Equipment delivery delays in Egypt experienced in late 2005 and early 2006 have now been remedied with the delivery and installation of high performance pumps in several wells. Production is currently increasing towards projected guidance.

Based in Calgary, Alberta, Canada, Rally Energy is an oil and gas exploration, development and production company. The Corporation's primary area of operations is in Egypt, where it has a 100% operating interest in the Issaran Oilfield, a significant heavy oil development opportunity with strong growth potential. In Pakistan, the Corporation holds a 22.5% interest in the Safed Koh Block, where it is participating in the development of a large natural gas/condensate discovery. In Canada, Rally Energy is active in Alberta and Saskatchewan with varied working interests in several producing properties.

FORWARD-LOOKING STATEMENTS

Except for statements of historical fact, all statements in this news release - including, without limitation, statements regarding production estimates, potential reserves and future plans and objectives of the Corporation are forward-looking statements that involve various risks and uncertainties. There can be no assurance that such statements will prove to be accurate; actual results and future events could differ materially from those anticipated in such statements. Important factors that could cause actual results to differ materially from anticipated results include risks and uncertainties most of which are beyond the Corporation's control such as: risks relating to estimates of reserves and recoveries; production rates and operating cost assumptions; development risks and costs; the risk of commodity price and currency fluctuations; general economic and industry conditions; political and regulatory risks; environmental risks; stock market volatility; access to sufficient capital from internal and external sources; and other risks and uncertainties as disclosed under the heading "Business Risks and Uncertainties" and elsewhere in the Corporation's documents filed from time-to-time with the Toronto Stock Exchange and other regulatory authorities. The reader is cautioned that assumptions used in the preparation of such information, while considered reasonable by the Corporation at the time, may prove to be incorrect. The Corporation disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

The TSX has neither approved nor disapproved of the contents of this news release.

RALLY ENERGY CORP.

Management's Discussion and Analysis ("MD&A")

For the Year Ended December 31, 2005

This discussion and analysis outlines management's assessment of the consolidated financial and operating results of Rally Energy Corp. ("Rally Energy" or the "Corporation") and its subsidiaries, including its future opportunities and risks, and should be read in conjunction with the audited financial statements and related notes for the year ended December 31, 2005. Additional information regarding the Corporation can be found at www.sedar.com and www.rallyenergy.com.

The financial information contained herein has been prepared by management of Rally Energy in accordance with Canadian Generally Accepted Accounting Principles ("GAAP"). Unless otherwise indicated, all dollar amounts in this MD&A are in thousands of Canadian dollars. The majority of the Corporation's production is heavy oil (reported in barrels), however, the Corporation also uses the "barrels of oil equivalent" (boe) reference in this report to reflect Canadian natural gas sales. All boe conversions are derived by converting gas to oil in the ratio of six thousand cubic feet of gas to one barrel of oil, representing the approximate energy equivalency. This MD&A is dated March 24, 2006.

Non-GAAP Measures

Certain measures in this MD&A do not have any standardized meaning as prescribed by Canadian GAAP such as cash flow, cash flow per share - basic, cash flow from operations, and netback from operations. Therefore, they are considered non-GAAP measures and may not be comparable to similar information presented by other issuers. These measures have been described and presented in order to provide shareholders and potential investors with additional information regarding the Corporation's liquidity and its ability to generate funds to finance its operations. Management's use of these measures has been disclosed further in this MD&A as they are discussed and presented.

Forward-Looking Statements

Except for statements of historical fact, all statements in this news release - including, without limitation, statements regarding production estimates, potential reserves and future plans and objectives of the Corporation are forward-looking statements that involve various risks and uncertainties. There can be no assurance that such statements will prove to be accurate; actual results and future events could differ materially from those anticipated in such statements. Important factors that could cause actual results to differ materially from anticipated results include risks and uncertainties most of which are beyond the Corporation's control such as: risks relating to estimates of reserves and recoveries; production rates and operating cost assumptions; development risks and costs; the risk of commodity price and currency fluctuations; general economic and industry conditions; political and regulatory risks; environmental risks; stock market volatility; access to sufficient capital from internal and external sources; and other risks and uncertainties as disclosed under the heading "Business Risks and Uncertainties" and elsewhere in the Corporation's documents filed from time-to-time with the Toronto Stock Exchange and other regulatory authorities. The reader is cautioned that assumptions used in the preparation of such information, while considered reasonable by the Corporation at the time, may prove to be incorrect. The Corporation disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Vision, Core Business and Strategy

Rally Energy is a Calgary-based oil and gas exploration, development and production company with production, development and exploration activities in Egypt and Canada and exploration activities in Pakistan. The Corporation's international strategy is to enhance value by applying Canadian exploration/development techniques and technology to the production of reserves.

Our primary property, the Issaran oilfield in Egypt, accounts for substantially all of the Corporation's revenues and has a large prospective inventory of additional well locations. A wholly-owned subsidiary of the Corporation entered into a Petroleum Service Agreement ("PSA") with The General Petroleum Co., S.A.E. ("GPC"), effective November 4, 1998, pursuant to which the Corporation was granted the exclusive right to develop and produce heavy oil from a 72 square kilometre portion of the Ras Issaran concession area located on the west shore of the Gulf of Suez. On October 18, 2001, the Corporation entered the Commercial Development Period of the PSA, after having successfully satisfied the terms of the three-year Piloting Period. The Corporation has the option to extend the 20-year term of the PSA (commencing from November 4, 1998), for up to two additional five-year terms subject to the concurrence of GPC. The Commercial Development Period does not require any specific capital expenditure commitments. Details of the PSA are disclosed in Note 12(a) of the consolidated financial statements and in the Production Entitlements, Marketing Costs and Royalties section. Rally Energy has established field and administration offices in Egypt, staffed mostly by Egyptian nationals, to manage and operate the Issaran oilfield. Calgary-based technical personnel, along with expatriate personnel, provide management and technical expertise to support planning, drilling and general operating activities. Additionally, the Corporation recognizes the importance of maintaining strong relationships with Egyptian authorities to resolve any operational or business issues as they may arise.

In Pakistan, Rally Energy, through a wholly-owned subsidiary, is party to a Concession Agreement, covering the 200,000 acre Safed Koh Block, with the Pakistan Government. The Corporation holds a 22.5% working interest and the drilling activity in 2005 lead to a Declaration of Commerciality in January 2006. Upon commencement of natural gas production, additional drilling will be carried out under Phase II of the exploration program.

OVERALL 2005 PERFORMANCE

Egypt:

- sales increased to 2,439 bbls/d.
- significant oil reserve increases.
- drilling of 15 Issaran wells.

Pakistan:

- re-entered and deepened two existing wells.
- significant natural gas and condensate reserves assigned.
- planning for pipeline and initial production.

Canada:

- realized production of 141 boe/d, primarily from the Harmattan area.
- drilled five wells as part of flow-through share requirements.

Equity:

- \$14.8 million of new equity financings.

ANNUAL COMPARATIVE SUMMARY

	2005	2004	2003
	(thousands of dollars, unless otherwise stated)		
Revenue	\$34,899	\$22,392	\$11,238
Cash flow from operations	\$11,883	\$8,283	\$2,402
<i>Per share - basic</i>	<i>\$0.15</i>	<i>\$0.12</i>	<i>\$0.04</i>
Income (loss)	\$1,541	\$1,238	\$(5,231)
<i>Per share - basic</i>	<i>\$0.02</i>	<i>\$0.02</i>	<i>\$(0.09)</i>
Total assets	\$59,698	\$43,116	\$34,800
Convertible debentures	\$1,314	\$6,000	\$6,000

No dividends have been declared by the Corporation.

Revenues increased by 56%, primarily as a result of increased oil sales from the Issaran oilfield in Egypt and higher world oil prices. The Corporation acquired its producing interests in Egypt through the acquisition of Scimitar Hydrocarbons Corporation in mid-2002 and has consistently increased sales through a successful and ongoing drilling program. Revenues from Canadian properties increased to \$3.0 million in 2005 (2004 - \$371,000). Revenues in 2006 will increase further as a result of ongoing drilling in Egypt, and will include production commencement from the Salsabil, Pakistan natural gas field.

Cash Flow from Operations

Cash flow represents funds from operations as detailed on the consolidated statements of cash flows. For the year ended December 31, 2005, Rally Energy's cash flow from operations increased to \$11.9 million (\$0.15/share) from \$8.3 million (\$0.12/share) for the comparable 2004 period. Cash flow from operations was \$3.4 million (\$0.05/share) in the fourth quarter of 2005 as compared to \$1.2 million (\$0.02/share) in the comparable 2004 quarter.

Cash flow from operations ("Cash Flow"), representing cash generated from operating activities before changes in non-cash working capital items, is a non-GAAP measure. Management utilizes Cash Flow as a key measure to assess the ability of the Corporation to finance operating activities and capital expenditures. Additionally, Cash Flow has been described and presented in order to provide shareholders and potential investors with information regarding the Corporation's liquidity and its ability to generate funds to finance its operations. This performance indicator may not be comparable to similar measures used by other companies.

Net Income

Net income for 2005 was \$1.5 million (\$0.02/share), a 24% increase from net income of \$1.2 million (\$0.02/share) for 2004. For the 2005 fourth quarter, reported income was \$0.6 million (\$0.01/share). For the fourth quarter of 2004, Rally Energy reported net income of \$1.1 million (\$0.02/share).

SUMMARY OF QUARTERLY RESULTS

(thousands of dollars, unless otherwise stated)

	<u>Revenue</u>	<u>Cash flow from operations</u>	<u>\$/share - basic</u>	<u>Income (Loss)</u>	<u>\$/share - basic</u>
2005					
Q1	\$ 5,369	\$ 856	\$0.01	\$ (895)	\$(0.010)
Q2	8,813	3,235	\$0.04	484	\$0.005
Q3	10,698	4,387	\$0.05	1,334	\$0.016
Q4	10,019	3,405	\$0.05	618	\$0.007
Year	<u>\$34,899</u>	<u>\$11,883</u>		<u>\$1,541</u>	
2004					
Q1	\$ 4,459	\$1,724	\$0.02	\$ (559)	\$(0.01)
Q2	5,400	2,202	\$0.03	(28)	\$(0.00)
Q3	6,743	3,187	\$0.05	687	\$0.01
Q4	5,790	1,170	\$0.02	1,138	\$0.02
Year	<u>\$22,392</u>	<u>\$8,283</u>		<u>\$1,238</u>	
2003					
Q1	\$ 3,239	\$ 535	\$0.01	\$ (914)	\$(0.02)
Q2	1,837	106	\$0.00	(1,208)	\$(0.02)
Q3	2,086	126	\$0.00	(1,259)	\$(0.02)
Q4	4,076	1,635	\$0.03	(1,850)	\$(0.03)
Year	<u>\$11,238</u>	<u>\$2,402</u>		<u>\$(5,231)</u>	

Quarterly revenues fluctuate with sales volumes and market-driven commodity prices. Quarterly income (loss) is also impacted by fluctuations in depletion charges based on estimated quarterly reserves additions supplemented by an independent reserves report update at year-end.

Sales, Revenue and Netback

(thousands of dollars, unless otherwise stated)

	2005									
	First Quarter		Second Quarter		Third Quarter		Fourth Quarter		Year	
Daily Sales:										
Oil (bbls/d)	2,177		2,734		2,558		2,656		2,533	
Natural gas (mcf/d)	84		240		330		462		276	
Total BOE (boe/d)	2,191		2,774		2,613		2,733		2,579	
		<u>\$/boe</u>		<u>\$/boe</u>		<u>\$/boe</u>		<u>\$/boe</u>		<u>\$/boe</u>
Gross revenue	\$5,369	\$27.23	\$8,813	\$34.91	\$10,698	\$44.51	\$10,019	\$39.85	\$34,899	\$37.07
Production entitlement										
– GPC (Egypt)	(1,565)	(7.94)	(2,380)	(9.43)	(2,898)	(12.07)	(2,631)	(10.47)	(9,474)	(10.06)
Royalty (Egypt)	(347)	(1.76)	(558)	(2.21)	(629)	(2.62)	(255)	(1.02)	(1,789)	(1.90)
Marketing fees	(174)	(0.88)	(186)	(0.74)	(103)	(0.43)	(159)	(0.63)	(622)	(0.66)
Royalties (Canada)	(5)	(0.03)	(5)	(0.01)	(104)	(0.43)	(143)	(0.57)	(257)	(0.27)
Operating expenses	(1,404)	(7.12)	(1,545)	(6.12)	(1,672)	(6.96)	(2,098)	(8.35)	(6,719)	(7.14)
Netback from Operations	\$1,874	\$9.50	\$4,139	\$16.40	\$5,292	\$22.00	\$4,733	\$18.81	\$16,038	\$17.04

	2004									
	First Quarter		Second Quarter		Third Quarter		Fourth Quarter		Year	
Daily Sales:										
Oil (bbls/d)	1,735		1,794		2,092		2,206		1,961	
Natural gas (mcf/d)	24		210		60		192		102	
Total BOE (boe/d)	1,739		1,829		2,102		2,238		1,978	
		<u>\$/boe</u>		<u>\$/boe</u>		<u>\$/boe</u>		<u>\$/boe</u>		<u>\$/boe</u>
Gross revenue	\$4,459	\$28.18	\$5,400	\$32.45	\$6,743	\$34.87	\$5,790	\$28.12	\$22,392	\$30.93
Production entitlement										
– GPC (Egypt)	(862)	(5.45)	(1,027)	(6.18)	(1,272)	(6.58)	(1,978)	(9.62)	(5,139)	(7.09)
Marketing fees	(100)	(0.63)	(141)	(0.85)	(124)	(0.64)	(161)	(0.78)	(526)	(0.73)
Royalties (Canada)	(6)	(0.04)	(21)	(0.12)	(12)	(0.06)	(25)	(0.12)	(64)	(0.09)
Operating expenses	(858)	(5.43)	(1,026)	(6.16)	(961)	(4.97)	(1,296)	(6.29)	(4,141)	(5.72)
Netback from Operations	\$2,633	\$16.63	\$3,185	\$19.14	\$4,374	\$22.62	\$2,330	\$11.31	\$12,522	\$17.30

	2003									
	First Quarter		Second Quarter		Third Quarter		Fourth Quarter		Year	
Daily Sales:										
Oil (bbls/d)	1,129		896		865		1,648		1,135	
		<u>\$/boe</u>		<u>\$/boe</u>		<u>\$/boe</u>		<u>\$/boe</u>		<u>\$/boe</u>
Gross revenue	\$3,239	\$31.88	\$1,837	\$22.53	\$2,086	\$26.22	\$4,076	\$26.89	\$11,238	\$27.13
Production entitlement										
– GPC (Egypt)	(638)	(6.29)	(380)	(4.66)	(443)	(5.56)	(752)	(4.97)	(2,213)	(5.34)
Marketing fees	(37)	(0.36)	(27)	(0.33)	(27)	(0.34)	(48)	(0.32)	(139)	(0.34)
Royalties (Canada)	-	-	-	-	-	-	12	0.08	12	0.03
Operating expenses	(1,253)	(12.34)	(702)	(8.61)	(697)	(8.76)	(573)	(3.78)	(3,225)	(7.78)
Netback from Operations	\$1,311	\$12.89	\$728	\$8.93	\$919	\$11.56	\$2,715	\$17.90	\$5,673	\$13.70

Average sales for 2005 were 2,579 boe/d, up 30% from 1,978 boe/d during 2004. Gross revenue from oil sales for 2005 increased to \$34.9 million (\$37.07/boe), before royalties and related credits. For the year ended December 31, 2004, Rally Energy reported gross revenue of \$22.4 million (\$30.93/boe). The revenue increase is attributable to additional sales from the Issaran oilfield in Egypt, supplemented by Canadian oil and natural gas sales, along with higher commodity prices. The impact of sales from new wells drilled in the Issaran field during 2005 more than offset natural reservoir declines, resulting in a proved reserves replacement ratio of 16. Fourth quarter 2005 sales averaged 2,733 boe/d with reported revenue of \$10.0 million (\$39.85/boe), a 73% increase from 2,238 boe/d and revenue of \$5.8 million (\$28.12/boe) reported for the fourth quarter of 2004.

Netback from operations represents gross revenue after satisfying all royalty burdens (including GPC's production entitlement), marketing fees and operating costs. For 2005, Rally Energy's netback was \$16.0 million (\$17.04/boe), as compared to the 2004 netback of \$12.5 million (\$17.30/boe). The netback for the fourth quarter of 2005 was \$4.7 million (\$18.81/boe), a significant increase from \$2.3 million (\$11.31/boe) for the corresponding 2004 fourth quarter. During the fourth quarter of 2004, an increased price differential between Brent oil prices and the heavier Ras Gharib blend prices lead to a reduction in realized wellhead oil price. This differential improved throughout 2005 resulting in the Issaran wellhead price averaging 54% of the Brent oil price (2004 - 62%). Netback from operations is also impacted by changes in GPC's production entitlement under the PSA and by marketing fees and operating expenses, as discussed below.

Effective July 1, 2004, a revised pricing agreement was negotiated for all oil sales from the Issaran oilfield in Egypt for a five-year period ending June 30, 2009. Previously, the realized oil sales price represented 80% of the Ras Gharib blend price. Under the new pricing formula, for average monthly sales less than 2,000 bbls/d, the Corporation's realized oil price is 82% of the Ras Gharib blend price. For incremental monthly sales between 2,001 and 3,000 bbls/d, the realized oil sales price increases to 85% of the Ras Gharib blend price. The realized sales price increases again to 88% of the Ras Gharib blend price for incremental monthly sales that exceed 3,000 bbls/d.

Production Entitlements, Marketing Costs and Royalties

Under the terms of the Issaran oilfield PSA, as amended, GPC is entitled to certain varying amounts of Issaran oilfield production. Historically, GPC's share has been 15% of production from wells drilled subsequent to the PSA commencement ("new wells") and is currently 55% of production from the nine wells that existed prior to the PSA. This payment satisfies the Corporation's entire tax liability for Issaran oil production in Egypt. The sharing ratio for new wells changes relative to oil production level and project cost recovery, as shown below:

<u>Oil Production Level (bbls/d)</u>	<u>Scimitar Egypt Interest Before Payout⁽¹⁾</u>	<u>Scimitar Egypt Interest After Payout⁽¹⁾</u>
Up to 3,146	85.0 %	73.0 %
3,147 to 6,292	82.5 %	70.5 %
6,293 to 9,438	78.0 %	64.0 %
9,439 to 12,584	76.0 %	62.0 %
12,585 to 18,876	67.5 %	52.0 %
18,877 to 25,168	57.0 %	43.0 %
Over 25,169	44.5 %	33.5 %

⁽¹⁾ Payout is defined as the point in time when 85% of all revenues, after taxes, received by Scimitar Egypt equates to the total of all GPC approved costs directly related to developing the Issaran oilfield.

For the year ended December 31, 2005, GPC payments totalled \$9.4 million (\$10.06/bbl), representing 27% of gross revenue. For the corresponding 2004 period, GPC payments were \$5.1 million (\$7.18/bbl), representing 23% of gross revenue. For the fourth quarter of 2005, the GPC entitlement increased to \$2.6 million (26%) from \$2.0 million (34%) for the comparable 2004 quarter. The average GPC entitlement from all wells, at current production levels, is 30% on a post-payout basis. Based on GPC-approved costs, payout was achieved in September 2004 and, accordingly GPC's portion of the Issaran revenue associated with wells drilled since 1999 increased to 27% (at current production levels) from 15%.

Effective January 1, 2005, the Corporation is required to make revenue-based royalty payments from the Issaran Oilfield to Gemini Oil and Gas Limited, an independent oil and gas investment fund. The revenue-based royalty of 10% (to a maximum of US\$1.5 million in each of 2005 and 2006) is reduced to 2.6% of Issaran oil revenues (net of marketing fees and GPC entitlements, derived from a maximum of 7,000 bbls/d of production) once aggregate royalties of US\$3.0 million have been paid, and will continue until December 31, 2012. Royalty payments for 2005 were \$1.8 million (US\$1.5 million) (\$1.90/boe), representing 5% of gross revenue (2004 - nil).

Pursuant to the terms of certain marketing agreements pertaining to Issaran oil sales, marketing fees, linked to realized oil prices and production, of \$622,000 (\$0.66/boe) were paid during 2005 as compared to \$526,000 (\$0.73/boe) for 2004. Marketing fees paid for the fourth quarter ended December 31, 2005 were \$159,000 (\$0.63/boe) and \$161,000 (\$0.78/boe) for the comparable 2004 period. Marketing fees are included in royalties and related credits on the consolidated statements of income and deficit.

Royalties incurred on the Canadian properties are reported net of the Alberta Royalty Tax Credit and are commensurate with the higher revenues realized in 2005. For 2005, total Canadian-property royalties were \$0.3 million representing \$0.27/boe (2004 - \$64,000; \$0.09/boe).

Operating Expenses

Operating expenses for 2005 were \$6.7 million (\$7.14/boe) as compared to \$4.1 million (\$5.72/boe) for 2004. Operating expenses were \$2.1 million (\$8.35/boe) in the fourth quarter of 2005 compared to \$1.3 million (\$6.29/boe) for the same period in 2004. On an overall basis, costs have increased commensurate with the higher oil production in 2005. A significant contributor to higher operating expenses was higher diesel fuel costs which fluctuate in accordance with oil commodity prices. Diesel fuel is used to power electricity generators for field operations in our Issaran oilfield. Rally Energy expects to realize lower operating costs in 2006 as it switches to utilize natural gas from nearby sources as an alternative to diesel fuel for generators. Also included in the 2005 operating expense amount is \$246,000 (2004 - \$73,000) of costs pertaining to Canadian production.

For the year ended December 31, 2005, operating expenses represent 19% of gross revenue as compared to 18% for the prior year. On a per-unit basis, higher oil sales can reasonably be expected to continue at lower per-unit costs since increased production can still be accommodated within our existing fixed cost structure.

General and Administrative Expenses

(thousands of dollars, unless otherwise stated)

	<u>Total</u>	<u>Capitalized</u>	<u>Expensed</u>	<u>\$/boe</u>
2005				
Canada	\$ 4,077	\$ (625)	\$ 3,452	\$3.67
Egypt	1,517	-	1,517	1.61
Pakistan	410	(313)	97	0.10
Total	<u>\$ 6,004</u>	<u>\$ (938)</u>	<u>\$ 5,066</u>	<u>\$5.38</u>
2004				
Canada	\$ 2,954	\$ (479)	\$ 2,475	\$3.42
Egypt	1,077	-	1,077	1.49
Pakistan	269	(15)	254	0.35
Total	<u>\$ 4,300</u>	<u>\$ (494)</u>	<u>\$ 3,806</u>	<u>\$5.26</u>
2003				
Canada	\$ 2,229	\$ (345)	\$ 1,884	\$4.55
Egypt	1,027	-	1,027	2.48
Pakistan	557	(427)	130	0.31
Total	<u>\$ 3,813</u>	<u>\$ (772)</u>	<u>\$ 3,041</u>	<u>\$7.34</u>

Consolidated general and administrative ("G&A") expenses were \$5.1 million (\$5.38/boe) for 2005 as compared to \$3.8 million (\$5.26/boe) for 2004, with the increase primarily attributable to higher labour costs resulting from staff additions and annual wage increases. Non-cash expenses related to the valuation of share options granted during 2005 were \$1.4 million as compared to \$0.5 million for 2004. Additional share options granted during 2005 and the higher valuation determination for the options lead to the increase. For the quarter ended December 31, 2005, consolidated G&A expenses were \$2.1 million (\$8.23/boe) as compared to \$1.1 million (\$5.35/boe) for the comparable 2004 quarter.

Rally Energy capitalizes those portions of G&A expenses that relate to exploration projects in Pakistan and Canada. Currently, all G&A costs related to Egypt are associated with development activities and, accordingly, to date none have been capitalized. During 2005, \$938,000 (16%) of G&A costs were capitalized. For the comparative 2004 period, the Corporation capitalized \$494,000 (11%) of G&A costs.

General and administrative costs associated with our Pakistan activities during 2005 totalled \$0.4 million (2004 - \$0.3 million) of which \$0.1 million (2004 - \$0.3 million) has been expensed. These costs increased in 2005 commensurate with the higher activity level in Pakistan.

Interest and Finance Charges

(thousands of dollars, unless otherwise stated)

	2005	2004	2003
Interest expense	\$ 629	\$ 828	\$ 502
Accretion expense on debentures	189	144	78
Amortization of deferred charge	77	144	78
Total expense	895	1,116	658
Interest income	37	50	92
Gain (loss) on foreign exchange	(24)	(129)	92
Gain on asset disposition	92	5	-
Total income (expense)	105	(74)	184
Net expense	\$ 790	\$ 1,190	\$ 474
\$/boe	\$0.84	\$1.64	\$1.14

Total interest and finance charges decreased to \$0.8 million during 2005 from \$1.2 million in 2004. On a quarterly basis, net interest and finance charges were \$45,000 for the fourth quarter of 2005, as compared to \$295,000 for the fourth quarter of 2004. During 2005, \$4.7 million of the Corporation's 12% unsecured convertible debentures were converted into common shares at \$1.00/share. This resulted in a lower interest expense associated with the debentures, partially offset by increased utilization of the bank credit facility. Included in the 2005 amount is \$266,000 (2004 - \$288,000) of non-cash charges pertaining to the conversion of convertible debentures issued in 2003. Additional details are disclosed in Note 6 of the consolidated financial statements. In the normal course of business, the Corporation earned interest from invested funds and recorded foreign exchange gains (losses) as applicable.

Depletion, Depreciation and Accretion

(thousands of dollars, unless otherwise stated)

	2005	2004	2003
Depletion, depreciation and accretion	\$ 8,371	\$ 6,288	\$ 6,146
\$/boe	\$8.89	\$8.69	\$14.84

Total depletion, depreciation and accretion ("DD&A") charges for 2005 were \$8.4 million (\$8.89/boe), of which depletion pertaining to producing properties in Egypt represented \$5.3 million. The remainder represents depletion charges of \$2.5 million for Canadian production, fixed asset depreciation of \$588,000 and \$23,000 for accretion of asset retirement obligations. No depletion was recorded for the Pakistan assets as they are in the pre-production stage. DD&A charges for 2004 were \$6.3 million (\$8.69/boe). On a quarterly basis, the 2005 fourth quarter DD&A was \$2.2 million (\$8.88/boe) as compared to (\$0.2) million ((\$1.00)/boe) for the 2004 fourth quarter; the 2004 amount reflected an adjustment of depletion from estimates in previous quarters.

The significant increase in our proved reserve base at December 31, 2005, as evaluated by DeGolyer and MacNaughton Canada Limited, an independent reservoir evaluation firm, coupled with the anticipated future capital requirements has resulted in a consistent consolidated DD&A rate (2005 - \$8.89/boe; 2004 - \$8.69/boe). DD&A also includes the depletion of the asset retirement obligation included in property and equipment and accretion expense related to the corresponding liability.

Capital Expenditures

In 2005, Rally Energy drilled 22 wells (18 net); 15 (15 net) at the Issaran oilfield in Egypt, two (0.5 net) in Pakistan and five (2.7 net) in Canada. Capital expenditures totalled \$22.7 million during 2005, up from \$11.6 million in 2004.

(thousands of dollars)	2005	2004	2003
Egypt			
Drill, complete and workovers	\$13,284	\$11,397	\$6,127
Seismic, evaluation and other	1,477	807	818
Inventory change	1,251	(616)	799
Property acquisition (disposition)	-	(3,923)	-
Capitalized admin. costs	-	-	-
Total	\$16,012	\$7,665	\$7,744
Canada			
Drill, complete and workovers	\$3,652	\$2,992	\$2,915
Seismic, evaluation and other	386	564	912
Property acquisition (disposition)	424	(170)	-
Capitalized admin. Costs	625	479	345
Total	\$5,087	\$3,865	\$4,172
Pakistan			
Drill, complete and workovers	\$1,221	-	-
Seismic, evaluation and other	36	\$11	\$67
Capitalized admin. costs	312	15	427
Total	\$1,569	\$26	\$494
Grand Total			
Drill, complete and workovers	\$18,157	\$14,389	\$9,042
Seismic, evaluation and other	1,899	1,382	1,797
Inventory change	1,251	(616)	799
Property acquisition (disposition)	424	(4,093)	-
Capitalized admin. costs	937	494	772
Total	\$22,668	\$11,556	\$12,410

The 2005 drilling and workover activities in Egypt resulted in increased oil sales and higher oil reserves. In Pakistan, the two well re-entries during 2005 resulted in a Commerciality Declaration based on the significant natural gas reserves assigned that will be on-stream in 2006. Canadian activities were focused on existing areas and satisfied all but \$614,000 of flow-through share renunciation requirements which must be met prior to the end of 2006. Included in the above amounts are casing and tubing inventory costs of \$1.8 million at December 31, 2005 (2004 - \$0.6 million) to be used in future Issaran drilling programs.

On February 24, 2005, the Corporation completed a transaction with Shannon International Resources Inc. ("Shannon"), whereby the Corporation disposed of its remaining interests in the Prince Edward Island project in exchange for 2.5 million common shares and 500,000 warrants, exercisable at US\$0.85 per share with a term of one year, of Shannon. At December 31, 2004 the value associated with the Shannon equity instruments received, after taking into account required hold periods, fair value discounts and transaction costs, was estimated at \$650,000. These assets were written down to \$150,000 on September 30, 2005. At December 31, 2005, the valuation was reviewed, and it was determined that the assets should continue to be carried at \$150,000.

Liquidity and Capital Resources

At December 31, 2005, Rally Energy had a cash position of \$0.8 million, as compared to \$0.4 million at December 31, 2004. Working capital at December 31, 2005 was \$0.7 million, as compared to a working capital shortfall of \$0.3 million at December 31, 2004. In addition, the US\$7 million credit facility remained available at December 31, 2005. Increased drilling activity in Egypt during the fourth quarter resulted in a higher level of accounts payable at year end. Additionally, accounts receivable are higher as a result of increased sales levels. The Corporation's remaining \$1.3 million of convertible debentures mature on July 1, 2006 and, accordingly, are classified as short term liabilities.

On October 14, 2005, Rally Energy commenced trading on the Toronto Stock Exchange ("TSX"). This migration from the TSX Venture Exchange is expected to increase the liquidity of the Corporation's shares by appealing to a broader investor audience.

On December 19, 2005, the Corporation issued 8,000,000 units priced at \$1.25 per unit for gross proceeds of \$10.0 million. Each unit consisted of one common share and one-half of a common share purchase warrant. Each full warrant is exercisable for \$1.60 per common share on or before December 19, 2006. If, at any time after June 19, 2006, the Corporation's common shares close at or above \$1.80 per share for ten consecutive trading days, the Corporation can accelerate the expiry date of the warrants with 15 days notice.

During 2005, Rally Energy received proceeds of \$1.3 million from the exercise of an aggregate 2.1 million common share options at an average price of \$0.60/share. On May 13, 2005, the Corporation realized gross proceeds of \$2.0 million from a private placement of 1.1 million flow-through common shares issued at \$1.80/share. Net proceeds were \$1.9 million, after payment of commissions and transaction fees. On August 2, 2005, Rally Energy realized proceeds of \$1.0 million from a non-brokered private placement of 732,000 common shares issued at \$1.32/share. Insiders of the Corporation subscribed for 69,555 common shares (\$125,199) and 155,000 common shares (\$204,600) of these placements, respectively.

During 2005, \$4.7 million of the 12% unsecured convertible subordinated debentures were converted into common shares at the prescribed rate of \$1.00/share, leaving a balance of \$1.3 million at December 31, 2005, down from \$6.0 million at December 31, 2004. The outstanding debentures are currently convertible, at the option of the holder, into common shares at a conversion price of \$1.10 per common share at any time prior to their maturity on July 1, 2006. The Corporation may redeem the debentures at any time at par, in whole or in part, if the closing price of the Corporation's common shares is at or above \$2.00 for 30 consecutive days. The debentures require semi-annual interest payments (January and July) and Rally Energy has accrued \$107,000 at December 31, 2005, on account of interest expenses, primarily related to the convertible debentures.

On October 31, 2005, the Corporation increased its credit facility with a major Canadian bank, secured by trade receivables insurance provided by Export Development Canada (EDC) to US\$7.0 million. Funds drawn on this facility bear interest at the US prime rate and a standby fee of 0.25% per annum applies to the unused portion of the facility. At December 31, 2005, the entire credit facility remained available.

As previously announced on November 28, 2005, Rally Energy has formally entered into negotiations with the International Finance Corporation ("IFC") (a member of the World Bank Group) for provision of long-term financing of up to US\$25 million, including reserve-based credit facilities, to fund upcoming capital requirements and working capital needs for the Egypt and Pakistan projects. Subject to ongoing discussions with the IFC and completion of all required documentation for approval, it is expected that this facility will be finalized by April 30, 2006.

At December 31, 2005, a \$705,000 future income tax asset has been recorded to offset the Corporation's required flow-through share renunciation requirements. The Corporation is required to expend additional qualifying expenditures of \$614,413 prior to December 31, 2006 to meet its commitments under the flow-through agreements.

Rally Energy expects to generate sufficient cash flow from operations to meet its ongoing commitments. In addition to internally generated sources, additional funds may be required from time-to-time to fund exploration and development activities. General market conditions in effect at the time additional funds are sought could impact on the Corporation's ability to raise additional funds either in equity or debt form.

Reserves

At December 31, 2005, Rally Energy's reserves were evaluated by the independent engineering firm of DeGolyer and MacNaughton Canada Limited. The 2005 drilling program resulted in significant reserves additions in Egypt and Pakistan, as compared to 2004. Additional details on the Corporation's reserves can be viewed in the "Statement of Reserves Data and Other Oil and Gas Information" report available at www.sedar.com and www.rallyenergy.com.

Reserves Reconciliation			
(company interest reserves before royalties, barrels of oil equivalent)			
	Proved Producing	Total Proved	Total Proved & Probable
Egypt:			
Opening balance	3,080,400	3,967,076	7,260,559
Additions/revisions	197,419	6,961,562	28,900,691
Sales	(890,070)	(890,070)	(890,070)
Closing balance	2,387,749	10,038,568	35,271,180
Pakistan:			
Opening balance	-	-	-
Additions	-	8,327,579	9,778,833
Sales	-	-	-
Closing balance	-	8,327,579	9,778,833
Canada:			
Opening balance	4,557	387,638	807,997
Additions/revisions	234,830	(58,513)	(141,601)
Sales	(3,846)	(51,354)	(51,354)
Closing balance	235,541	277,771	615,042
Consolidated:			
Opening balance	3,084,957	4,354,714	8,068,556
Additions/revisions	432,249	15,230,628	38,537,923
Sales	(893,916)	(941,424)	(941,424)
Closing balance	2,623,290	18,643,918	45,665,055

The valuation associated with these reserves and the finding costs, on both a Proved and Proved plus Probable basis, are summarized below:

Net Present Value at 5%			
(thousands of dollars before taxes)			
	Proved Producing	Total Proved	Total Proved & Probable
At December 31, 2005:			
Egypt	\$29,291	\$87,751	\$305,780
Pakistan	-	46,615	58,530
Canada	10,742	11,684	20,519
Total	\$40,033	\$146,050	\$384,829

Net Present Value at 10%			
(thousands of dollars before taxes)			
	Proved Producing	Total Proved	Total Proved & Probable
At December 31, 2005:			
Egypt	\$26,703	\$72,159	\$214,520
Pakistan	-	25,234	33,004
Canada	9,503	10,365	16,101
Total	\$36,206	\$107,758	\$263,625

Finding & Development Costs

(thousands of dollars, unless otherwise stated)

	2005 Capital Expenditures	Change in Future Capital	Total Capital	Reserve Additions (boe)	Finding & Development Cost (\$/boe)
Egypt					
Proved reserves	\$16,142	\$ 24,460	\$ 40,602	6,961,562	\$5.83
Proved & probable	\$16,142	\$ 96,252	\$112,394	28,900,691	\$3.89
Pakistan					
Proved reserves	\$ 1,612	\$ 11,859	\$ 13,471	8,327,579	\$1.62
Proved & probable	\$ 1,612	\$ 4,664	\$ 6,276	9,778,833	\$0.64
Canada					
Proved reserves	\$ 5,225	\$ (607)	\$ 4,618	(58,513)	\$(78.92)
Proved & probable	\$ 5,225	\$ (621)	\$ 4,604	(141,601)	\$(32.51)
Consolidated					
Proved reserves	\$22,979	\$ 35,712	\$ 58,691	15,230,628	\$3.85
Proved & probable	\$22,979	\$100,295	\$123,274	38,537,923	\$3.20

Business Risks and Uncertainties

Rally Energy is in the business of exploring for, developing and producing oil and natural gas. The Corporation has production operations in Egypt and Canada, as well as pre-production and exploration activities in Pakistan. Along with the competitive nature of the oil and gas industry, risk exposures, some of which are beyond the control of the Corporation, can be categorized as operational, political, regulatory, environmental and financial.

The long-term commercial success of Rally Energy depends on its ability to find, acquire, develop and commercially produce oil and natural gas reserves. Oil and natural gas exploration involves a high degree of risk and there is no assurance that expenditures made on future exploration by the Corporation will result in new discoveries of oil or natural gas in commercial quantities. It is difficult to project the costs of implementing an exploratory drilling program due to the inherent uncertainties of drilling in unknown formations, the costs associated with encountering various drilling conditions and changes in drilling plans and locations as a result of prior exploratory wells or additional seismic data and interpretations thereof.

The process of evaluating prospects and estimating oil and natural gas reserves is complex and subject to uncertainty. Actual operating results, including production performance, may vary from those estimated, possibly materially. Rally Energy manages these risks by having operational control, where possible, and working interests commensurate with the assessed risk in each project and by hiring qualified professionals, including independent reserves engineers, with appropriate industry experience. The Corporation focuses the majority of its activities on exploitation of existing reservoirs.

Some of the Corporation's operations and related assets are located in countries which carry a higher degree of political and economic risk. Rally Energy's management has considerable expertise operating internationally and has developed solid, long-term relationships within each of the jurisdictions in which it operates. The Corporation adheres to all governmental and environmental regulations as they apply in each operating jurisdiction. Regulation changes could increase costs of the Corporation's operations.

Rally Energy's production base is heavily weighted to heavy oil produced in Egypt which is subject to pricing based on international oil price fluctuations. Oil and natural gas are commodities whose prices have fluctuated widely in recent years and are determined based on world demand, supply and other factors, all of which are beyond the control of the Corporation.

Rally Energy maintains an insurance program which is consistent with industry practice to provide adequate coverage of drilling, operations, safety and the environment.

Sensitivities

The Corporation's cash flow is sensitive to changes in production, commodity prices and currency exchange rates. The expected annual impact, based on the 2005 fourth quarter information, is:

(thousands of dollars, unless otherwise stated)

	Variance in Cash Flow	Variance in Cash Flow per share
Oil Price ⁽¹⁾	\$318	\$0.0040
Oil Production ⁽²⁾	\$296	\$0.0037
Foreign Currency ⁽³⁾	\$155	\$0.0020

⁽¹⁾ change of US\$1/boe

⁽²⁾ change of 100 boe/d

⁽³⁾ \$0.01 change in CDN\$ in relation to US\$

Off Balance Sheet Items

There are no off balance sheet assets or liabilities.

Related Party Transactions

Transactions between the Corporation and related parties occurred during the year, as disclosed in Note 9 to the consolidated financial statements. During 2005, the Corporation paid \$1.0 million as consulting fees to related parties. All such transactions were in respect of technical and specialized services rendered in the normal course of business operations and represent consideration established and agreed to by the related parties which is similar to those negotiated with third parties. Certain of the payments relate to services provided on an as-needed basis; ongoing contractual commitments with related parties are currently \$33,000 per month.

Contractual Obligations

(thousands of dollars)

	Payments Due by Period			Total
	Less Than 1 Year	1-5 Years	After 5 Years	
Convertible debentures ⁽¹⁾	\$1,314	-	-	\$1,314
Office lease	108	-	-	108
Asset retirement obligations ⁽²⁾	-	-	\$933	933

⁽¹⁾ See Note 6 to the consolidated financial statements.

⁽²⁾ See Note 11 to the consolidated financial statements.

CRITICAL ACCOUNTING ESTIMATES

Rally Energy's significant accounting policies are disclosed in Note 2 to the consolidated financial statements. Certain accounting policies require that management make appropriate decisions with respect to the formulation of estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. The following discusses such accounting policies and is included in the MD&A to assist the reader in assessing our critical accounting policies and practices and the likelihood of materially different results being reported. As management, we review estimates regularly. The emergence of new information and changed circumstances, including accounting standards, may result in actual results or changes to estimated amounts that differ materially from current estimates.

Reserves Determination

The petroleum and natural gas reserves used in determining our depletion rates and the ceiling test are based upon management's best estimates, and are subject to uncertainty. Through the use of geological, geophysical and engineering data, the reservoirs and deposits of petroleum and natural gas are examined to determine quantities available for future production, given existing operating and economic conditions and technology. The evaluation of recoverable reserves is an ongoing process impacted by current production, continuing development activities and changing economic conditions as reflected in crude oil and natural gas prices and costs. Consequently, the reserves are estimates which are subject to variability. We employ the services of independent oil and gas reservoir engineers (DeGolyer and MacNaughton Canada Limited) to assist with the reserve evaluation process.

Full Cost Accounting for Oil and Gas Activities

Rally Energy uses the full cost method of accounting for exploration and development activities. In accordance with this method of accounting, all costs associated with exploration and development, are capitalized whether successful or not. The aggregate of net capitalized costs and estimated future development costs is amortized using the unit-of-production method based on estimated proved oil and gas reserves before royalties, as determined by qualified independent petroleum evaluation engineers. Accordingly, changes in estimated proved oil and gas reserves and estimated future development costs would result in changes to the depletion rate.

Certain costs related to unproved properties and major development projects may be excluded from costs subject to depletion until proved reserves have been determined or their value is impaired. These properties are assessed periodically and any impairment is transferred to the costs subject to depletion.

Asset Impairments

Under full cost accounting, a ceiling test is performed to ensure that unamortized capitalized costs in each cost centre (country) do not exceed their fair value. Impairment is recognized when the carrying value is greater than the undiscounted future cash flows. In the event of impairment, the amount by which the carrying value exceeds the estimated fair value of the long-lived asset is charged to earnings. Fair value is determined using expected future product prices and costs, and amounts are discounted using a risk-free interest rate. At December 31, 2005 the impairment test was met for the Egyptian, Pakistan and Canadian capitalized costs and no ceiling test write-down was required.

Asset Retirement Obligations

The fair value of the future retirement obligation is discounted to present value and is recorded as an increase to the related property and equipment with the corresponding balance recorded as a future asset retirement obligation. The increased asset value is amortized according to our policies for property and equipment and the future liability is accreted to expense until the future retirement obligation is expected to be settled.

Stock-Based Compensation

The Corporation uses the fair value method for valuing stock option grants. Under this method, compensation cost attributable to all stock options granted is measured at fair value at the grant date, using the Black-Scholes valuation model, and expensed over the vesting period with a corresponding increase to contributed surplus. Upon exercise of options, consideration received together with the amount previously recognized in contributed surplus is recorded as an increase to share capital.

Accounting for Derivative Instruments and Hedging Activities

Rally Energy has not entered into any hedging arrangements.

Income Tax Accounting

The determination of the Corporation's income and other tax liabilities requires interpretation of complex laws and regulations often involving multiple jurisdictions. All tax filings are subject to audit and potential reassessment after the lapse of considerable time. Accordingly, the actual income tax liability may differ significantly from that estimated and recorded by management.

Legal, Environmental Remediation and Other Contingent Matters

Rally Energy is required to both determine whether a loss is probable, based on judgment and interpretation of laws and regulations, and determine that the loss reasonably be estimated and included in the Corporation's financial statements. Management continually monitors known and potential contingent matters and makes appropriate provisions by charges to earnings when warranted by circumstances.

Disclosure Controls and Procedures

Disclosure controls and procedures have been designed to ensure that information required to be disclosed by the Corporation is accumulated and communicated to the Corporation's management as appropriate to allow timely decisions regarding required disclosures. The Corporation's Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") have concluded, based on their evaluation as of the end of the period covered by this MD&A, that the Corporation's disclosure controls and procedures are effective to provide reasonable assurance that material information related to the Corporation, including its consolidated subsidiaries, is made known to them by others within those entities. It should be noted that while the Corporation's CEO and CFO believe that the Corporation's disclosure controls and procedures provide a reasonable level of assurance that they are effective, they do not expect that the disclosure controls and procedures or internal control over financial reporting will prevent all errors and fraud. A control system, no matter how well conceived or operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met.

2006 OUTLOOK

A planned 22 well drilling program, combined with a continuation of steam pilots, is expected to convert probable reserves to the proved category and to increase production from our significantly increased 2005 Egypt oil reserves. Production from existing wells will continue to be enhanced through the installation of high performance pumps and through an on-going well optimization program. The Corporation has submitted bids on concessions contiguous to our existing acreage holdings which, if successful, will further enhance opportunities for reserves and production growth in Egypt.

In Pakistan, the 2005 drilling program led to a sizable independent recognition of natural gas reserves and associated condensate. The January 2006 "Commerciality Declaration" has now created an opportunity to proceed with construction of a tie-in pipeline. Sales are expected to commence in the latter half of 2006. Additionally, two development wells are expected to be drilled on the Rodho discovery structure to increase deliverability from the recognized recoverable reserves and to test deeper reservoir horizons.

Rally Energy Corp.
Consolidated Balance Sheets

As at December 31	2005	2004
Assets		
Current		
Cash	\$ 801,639	\$ 358,245
Accounts receivable	8,906,244	6,503,769
Cash calls receivable	-	104,499
Notes receivable (Note 3)	-	740,270
Inventory (Note 5)	305,061	540,447
Prepaid expenses and deposits	468,943	266,361
	<u>10,481,887</u>	<u>8,513,591</u>
Future income tax asset (Note 10)	705,000	-
Long-term investments (Note 4)	150,000	650,000
Property and equipment (Note 5)	48,334,494	33,737,226
Deferred charges (Note 6)	26,440	215,466
	<u>\$ 59,697,821</u>	<u>\$ 43,116,283</u>
Liabilities and Shareholders' Equity		
Current		
Accounts payable – operations	\$ 4,572,583	\$ 3,137,551
Accounts payable – capital	3,922,935	5,053,800
Convertible debentures (Note 6)	1,287,555	-
Cash call obligations	-	184,478
Deferred revenue (Note 3)	-	483,000
	<u>9,783,073</u>	<u>8,858,829</u>
Asset retirement obligations (Note 11)	590,382	289,846
Convertible debentures (Note 6)	-	5,784,486
	<u>10,373,455</u>	<u>14,933,161</u>
Shareholders' equity		
Equity instruments (Note 8(b))	56,249,969	37,554,329
Contributed surplus (Note 8(g))	1,968,082	1,063,620
Deficit	(8,893,685)	(10,434,827)
	<u>49,324,366</u>	<u>28,183,122</u>
	<u>\$ 59,697,821</u>	<u>\$ 43,116,283</u>
Commitments (Note 12)		

The accompanying notes are an integral part of the consolidated financial statements

Rally Energy Corp.
Consolidated Statements of Income and Deficit

For the years ended December 31	2005	2004
Oil and natural gas revenue	\$ 34,898,825	\$ 22,391,915
Less: Royalties and related credits	<u>(12,141,874)</u>	<u>(5,728,576)</u>
	22,756,951	16,663,339
Operating expenses	<u>6,719,395</u>	<u>4,140,915</u>
	<u>16,037,556</u>	<u>12,522,424</u>
Expenses		
Administrative expenses:		
Legal, professional and audit	400,410	286,936
Shareholder reporting and communication	151,709	143,883
Administration	2,980,445	2,492,812
Pakistan administrative costs	97,821	254,576
Project evaluation costs	-	158,822
Stock-based compensation	<u>1,435,925</u>	<u>468,881</u>
	5,066,310	3,805,910
Interest expense	629,353	828,652
Depletion, depreciation and accretion	8,371,352	6,287,912
Accretion expense on convertible debentures	189,069	143,676
Amortization of deferred charge	<u>76,381</u>	<u>143,640</u>
	<u>14,332,465</u>	<u>11,209,790</u>
Income before other items and taxes	<u>1,705,091</u>	<u>1,312,634</u>
Other items		
Interest income	36,899	50,125
Loss on foreign exchange	(24,429)	(129,272)
Write-down of assets held for sale (Note 4)	(500,000)	-
Other recoveries, net	<u>92,581</u>	<u>5,003</u>
	<u>(394,949)</u>	<u>(74,144)</u>
Income before taxes	1,310,142	1,238,490
Future income tax recovery (Note 10)	<u>231,000</u>	<u>-</u>
Net income for the year	1,541,142	1,238,490
Deficit, beginning of year	<u>(10,434,827)</u>	<u>(11,673,317)</u>
Deficit, end of year	<u>\$ (8,893,685)</u>	<u>\$ (10,434,827)</u>
Income per share (Note 8(h))		
Basic	\$0.019	\$0.017
Diluted	\$0.018	\$0.016

The accompanying notes are an integral part of the consolidated financial statements

Rally Energy Corp.
Consolidated Statements of Cash Flows

For the years ended December 31	2005	2004
Cash flows from operating activities		
Net income for the year	\$ 1,541,142	\$ 1,238,490
Non-cash items:		
Future income taxes	(231,000)	-
Stock-based compensation	1,435,925	468,881
Accretion expense on convertible debentures	189,069	143,676
Amortization of deferred charges	76,381	143,640
Depletion, depreciation and accretion	8,371,352	6,287,912
Write-down of assets held for sale	500,000	-
Cash flow from operations	<u>11,882,869</u>	<u>8,282,599</u>
Changes in non-cash working capital balances		
Accounts receivable	(2,402,475)	(4,090,526)
Notes receivable	257,270	(88,708)
Inventory	235,386	(154,563)
Prepaid expenses and deposits	(202,582)	10,670
Accounts payable – operations	1,435,032	901,242
	<u>11,205,500</u>	<u>4,860,714</u>
Cash flows from investing activities		
Petroleum and natural gas assets, net	(22,668,084)	(15,648,863)
Proceeds from sale of petroleum and natural gas interests	-	4,093,045
Accounts payable – capital	(1,205,020)	2,552,068
Notes receivable	-	(168,562)
	<u>(23,873,104)</u>	<u>(9,172,312)</u>
Cash flows from financing activity		
Issuance of equity instruments, net	<u>13,116,822</u>	<u>2,428,685</u>
Foreign exchange loss on cash held in a foreign currency		
	<u>(5,824)</u>	<u>(19,268)</u>
Increase (decrease) in cash	443,394	(1,902,181)
Cash, beginning of year	<u>358,245</u>	<u>2,260,426</u>
Cash, end of year	<u>\$ 801,639</u>	<u>\$ 358,245</u>

The accompanying notes are an integral part of the consolidated financial statements

Rally Energy Corp.
Notes To Consolidated Financial Statements

December 31, 2005 and 2004

1. Nature of Operations

Rally Energy Corp. (the "Corporation") was incorporated on June 30, 1989 pursuant to the Ontario Business Corporations Act. Since inception, the Corporation's efforts have been devoted to the acquisition, exploration, and development of petroleum and natural gas properties. The Corporation is listed on the Toronto Stock Exchange (RAL) and the Frankfurt Stock Exchange (RLE).

Effective July 11, 2002, the Corporation completed the acquisition of Scimitar Hydrocarbons Corporation ("Scimitar") which has interests in oil production in Egypt and interests in natural gas properties in Pakistan. The Corporation has rights to certain oil and natural gas production in Egypt through a Petroleum Service Agreement ("PSA"), and in Pakistan through a Concession Agreement.

2. Significant Accounting Policies

The consolidated financial statements of the Corporation have been prepared by management in accordance with generally accepted accounting principles in Canada. The preparation of consolidated financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates. The consolidated financial statements have, in management's opinion, been properly prepared using careful judgment with reasonable limits of materiality and within the framework of the significant accounting policies summarized below.

(a) Principles of consolidation

The consolidated financial statements include the accounts of the Corporation and its wholly-owned subsidiaries.

(b) Property and equipment

The Corporation follows the full-cost method of accounting for oil and natural gas activities whereby all costs associated with the acquisition of, exploration for, and the development of oil and natural gas reserves are capitalized on a country by country basis in three cost centres, Canada, Egypt and Pakistan. Such costs include lease acquisitions, geological and geophysical expenditures, lease rentals on non-producing properties, drilling, equipment, and technical consulting directly related to exploration and development activities. Proceeds from sales of oil and natural gas properties are recorded as reductions of capitalized costs unless the reduction of capitalized costs results in a change of 20% or more in the depletion rate. In this case, a gain or loss would be recognized into income.

For each cost centres, the Corporation applies an impairment test ("ceiling test") to determine if capitalized costs are not recoverable and exceed their fair value. Capitalized costs are not recoverable if they are greater than estimated undiscounted cash flows from future production of proved reserves plus the cost (net of impairment) of unproved properties excluded from depletion. Commodity prices used in calculating estimated cash inflows are based on quoted benchmark prices in the futures market. Costs used in estimating cash outflows are based on expected future production and other costs. An impairment loss is recognized if capitalized costs are greater than their recoverable amount. The impairment loss is measured as the amount by which capitalized costs exceed the fair value of proved and probable reserves plus the cost (net of impairment) of unproved properties excluded from depletion. Fair value is determined based on the present value of future cash flows, after deducting abandonment and site restoration costs, discounted at a risk free interest rate, adjusted for prevailing market conditions. Any

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reduction of value, as a result of the ceiling test, is charged to operations in the period of impairment.

2. Significant Accounting Policies – continued

Depletion of petroleum and natural gas properties and amortization of well equipment is provided on a unit-of-production basis based on gross proved petroleum and natural gas reserves. Natural gas is converted to equivalent units of petroleum products at approximately six thousand cubic feet to one barrel of oil.

Costs of acquiring and evaluating unproved properties are initially excluded from depletion calculations. These unevaluated properties are assessed periodically to ascertain whether impairment has occurred. When reserves are assigned or the property is considered to be impaired, the cost of the property or the amount of the impairment is added to costs subject to depletion.

Capital assets are recorded at cost. Amortization is provided using a straight-line basis over the estimated useful lives of the assets at annual amortization rates of 10% to 30%.

(c) Asset retirement obligations

The Corporation recognizes the fair value of an asset retirement obligation ("ARO") in the period in which it is incurred and a reasonable estimate of the fair value can be made. The fair value of the estimated ARO is recorded as a long-term liability, with a corresponding increase in the carrying amount of property and equipment. The liability amount is increased each reporting period due to the passage of time and the amount of accretion is charged to earnings in the period. Revisions to the estimated undiscounted cost would also be an increase or decrease to the ARO. Actual costs incurred upon settlement of the ARO are charged against the ARO to the extent of the liability recorded. Any difference between the actual costs incurred upon settlement of the ARO and the recorded liability is recognized in the Corporation's earnings in the period in which the settlement occurs.

(d) Joint ventures

The Corporation's activities in Canada and Pakistan are conducted jointly with others. These consolidated financial statements reflect only the Corporation's participating share of revenue and expenditures on these petroleum and natural gas interests.

(e) Income taxes

The Corporation follows the liability method of accounting for income taxes. Under this method, the Corporation records future income taxes for the effect of any difference between the accounting and income tax basis of an asset or liability, using the substantively enacted income tax rates expected to apply in the period in which the asset or liability is realized. Accumulated future income tax balances are adjusted to reflect changes in income tax rates that are substantively enacted with the adjustment being recognized in earnings in the period that the change occurs. The Corporation does not provide for foreign withholding taxes on the undistributed earnings of its foreign subsidiaries, as the Corporation intends to invest such earnings indefinitely in foreign operations.

(f) Flow-through equity instruments

Expenditure deductions for income tax purposes related to exploratory activities funded by flow-through equity instruments are renounced to investors in accordance with income tax legislation. The Corporation provides for the future effect on income taxes related to flow-through equity instruments as a reduction of share capital and an increase in future income tax liabilities when the expenditures are renounced to subscribers at the effective date of renunciation.

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2. Significant Accounting Policies – continued

(g) Revenue recognition

For Egypt operations, title passes when the crude oil is delivered and accepted based on an agreed upon formula by the Egyptian General Petroleum Corporation (“EGPC”). When the Corporation produces more oil than that delivered, such production is recorded as inventory. In Canada, revenue is recognized when title passes from the Corporation to its customers. No revenue was derived from the Pakistan properties in 2005 or 2004. As is normal to the industry, the Corporation's oil production in Egypt and Canada is subject to royalties.

(h) Stock-based compensation

The Corporation accounts for its stock-based compensation plan using the fair value method. Under this method, a compensation cost is charged for stock options granted with a corresponding increase to contributed surplus. Upon exercise of the stock options, consideration paid, together with the amount previously recognized in contributed surplus is recorded as an increase to share capital.

(i) Financial instruments

The Corporation carries a number of financial instruments. It is management's opinion that the Corporation is not exposed to significant interest, currency or credit risks arising from these financial instruments. The fair values of these financial instruments approximate their carrying values, unless otherwise noted. The Corporation has not entered into any hedging relationships.

(j) Foreign currency translation

The Corporation uses the temporal method when translating foreign currency transactions as the financial statements of all its subsidiaries are considered to be integrated operations.

Under this method, monetary items denominated in a foreign currency are translated into Canadian dollars at the rate of exchange in effect at the balance sheet date and non-monetary items are translated at rates of exchange in effect when the assets were acquired or obligations incurred. Revenues and expenses are translated at rates in effect at the time of the transactions. Foreign exchange gains and losses are included in the determination of earnings.

(k) Measurement uncertainty

The amounts recorded for depletion and depreciation of property and equipment, the asset retirement obligations and the ceiling test calculation are based on estimates of reserves, production rates, commodity prices, future costs, foreign currency exchange rates and other relevant assumptions. By their nature, these estimates are subject to measurement uncertainty and the effect on the consolidated financial statements of changes in such estimates in future periods could be significant.

The financial statements include accruals based on the terms of existing joint venture agreements and the terms of the PSA. Due to varying interpretations of the definition of terms in these agreements the accruals made by management in this regard may be significantly different from those determined by the Corporation's partners. The effect on the financial statements resulting from such adjustments, if any, is reflected prospectively.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which were fully tradable with no vesting restrictions. This option valuation model requires the input of highly subjective assumptions including the expected stock price volatility.

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2. Significant Accounting Policies – continued

Because of the Corporation's stock options and performance incentive warrants have characteristics significantly different from those of traded options and because changes in the subjective input assumptions can materially affect the calculated fair value, such value is subject to measurement uncertainty

(l) Cash and cash equivalents

Cash and cash equivalents include short-term, highly liquid investments that mature within three months of their purchase. They are recorded at cost, which approximates market value.

(m) Transportation costs

Costs to transport petroleum products are recognized when the products are delivered and the services provided.

(n) Inventories

Inventories of petroleum products, operating supplies and raw materials are valued at the lower of cost and net realizable value. Cost is determined based on the average per barrel cost of production for the month.

(o) Deferred charges

Deferred charges relate to the convertible note and are amortized over the term of the related convertible note, adjusted for conversions.

3. Notes Receivable

In December 2004, the Corporation sold a 2% gross overriding royalty on its PEI working interests to an arm's-length private company in return for \$2,000 in cash and a \$483,000 note receivable due on June 29, 2005, secured solely by the overriding royalty. At December 31, 2004, the sale involving the non-interest bearing note was recorded as deferred revenue pending collection of the note on June 29, 2005. The private company did not pay the note in accordance with the terms of the Assignment Agreement and, accordingly, the Corporation has seized the royalty interest.

The Corporation received \$257,270 in early 2005 for payment of Notes outstanding at December 31, 2004 pertaining to the 2004 disposition of Prince Edward Island permits and other matters.

4. Long-term Investments

On February 24, 2005, the Corporation completed a transaction with Shannon International Resources Inc. ("Shannon"), whereby the Corporation disposed of its remaining interests in the PEI project in exchange for 2.5 million common shares and 500,000 warrants, exercisable at US\$0.85 per share with a term of one year, of Shannon. At December 31, 2004 the value associated with the Shannon equity instruments received, after taking into account required hold periods in order to register the equity instruments, related fair value discounts and estimated transaction costs, was estimated at \$650,000. These assets were written-down to \$150,000 on September 30, 2005. At December 31, 2005, the valuation was reviewed, and it was determined that the assets should continue to be carried at \$150,000, reflecting management's best estimate of current value. A director of the Corporation was a director and officer of Shannon until February 1, 2006.

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5. Property and Equipment

The Corporation holds various working interests in developed and undeveloped petroleum and natural gas properties and has deferred costs related to the PSA. The carrying amounts of these assets are as follows:

	2005		2004
Petroleum and natural gas assets	\$ 69,248,721	\$	47,031,976
Mining claims	1		1
Furniture, machinery and equipment	2,855,712		2,093,124
	72,104,434		49,125,101
Accumulated depletion, depreciation and write-downs	(23,769,940)		(15,387,875)
Net book value (Note 14)	\$ 48,334,494	\$	33,737,226

The expenditures deferred in Egypt are being depleted on a unit-of-production basis. These costs include exploration, drilling and equipping costs. All other capital expenditures are also capitalized under the terms of an agreement between The General Petroleum Co. S.A.E. ("GPC") and a wholly-owned subsidiary of the Corporation, Scimitar Production Egypt Ltd. ("Scimitar Egypt"). Scimitar Egypt has the right to explore and exploit the concession area for an initial term of 20 years (Note 12(a)) plus two additional five-year terms. The renewals are subject to GPC approval. The depletion factor used to deplete these assets is based on the production expected to be achieved over the next 13 years. At the end of each year, the ownership of all assets, tangibles and intangibles, reverts to GPC. It is intended that the deferred expenditures will be fully depleted by the end of the concession term, and that assets under lease will be either returned to lessors or re-leased by GPC.

The Corporation has recorded deferred exploration expenditures of \$1,638,638 in Pakistan. Production is expected to commence in 2006 and these costs will be depleted on a unit-of-production basis thereafter.

During the year ended December 31, 2005, the Corporation capitalized general and administrative expenditures in Canada of \$624,918 (2004 - \$479,413), which were included in petroleum and natural gas assets. The Corporation did not capitalize any general and administrative expenditures related to its Egypt properties. For the Pakistan properties, general and administrative expenditures in the amount of \$312,713 (2004 - \$14,965) were capitalized in 2005. No interest has been capitalized.

At December 31, 2005, the Corporation held \$2,126,159 (2004 - \$1,111,058) of inventory available for future capital expenditures in the Issaran oilfield in Egypt. Of this amount, (i) \$1,821,098 (2004 - \$570,611) relates to capital equipment, primarily pipe, and is included in property and equipment and (ii) \$305,061 (2004 - \$540,447) represents consumable supplies to be used in oilfield operations and is recorded as inventory under current assets. The capital inventory is being utilized in the Corporation's ongoing drilling program. No amortization has been taken on such inventory.

Mining claims represent a 35.3% undivided interest in 20-patented mining claims and 10 mining leases located in Cunningham Township, Province of Ontario. The claims are being carried at the nominal value of \$1.

Costs of unproved petroleum and natural gas properties, primarily in Canada, amounting to \$65,966 (2004 - \$266,521) have been excluded from the depletion calculation.

Impairment calculations were performed on the Corporation's petroleum and natural gas properties at December 31, 2005 and 2004 in which the estimated undiscounted future net cash flows associated with the proved and probable reserves exceeded the carrying amount of the Corporation's property and equipment.

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5. Property and Equipment - continued

The following table outlines benchmark prices used in the impairment test at December 31, 2005:

Year	Issaran Wellhead US\$/bbl	WTI Crude Oil US\$/bbl	AECO Natural Gas CAD\$/mcf	Pakistan Natural Gas US\$/mcf
2006	30.67	58.00	10.04	2.83
2007	29.97	56.38	9.38	2.83
2008	27.74	52.53	8.33	2.83
2009	27.22	51.69	7.73	2.83
2010	27.79	52.72	7.05	2.83
Thereafter (inflation %)	2%	2%	2%	0%

6. Convertible Debentures

On June 13, 2003, the Corporation issued \$6.0 million, 12% unsecured convertible subordinated debentures which are entitled to semi-annual interest payments and mature on July 1, 2006. The debentures were convertible, at the option of the holder, at any time prior to July 1, 2005, into common shares at a conversion price of \$1.00 per common share. After July 1, 2005, the conversion price increased to \$1.10 per common share. The debentures are redeemable by the Corporation at par, in whole or in part, if the closing price of the Corporation's common shares are at or above \$2.00 for 30 consecutive trading days. An agent's commission of \$420,000 was paid in relation to debenture subscriptions. The legal fees and cash commissions incurred to secure the debenture financing were recorded as deferred charges, are being amortized over the term of the debentures and the related amortization charges have been included in interest and related charges.

As the convertible debentures are considered to be compound financial instruments, the principal amount has been allocated between the liability and equity components, which are then classified separately on the balance sheet. The liability component is accreted over the term of the debentures such that at maturity the liability will be equivalent to the principal amount.

The equity portion of the convertible debenture is recorded as contributed surplus and represented \$437,000 as determined using a Black-Scholes model. The fair value of the conversion right was estimated using the following assumptions: Dividend yield (nil), volatility (18%), risk-free interest rate (5%), and weighted average life of 1.5 years.

During 2005, \$4,686,000 of the 12% convertible debentures were converted to an equal number of common shares of the Corporation at \$1.00 per share, pursuant to the conversion terms contained therein. Accordingly, \$112,645 of deferred charges related to the issuance of the converted debentures has been reclassified as share issue costs. \$76,381 (2004 - \$143,640) has also been recognized in accretion expense for the remaining convertible debentures. The remaining \$1,314,000, of which \$26,445 has been classified as the remaining equity portion (Note 8 (g)), of convertible debentures are convertible into 1,194,546 common shares at \$1.10/share at any time prior to maturity on July 1, 2006.

At December 31, 2005, the remaining amount to be accreted was \$26,445 (2004 - \$215,514) with respect to the convertible debentures outstanding at year end.

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7. Credit Facility

On October 31, 2005, the Corporation finalized a US\$7.0 million credit facility with a major Canadian bank which is secured by trade receivables insurance provided by Export Development Canada (EDC). The Corporation has provided a \$10.0 million demand debenture as general and collateral security. Funds drawn on this facility bear interest at the US prime rate and a standby fee of 0.25% per annum applies to the unused portion of the facility. At December 31, 2005, the entire credit facility remained available.

8. Equity Instruments

(a) Authorized

Unlimited number of voting Common Shares

Unlimited number of voting Convertible Preference Shares, cumulative preferential dividend at the rate of \$0.06 per share per annum, redeemable by the Corporation.

(b) Issued and outstanding

	2005		2004	
	Number of Shares	Amounts	Number of Shares	Amounts
Common shares				
Balance, beginning of year	74,350,379	\$ 38,332,943	71,389,740	\$ 35,938,359
Private placement – flow-through shares (Note 8(d))	1,120,000	2,016,000	-	-
Private placement (Note 8(e))	732,000	966,240	-	-
Prospectus issue (Note 8(f))	8,000,000	9,095,758	-	-
Stock options exercised	2,137,000	1,811,673	1,284,167	653,209
Debentures converted (Note 6)	4,686,000	4,686,000	-	-
Share purchase warrants – common shares exercised (Note 8(f))	-	-	1,676,472	1,741,375
	<u>91,025,379</u>	<u>56,908,614</u>	<u>74,350,379</u>	<u>38,332,943</u>
LESS: Share issue costs (net of tax effect of \$474,000)	-	(1,562,887)	-	(778,614)
	<u>91,025,379</u>	<u>55,345,727</u>	<u>74,350,379</u>	<u>37,554,329</u>
Share purchase warrants – common shares (Note 8(f))				
Balance, beginning of year	-	-	1,676,472	64,903
Issued	4,000,000	904,242	-	-
Exercised	-	-	(1,676,472)	(64,903)
	<u>4,000,000</u>	<u>904,242</u>	<u>-</u>	<u>-</u>
Balance, end of year, all equity instruments		<u><u>\$ 56,249,969</u></u>		<u><u>\$ 37,554,329</u></u>

Rally Energy Corp.
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8. Equity Instruments - continued

(c) Options

The shareholders of the Corporation have annually approved a formal stock option plan under which directors, officers, employees and consultants are eligible to receive grants. Stock option agreements have vesting periods varying from immediate to three years and expiration terms vary from two to five years.

	2005		2004	
	Share Options	Weighted Average Exercise Price	Share Options	Weighted Average Exercise Price
Outstanding, beginning of year	6,327,757	\$0.63	6,462,530	\$0.62
Granted	3,361,000	\$1.48	1,640,000	\$0.71
Exercised	(2,137,000)	\$0.60	(1,284,167)	\$0.51
Cancelled	(194,998)	\$0.93	(490,606)	\$1.06
Outstanding, end of year	7,356,759	\$1.02	6,327,757	\$0.63

Options Outstanding

Exercise Price	2005			2004		
	Number of Options		Weighted Average Years to Expiry	Number of Options		Weighted Average Years to Expiry
	Outstanding	Exercisable		Outstanding	Exercisable	
\$0.50	-	-	-	445,000	445,000	0.25
\$0.54	200,000	150,000	2.76	200,000	66,667	4.42
\$0.60	2,245,000	2,170,000	1.60	3,436,000	3,286,000	2.56
\$0.61	451,667	451,667	2.38	757,666	495,672	3.83
\$0.76	865,000	793,334	3.49	1,215,000	971,668	4.67
\$0.80	240,000	240,000	2.25	240,000	240,000	3.26
\$0.88	34,091	34,091	0.25	34,091	34,091	1.25
\$1.32	500,000	250,000	4.54	-	-	-
\$1.34	1,208,000	604,000	5.00	-	-	-
\$1.40	310,000	103,334	4.71	-	-	-
\$1.54	250,000	83,334	4.33	-	-	-
\$1.55	335,000	111,670	4.83	-	-	-
\$1.79	543,001	211,008	3.77	-	-	-
\$1.85	175,000	58,334	4.21	-	-	-
	7,356,759	5,260,772	3.27	6,327,757	5,539,098	3.86

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8. Equity Instruments - continued

The Corporation recorded an expense of \$1,435,925 for options issued in 2005 (2004 – \$468,881). The stock-based compensation expense associated with the value ascribed to options granted is recorded as contributed surplus. The fair value of share options was estimated using the Black-Scholes option-pricing model with the following assumptions: dividend yield (nil) (2004 – nil), volatility (38% to 56%) (2004 - 30% to 43%), risk-free interest rate (5%) (2004 – 5%), and weighted average life of 5 years (2004 - 5 years). The weighted average fair value at grant date of the options issued was \$0.69 (2004 - \$0.31).

(d) Private placement – flow-through common shares

On May 13, 2005, the Corporation completed an agency private placement of 1,120,000 common shares issued on a flow-through basis at a price of \$1.80 per share. Net proceeds were \$1.9 million, after payment of commissions and estimated transaction fees. Directors and Officers of the Corporation, or companies controlled by them, subscribed for an aggregate 69,555 flow-through common shares (\$125,199). At December 31, 2005, the Corporation is required to expend additional qualifying expenditures of \$614,413 prior to December 31, 2006 to meet its commitments under the flow-through agreements.

(e) Private placement – common shares

On August 2, 2005, the Corporation completed a non-brokered private placement of 732,000 common shares issued at a price of \$1.32 per share. Gross proceeds were \$966,240; no agent commissions were paid in connection with this offering. A company controlled by a Director and Officer of the Corporation subscribed for 155,000 common shares (\$204,600).

(f) Prospectus issue – common shares and purchase warrants

On December 19, 2005, the Corporation issued 8,000,000 units priced at \$1.25 per unit for gross proceeds of \$10,000,000. Each unit consisted of one common share and one-half of a common share purchase warrant. Each full warrant is exercisable for \$1.60 per common share on or before December 19, 2006. If, at any time after June 19, 2006, the Corporation's common shares close at or above \$1.80 per share for ten consecutive trading days, the Corporation can accelerate the expiry date of the warrants with 15 days notice. A value of \$904,242 has been attributed to these warrants. The fair value of the warrants was estimated using the Black-Scholes option-pricing model with the following assumptions: dividend yield (nil), volatility (0.56), and a risk-free interest rate (5%). Agent commissions of \$640,859 were paid in relation to unit subscriptions.

On June 13, 2003, the Corporation issued 2,941,117 units priced at \$0.85 per unit for gross proceeds of \$2,500,000. Each unit consisted of one common share and one-half of a common share purchase warrant and an additional 205,882 common share purchase warrants were issued to the agent. The total of these 1,676,4772 warrants were valued using the Black Scholes model and a total fair value was calculated to be \$64,903. Each full warrant was exercisable for \$1.00 per common share and all warrants were exercised prior to their expiry on December 31, 2004.

(g) Contributed surplus

	<u>2005</u>	<u>2004</u>
Balance, beginning of year	\$1,063,620	\$ 157,739
Equity portion of convertible debentures	-	437,000
Stock-based compensation expense	1,435,925	468,881
Options exercised, transferred to share capital	<u>(531,463)</u>	-
Balance end of year	<u>\$1,968,082</u>	<u>\$1,063,620</u>

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8. Equity Instruments - continued

(h) Per share amounts

The income per share figures have been calculated using the weighted average number of common shares outstanding during the periods. Diluted per share amounts reflect the potential dilution that could occur if in-the-money securities or other contracts to issue common shares were exercised or converted to common shares. The treasury stock method is used to determine the dilutive effect of stock options and other dilutive instruments. Anti-dilutive options or instruments are not included in the calculation.

The following table summarizes the calculation of basic net income and diluted net income per share.

	<u>2005</u>	<u>2004</u>
Net income available to common shareholders	<u>\$ 1,541,142</u>	<u>\$ 1,238,490</u>
Weighted-average number of common shares outstanding – basic	<u>80,261,218</u>	71,870,510
Dilution effect of stock options	<u>1,965,623</u>	1,995,959
Dilution effect of warrants	-	-
Dilution effect of convertible debentures	<u>1,194,546</u>	6,000,000
Weighted-average number of common shares outstanding – diluted	<u>83,421,387</u>	<u>79,866,469</u>
Net income per share (\$/share)		
Basic	<u>\$0.019</u>	<u>\$0.017</u>
Diluted	<u>\$0.018</u>	<u>\$0.016</u>

Outstanding stock options are the only instruments that are currently dilutive to earnings per share. For 2005, 1,303,001 stock options that were antidilutive have been excluded from the computation of diluted earnings per share (2004 – 788,659)

9. Related Party Transactions

(a) Except as noted elsewhere in these financial statements, the Corporation was involved in the following related party transactions:

	<u>2005</u>	<u>2004</u>
Consulting fees paid to companies whose shareholders are directors and officers of the Corporation:		
Included in general and administrative expenses	<u>\$ 516,233</u>	\$ 472,503
Capitalized (Note 5)	<u>530,174</u>	595,390
	<u>\$ 1,046,407</u>	<u>\$1,067,893</u>

The above transactions occurred in the normal course of business operations and represent consideration established and agreed to by the related parties which is similar to those negotiated with third parties.

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10. Income Taxes

The provision for income taxes differs from the amount obtained by applying the combined Federal and Provincial income tax rates to income before income taxes. The difference relates to the following items:

	<u>2005</u>	<u>2004</u>
Income before taxes	\$ 1,310,142	\$ 1,238,490
Corporate tax rate	37.6%	38.9%
Expected income tax	492,613	481,773
Stock compensation	540,195	182,395
Canadian resource related items	(17,207)	189,659
Foreign income	(2,216,281)	(1,920,632)
Rate change and recognition of losses	39,000	-
Expiration of non-capital loss	81,680	132,950
Change in valuation allowance	849,000	933,855
	<u>\$ (231,000)</u>	<u>-</u>

At December 31, 2005, the Corporation has exploration and development expenditures (direct and successored) and undepreciated capital costs which may be carried forward indefinitely to reduce future Canadian taxable income:

	<u>2005</u>	<u>2004</u>
Canadian oil and natural gas property expenses (COGPE)	\$ 5,499,400	\$4,883,795
Canadian development expenses (CDE)	1,909,300	1,390,938
Canadian exploration expenses (CEE)	6,037,300	2,546,838
Undepreciated capital costs	1,138,600	457,839
Loss carryforwards expiring between 2006 and 2016	8,413,600	8,581,467
Share issue costs	1,473,800	779,000
	<u>\$24,472,000</u>	<u>\$18,639,877</u>

The components of the net future income tax asset in Canada are as follows:

	<u>2005</u>	<u>2004</u>
Future income tax assets:		
Loss carryforwards	\$2,882,000	\$2,871,000
Share issue costs	496,000	288,000
	<u>3,378,000</u>	<u>3,159,000</u>
Future income tax liabilities:		
Carrying value of property and equipment in excess of tax basis	1,357,000	2,692,000
	<u>2,021,000</u>	<u>467,000</u>
Valuation allowance	(1,316,000)	(467,000)
Net future income tax asset	<u>\$ 705,000</u>	<u>\$ -</u>

Under the terms of the PSA with GPC, the payment received on account of production in Egypt is not subject to income tax. All production in Egypt is subject to a royalty charge pursuant to the terms of the PSA, which satisfied all tax liabilities.

In Pakistan, the Corporation has accumulated total costs of \$2,849,463, the majority of which are deductible from future income tax obligations in Pakistan. The excess of tax pools over the carrying value of assets in Pakistan creates a future income tax asset of approximately \$600,000, which has not been recognized as its ultimate utilization is uncertain.

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11. Asset Retirement Obligations

The Corporation has asset retirement obligations in Egypt (resulting from the PSA), Pakistan (resulting from the Concession Agreement) and in Canada, from net ownership interests in petroleum and natural gas assets. The Corporation estimates the total undiscounted amount of cash flows required to settle its asset retirement obligations and time frame, is as follows. A credit-adjusted risk-free rate of 7% and an inflation rate of 2% were used to calculate the fair value of the asset retirement obligations.

	Asset Retirement Obligations	Cost Incurrence	
		Range	Majority
Egypt	\$684,740	2015-2017	2017
Pakistan	39,251	2015-2020	2020
Canada	209,500	2006-2019	2019
	<u>\$933,491</u>		

A reconciliation of the asset retirement obligations is provided below:

<i>Asset retirement obligations</i>	<u>2005</u>	<u>2004</u>
Balance, beginning of year	\$289,846	\$169,958
Liability adjustments from prior year	33,562	-
Liabilities incurred in year, net	243,992	110,821
Accretion expense	22,982	9,067
Balance, end of year	<u>\$590,382</u>	<u>\$289,846</u>

12. Commitments

- (a) Scimitar Egypt, a wholly-owned subsidiary of the Corporation, entered into a PSA with GPC effective November 4, 1998, pursuant to which the Corporation is granted the exclusive right to develop and produce heavy oil from the Issaran, Egypt oilfield. On October 18, 2001, the Corporation entered the Commercial Development Period of the PSA, after having successfully satisfied the terms of the three-year Piloting Period. The Corporation has the option to extend the 20-year term of the PSA (commencing from November 4, 1998) for up to two additional five-year terms subject to the concurrence of GPC. The Commercial Development Period does not require any specific capital expenditure commitments. Effective July 1, 2004, a revised pricing agreement was negotiated for all oil sales from the Issaran oilfield in Egypt for a five-year period ending June 30, 2009. Under this pricing formula, for average monthly sales less than 2,000 bbls/d, the Corporation's realized oil price is 82% of the Ras Gharib blend price. For incremental monthly sales between 2,001 and 3,000 bbls/d, the realized oil sales price increases to 85% of the Ras Gharib blend price. The realized sales price increases again to 88% of the Ras Gharib blend price for incremental monthly sales that exceed 3,000 bbls/d.
- (b) In November 2001, an 80% interest in an Exploration License over the Safed Koh Block in Pakistan was awarded to a wholly-owned subsidiary of the Corporation. The corresponding Concession Agreement was finalized in January 2002. The commitment fulfilled during the evaluation period was to carry out certain activities, including a review of existing geological, geophysical and well data. In 2004, an arrangement was negotiated whereby a new partner, as operator, committed to future expenditures of up to US\$2.2 million, and the Corporation will have a 22.5% carried interest for its share of the project expenditure commitment. During 2005, Phase

December 31, 2005 and 2004

12. Commitments – continued

I of the exploration program was completed by re-entering two wells and testing commercial natural gas and condensate discoveries. In January 2006, the Government of Pakistan approved the "Declaration of Commercial Discovery and Development Plan" for the field. The Corporation and its partners have committed to drill two additional wells under Phase II of the exploration program.

- (c) The Corporation is required to make revenue-based royalty payments from the Issaran Oilfield to Gemini Oil and Gas Limited, an independent oil and natural gas investment fund. The revenue-based royalty of 10% (to a maximum of US\$1.5 million in each of 2005 and 2006) is reduced to 2.6% of Issaran oil revenues (net of marketing fees and GPC entitlements, derived from a maximum of 7,000 bbls/d of production) once royalties of US\$3.0 million have been paid, and will continue until December 31, 2012. In 2005, royalties of US\$1.5 million (2004 – nil) were accrued in respect to this agreement of which US\$902,241 has been paid.
 - (d) The Corporation rents premises under an operating lease, expiring on December 30, 2006 with annual payments of \$108,481 in 2006.
 - (e) In February 2004, a wholly-owned subsidiary of the Corporation entered into a consulting agreement with a then director of Scimitar Egypt to provide advisory services. The agreement requires payments, to a maximum of US\$300,000 annually, calculated as to US\$0.10/bbl of Issaran sales and an increment representative of the Issaran field price in excess of 80% of the Ras Gharib oil price. In 2005, marketing fees of US\$63,774 (2004 – US\$86,103) were paid in respect to this agreement. The agreement terminated on February 23, 2006.
 - (f) In the ordinary course of business, the Corporation and its subsidiaries enter into contracts which contain indemnification provisions, such as loan agreements, purchase contracts, service agreements, licensing agreements, asset purchase and sale agreements, joint venture agreements, operating agreements, leasing agreements, land use agreements, etc. In such contracts, the Corporation may indemnify counterparties to the contracts if certain events occur. These indemnification provisions vary on an agreement by agreement basis. In some cases, there are no pre-determined amounts or limits included in the indemnification provisions and the occurrence of contingent events that will trigger payment under them is difficult to predict. Therefore, the maximum potential future amount that the Corporation could be required to pay cannot be estimated.
 - (g) Under the terms of the by-laws of the Corporation, the Corporation indemnifies individuals who have acted at the Corporation's request to be a director and/or officer of the Corporation (and/or one or more of its direct and indirect subsidiaries), to the extent permitted by law, against any and all damages, liabilities, costs, charges or expenses suffered by or incurred by the individuals as a result of their service. The claims covered by such indemnifications are subject to statutory and other legal limitation periods. The nature of the indemnification agreements prevents the Corporation from making a reasonable estimate of the maximum potential amount it could be required to pay to beneficiaries of such indemnification agreements. The Corporation has purchased various insurance policies to reduce the risks associated with such indemnifications.
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Rally Energy Corp.
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13. Major Customers

Substantially all of the Corporation's revenue for the year has been derived from a PSA with the GPC. Oil is currently marketed to the EGPC, a company wholly-owned by the Arab Republic of Egypt. At December 31, 2005, there was an amount of \$7,480,509 (2004 - \$5,562,127) included in accounts receivable due from EGPC.

14. Segmented Information

The Corporation operates in the petroleum and natural gas industry and has operations in Egypt, Pakistan and Canada. Its reportable segments are identified on a geographic basis. Gross revenue and income (loss) for the year ended and capital assets are summarized on a country basis below:

2005	Egypt	Canada	Pakistan	Total
Gross revenue	\$ 31,879,199	\$ 3,019,626	\$ -	\$ 34,898,825
Income (loss)	\$ 5,965,291	\$ (4,581,128)	\$ (74,021)	\$ 1,310,142
Property and equipment	\$ 30,153,344	\$ 16,542,512	\$ 1,638,638	\$ 48,334,494
2004	Egypt	Canada	Pakistan	Total
Gross revenue	\$ 22,020,471	\$ 371,444	\$ -	\$ 22,391,915
Income (loss)	\$ 5,203,030	\$ (3,698,868)	\$ (265,672)	\$ 1,238,490
Property and equipment	\$ 19,844,850	\$ 13,865,875	\$ 26,501	\$ 33,737,226

15. Financial Instruments

As disclosed in Note 2 (i), the Corporation holds various forms of financial instruments. The nature of these instruments and the Corporation's operations expose the Corporation to normal industry credit risks. The Corporation manages its exposure to these risks by operating in a manner that minimizes its exposure to the extent practical.

(a) Credit risk

A significant portion of the Corporation's trade accounts receivable are from working interest partners in the oil and natural gas industry and, as such, the Corporation is exposed to all the risks associated with that industry. In addition, 86% (2004 - 88%) of trade receivables are due from one customer (Note 13). Due to this and the fact that the majority of the Corporation's cash is held at one institution, the Corporation is exposed to concentrations on credit risk.

(b) Commodity price risk

The Corporation is subject to commodity price risk for the delivery of natural gas and crude oil. As detailed in Note 12(a), the Corporation is subject to price limits on all of its current production.

Commodity price hedging may occur from time to time to protect the integrity of the Corporation's revenue stream. There were no hedges outstanding at year-end.

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15. Financial Instruments - continued

(c) Foreign currency rate risk management

A significant portion of the Corporation's operations are located outside of Canada and, accordingly, the related financial assets and liabilities are subject to fluctuations in exchange rates.

The Corporation manages its exposure to foreign currency fluctuations by maintaining foreign currency bank accounts and receivables to offset foreign currency payables and planned expenditures.

16. Supplementary Cash Flow Information

	<u>2005</u>	<u>2004</u>
Interest paid	<u>\$ 968,032</u>	<u>\$ 781,722</u>
