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RALLY ENERGY REPORTS RECORD PRODUCTION, REVENUE, CASH FLOW AND INCOME IN 2006

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“RAL” - TSX Exchange “RLE” - Frankfurt Stock Exchange www.rallyenergy.com

Rally Energy Corp. (the “Corporation”) is pleased to announce record operational and financial results for year-end 2006.

HIGHLIGHTS:

	2006	2005	Change
Production (BOE/D)			
Exit rate	6,350	2,970	114%
Average	4,601	2,579	78%
Average Price (\$/BOE)	44.54	37.07	20%
Revenue (\$ million)	74.8	34.9	114%
Cash Flow (\$ million)	31.2	11.9	162%
Net Income (\$ million)	6.1*	1.5	307%
<i>*after Canadian oil and gas asset write-down of \$10.5 million</i>			
Reserves (MBOE)			
Proved	44,588	18,644	139%
Proved & Probable	104,386	45,665	129%

The Corporation’s 2006 capital program of \$70.1 million included the drilling of 34 wells, construction of production facilities in Egypt and Pakistan and the acquisition of an additional interest in the Safed Koh concession in Pakistan.

In Egypt, 28 conventional and thermal wells were originally planned for 2006, but 31 wells were actually drilled, resulting in 31 oil wells. In Canada, three wells were drilled resulting in three oil/gas wells (.82 wells net). In Egypt, a 5,000 BOPD central production facility and a 50 million BTU steam generating plant are in the final stages of construction. Commissioning is scheduled to begin in a few weeks. In Pakistan, an 18 km gas pipeline and a 60 MMCF/D gas plant have been completed; the first 30 MMCF/D gas plant train is expected to commence operations later this month and the second train will be completed by June of this year.

Successful drilling combined with successful Cyclic Steam Stimulation performance results at the Issaran field in Egypt and increased ownership in Pakistan resulted in a 129% increase in recognized year-end 2006 proved and probable oil and gas reserves to 104 million BOE.

Other highlights of 2006 include a proved and probable finding and development cost, including facility costs of \$4.80/BOE (proved - \$6.04/BOE), achievement of a proved reserves replacement ratio of 16 times and operating costs averaging \$7.88/BOE.

The Corporation ended the year with \$23.3 million long term debt, \$6.5 million of capital inventory and \$3.3 working capital, of which \$18.9 million was cash.

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 30% interest in the Safed Koh Block, where it is participating in the development of a large natural gas/condensate discovery.

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 Rally - 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 Rally'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 "Risk Factors" and elsewhere in Rally'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 Rally 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, 2006

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, 2006. 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 23, 2007.

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 MD&A 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 and 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 securities 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, Pakistan and Canada. The Corporation's international strategy is to enhance value by applying Canadian exploration/development techniques and technology to the exploration for and production of reserves.

The Issaran oilfield in Egypt, accounts for substantially all of the Corporation's revenues and has a large prospective inventory of additional well locations. Scimitar Production Egypt Ltd., 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) to the consolidated financial statements and in the Production Entitlements, Marketing Costs and Royalties section below. Rally Energy has established field and operations and administration offices in Egypt, staffed 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 Safed Koh ("RESK"), another wholly-owned subsidiary of the Corporation, is party to a Concession Agreement, covering the 200,000 acre Safed Koh Block, with the Pakistan Government. During 2006, Rally Energy established an administration office in Islamabad, staffed by Pakistani nationals, to more effectively liaise with the operator of the concession. With completion of the acquisition of an additional 7.5% working interest, the Corporation holds a 30% working interest in the Safed Koh Concession. Drilling activity in 2005 led 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 2006 PERFORMANCE

Egypt:

- average annual oil production increased to 4,474 bbls/d.
- significant oil reserves increase to 91.7 million barrels.
- drilling of 31 successful oil wells.
- significant progress in construction of production and thermal program facilities.

Pakistan:

- received Commerciality Declaration for Salsabil field in January 2006.
- commenced building gas plant and related facilities for production commencement in 2007.
- acquired an additional 7.5% interest, increasing ownership to 30%.

Canada:

- sold the majority of Canadian reserve base and production for \$6.9 million.
- drilled three (0.8 net) successful oil and gas wells; satisfied all remaining flow-through share requirements.

Debt/Equity:

- raised \$14.5 million of new equity from exercise of warrants and options and conversion of debentures.
- established a long-term \$23 (US\$20) million revolving credit facility.

ANNUAL COMPARATIVE SUMMARY

	2006	2005	2004
	(thousands of dollars, unless otherwise stated)		
Production (boe/d)	4,601	2,579	1,978
Revenue	\$74,794	\$34,899	\$22,392
Cash flow from operations	\$31,246	\$11,883	\$8,283
<i>Per share - basic</i>	<i>\$0.33</i>	<i>\$0.15</i>	<i>\$0.12</i>
Income	\$6,108*	\$1,541	\$1,238
<i>Per share - basic</i>	<i>\$0.07</i>	<i>\$0.02</i>	<i>\$0.02</i>
Total assets	\$135,080	\$59,698	\$43,116
Convertible debentures	-	\$1,314	\$6,000
Long-term debt	\$23,308	-	-
Working capital	\$3,345	\$699	\$(345)

* After 10.5 million write-down of Canadian oil and gas assets.

No dividends have been declared by the Corporation.

In 2006, revenues increased by 114%, primarily as a result of increased oil production 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 production through a successful and ongoing drilling and development program. Revenues from Canadian properties, the majority of which were sold on December 1, 2006, were \$2.4 million in 2006 (2005 - \$3.0 million). Revenues in 2007 are expected to increase further as a result of ongoing drilling and production in Egypt and commencement of gas production 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, 2006, Rally Energy's cash flow from operations increased to \$31.2 million (\$0.33/share) from \$11.9 million (\$0.15/share) for the comparable 2005 period. Cash flow from operations was \$6.3 million (\$0.06/share) in the fourth quarter of 2006 as compared to \$3.4 million (\$0.05/share) in the comparable 2005 quarter. Cash flow from operations was lower for the 2006 fourth quarter, as compared to the 2006 third quarter, primarily as a result of an average 19% commodity price reduction in conjunction with a 7% production decline, higher activity-related operating expenses and year-end compensation adjustments. During the fourth quarter, the Corporation had anticipated its Egyptian oil production would be slightly lower than third quarter production since the drilling program was concentrated on thermal wells which require a 50 day steam injection cycle prior to production, as compared to conventional wells which are usually on-stream within 10 days of drilling commencement.

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 2006 was \$6.1 million (\$0.07/share), a 296% increase from net income of \$1.5 million (\$0.02/share) for 2005. The 2006 net income was negatively affected by a \$10.5 million write-down of Canadian oil and gas assets. For the 2006 fourth quarter, reported income was \$1.5 million (\$0.02/share). For the fourth quarter of 2005, Rally Energy reported net income of \$0.6 million (\$0.01/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>
2006					
Q1	\$10,061	\$ 3,445	\$0.04	\$ 866	\$0.010
Q2	19,605	8,362	\$0.09	4,213	\$0.046
Q3	25,708	13,092	\$0.14	(505)	\$(0.005)
Q4	19,420	6,347	\$0.06	1,534	\$0.016
Year	<u>\$74,794</u>	<u>\$31,246</u>		<u>\$6,108</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>	

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)

	2006									
	<u>First Quarter</u>		<u>Second Quarter</u>		<u>Third Quarter</u>		<u>Fourth Quarter</u>		<u>Year</u>	
Production:										
Oil (bbls/d)	2,676		4,509		5,658		5,289		4,543	
Natural gas (mcf/d)	388		396		348		258		348	
Total BOE (boe/d)	2,741		4,575		5,716		5,332		4,601	
Gross revenue	\$10,061	<u>\$/boe \$40.79</u>	\$19,605	<u>\$/boe \$47.09</u>	\$25,708	<u>\$/boe \$48.89</u>	\$19,420	<u>\$/boe \$39.58</u>	\$74,794	<u>\$/boe \$44.54</u>
Production entitlement										
– GPC (Egypt)	(2,695)	(10.93)	(5,585)	(13.41)	(7,397)	(14.08)	(5,692)	(11.61)	(21,369)	(12.72)
Overriding Royalty (Egypt)	(611)	(2.48)	(1,061)	(2.55)	-	-	-	-	(1,672)	(1.00)
Marketing fees	(171)	(0.69)	(213)	(0.51)	(257)	(0.49)	(247)	(0.50)	(888)	(0.53)
Royalties (Canada)	(142)	(0.57)	(105)	(0.25)	(108)	(0.21)	(35)	(0.07)	(390)	(0.23)
Operating expenses	(2,122)	(8.60)	(2,898)	(6.96)	(3,601)	(6.85)	(4,612)	(9.40)	(13,233)	(7.88)
Netback from Operations	\$4,320	\$17.52	\$9,743	\$23.41	\$14,345	\$27.26	\$8,834	\$18.00	\$37,242	\$22.18

	2005									
	First Quarter		Second Quarter		Third Quarter		Fourth Quarter		Year	
Production:										
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)
Overriding 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	
Production:										
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

Average production for 2006 was 4,601 boe/d, up 78% from 2,579 boe/d during 2005. Gross revenue for 2006 increased to \$74.8 million (\$44.54/boe), before royalties and related credits, as compared to \$34.9 million (\$37.07/boe) for 2005. 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. Production optimization from new pump installations and well workovers, coupled with new production from the Corporation's ongoing drilling program, have resulted in consistently higher production levels and additional reserves, resulting in a proved reserves replacement ratio of 16 times for 2006. Fourth quarter 2006 production averaged 5,332 boe/d with reported revenue of \$19.4 million (\$39.58/boe), a 95% increase from 2,733 boe/d and revenue of \$10.0 million (\$39.85/boe), for the fourth quarter of 2005.

Netback from operations represents gross revenue after satisfying all royalty burdens (including GPC's production entitlement), marketing fees and operating costs. For 2006, Rally Energy's netback was \$37.2 million (\$22.18/boe), a significant increase from the 2005 netback of \$16.0 million (\$17.04/boe). The netback for the fourth quarter of 2006 was \$8.8 million (\$18.00/boe), as compared to \$4.7 million (\$18.81/boe) for the corresponding 2005 fourth quarter.

Heavy oil produced from the Issaran oilfield is marketed as Ras Gharib blend. For 2006, the Corporation's realized wellhead oil price averaged 60% of the Brent oil price as compared to 54% for 2005. The realized wellhead oil price fluctuated between 55% and 63% during 2006.

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. For 2006, GPC's share of production from wells drilled subsequent to the PSA commencement ("new wells") was 28% and 55% of production from the nine wells that existed prior to the PSA, for an average of 29%. During 2005, GPC's total share was 27%. 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, as follows:

Oil Production Level (bbls/d)	Rally's Share of Production	
	Incremental	Cumulative
Up to 3,146	73.0 %	73%
3,147 to 6,292	70.5 %	71%
6,293 to 9,438	64.0 %	69%
9,439 to 12,584	62.0 %	67%
12,585 to 18,876	52.0 %	62%
18,877 to 25,168	43.0 %	57%
Over 25,169	33.5 %	53%

For the year ended December 31, 2006, GPC payments totalled \$21.4 million (\$12.72/boe), representing 29% of gross revenue. For the corresponding 2005 period, GPC payments were \$9.4 million (\$10.06/boe), representing 27% of gross revenue. For the fourth quarter of 2006, GPC's entitlement increased to \$5.7 million (29%) from \$2.6 million (26%) for the comparable 2005 quarter.

The Corporation is required to make revenue-based overriding 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), from a maximum of 7,000 bbls/d of production, commencing January 1, 2007 and continuing until December 31, 2012. Royalty payments for 2006 were \$1.7 million (\$1.00/boe), representing 2% of gross revenue (2005 – \$1.8 million (\$1.90/boe)).

Pursuant to the terms of certain marketing agreements pertaining to Issaran oil sales, marketing fees, linked to realized oil prices and production, of \$888,000 (\$0.53/boe) were paid during 2006 as compared to \$622,000 (\$0.66/boe) for 2005. Marketing fees paid for the fourth quarter ended December 31, 2006 were \$246,000 (\$0.50/boe) and \$159,000 (\$0.63/boe) for the comparable 2005 period. Marketing fees are included in royalties and related credits on the consolidated statements of income and deficit. Obligations under one marketing agreement were fully satisfied on February 28, 2006 which has resulted in lower per-unit marketing costs for the balance of 2006.

Royalty obligations on Canadian production for 2006 and 2005 were \$390,000 (\$0.23/boe) and \$257,000 (\$0.27/boe), respectively. During 2005, production from a primary producing property benefited from a one-year oil royalty holiday which expired in January 2006.

Operating Expenses

Operating expenses for 2006 were \$13.2 million (\$7.88/boe) as compared to \$6.7 million (\$7.14/boe) for 2005. Operating expenses were \$4.6 million (\$9.40/boe) in the fourth quarter of 2006 compared to \$2.1 million (\$8.35/boe) for the same period in 2005. On an overall basis, costs have increased commensurate with the higher oil production in 2006. Approximately 73% of operating expenses in 2006 represent variable costs as compared to 69% in 2005. Primary contributors to higher operating expenses are related to the Corporation's health, safety and environmental program ("HSE"), diesel fuel costs, and increased trucking costs. Additionally, well workover activity increased during the fourth quarter of 2006. In Egypt, the Corporation enhanced its HSE program resulting in higher expenditures during the last quarter, a portion of which is non-recurring; on an annual basis, HSE costs will be lower overall and more evenly distributed. Diesel fuel is used to power generators to provide electricity for field operations in our Issaran oilfield and, in the second quarter of 2007, Rally Energy will commence utilization of lower cost natural gas from nearby sources as an alternative to diesel fuel for generators. Trucking rates for the Corporation's Issaran oil deliveries have increased due to the increased fleet requirements associated with higher production. Also included in the 2006 operating expense amount is \$292,000 (2005 - \$246,000) of costs pertaining to Canadian production.

For the year ended December 31, 2006, operating expenses represent 18% of gross revenue as compared to 19% for the prior year. On a per-unit basis, higher oil sales can reasonably be expected to be achieved with 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>
2006					
Canada	\$	6,424	\$ (1,094)	\$ 5,330	\$3.17
Egypt		1,702	-	1,702	1.01
Pakistan		724	(485)	239	0.15
Total	\$	8,850	\$ (1,579)	\$ 7,271	\$4.33
2005					
Canada	\$	4,077	\$ (625)	\$ 3,452	\$3.67
Egypt		1,517	-	1,517	1.61
Pakistan		410	(313)	97	0.10
Total	\$	6,004	\$ (938)	\$ 5,066	\$5.38
2004					
Canada	\$	2,954	\$ (479)	\$ 2,475	\$3.42
Egypt		1,077	-	1,077	1.49
Pakistan		269	(15)	254	0.35
Total	\$	4,300	\$ (494)	\$ 3,806	\$5.26

Consolidated general and administrative (“G&A”) expenses were \$7.3 million (\$4.33/boe) for 2006 as compared to \$5.1 million (\$5.38/boe) for 2005, with the increase primarily attributable to higher labour costs resulting from staff additions, options expensing and annual wage increases. Non-cash expenses related to the valuation of share options granted during 2006 were \$2.1 million as compared to \$1.4 million for 2005. Additional share options granted during 2006 and the higher valuation determination for the options led to the increase. For the quarter ended December 31, 2006, consolidated G&A expenses were \$2.4 million (\$4.92/boe) as compared to \$2.1 million (\$8.23/boe) for the comparable 2005 quarter.

Excluding the non-cash component, G&A costs for 2006 were \$5.2 million (\$3.08/boe) down 20% on a boe basis from \$3.6 million (\$3.86/boe) for the comparable 2005 period.

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 2006, \$1.6 million (18%) of G&A costs were capitalized as compared to \$938,000 (16%) for 2005.

General and administrative costs associated with our Pakistan activities during 2006 totalled \$0.7 million (2005 - \$0.4 million) of which \$0.2 million (2005 - \$0.1 million) has been expensed. These costs increased in 2006 commensurate with the higher activity level in Pakistan associated with development of facilities and related infrastructure.

Interest and Finance Charges

(thousands of dollars, unless otherwise stated)

	2006	2005	2004
Interest expense	\$ 871	\$ 629	\$ 828
Accretion expense on debentures	26	189	144
Amortization of deferred charge	625	77	144
Total expense	1,522	895	1,116
Interest income	193	37	50
Loss on foreign exchange	(543)	(24)	(129)
Gain (loss) on asset disposition	(37)	92	5
Total income (expense)	(387)	105	(74)
Net expense	\$ 1,909	\$ 790	\$ 1,190
\$/boe	\$1.14	\$0.84	\$1.64

Total interest and finance charges increased to \$1.9 million during 2006 from \$0.8 million in 2005 primarily as a result of interest paid under the Corporation's credit facilities as described in Note 7 of the consolidated financial statements. Additionally, amortization of deferred charges commenced in mid-2006 with the establishment of the International Finance Corporation credit facility. On a quarterly comparison basis, net interest and finance charges were \$962,000 for the fourth quarter of 2006, as compared to \$45,000 for the fourth quarter of 2005.

Higher average borrowing levels under the Corporation's credit facilities in 2006 resulted in higher interest expense which was partially offset by lower interest expense associated with the Corporation's 12% unsecured convertible debentures of which all but \$7,000, which were paid out at maturity, were converted into common shares at \$1.10/share. Additional details are disclosed in Note 6 of the consolidated financial statements. In the normal course of business, the Corporation earns interest from invested funds and records foreign exchange gains (losses) as applicable.

Depletion, Depreciation and Accretion

(thousands of dollars, unless otherwise stated)

	2006	2005	2004
Depletion, depreciation and accretion	\$ 11,283	\$ 8,371	\$ 6,288
\$/boe	<u>\$6.72</u>	<u>\$8.89</u>	<u>\$8.69</u>

Total depletion, depreciation and accretion ("DD&A") charges for 2006 were \$11.3 million (\$6.72/boe), of which depletion pertaining to producing properties in Egypt represented \$8.0 million (2005 - \$5.3 million). The remainder represents depletion charges of \$2.7 million for Canadian production, fixed asset depreciation of \$552,000 and \$26,000 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 2005 were \$8.4 million (\$8.89/boe). On a quarterly comparison basis, 2006 fourth quarter DD&A was \$2.9 million (\$5.84/boe) as compared to \$2.2 million (\$8.88/boe) for the 2005 fourth quarter.

The significant increase in the Corporation's proved reserve base at December 31, 2006, as evaluated by DeGolyer and MacNaughton Canada Limited, an independent reservoir evaluation firm, including the anticipated future capital requirements, has resulted in a lower consolidated DD&A rate for 2006 of \$6.72/boe (2005 - \$8.89/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 Invested

In 2006, Rally Energy drilled 34 wells (31.8 net); 31 (31 net) at the Issaran oilfield in Egypt, and 3 (0.8 net) in Canada. In Egypt, 24 were conventional Nukhul wells and 7 were Upper Dolomite steam wells in stage one of the Cyclic Steam Stimulation ("CSS") thermal expansion program. Capital expenditures totalled \$70.1 million during 2006 (before disposition proceeds of \$6.9 million from the Canadian properties), up from \$22.7 million in 2005.

(thousands of dollars)	2006	2005	2004
Egypt			
Drill, complete and workovers	\$23,966	\$13,284	\$11,397
Facilities, equipment and other	8,254	1,477	807
Thermal project	8,904	-	-
Inventory change	4,680	1,251	(616)
Property acquisition (disposition)	-	-	(3,923)
Capitalized admin. costs	-	-	-
Total	\$45,804	\$16,012	\$7,665
Canada			
Drill, complete and workovers	\$3,035	\$3,652	\$2,992
Facilities, equipment and other	247	386	564
Property acquisition (disposition)	(6,938)	424	(170)
Capitalized admin. costs	1,094	625	479
Total	\$(2,562)	\$5,087	\$3,865
Pakistan			
Drill, complete and workovers	-	\$1,221	-
Facilities, equipment and other	\$6,404	36	\$11
Property acquisition (disposition)	13,018	-	-
Capitalized admin. costs	486	312	15
Total	\$19,908	\$1,569	\$26
Grand Total			
Drill, complete and workovers	\$27,001	\$18,157	\$14,389
Facilities, equipment and other	14,905	1,899	1,382
Thermal project	8,904	-	-
Inventory change	4,680	1,251	(616)
Property acquisition (disposition)	6,080	424	(4,093)
Capitalized admin. costs	1,580	937	494
Total	\$63,150	\$22,668	\$11,556
Write-down of assets			
Canada	\$(10,529)	-	-
Net Additions	\$ 52,621	-	-

The 2006 drilling and workover activities in Egypt, coupled with successful results from the CSS program, resulted in increased oil sales and higher oil reserves. In Pakistan, the Corporation was focused on building necessary facilities to bring natural gas production on-stream in early 2007. Canadian activities were limited to existing non-core areas and satisfied all remaining flow-through share renunciation requirements. Included in the above amounts are casing, tubing and capital equipment inventory costs of \$6.5 million at December 31, 2006 (2005 - \$1.8 million) to be used in future Issaran drilling programs.

On October 24, 2006, the Corporation announced it had signed an agreement to increase its working interest in the Safed Koh Concession from 22.5% to 30%. The \$13.0 (US\$11.4) million Offer to Purchase the additional 7.5% working interest was made to one of Rally Energy's existing Safed Koh Block partners (a private company). On March 2, 2007, all requisite Pakistan government approvals were received and the US\$11.4 million purchase price was satisfied by way of US\$8.55 million in cash and 1,372,846 common shares of Rally Energy Corp. The shares were reserved for issuance in June 2006 at the then prevailing price of \$2.30 per share.

On December 15, 2006, the Corporation announced it had disposed of certain Canadian oil and gas properties, effective December 1, 2006, to an independent private company, for \$6.9 million (\$5.0 million in cash and \$1.9 million in common shares of the private company).

At December 31, 2006, the Corporation continued to meet the asset impairment test for capitalized costs related to oil and gas investments in Egypt and Pakistan, and no ceiling test write-down was required. At December 31, 2006, the Corporation recorded a write-down of \$10.5 million related to valuation impairments associated with the carrying value of the Canadian petroleum and natural gas assets. The write-down primarily relates to costs originally incurred between 2001 and 2004 resulting from the Corporation's abandoned Prince Edward Island oil and gas exploration programs.

Liquidity and Capital Resources

At December 31, 2006, Rally Energy had a cash position of \$18.9 million, as compared to \$0.8 million at December 31, 2005. Working capital at December 31, 2006 was \$3.3 million, as compared to a working capital of \$0.7 million at December 31, 2005. Increased capital activities in Egypt and Pakistan during the fourth quarter resulted in a higher level of accounts payable at year end. At December 31, 2006, accounts receivable are higher as a result of increased sales levels and represent normal industry collection terms. Additionally, the Corporation secured long-term debt to replace short-term borrowings, received proceeds from warrant and option exercises (\$13.2 million) and converted debentures to equity.

On May 19, 2006, Rally finalized loan agreements with the International Finance Corporation (the "IFC") (a member of the World Bank Group) for the provision of reserve-based long-term financing of up to US\$25 million to fund capital requirements and working capital needs for the Corporation's projects in Egypt and Pakistan. The loan agreements consist of a US\$5 million term facility (expiring on October 15, 2010) and a US\$20 million revolving facility, consisting of two US\$10 million tranches. The maturity date for both revolving facility tranches is October 15, 2009. In connection with these credit facilities, Rally issued 3,000,000 common share purchase warrants to IFC. Each Warrant entitled IFC to purchase one share of the Corporation at a price of \$1.92 per share on or before May 19, 2009. Under the terms of the agreement, Rally accelerated the expiry date of the Warrants as a result of the Corporation's shares closing at or above \$2.95 per share for ten consecutive trading days. As a result of the expiry date being accelerated by Rally, IFC exercised all of the Warrants on December 4, 2006. The aggregate exercise price for the Warrants was \$5.76 million. To fund this exercise price, IFC offset the amount owing to it by Rally under the term facility (approximately \$5.71 million (US\$5 million)) and paid Rally Energy the balance owing of \$52,500 in cash, thereby terminating the term facility. At December 31, 2006, the Corporation had fully drawn the remaining US\$20 million revolving facility in anticipation of cash requirements for the active capital program in the fourth quarter.

By June 30, 2006, all outstanding Convertible Debentures were either converted to common shares (at \$1.10/share) or redeemed. The outstanding Convertible Debentures had previously been classified as current due to their maturity on July 1, 2006. In addition, the Corporation's previous US\$7 million short-term credit facility with a major Canadian bank was paid out and all related security was discharged on June 30, 2006.

During the 12 months ended December 31, 2006, Rally Energy received proceeds of \$1.1 million from the exercise of an aggregate of 1,484,000 common share options and \$12.1 million from the exercise of an aggregate of seven million common share purchase warrants (four million warrants at \$1.60 per share and three million warrants, held by IFC, at \$1.92 per share).

With the recent closing of a \$55 million equity financing, Rally Energy currently expects to generate sufficient cash flow from operations to meet its ongoing commitments and capital expenditures for 2007 and 2008. 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, 2006, Rally Energy's reserves were evaluated by the independent engineering firm of DeGolyer and MacNaughton Canada Limited ("D&M"). The 2006 drilling program in Egypt and the Pakistan acquisition resulted in significant reserves additions, as compared to 2005. The following information is prepared using D&M's forecast pricing assumptions. Additional details on the Corporation's reserves, including constant dollar pricing, can be viewed in the "Statement of Reserves Data and Other Oil and Gas Information" report, when filed, 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	2,387,749	10,038,568	35,271,180
Additions/revisions	2,066,296	25,369,000	58,019,912
Production	(1,632,924)	(1,632,924)	(1,632,924)
Closing balance	2,821,121	33,774,644	91,658,168
Pakistan:			
Opening balance	-	8,327,579	9,778,833
Additions	-	-	-
Acquisition (Disposition)	-	2,473,637	2,919,663
Production	-	-	-
Closing balance	-	10,801,216	12,698,496
Canada:			
Opening balance	235,541	277,771	615,042
Additions/revisions	436	12,437	30,215
Acquisition (Disposition)	(189,037)	(231,267)	(568,538)
Production	(46,504)	(46,504)	(46,504)
Closing balance	436	12,437	30,215
Consolidated:			
Opening balance	2,623,290	18,643,918	45,665,055
Additions/revisions	2,066,732	25,381,437	58,050,127
Acquisition (Disposition)	(189,037)	2,242,370	2,351,125
Production	(1,679,428)	(1,679,428)	(1,679,428)
Closing balance	2,821,557	44,588,297	104,386,879

The valuations 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, 2006:			
Egypt	\$45,147	\$303,262	\$566,969
Pakistan	-	140,060	149,385
Canada	(15)	179	573
Total	\$45,132	\$443,501	\$716,927

Net Present Value at 10%

(thousands of dollars before taxes)

	Proved Producing	Total Proved	Total Proved & Probable
At December 31, 2006:			
Egypt	\$42,443	\$249,175	\$428,278
Pakistan	-	105,799	109,221
Canada	(15)	171	528
Total	\$42,428	\$355,145	\$538,027

Finding & Development Costs

(thousands of dollars, unless otherwise stated)

	2006 Capital Expenditures	Change in Future Capital	Total Capital	Reserve Additions (boe)	Finding & Development Cost (\$/boe)
Egypt					
Proved reserves	\$ 45,804	\$ 97,566	\$ 143,370	25,369,000	\$5.65
Proved & probable	\$ 45,804	\$ 217,990	\$ 263,794	58,019,912	\$4.55
Pakistan					
Proved reserves	\$ 19,908	\$ (735)	\$ 19,173	2,473,637	\$7.75
Proved & probable	\$ 19,908	\$ 2,034	\$ 21,942	2,919,663	\$7.52
Canada					
Proved reserves	\$ 4,376	\$ (141)	\$ 4,235	(218,830)	\$(19.35)
Proved & probable	\$ 4,376	\$ (141)	\$ 4,235	(538,323)	\$(7.87)
Consolidated					
Proved reserves	\$ 70,088	\$ 96,690	\$ 166,778	27,623,807	\$6.04
Proved & probable	\$ 70,088	\$ 219,883	\$ 289,971	60,401,252	\$4.80

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 identified 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 2006 fourth quarter information, is:

(thousands of dollars, unless otherwise stated)

	Variance in Cash Flow	Variance in Cash Flow per share
Oil Price ⁽¹⁾	\$1,695	\$0.0169
Oil Production ⁽²⁾	\$ 799	\$0.0084
Foreign Currency ⁽³⁾	\$ 318	\$0.0034

- ⁽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 2006, the Corporation paid \$279,000 (2005 - \$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 \$14,000 per month.

Contractual Obligations

(thousands of dollars)

	Payments Due by Period			Total
	Less Than 1 Year	1-5 Years	After 5 Years	
Office lease ⁽¹⁾	\$330	\$1,187	-	\$1,517
Asset retirement obligations ⁽²⁾	-	-	\$1,302	\$1,302

⁽¹⁾ See Note 12(d) 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, 2006 the impairment test was met for the Egyptian and Pakistan properties capitalized costs and no ceiling test write-down was required. A write-down of the Canadian assets was recorded at December 31, 2006, as disclosed.

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.

Recent Accounting Pronouncement

Effective January 1, 2007, the Corporation will be required to adopt several new and revised standards issued by the Canadian Institute of Chartered Accountants in January 2005 related to Financial Instruments. Under the new standards, a Statement of Comprehensive Income has been introduced that will provide for certain gains (losses) and other amounts arising from changes in fair value to be temporarily recorded outside the income statement. In addition, all financial instruments including derivatives are to be included on the balance sheet and measured at fair values in most instances. The requirements for hedge accounting have also been further clarified under the revised standards. Management is currently evaluating the impact of the new and revised standards and does not anticipate they will have a material impact on its consolidated financial statements.

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 controls 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.

Internal Controls over Financial Reporting

The Corporation maintains a set of internal controls over financial reporting which have been designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with Canadian GAAP. The Corporation, and independent consultants, evaluated the design of its internal controls and procedures as defined under Multilateral Instrument 52-109 for the year ended December 31, 2006. This evaluation was led by the CEO and CFO, with the assistance of other employees, to the extent necessary and appropriate. Based on this evaluation, the CEO and CFO concluded that the design of these internal controls and procedures was effective. The results of this evaluation were presented to the Audit Committee and the Corporation's Board of Directors.

Additional testing of the Corporation's internal controls over financial reporting, by independent consultants, will be performed in 2007.

There were no changes in the Corporation's internal control over financial reporting that occurred during the fourth quarter that have materially affected, or are reasonably likely to materially affect the Corporation's internal control over financial reporting.

2007 OUTLOOK

The 2007 capital program will include drilling up to 30 conventional and 30 thermal wells in Egypt and a development and an exploration well in Pakistan. In Egypt, additional thermal and production facilities are also planned to accommodate higher production expected to result from phased development of the CSS thermal expansion program. In addition to the existing 10 CSS wells at December 31, 2006, the 2007 drilling program will increase the CSS program to a total of 40 CSS wells by the end of 2007. In Pakistan, production facilities will be completed to accommodate gas production from the Salsabil development program. Exploration drilling results on the Safed Koh Concession will determine any additional production facility requirements.

Rally Energy Corp.
Consolidated Balance Sheets

As at December 31	2006	2005
Assets		
Current		
Cash and cash equivalents	\$ 17,743,645	\$ 801,639
Restricted cash (Note 3)	1,169,768	-
Accounts receivable	20,594,214	8,906,244
Inventory (Note 5)	617,427	305,061
Prepaid expenses and deposits	627,228	468,943
	<u>40,752,282</u>	<u>10,481,887</u>
Future income tax asset (Note 10)	-	705,000
Long-term investments (Note 4)	1,905,500	150,000
Property and equipment (Note 5)	89,853,531	48,334,494
Deferred charges (Note 7)	2,568,325	26,440
	<u>\$ 135,079,638</u>	<u>\$ 59,697,821</u>
Liabilities and Shareholders' Equity		
Current		
Accounts payable – operations	\$ 6,780,795	\$ 4,572,583
Accounts payable – capital	30,626,765	3,922,935
Convertible debentures (Note 6)	-	1,287,555
	<u>37,407,560</u>	<u>9,783,073</u>
Asset retirement obligations (Note 11)	770,740	590,382
Long-term debt (Note 7)	23,308,000	-
	<u>61,486,300</u>	<u>10,373,455</u>
Shareholders' equity		
Equity instruments (Note 8(b))	73,248,886	56,249,969
Contributed surplus (Note 8(f))	3,130,482	1,968,082
Deficit	(2,786,030)	(8,893,685)
	<u>73,593,338</u>	<u>49,324,366</u>
	<u>\$ 135,079,638</u>	<u>\$ 59,697,821</u>
Commitments (Note 12)		

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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	2006	2005
Oil and natural gas revenue	\$ 74,794,346	\$ 34,898,825
Less: Royalties and related credits	<u>(24,318,725)</u>	<u>(12,141,874)</u>
	50,475,621	22,756,951
Operating expenses	<u>13,233,436</u>	<u>6,719,395</u>
	<u>37,242,185</u>	<u>16,037,556</u>
Expenses		
Administrative expenses:		
Administration	5,166,852	3,630,385
Stock-based compensation	<u>2,103,992</u>	<u>1,435,925</u>
	7,270,844	5,066,310
Interest expense	871,105	629,353
Depletion, depreciation and accretion	11,282,676	8,371,352
Accretion expense on convertible debentures	26,445	189,069
Amortization of deferred charge	623,969	76,381
Write-down of assets (Note 5)	<u>10,528,813</u>	<u>-</u>
	<u>30,603,852</u>	<u>14,332,465</u>
Income before other items and taxes	<u>6,638,333</u>	<u>1,705,091</u>
Other items		
Interest income	192,914	36,899
Loss on foreign exchange	(543,236)	(24,429)
Write-down of long-term investments (Note 4)	(144,500)	(500,000)
Other recoveries (expenses)	<u>(35,856)</u>	<u>92,581</u>
	<u>(530,678)</u>	<u>(394,949)</u>
Income before taxes	6,107,655	1,310,142
Future income tax recovery (Note 10)	<u>-</u>	<u>231,000</u>
Net income for the year	6,107,655	1,541,142
Deficit, beginning of year	<u>(8,893,685)</u>	<u>(10,434,827)</u>
Deficit, end of year	<u>\$ (2,786,030)</u>	<u>\$ (8,893,685)</u>
Income per share (Note 8(g))		
Basic	\$0.065	\$0.019
Diluted	\$0.062	\$0.018

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	2006	2005
Cash flows from operating activities		
Net income for the year	\$ 6,107,655	\$ 1,541,142
Non-cash items:		
Future income taxes	-	(231,000)
Stock-based compensation	2,103,992	1,435,925
Accretion expense on convertible debentures	26,445	189,069
Amortization of deferred charges	623,969	76,381
Depletion, depreciation and accretion	11,282,676	8,371,352
Unrealized foreign exchange loss	427,499	-
Write-down of assets	10,673,313	500,000
	<u>31,245,549</u>	<u>11,882,869</u>
Changes in non-cash working capital balances		
Accounts receivable	(11,687,970)	(2,402,475)
Notes receivable	-	257,270
Inventory	(312,366)	235,386
Prepaid expenses and deposits	(158,285)	(202,582)
Accounts payable – operations	2,208,212	1,435,032
	<u>21,295,140</u>	<u>11,205,500</u>
Cash flows from investing activities		
Oil and gas assets	(70,088,311)	(22,668,084)
Proceeds from sale of oil and gas interests	5,038,143	-
Restricted cash increase	(1,169,768)	-
Changes in accounts payable – capital	25,824,593	(1,205,020)
	<u>(40,395,343)</u>	<u>(23,873,104)</u>
Cash flows from financing activity		
Issuance of equity instruments (Note 8(e))	7,529,958	13,116,822
Bank debt increase (Note 7)	29,015,500	-
Increase in deferred financing charges	(947,981)	-
Redemption of convertible debentures	(7,006)	-
	<u>35,590,471</u>	<u>13,116,822</u>
Foreign exchange loss on cash held in a foreign currency	<u>451,738</u>	<u>(5,824)</u>
Increase in cash	16,942,006	443,394
Cash and cash equivalents, beginning of year	<u>801,639</u>	<u>358,245</u>
Cash and cash equivalents, end of year	\$ 17,743,645	\$ 801,639

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

December 31, 2006 and 2005

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 ("Concession").

2. Significant Accounting Policies

The consolidated financial statements of the Corporation have been prepared by management in accordance with Canadian generally accepted accounting principles ("GAAP"). The preparation of consolidated financial statements in conformity with GAAP 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 centre, 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 reduction of value, as a result of the ceiling test, is charged to operations in the period of impairment.

December 31, 2006 and 2005

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.

December 31, 2006 and 2005

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 2006 or 2005. As is normal to the industry, the Corporation's oil production in Egypt and Canada is subject to royalties. In addition, Pakistan production will also be subject to a royalty.

(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

Financial instruments consist primarily of cash and cash equivalents, accounts receivable, deposits, long-term investments, accounts payable, accrued liabilities and long-term debt. There are no significant differences between the carrying value of these instruments and their estimated fair value. 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 and concession 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.

December 31, 2006 and 2005

2. Significant Accounting Policies – continued

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 long-term credit facility, as described in Note 7, and are amortized over the life of the facility. In 2005, the deferred charges related to the convertible debentures and were amortized over their term, adjusted for conversions.

(p) Long-term investments

Long-term investments are carried at cost (Note 4) and reviewed regularly for any loss in value of the investments that is other than a temporary decline. If a loss in value that is other than a temporary decline, the investment will be written down to the value, and the impairment included in the determination of earnings.

3. Restricted Cash

As security for letters of credit issued to secure equipment orders for Egyptian drilling operations and work commitments in Pakistan, \$1,169,768 is held on deposit with Canadian and Foreign chartered banks. The funds are invested in interest-bearing revolving term deposits. The letters of credit will expire on or before July 31, 2007.

4. Long-term Investments

On December 15, 2006, the Corporation completed the sale of certain Canadian oil and gas assets for a purchase price of \$6.9 million, with an effective date of December 1, 2006. Proceeds from the disposition were settled by way of \$5 million in cash and \$1.9 million in equity from the arms-length purchaser, a private Canadian company.

The Corporation holds a minority equity position in a registered public company resulting from an asset disposition in February 2005. At December 31, 2006 the valuation was reviewed and it was determined that the carrying value should be written-down by \$144,500 as a result of a decline in the company's common share price.

Rally Energy Corp.
Notes To Consolidated Financial Statements

December 31, 2006 and 2005

5. Property and Equipment

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

	2006		2005	
Petroleum and natural gas assets	\$	130,283,985	\$	69,248,722
Furniture, machinery and equipment		4,896,264		2,855,712
		135,180,249		72,104,434
Accumulated depletion, depreciation and write-downs		(45,326,718)		(23,769,940)
Net book value (Note 14)	\$	89,853,531	\$	48,334,494

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 12 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 and development expenditures of \$21,546,349 (2005 - \$1,638,638) in Pakistan. These costs will be depleted on a unit-of-production basis when production commences in Pakistan.

During the year ended December 31, 2006, the Corporation capitalized general and administrative expenditures in Canada of \$1,094,037 (2005 - \$624,918), 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 \$485,527 (2005 - \$312,713) were capitalized in 2006. No interest has been capitalized.

At December 31, 2006, the Corporation held \$7,117,814 (2005 - \$2,126,159) of inventory available for future capital expenditures in the Issaran oilfield in Egypt. Of this amount, (i) \$6,500,387 (2005 - \$1,821,098) relates to capital equipment, primarily pipe, and is included in property and equipment and (ii) \$617,427 (2005 - \$305,061) 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.

Costs of unproved petroleum and natural gas properties, primarily in Canada, amounting to \$nil (2005 - \$65,966) have been excluded from the depletion calculation.

Impairment calculations were performed on the Corporation's petroleum and natural gas properties at December 31, 2006 and 2005 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 in Egypt and Pakistan.

At December 31, 2006, the Corporation recorded a write-down of \$10,528,813 related to valuation impairments associated with the carrying value of Canadian petroleum and natural gas assets.

Rally Energy Corp.
Notes To Consolidated Financial Statements

December 31, 2006 and 2005

5. Property and Equipment - continued

The following table outlines benchmark prices used in the impairment test at December 31, 2006:

Year	Issaran Wellhead US\$/bbl	WTI Crude Oil US\$/bbl	AECO Natural Gas CAD\$/mcf	Pakistan Natural Gas US\$/mcf
2007	36.66	65.00	7.32	3.47
2008	36.95	65.52	7.91	3.47
2009	36.25	64.27	7.72	3.47
2010	34.82	61.73	7.48	3.47
2011	33.32	59.07	7.68	3.47
Thereafter (inflation %)	2%	2%	2%	0%

6. Convertible Debentures

During 2006, \$1,306,994 of Convertible Debentures converted to common shares (at \$1.10/share) and \$7,006 were redeemed by June 30, 2006. Issued on June 13, 2003, the 12% unsecured convertible subordinated debentures were entitled to semi-annual interest payments and matured on July 1, 2006.

7. Long-Term Debt

On May 19, 2006, the Corporation finalized agreements with the International Finance Corporation ("IFC"), (a member of the World Bank Group), for US\$25 million of long-term financing facilities. The facilities are comprised of a US\$5 million Term Loan ("Term") to the Corporation and a US\$20 million Revolving Credit Facility ("Revolving") to two of its wholly-owned subsidiaries, Scimitar Production Egypt Ltd. ("SPEL") and Rally Energy Safed Koh Ltd. ("RESK"). The Term loan matures in its entirety on October 15, 2010 and requires semi-annual interest payments calculated at LIBOR plus 2.75%. The Revolving loan, comprised of two US\$10 million tranches, matures on October 15, 2009 and requires semi-annual interest payments at LIBOR plus 2.75%. A 1.3125% standby fee on the unused portion of the available Revolving loan is payable semi-annually. Setup costs of \$3,165,854 pertaining to these facilities, including the value attributed to the share purchase warrants (Note 8(e)), have been recorded as deferred financing charges and will be amortized over the life of the Revolving facility. The effective interest rate of the IFC revolving credit facility at December 31, 2006 is 8.025%.

This reserve-based facility is secured by proceeds from oil and gas sales, shares of SPEL and RESK and the Corporation's rights under the Issaran PSA and the Safed Koh Concession Agreement. Additionally, SPEL and RESK, collectively, have provided a US\$20 million debenture creating first ranking fixed and floating charges, along with a guarantee from the Corporation.

On December 4, 2006, IFC utilized the fully-drawn US\$5 million Term loan as payment proceeds to exercise warrants, as more fully described in Note 8(e). The Term loan facility was terminated on December 4, 2006.

At December 31, 2006, US\$20 million was drawn under the Revolving loan.

The Corporation's previous US\$7 million credit facility with a major Canadian bank was paid out and all related security was discharged on June 30, 2006.

Rally Energy Corp.
Notes To Consolidated Financial Statements

December 31, 2006 and 2005

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

	2006		2005	
	Number of		Number of	
	Shares	Amounts	Shares	Amounts
Common shares				
Balance, beginning of year	91,025,379	\$ 56,908,614	74,350,379	\$ 38,332,943
Private placement – flow-through shares	-	-	1,120,000	2,016,000
Private placement	-	-	732,000	966,240
Prospectus issue (Note 8(d))	-	-	8,000,000	9,095,758
Stock options exercised (Note 8(c) and (f))	1,484,093	1,589,758	2,137,000	1,811,673
Debentures converted (Note 6 and 8(f))	1,188,176	1,743,993	4,686,000	4,686,000
Warrants exercised (Note 8(d) and (e))	7,000,000	15,282,115	-	-
	<u>100,697,648</u>	<u>75,524,480</u>	<u>91,025,379</u>	<u>56,908,614</u>
LESS: Share issue costs	-	(2,275,594)	-	(1,562,887)
	<u>100,697,648</u>	<u>73,248,886</u>	<u>91,025,379</u>	<u>55,345,727</u>
Share purchase warrants – common shares				
Balance, beginning of year	4,000,000	904,242	-	-
Issued (Note 8(e))	3,000,000	2,217,873	4,000,000	904,242
Exercised	(7,000,000)	(3,122,115)	-	-
	<u>-</u>	<u>-</u>	<u>4,000,000</u>	<u>904,242</u>
Balance, end of year, all equity instruments		<u>\$ 73,248,886</u>		<u>\$ 56,249,969</u>

(c) Options

The shareholders of the Corporation have approved a formal 10% rolling 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 to five years, with a weighted average life of 2.64 (2005 – 3.27) years.

	2006		2005	
	Share Options	Weighted Average Exercise Price	Share Options	Weighted Average Exercise Price
Outstanding, beginning of year	7,356,759	\$1.02	6,327,757	\$0.63
Granted	1,165,000	\$2.36	3,361,000	\$1.48
Exercised	(1,484,093)	\$0.73	(2,137,000)	\$0.60
Cancelled	(175,000)	\$1.34	(194,998)	\$0.93
Outstanding, end of year	<u>6,862,666</u>	<u>\$1.30</u>	<u>7,356,759</u>	<u>\$1.02</u>

Rally Energy Corp.
Notes To Consolidated Financial Statements

December 31, 2006 and 2005

8. Equity Instruments - continued

Exercise Price	Options Outstanding					
	2006			2005		
	Number of Options Outstanding	Number of Options Exercisable	Weighted Average Years to Expiry	Number of Options Outstanding	Number of Options Exercisable	Weighted Average Years to Expiry
\$0.54	150,000	150,000	0.17	200,000	150,000	2.76
\$0.60	1,293,000	1,293,000	0.86	2,245,000	2,170,000	1.60
\$0.61	257,000	257,000	1.83	451,667	451,667	2.38
\$0.76	815,000	815,000	2.67	865,000	793,334	3.49
\$0.80	240,000	240,000	1.25	240,000	240,000	2.25
\$0.88	-	-	-	34,091	34,091	0.25
\$1.32	500,000	500,000	3.54	500,000	250,000	4.54
\$1.34	958,000	958,000	4.00	1,208,000	604,000	5.00
\$1.40	243,333	140,001	3.71	310,000	103,334	4.71
\$1.54	250,000	166,668	3.33	250,000	83,334	4.33
\$1.55	318,333	240,002	3.83	335,000	111,670	4.83
\$1.79	498,000	332,005	3.04	543,001	211,008	3.77
\$1.85	175,000	116,667	3.21	175,000	58,334	4.21
\$2.30	1,105,000	865,000	4.46	-	-	-
\$3.49	60,000	30,000	4.83	-	-	-
	6,862,666	6,103,343	2.64	7,356,759	5,260,772	3.27

The Corporation recorded an expense of \$2,103,992 for options issued in 2006 (2005 – \$1,435,925). 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) (2005 – nil), volatility (48% to 50%) (2005 - 38% to 56%), risk-free interest rate (5%) (2005 – 5%), and weighted average life of 5 years (2005 - 5 years). The weighted average fair value at grant date of the options issued was \$1.17 (2005 - \$0.69).

(d) 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 was exercisable for \$1.60 per common share on or before December 19, 2006. Under the terms of the agreement, the Corporation accelerated the expiry date of the warrants to July 20, 2006 as a result of the Corporation's common shares closing above \$1.80 per share for ten consecutive trading days. Prior to their expiry, all the warrants were exercised for an aggregate exercise price of \$6.4 million.

(e) Credit facility – common share purchase warrants

In connection with the IFC credit facilities (Note 7), the Corporation issued three million common share purchase warrants to IFC on May 19, 2006. Each warrant entitled IFC to purchase one common share of the Corporation at a price of \$1.92 per common share until May 19, 2009. Under the terms of the agreement, the Corporation accelerated the expiry date of the warrants as a result of the Corporation's common shares closing at or above \$2.95 per share for ten consecutive trading days. IFC exercised all of the warrants on December 4, 2006 for an aggregate exercise price of \$5.76 million. To fund this exercise price, IFC offset the amount owing to it by the Corporation under the Term facility (approximately \$5.71 million) and \$52,500 in cash. A value of \$2,217,873 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:

Rally Energy Corp.
Notes To Consolidated Financial Statements

December 31, 2006 and 2005

8. Equity Instruments - continued

dividend yield (nil), volatility (50%), and a risk-free interest rate (5%).

(f) <u>Contributed surplus</u>	<u>2006</u>	<u>2005</u>
Balance, beginning of year	\$1,968,082	\$1,063,620
Stock-based compensation expense	2,103,992	1,435,925
Options exercised, transferred to share capital	(504,592)	(531,463)
Debentures exercised, transferred to share capital	(437,000)	-
Balance end of year	<u>\$3,130,482</u>	<u>\$1,968,082</u>

(g) Per share amounts

The income per share figures has 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>2006</u>	<u>2005</u>
Net income available to common shareholders	<u>\$ 6,107,655</u>	<u>\$ 1,541,142</u>
Weighted-average number of common shares outstanding – basic	<u>94,660,474</u>	80,261,218
Dilution effect of stock options	<u>3,294,494</u>	1,965,623
Dilution effect of convertible debentures	-	1,194,546
Weighted-average number of common shares outstanding – diluted	<u>97,954,968</u>	<u>83,421,387</u>
Net income per share (\$/share)		
Basic	<u>\$0.065</u>	\$0.019
Diluted	<u>\$0.062</u>	\$0.018

Outstanding stock options are the only instruments that are currently dilutive to earnings per share. For 2006, no stock options were antidilutive and excluded from the computation of diluted earnings per share (2005 – 1,303,001)

9. Related Party Transactions

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

	<u>2006</u>	<u>2005</u>
Consulting fees paid to companies whose shareholders are directors and officers of the Corporation:		
Included in general and administrative expenses	<u>\$ 135,925</u>	\$ 516,233
Capitalized (Note 5)	<u>142,875</u>	530,174
	<u>\$ 278,800</u>	<u>\$ 1,046,407</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.

Rally Energy Corp.
Notes To Consolidated Financial Statements

December 31, 2006 and 2005

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>2006</u>	<u>2005</u>
Income before taxes	\$6,107,655	\$ 1,310,142
Corporate tax rate	32.5%	37.6%
Expected income tax	1,984,988	492,613
Stock compensation	683,797	540,195
Canadian resource related items	9,952	(17,207)
Foreign income	(7,840,123)	(2,216,281)
Rate changes and other	715,586	39,000
Expiration of non-capital loss	-	81,680
Change in valuation allowance	4,445,800	849,000
	<u>\$ -</u>	<u>\$ (231,000)</u>

At December 31, 2006, 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>2006</u>	<u>2005</u>
Canadian oil and natural gas property expenses (COGPE)	\$ 4,905,600	\$ 5,499,400
Canadian development expenses (CDE)	3,237,800	1,909,300
Canadian exploration expenses (CEE)	4,509,100	6,037,300
Undepreciated capital costs	2,323,500	1,138,600
Loss carryforwards expiring between 2007 and 2016	5,556,800	8,413,600
Share issue costs	1,327,500	1,473,800
	<u>\$21,860,300</u>	<u>\$24,472,000</u>

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

	<u>2006</u>	<u>2005</u>
Loss carryforwards	\$1,694,800	\$2,882,000
Share issue costs	376,800	496,000
Carrying value of property and equipment in excess of tax basis	3,690,200	(1,357,000)
	<u>5,761,800</u>	<u>2,021,000</u>
Valuation allowance	(5,761,800)	(1,316,000)
Net future income tax asset	<u>\$ -</u>	<u>\$ 705,000</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 satisfies all tax liabilities.

In Pakistan, the Corporation has accumulated total costs of \$22,757,174, the majority of which are deductible from future income tax obligations in Pakistan.

Rally Energy Corp.
Notes To Consolidated Financial Statements

December 31, 2006 and 2005

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	\$1,222,824	2015-2018	2018
Pakistan	39,332	2015-2020	2020
Canada	40,000	2009-2014	2014
	<u>\$1,302,156</u>		

A reconciliation of the asset retirement obligations is provided below:

<i>Asset retirement obligations</i>	2006	2005
Balance, beginning of year	\$590,382	\$289,846
Liability adjustments from prior year	57,829	33,562
Liability adjustments from disposition of assets	(186,486)	-
Liabilities incurred in year, net	282,591	243,992
Accretion expense	26,424	22,982
Balance, end of year	\$770,740	\$590,382

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

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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. On October 20, 2005, the Corporation increased its interest in the Concession Agreement to 30% (Note 16(a)).

- (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), from a maximum of 7,000 bbls/d of production, commencing January 1, 2007 and continuing until December 31, 2012. In 2006, royalties of \$1.7 (US\$1.5) million (2005 – \$1.8 (US\$1.5) million) were paid.
- (d) The Corporation and two wholly-owned subsidiaries rent premises under operating leases for office premises, requiring the following payments:

	Canada	Egypt	Pakistan	Total
2007	\$ 208,576	\$ 108,000	\$ 13,500	\$ 330,076
2008	208,576	111,500	-	320,076
2009	208,576	114,000	-	322,576
2010	208,576	114,000	-	322,576
2011	173,813	47,500	-	221,313
	\$ 1,008,117	\$ 495,000	\$ 13,500	\$ 1,516,617

- (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 2006, marketing fees of US\$19,082 (2005 – US\$63,774) 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

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12. Commitments – continued

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.

13. 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:

2006	Egypt	Canada	Pakistan	Total
Gross revenue	\$ 72,415,056	\$ 2,379,290	\$ -	\$ 74,794,346
Income (loss)	\$ 24,578,941	\$ (18,015,801)	\$ (455,485)	\$ 6,107,655
Property and equipment	\$ 67,671,654	\$ 635,528	\$ 21,546,349	\$ 89,853,531
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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

14. 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 EGPC, a company wholly-owned by the Arab Republic of Egypt, and 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, 94% (2005 – 86%) of trade receivables are due from one customer. Revenues resulting from the PSA and paid by EGPC, represented 97% (2005 – 91%) of consolidated revenues. With respect to counterparties to financial instruments, the Corporation partially mitigates associated credit risk by limiting transactions to counterparties with investment grade credit ratings.

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14. Financial Instruments - continued

(b) Commodity price risk

The Corporation's operational results and financial condition are dependent on the prices received for the delivery of natural gas and crude oil. Oil and gas prices have fluctuated widely during recent years and are determined by economic and, in the case of oil prices, political factors. Supply and demand factors, including weather and general economic conditions as well as conditions in other oil and natural gas regions impact prices. Any movement in oil and natural gas prices could have an effect on the Corporation's financial condition. The Corporation may manage the risk associated with changes in commodity prices by entering into oil or natural gas price derivatives. To the extent that the Corporation engages in risk management activities related to commodity prices, it will be subject to credit risks associated with counterparties with which it contracts. There were no hedges during 2006 or outstanding at year-end.

(c) Foreign currency exchange and interest rate risk

The Corporation's core 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.

Fluctuations in interest rates could result in a significant change in the amount the Corporation pays to service variable interest US dollar-denominated debt. World oil prices are quoted in US dollars and the price received is also affected by the Canadian/US dollar exchange rate that may fluctuate over time. Variations in the exchange rate of the Canadian dollar could have a significant positive or negative impact. To the extent that the Corporation engages in risk management activities related to foreign exchange rates, it will be subject to credit risk associated with counterparties with which it contracts. No derivative contracts were entered into during 2006, nor outstanding at year-end, to mitigate these risks. The increase in the exchange rate for the Canadian dollar and future Canadian/US exchange rates will impact the future value of the Corporation's reserves as determined by independent evaluators.

15. Subsequent Events

- (a) On October 24, 2006, the Corporation announced it had signed an agreement to increase its working interest in the Safed Koh Concession from 22.5% to 30%. The US\$11.4 million offer to purchase the additional 7.5% working interest is with one of the Corporation's existing Safed Koh Block partners (a private company). On March 2, 2007, having received the requisite approvals from relevant Pakistan government agencies, the purchase price of US\$11.4 million was satisfied by way of US\$8.55 million in cash and 1,372,846 common shares of Rally Energy Corp. The shares are subject to a four month hold, and were reserved for issuance in June 2006 at a price of \$2.30 per share.
- (b) On March 13, 2007, the Corporation issued 11 million common shares at \$5.00 per share for gross proceeds of \$55 million, pursuant to the terms of a prospectus. Agent commissions of \$2.8 million were paid in relation to common shares subscriptions.

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16. Supplementary Cash Flow Information

	2006	2005
(a) Interest paid	<u>\$ 695,623</u>	<u>\$ 968,032</u>
(b) Taxes paid	<u>\$ -</u>	<u>\$ -</u>
(c) Cash and cash equivalents, end of year		
Cash	\$ 9,549,396	\$ 801,639
Term deposits	8,194,249	-
Cash and cash equivalents	<u>\$17,743,645</u>	<u>\$ 801,639</u>