



# RALLY ENERGY CORP.

August 10, 2006

## RALLY ENERGY REPORTS RECORD PRODUCTION, CASH FLOW AND EARNINGS FOR SECOND QUARTER 2006

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*"RAL" - TSX Exchange*

*"RLE" - Frankfurt Stock Exchange*

[www.rallyenergy.com](http://www.rallyenergy.com)

Rally Energy (the "Corporation") announced today record operational and financial results for the second quarter of 2006.

### HIGHLIGHTS

|                                   | <u>Quarter ended June 30</u> |             |               |
|-----------------------------------|------------------------------|-------------|---------------|
|                                   | <u>2006</u>                  | <u>2005</u> | <u>Change</u> |
| Production (boe/d)                | <b>4,575</b>                 | 2,774       | +65%          |
| Average Price (\$/boe)            | <b>47.09</b>                 | 34.91       | +35%          |
| Revenue (\$ million)              | <b>19.6</b>                  | 8.8         | +122%         |
| Cash Flow (\$ million)            | <b>8.4</b>                   | 3.2         | +159%         |
| Net Income (\$ million)           | <b>4.2</b>                   | 0.5         | +771%         |
| Capital Expenditures (\$ million) | <b>7.1</b>                   | 5.6         | +26%          |

Production from the Issaran oilfield in Egypt was 4,433 boe/d for the 2006 second quarter with the remaining 142 boe/d from production in Canada. Current corporate production exceeds 5,700 boe/d, of which 5,600 boe/d is from Egypt.

During the second quarter, the Corporation drilled seven wells in Egypt resulting in seven oil wells and in Canada drilled two wells resulting in a gas well at Valhalla (40% net) and an oil well at Gold Creek (12% net).

Working capital at the end of the second quarter was \$11.4 million and increased by an additional \$5.6 million on July 20 through proceeds realized from the previously announced warrant exercise. At June 30, 2006, long-term debt drawn under the new US\$25 million loan facility from the International Finance Corporation was \$11.2 million (US\$10 million).

### CORPORATE UPDATE

In Pakistan, the Corporation expects to finalize documentation and receive necessary approvals to complete the acquisition of an additional 7.5% working interest in the Safed Koh Concession, as previously announced, by the end of this month. Sui Northern has started construction of the 18 kilometre, 10 inch lateral pipeline to the field and we expect an update on gas price agreement and first production date following our meeting with the operator later on in August.

Regarding the Corporation's Canadian properties asset sale, several companies are completing their due diligence and we expect to receive proposals over the next few weeks.

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

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#### **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 Six Months ended June 30, 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 consolidated financial statements and MD&A for the year ended December 31, 2005. Additional information regarding the Corporation can be found at [www.sedar.com](http://www.sedar.com) and [www.rallyenergy.com](http://www.rallyenergy.com).

These financial statements of Rally Energy and the accompanying interim consolidated balance sheet as at June 30, 2006 and the interim consolidated statements of income and deficit and cash flows for the three and six month periods then ended, are the responsibility of the Corporation's management.

The financial information contained herein has been prepared by management and includes the selection of appropriate accounting principles, judgments and estimates necessary to prepare these financial statements in accordance with Canadian Generally Accepted Accounting Principles ("Canadian GAAP"). Unless otherwise indicated, all dollar amounts in this report 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 August 10, 2006.

**Non-GAAP Measures**

Certain measures in this MD&A do not have any standardized meaning as prescribed by Canadian GAAP such as cash flow, cash flow per share, 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 is disclosed further in this MD&A.

**Forward-Looking Statements**

This disclosure contains certain forward-looking statements that involve substantial known and unknown risks and uncertainties, including the impact of general economic conditions in all the jurisdictions in which the Corporation operates, changes in industry conditions, changes in laws and regulations including the adoption of new environmental laws, increased competition, the lack of availability of qualified personnel or management, fluctuations in foreign exchange or interest rates, stock market volatility and the Corporation's ongoing ability to obtain financing for its operations. Rally Energy's actual results, performance or achievements could differ materially from those expressed in or implied by these forward-looking statements. Accordingly, no assurance can be given that any of the events anticipated will transpire or occur, or that benefits, including the amount of revenues or proceeds, will be derived therefrom. These factors, many of which are outside the control of the Corporation, are discussed further in the December 31, 2005 MD&A and in the 2005 Annual Information Form filed on March 31, 2006.

## Production, Revenue and Netback

(thousands of dollars, unless otherwise stated)

### Six Month Comparison

|                                      | For the six months ended June 30 |                |                 |                |
|--------------------------------------|----------------------------------|----------------|-----------------|----------------|
|                                      | 2006                             |                | 2005            |                |
| <b>Production:</b>                   |                                  |                |                 |                |
| Oil (bbls/d)                         | 3,598                            |                | 2,457           |                |
| Natural gas (mcf/d)                  | 390                              |                | 162             |                |
| Total BOE (boe/d)                    | 3,663                            |                | 2,484           |                |
|                                      |                                  | <u>\$/boe</u>  |                 | <u>\$/boe</u>  |
| Gross revenue                        | \$ 29,667                        | \$44.75        | \$ 14,182       | \$31.54        |
| Production entitlement – GPC (Egypt) | (8,280)                          | (12.49)        | (3,945)         | (8.77)         |
| Overriding royalty (Egypt)           | (1,672)                          | (2.52)         | (905)           | (2.01)         |
| Marketing fees                       | (385)                            | (0.58)         | (360)           | (0.80)         |
| Royalties (Canada)                   | (247)                            | (0.37)         | (10)            | (0.03)         |
| Operating expenses                   | (5,020)                          | (7.57)         | (2,949)         | (6.56)         |
| <b>Netback from operations</b>       | <b>\$ 14,063</b>                 | <b>\$21.22</b> | <b>\$ 6,013</b> | <b>\$13.37</b> |

### Quarterly Comparison

|   | 2006           |                |                |                | 2005           |                |                |                |
|---|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
|   | Second Quarter |                | First Quarter  |                | Fourth Quarter |                | Third Quarter  |                |
| <b>Production:</b>                      |                |                |                |                |                |                |                |                |
| Oil (bbls/d)                            | 4,509          |                | 2,676          |                | 2,656          |                | 2,558          |                |
| Natural gas (mcf/d)                     | 396            |                | 388            |                | 462            |                | 330            |                |
| Total BOE (boe/d)                       | 4,575          |                | 2,741          |                | 2,733          |                | 2,613          |                |
|   |                | <u>\$/boe</u>  |                | <u>\$/boe</u>  |                | <u>\$/boe</u>  |                | <u>\$/boe</u>  |
| Gross revenue                           | \$19,605       | \$47.09        | \$10,061       | \$40.79        | \$10,019       | \$39.85        | \$10,698       | \$44.51        |
| Production entitlement<br>- GPC (Egypt) | (5,585)        | (13.41)        | (2,695)        | (10.93)        | (2,631)        | (10.47)        | (2,898)        | (12.07)        |
| Overriding royalty<br>(Egypt)           | (1,061)        | (2.55)         | (611)          | (2.48)         | (255)          | (1.02)         | (629)          | (2.62)         |
| Marketing fees                          | (213)          | (0.51)         | (171)          | (0.69)         | (159)          | (0.63)         | (103)          | (0.43)         |
| Royalties (Canada)                      | (105)          | (0.25)         | (142)          | (0.57)         | (143)          | (0.57)         | (104)          | (0.43)         |
| Operating expenses                      | (2,898)        | (6.96)         | (2,122)        | (8.60)         | (2,098)        | (8.35)         | (1,672)        | (6.96)         |
| <b>Netback from operations</b>          | <b>\$9,743</b> | <b>\$23.41</b> | <b>\$4,320</b> | <b>\$17.52</b> | <b>\$4,733</b> | <b>\$18.81</b> | <b>\$5,292</b> | <b>\$22.00</b> |

|   | 2005           |                |                |               | 2004           |                |                |                |
|---|----------------|----------------|----------------|---------------|----------------|----------------|----------------|----------------|
|   | Second Quarter |                | First Quarter  |               | Fourth Quarter |                | Third Quarter  |                |
| <b>Production:</b>                      |                |                |                |               |                |                |                |                |
| Oil (bbls/d)                            | 2,734          |                | 2,177          |               | 2,206          |                | 2,092          |                |
| Natural gas (mcf/d)                     | 240            |                | 41             |               | 192            |                | 60             |                |
| Total BOE (boe/d)                       | 2,774          |                | 2,191          |               | 2,238          |                | 2,102          |                |
|   |                | <u>\$/boe</u>  |                | <u>\$/boe</u> |                | <u>\$/boe</u>  |                | <u>\$/boe</u>  |
| Gross revenue                           | \$8,813        | \$34.91        | \$5,369        | \$27.23       | \$5,790        | \$28.12        | \$6,743        | \$34.87        |
| Production entitlement<br>- GPC (Egypt) | (2,380)        | (9.43)         | (1,565)        | (7.94)        | (1,978)        | (9.62)         | (1,272)        | (6.58)         |
| Overriding royalty<br>(Egypt)           | (558)          | (2.21)         | (347)          | (1.76)        | -              | -              | -              | -              |
| Marketing fees                          | (186)          | (0.74)         | (174)          | (0.88)        | (161)          | (0.78)         | (124)          | (0.64)         |
| Royalties (Canada)                      | (5)            | (0.01)         | (5)            | (0.03)        | (25)           | (0.12)         | (12)           | (0.06)         |
| Operating expenses                      | (1,545)        | (6.12)         | (1,404)        | (7.12)        | (1,296)        | (6.29)         | (961)          | (4.97)         |
| <b>Netback from operations</b>          | <b>\$4,139</b> | <b>\$16.40</b> | <b>\$1,874</b> | <b>\$9.50</b> | <b>\$2,330</b> | <b>\$11.31</b> | <b>\$4,374</b> | <b>\$22.62</b> |

Gross revenue for the second quarter of 2006 was \$19.6 million (\$47.09/boe; production of 4,575 boe/d), up 122% from \$8.8 million (\$34.91/boe; production of 2,774 boe/d) for the second quarter of 2005. For the six months ended June 30, 2006, gross revenue increased 109% to \$29.7 million (\$44.75/boe; production of 3,663 boe/d) from \$14.2 million (\$31.54/boe; production of 2,484 boe/d) for the comparable 2005 period. The revenue increase is primarily attributable to significantly higher production from the Issaran oilfield in Egypt commencing in March 2006. 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. Canadian production for the

second quarter was relatively consistent at 142 boe/d (Q2 2005 – 150 boe/d) and average commodity prices were \$48.15 boe/d (Q2 2005 - \$51.79 boe/d). For the six month period ended June 30, 2006 and 2005 the Canadian production was 155 boe/d (at an average commodity price of \$53.66) and 93 boe/d (at \$51.37 boe/d), respectively.

Heavy oil produced from the Issaran oilfield is marketed as Ras Gharib blend. In the first six months of 2006, the Corporation's realized wellhead oil price represented 58% of the Brent oil price as compared to 50% for the comparable 2005 period. The heavy oil price differential improved further in the 2006 second quarter to a wellhead price representing 60% of the Brent oil price as compared to 53% for the 2005 second quarter.

### **Production Entitlements, Marketing Costs and Royalties**

For the quarter ended June 30, 2006, the production entitlement of The General Petroleum Co. S.A.E. ("GPC") totaled \$5.6 million (\$13.41/boe), representing 28% of gross revenue. For the corresponding 2005 quarter, GPC's entitlement was \$2.4 million (\$9.43/boe), representing 27% of gross revenue. GPC's production entitlement was consistent at 28% for both six month periods ended June 30, 2006 and 2005, totaling \$8.3 million (\$12.49/boe) and \$3.9 million (\$8.77/boe), respectively. Under the terms of the Petroleum Service Agreement ("PSA") with GPC, the production entitlement changes on an incremental basis as production levels increase, as disclosed in the Corporation's Annual Report. This production entitlement includes all obligations with respect to government royalties and corporate income tax.

Revenue-based overriding royalty payment obligations of \$1.1 million for the 2006 second quarter increased from \$559,000 in the 2005 second quarter, commensurate with the higher Issaran oil production and realized price. For the six months ended June 30, 2006, the obligations totaled \$1.7 million (US\$1.5 million) as compared to \$905,000 for the comparable 2005 period. The capped revenue-based entitlement (10%, net of GPC's entitlement and marketing fees) amount for 2006 of US\$1.5 million was reached in June 2006. As a result, no further obligations will be generated on the remaining 2006 production; the royalty obligation will resume in January 2007 at the lower rate of 2.6%, under the terms of the agreement. This will result in significantly lower per-unit royalty costs for the balance of 2006 and in future periods.

Pursuant to the terms of certain marketing agreements pertaining to Issaran oil sales, marketing fees, linked to realized oil prices and production, of \$213,000 (\$0.51/boe) were paid during the second quarter of 2006 as compared to \$186,000 (\$0.74/boe) for the comparable 2005 quarter. For the six months ended June 30, 2006, the marketing fees totaled \$385,000 (\$0.58/boe) as compared to \$360,000 (\$0.80/boe) for the 2005 six month period. The obligations under one marketing agreement were fully satisfied at February 28, 2006 which resulted in lower per-unit costs in the second quarter of 2006.

Royalty obligations on Canadian production for the second quarter of 2006 were \$105,000 (net of the Alberta Royalty Tax Credit) increasing from \$5,000 for the 2005 second quarter. For the six month periods ended June 30, 2006 and 2005 the Canadian royalties were \$247,000 and \$10,000, respectively. During 2005, production from the primary property received a one-year oil royalty holiday which expired in January 2006.

### **Operating Expenses**

For the second quarter of 2006, operating expenses were \$2.9 million (\$6.96/boe), up from \$1.5 million (\$6.12/boe) for the 2005 second quarter. Operating expenses for the six months ended June 30, 2006 were \$5.0 million (\$7.57/boe) as compared to \$2.9 million (\$6.56/boe) for the comparable 2005 period. On a general basis, costs have increased commensurate with higher oil production in 2006. The largest contributor to this cost increase related to higher diesel fuel costs. Diesel fuel is used to power generators to provide electricity for field operations. The Corporation expects to utilize natural gas from nearby sources per boe as an alternative to diesel fuel for generators by the end of 2006 and expects to incur lower operating costs after conversion.

## General and Administrative Expenses

(thousands of dollars, unless otherwise stated)

|             |              | Three months ended June 30 |                    |                 |               |
|-------------|--------------|----------------------------|--------------------|-----------------|---------------|
|             |              | <u>Total</u>               | <u>Capitalized</u> | <u>Expensed</u> | <u>\$/boe</u> |
| <b>2006</b> |              |                            |                    |                 |               |
|             | Canada       | \$ 2,240                   | \$ 201             | \$ 2,039        | \$4.90        |
|             | Egypt        | \$ 371                     | -                  | \$ 371          | \$0.89        |
|             | Pakistan     | \$ 148                     | \$ 109             | \$ 39           | \$0.09        |
|             | <b>Total</b> | <b>\$ 2,759</b>            | <b>\$ 310</b>      | <b>\$ 2,449</b> | <b>\$5.88</b> |
| <b>2005</b> |              |                            |                    |                 |               |
|             | Canada       | \$ 686                     | \$ 77              | \$ 609          | \$2.41        |
|             | Egypt        | \$ 348                     | -                  | \$ 348          | \$1.38        |
|             | Pakistan     | \$ 130                     | \$ 97              | \$ 33           | \$0.13        |
|             | <b>Total</b> | <b>\$ 1,164</b>            | <b>\$ 174</b>      | <b>\$ 990</b>   | <b>\$3.92</b> |
|             |              | Six months ended June 30   |                    |                 |               |
|             |              | <u>Total</u>               | <u>Capitalized</u> | <u>Expensed</u> | <u>\$/boe</u> |
| <b>2006</b> |              |                            |                    |                 |               |
|             | Canada       | \$ 3,244                   | \$ 396             | \$ 2,848        | \$4.30        |
|             | Egypt        | \$ 645                     | -                  | \$ 645          | \$0.97        |
|             | Pakistan     | \$ 212                     | \$ 157             | \$ 55           | \$0.08        |
|             | <b>Total</b> | <b>\$ 4,101</b>            | <b>\$ 553</b>      | <b>\$ 3,548</b> | <b>\$5.35</b> |
| <b>2005</b> |              |                            |                    |                 |               |
|             | Canada       | \$ 1,315                   | \$ 188             | \$ 1,127        | \$2.51        |
|             | Egypt        | \$ 723                     | -                  | \$ 723          | \$1.61        |
|             | Pakistan     | \$ 176                     | \$ 132             | \$ 44           | \$0.09        |
|             | <b>Total</b> | <b>\$ 2,214</b>            | <b>\$ 320</b>      | <b>\$ 1,894</b> | <b>\$4.21</b> |

For the six months ended June 30, 2006, consolidated general and administrative (“G&A”) expenses were \$3.5 million (\$5.35/boe) as compared to \$1.9 million (\$4.21/boe) for the comparable 2005 period. For the second quarters, G&A costs were \$2.4 million (\$5.88/boe) and \$990,000 (\$3.92/boe) for 2006 and 2005, respectively. Increased G&A cost is primarily attributable to staff additions and annual wage increases. Non-cash expenses included in expensed G&A related to vesting of share options granted were \$1.6 million as compared to \$339,000 for the 2005 comparable period. Exclusive of the non-cash component, G&A costs for the six months ended June 30, 2006 were \$2.0 million (\$2.98/boe) down 14% on a boe basis from \$1.6 million (\$3.46/boe) for the comparable 2005 period.

## Interest and Finance Charges

(thousands of dollars, unless otherwise stated)

|                                  | Three months ended<br>June 30 |               | Six months ended<br>June 30 |               |
|----------------------------------|-------------------------------|---------------|-----------------------------|---------------|
|                                  | 2006                          | 2005          | 2006                        | 2005          |
| Interest expense                 | \$ 110                        | \$ 167        | \$ 163                      | \$ 370        |
| Accretion expense on debentures  | 13                            | 127           | 26                          | 163           |
| Amortization of deferred charge  | 106                           | 14            | 119                         | 50            |
| Total expense                    | <u>229</u>                    | <u>308</u>    | <u>308</u>                  | <u>583</u>    |
| Interest income                  | 13                            | 8             | 22                          | 17            |
| Gain (loss) on foreign exchange  | (91)                          | 106           | (105)                       | (15)          |
| Gain (loss) on asset disposition | (36)                          | -             | (36)                        | -             |
| Total income (expense)           | <u>(114)</u>                  | <u>114</u>    | <u>(119)</u>                | <u>2</u>      |
| Net expense                      | <u>\$ 343</u>                 | <u>\$ 194</u> | <u>\$ 427</u>               | <u>\$ 581</u> |
| \$/boe                           | <u>\$0.82</u>                 | <u>\$0.77</u> | <u>\$0.64</u>               | <u>\$1.29</u> |

Total interest and finance charges decreased to \$427,000 for the six months ended June 30, 2006 from \$581,000 for the comparable 2005 period primarily as a result of lower outstanding debt amounts and fluctuations in foreign exchange rates. During the second quarter of 2006, only \$1.3 million of the Corporation's 12% unsecured convertible debentures were outstanding as compared to an average of \$4.7 million during the comparable 2005. Interest expenses were higher in 2005 due to the higher average debt during the comparable 2006 period. Included in the 2006 six month amount is \$139,000 (2005 - \$213,000) of non-cash charges pertaining to the convertible debentures issued in 2003.

### Depletion, Depreciation and Accretion

(thousands of dollars, unless otherwise stated)

|                                       | Three months ended |          | Six months ended |          |
|---------------------------------------|--------------------|----------|------------------|----------|
|                                       | June 30            |          | June 30          |          |
|                                       | 2006               | 2005     | 2006             | 2005     |
| Depletion, depreciation and accretion | \$ 2,738           | \$ 2,472 | \$ 5,008         | \$ 3,950 |
| \$/boe                                | \$6.58             | \$9.79   | \$7.55           | \$8.79   |

Total depletion, depreciation and accretion ("DD&A") charges for the six months ended June 30, 2006 were \$5.0 million (\$7.55/boe), of which depletion pertaining to producing properties in Egypt represented \$3.3 million. The remainder represents depletion charges of \$1.5 million for Canadian production and fixed asset depreciation of \$237,000. DD&A charges for the second quarter of 2006 were \$2.7 million (\$6.58/boe) and \$2.5 million (\$9.79/boe) for the 2005 second quarter. Overall, depletion rates have declined due to reserve additions achieved through the Corporation's \$14.2 million capital expenditure investment in the first six months of 2006.

### Cash Flow from Operations

Cash flow from operations represents net income (loss) plus items not affecting cash which include stock-based compensation, accretion, depletion, depreciation and other non-cash items. For the quarter ended June 30, 2006, Rally Energy's cash flow from operations was \$8.4 million (\$0.09/share) an increase of 158% over \$3.2 million (\$0.04/share) for the 2005 second quarter. For the six months ended June 30, 2006, Rally Energy's cash flow from operations increased by 189% to \$11.8 million (\$0.13/share) as compared \$4.1 million (\$0.05/share) for the comparable 2005 period.

### Net Income

Rally Energy recorded net income of \$4.2 million (\$0.05/share) for the second quarter of 2006, an eight fold increase from \$484,000 (\$0.01/share) for the comparable 2005 quarter. For the six months ended June 30, 2006, Rally Energy's net income was \$5.1 million (\$0.06/share) as compared to a net loss of \$412,000 ((\$0.01)/share) for the comparable 2005 period.

### SUMMARY OF QUARTERLY RESULTS

(thousands of dollars, unless otherwise stated)

|          | Revenue  | Cash flow<br>from<br>operations | \$/share -<br>basic | Income (loss) | \$/share -<br>basic |
|----------|----------|---------------------------------|---------------------|---------------|---------------------|
| 2006: Q2 | \$19,605 | \$8,362                         | \$0.09              | \$ 4,213      | \$0.046             |
| Q1       | \$10,061 | \$3,445                         | \$0.04              | \$ 866        | \$0.010             |
| 2005: Q4 | \$10,019 | \$3,405                         | \$0.05              | \$ 618        | \$0.007             |
| Q3       | \$10,693 | \$4,387                         | \$0.05              | \$ 1,334      | \$0.016             |
| Q2       | \$8,813  | \$3,235                         | \$0.04              | \$ 484        | \$0.005             |
| Q1       | \$5,369  | \$ 856                          | \$0.01              | \$ (895)      | \$(0.01)            |
| 2004: Q4 | \$5,790  | \$1,170                         | \$0.02              | \$ 1,138      | \$0.02              |
| Q3       | \$6,743  | \$3,187                         | \$0.05              | \$ 687        | \$0.01              |

## Capital Expenditures

During the first six months of 2006, Rally Energy drilled 11 successful oil wells (11 net) in Egypt and participated in the drilling of two successful oil and gas wells (0.62 net) in Canada. Capital expenditures for the six months ended June 30, 2006 totaled \$14.2 million, up from \$11.5 million for the comparable 2005 period.

| (thousands of dollars)             | Three months ended<br>June 30 |                 | Six months ended<br>June 30 |                  |
|------------------------------------|-------------------------------|-----------------|-----------------------------|------------------|
|                                    | 2006                          | 2005            | 2006                        | 2005             |
| <b>Egypt</b>                       |                               |                 |                             |                  |
| Drill, complete and workovers      | \$ 4,761                      | \$ 2,216        | \$ 10,191                   | \$ 5,353         |
| Facilities, equipment and other    | 574                           | 252             | 1,069                       | 352              |
| Thermal project                    | 360                           | 410             | 704                         | 581              |
| Inventory change                   | 205                           | 110             | 16                          | (19)             |
| Property acquisition (disposition) | -                             | -               | -                           | -                |
| Capitalized admin. costs           | -                             | -               | -                           | -                |
| <b>Total</b>                       | <b>\$ 5,900</b>               | <b>\$ 2,988</b> | <b>\$ 11,980</b>            | <b>\$ 6,267</b>  |
| <b>Canada</b>                      |                               |                 |                             |                  |
| Drill, complete and workovers      | \$ 792                        | \$ 1,680        | \$ 1,545                    | \$ 3,144         |
| Facilities, equipment and other    | 114                           | 66              | 119                         | 297              |
| Property acquisition (disposition) | -                             | -               | -                           | 467              |
| Capitalized admin. costs           | 201                           | 78              | 396                         | 188              |
| <b>Total</b>                       | <b>\$ 1,107</b>               | <b>\$ 1,824</b> | <b>\$ 2,060</b>             | <b>\$ 4,096</b>  |
| <b>Pakistan</b>                    |                               |                 |                             |                  |
| Drill and complete                 | \$ -                          | \$ 686          | \$ -                        | \$ 983           |
| Facilities, equipment and other    | (37)                          | 21              | 27                          | 21               |
| Capitalized admin. costs           | 109                           | 97              | 157                         | 132              |
| <b>Total</b>                       | <b>\$ 72</b>                  | <b>\$ 804</b>   | <b>\$ 184</b>               | <b>\$ 1,136</b>  |
| <b>Grand Total</b>                 |                               |                 |                             |                  |
| Drill, complete and workovers      | \$ 5,553                      | \$ 4,582        | \$ 11,736                   | \$ 9,480         |
| Facilities, equipment and other    | 651                           | 339             | 1,215                       | 670              |
| Thermal project                    | 360                           | 410             | 704                         | 581              |
| Inventory change                   | 205                           | 110             | 16                          | (19)             |
| Property acquisition (disposition) | -                             | -               | -                           | 467              |
| Capitalized admin. costs           | 310                           | 175             | 553                         | 320              |
| <b>Total</b>                       | <b>\$ 7,079</b>               | <b>\$ 5,616</b> | <b>\$ 14,224</b>            | <b>\$ 11,499</b> |

Included in the above amounts are casing and tubing inventory costs of \$1.8 million at June 30, 2006 (December 31, 2005 - \$571,000) to be used in future Issaran drilling programs.

On June 12, 2006, the Corporation announced that it had entered into an agreement to increase its working interest in the Safed Koh Concession from 22.5% to 30%. The Offer to Purchase the additional 7.5% working interest is to one of the existing Safed Koh Block partners (a private company) for a purchase price of US\$11.4 million and is subject to certain conditions. Rally Energy has reserved for issuance to the vendor 1,372,846 million common shares, at a price of \$2.30 per share, representing 25% of the purchase price. The remaining balance of US\$8.55 million will be paid in cash at closing from existing credit facilities.

At June 30, 2006 the Corporation continued to meet the asset impairment test for the capitalized costs and no ceiling test write-down was required.

## **Liquidity and Capital Resources**

At June 30, 2006, the Corporation had a cash position of \$5.3 million, of which \$753,000 represented funds on deposit to secure letters of credit. Working capital at June 30, 2006 was \$11.4 million, a substantial increase from \$699,000 at December 31, 2005 and from a working capital shortfall of \$2.9 million at March 31, 2006. A significant portion of this related to moving current bank debt to long-term debt and converting or redeeming outstanding convertible debentures. Increased accounts receivable from higher production levels were largely offset by accounts payable related to the Corporation's increased capital program.

As a result of establishing a new US\$25 million debt facility with the International Finance Corporation ("IFC") (a member of the World Bank Group) during the 2006 second quarter, all borrowings are now classified as long-term. At June 30, 2006, Rally Energy had drawn US\$10 million on the IFC credit facility. Additionally, all of the remaining \$1.3 million of Convertible Debentures either converted to common shares (at \$1.10/share) or were redeemed by June 30, 2006. The Convertible Debentures had previously been classified as current due to their maturity on July 1, 2006.

During the first six months of 2006, Rally Energy received proceeds of \$539,000 from the exercise of an aggregate of 796,000 common share options and \$849,000 from the exercise of an aggregate of 531,000 common share purchase warrants. Subsequent to June 30, 2006, the Corporation received \$5.6 million pursuant to the exercise of 3.5 million warrants (at \$1.60 per share). All remaining \$1.60 warrants were exercised on or before July 20, 2006.

On May 19, 2006, the Corporation finalized agreements with the IFC, for a US\$25 million of long-term financing facilities. The facility is 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. and Rally Energy Safed Koh Ltd. The facilities will be used to fund working capital requirements and upcoming capital requirements for the Corporation's projects in Egypt and Pakistan. 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 matures on October 15, 2009 and requires semi-annual interest payments at LIBOR plus 2.625%. The Revolving loan is comprised of two US\$10 million tranches of which the second tranche will become available upon completion of certain documents related to the Pakistan project. In connection with the credit facilities, the Corporation issued three million common share purchase warrants to the IFC on May 19, 2006. Each warrant entitles the holder to purchase one common share of the Corporation at a price of \$1.92 per common share until the earlier of three years from issuance or 30 days after the date on which the Corporation's common shares close at or above \$2.95 for ten consecutive trading days.

## **2006 OUTLOOK**

A planned 15 well drilling program, combined with a continuation of steam pilots, is expected to convert probable reserves to the proved category and to increase production from our significantly increased 2005 Egypt oil reserves. Production from existing wells will continue to be enhanced through the installation of high performance pumps and through an on-going well optimization program. The Corporation is committed to increasing its land holdings in Egypt and will continue to examine available opportunities, including the evaluation of the October 2006 bid round lands, which, if successful, will further enhance opportunities for reserves and production growth in Egypt.

In Pakistan, the January 2006 "Commerciality Declaration" has now created an opportunity to proceed with construction of a tie-in pipeline for the sizable gas and associated condensate reserve discoveries reported in 2005. Sales are expected to commence in November 2006, and additional drilling is expected to commence in the 2006 third quarter. Initially, two development wells are expected to be drilled on the Salsabil (Rodho) discovery structure to increase deliverability from the recognized recoverable reserves and test deeper reservoir horizons. Subsequent exploration wells will follow immediately thereafter in the Afiband and Zindapir structures. Closing of the announced acquisition of an additional 7.5% working interest in Safed Koh later this year will increase the Corporation's working interest to 30% (see "Capital Expenditures").

**Rally Energy Corp.**  
**Consolidated Balance Sheets**  
**(unaudited)**

**June 30,**  
**2006**                      **December 31,**  
**2005**

**Assets**

**Current**

|                               |                   |                   |
|-------------------------------|-------------------|-------------------|
| Cash                          | \$ 4,517,341      | \$ 801,639        |
| Restricted cash (Note 1)      | 752,618           | -                 |
| Accounts receivable           | 17,317,551        | 8,906,244         |
| Inventory (Note 2)            | 499,257           | 305,061           |
| Prepaid expenses and deposits | 511,577           | 468,943           |
|                               | <b>23,598,344</b> | <b>10,481,887</b> |

**Future income tax asset (Note 7)**

-                      705,000

**Long-term investments**

150,000                      150,000

**Property and equipment**

57,677,254                      48,334,494

**Deferred charges (Note 4)**

2,823,472                      26,440

**\$ 84,249,070**                      **\$ 59,697,821**

**Liabilities and Shareholders' Equity**

**Current**

|                               |                   |                  |
|-------------------------------|-------------------|------------------|
| Accounts payable – operations | \$ 5,419,084      | \$ 4,572,583     |
| Accounts payable – capital    | 6,740,753         | 3,922,935        |
| Convertible debentures        | -                 | 1,287,555        |
|                               | <b>12,159,837</b> | <b>9,783,073</b> |

**Asset retirement obligations (Note 3)**

717,236                      590,382

**Long-term debt (Note 4)**

11,194,500                      -

**24,071,573**                      **10,373,455**

**Shareholders' equity**

|                                 |                   |                   |
|---------------------------------|-------------------|-------------------|
| Equity instruments (Note 5(a))  | 61,149,452        | 56,249,969        |
| Contributed surplus (Note 5(d)) | 2,842,392         | 1,968,082         |
| Deficit                         | (3,814,347)       | (8,893,685)       |
|                                 | <b>60,177,497</b> | <b>49,324,366</b> |

**\$ 84,249,070**                      **\$ 59,697,821**

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

**Rally Energy Corp.**  
**Consolidated Statements of Income and Deficit**  
(unaudited)

|   | Three months ended<br>June 30 |                 | Six months ended<br>June 30 |                 |
|---|-------------------------------|-----------------|-----------------------------|-----------------|
|   | 2006                          | 2005            | 2006                        | 2005            |
| <b>Oil and gas revenue</b>                    | <b>\$ 19,605,132</b>          | \$ 8,812,726    | <b>\$ 29,666,579</b>        | \$ 14,182,311   |
| Less: Royalties and related credits           | <b>(6,964,098)</b>            | (3,128,841)     | <b>(10,583,517)</b>         | (5,220,006)     |
|   | <b>12,641,034</b>             | 5,683,885       | <b>19,083,062</b>           | 8,962,305       |
| Operating expenses                            | <b>2,897,946</b>              | 1,544,588       | <b>5,019,866</b>            | 2,948,982       |
|   | <b>9,743,088</b>              | 4,139,297       | <b>14,063,196</b>           | 6,013,323       |
| <b>Expenses</b>                               |                               |                 |                             |                 |
| Administrative expenses:                      |                               |                 |                             |                 |
| Administration                                | <b>1,157,407</b>              | 851,486         | <b>1,974,357</b>            | 1,554,553       |
| Stock-based compensation                      | <b>1,291,508</b>              | 137,910         | <b>1,573,910</b>            | 339,304         |
|   | <b>2,448,915</b>              | 989,396         | <b>3,548,267</b>            | 1,893,857       |
| Interest expense                              | <b>110,406</b>                | 167,646         | <b>163,352</b>              | 370,336         |
| Depletion, depreciation and accretion         | <b>2,738,046</b>              | 2,472,416       | <b>5,008,341</b>            | 3,950,477       |
| Accretion expense on convertible debentures   | <b>13,221</b>                 | 126,702         | <b>26,445</b>               | 162,621         |
| Amortization of deferred charges              | <b>105,630</b>                | 14,029          | <b>118,851</b>              | 49,939          |
|   | <b>5,416,218</b>              | 3,770,189       | <b>8,865,256</b>            | 6,427,230       |
| <b>Income (loss) before under noted items</b> | <b>4,326,870</b>              | 369,108         | <b>5,197,940</b>            | (413,907)       |
| <b>Other items</b>                            |                               |                 |                             |                 |
| Interest income                               | <b>13,037</b>                 | 8,104           | <b>22,468</b>               | 17,382          |
| Gain (loss) on foreign exchange               | <b>(90,505)</b>               | 106,334         | <b>(105,214)</b>            | (14,996)        |
| Gain (loss) on asset disposition              | <b>(35,856)</b>               | -               | <b>(35,856)</b>             | -               |
|   | <b>(113,324)</b>              | 114,438         | <b>(118,602)</b>            | 2,386           |
| <b>Net income (loss) for the period</b>       | <b>4,213,546</b>              | 483,546         | <b>5,079,338</b>            | (411,521)       |
| Deficit, beginning of period                  | <b>(8,027,893)</b>            | (11,329,894)    | <b>(8,893,685)</b>          | (10,434,827)    |
| <b>Deficit, end of period</b>                 | <b>\$ (3,814,347)</b>         | \$ (10,846,348) | <b>\$ (3,814,347)</b>       | \$ (10,846,348) |
| <b>Income (loss) per share (Note 5(e))</b>    |                               |                 |                             |                 |
| Basic   | <b>\$ 0.046</b>               | \$ 0.005        | <b>\$ 0.055</b>             | \$ (0.006)      |
| Diluted                                       | <b>\$ 0.043</b>               | \$ 0.005        | <b>\$ 0.053</b>             | \$ n/a          |

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

**Rally Energy Corp.**  
**Consolidated Statements of Cash Flows**  
(unaudited)

|  | Three months ended<br>June 30 |                    | Six months ended<br>June 30 |                     |
|--|-------------------------------|--------------------|-----------------------------|---------------------|
|  | 2006                          | 2005               | 2006                        | 2005                |
| <b>Cash flows from operating activities</b>                            |                               |                    |                             |                     |
| Net income (loss) for the period                                       | \$ 4,213,546                  | \$ 483,546         | \$5,079,338                 | \$ (411,521)        |
| Non-cash items:  |                               |                    |                             |                     |
| Stock-based compensation   | 1,291,508                     | 137,910            | 1,573,910                   | 339,304             |
| Accretion expense on convertible debentures                            | 13,221                        | 126,702            | 26,445                      | 162,621             |
| Amortization of deferred charges                                       | 105,630                       | 14,029             | 118,851                     | 49,939              |
| Depletion, depreciation and accretion                                  | 2,738,046                     | 2,472,416          | 5,008,341                   | 3,950,477           |
|  | <u>8,361,951</u>              | <u>3,234,603</u>   | <u>11,806,885</u>           | <u>4,090,820</u>    |
| Changes in non-cash working capital balances:                          |                               |                    |                             |                     |
| Accounts receivable  | (7,608,889)                   | (2,325,836)        | (8,411,307)                 | (1,334,501)         |
| Notes receivable   | -                             | -                  | -                           | 257,270             |
| Inventory  | (142,786)                     | 95,317             | (194,196)                   | 246,303             |
| Prepaid expenses and deposits  | 68,736                        | 52,565             | (42,634)                    | 14,209              |
| Accounts payable - operations  | 1,458,855                     | 697,472            | 846,501                     | 1,212,824           |
|  | <u>2,137,867</u>              | <u>1,754,121</u>   | <u>4,005,249</u>            | <u>4,486,925</u>    |
| <b>Cash flows from investing activities</b>                            |                               |                    |                             |                     |
| Oil and gas assets, net  | (7,079,587)                   | (5,616,213)        | (14,224,247)                | (11,499,272)        |
| Changes in accounts payable - capital                                  | 841,101                       | (41,436)           | 2,858,112                   | 742,856             |
|  | <u>(6,238,486)</u>            | <u>(5,657,649)</u> | <u>(11,366,135)</u>         | <u>(10,756,416)</u> |
| <b>Cash flows from financing activities</b>                            |                               |                    |                             |                     |
| Issuance of common shares, net of share issue costs                    | 1,240,410                     | 1,930,546          | 1,380,016                   | 2,742,563           |
| Increase in restricted cash  | (752,618)                     | -                  | (752,618)                   | -                   |
| Bank debt increase (decrease)  | (2,349,306)                   | 1,935,804          | -                           | 3,155,418           |
| Long-term debt increase  | 11,194,500                    | -                  | 11,194,500                  | -                   |
| Increase in deferred financing charges                                 | (698,010)                     | -                  | (698,010)                   | -                   |
| Redemption of convertible debentures                                   | (7,006)                       | -                  | (7,006)                     | -                   |
|  | <u>8,627,970</u>              | <u>3,866,350</u>   | <u>11,116,882</u>           | <u>5,897,981</u>    |
| <b>Foreign exchange gain (loss) on cash held in a foreign currency</b> | <u>(10,010)</u>               | <u>37,178</u>      | <u>(40,294)</u>             | <u>13,265</u>       |
| <b>Increase (decrease) in cash</b>                                     | <u>4,517,341</u>              | <u>-</u>           | <u>3,715,702</u>            | <u>(358,245)</u>    |
| Cash, beginning of period  | -                             | -                  | 801,639                     | 358,245             |
| <b>Cash, end of period</b>   | <u>\$ 4,517,341</u>           | <u>\$ -</u>        | <u>\$ 4,517,341</u>         | <u>\$ -</u>         |

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

**Rally Energy Corp.**  
**Selected Notes to Consolidated Financial Statements**  
**Six months ended June 30, 2006 (unaudited)**

The interim consolidated financial statements of Rally Energy Corp. (the "Corporation") have been prepared by management in accordance with accounting principles generally accepted in Canada. The interim consolidated financial statements have been prepared following the same accounting policies and methods of computation as the consolidated financial statements for the fiscal year ended December 31, 2005, unless otherwise stated below. The disclosure applied to the interim consolidated financial statements does not conform in all respects to the requirements of generally accepted accounting principles for annual financial statements and, therefore, should be read in conjunction with the consolidated financial statements and notes thereto in the Corporation's annual report for the year ended December 31, 2005.

**1. Restricted Cash**

As security for letters of credit issued to secure equipment orders for Egyptian drilling operations and work commitments in Pakistan, \$752,618 is held on deposit with a Canadian chartered bank. The funds are invested in a monthly interest-bearing revolving term deposit. The letters of credit expire on October 31, 2006 and the funds will be released on or before that date.

**2. Property and Equipment**

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

|   | June 30, 2006        | December 31, 2005    |
|---|----------------------|----------------------|
| Petroleum and natural gas assets                    | \$ 82,619,323        | \$ 69,248,721        |
| Mining claims                                       | 1                    | 1                    |
| Furniture, machinery and equipment                  | 3,817,113            | 2,855,712            |
|   | <u>86,436,437</u>    | <u>72,104,434</u>    |
| Accumulated depletion, depreciation and write-downs | (28,759,183)         | (23,769,940)         |
| Net book value                                      | <u>\$ 57,677,254</u> | <u>\$ 48,334,494</u> |

The Corporation has recorded deferred exploration expenditures of \$1,822,008 in Pakistan. When production commences, these costs will be depleted on a unit-of-production basis thereafter.

During the six months ended June 30, 2006, the Corporation capitalized general and administrative expenditures, which were included in petroleum and natural gas assets as follows:

|          | Three months ended |                   | Six months ended  |                   |
|----------|--------------------|-------------------|-------------------|-------------------|
|          | June 30            |                   | June 30           |                   |
|          | 2006               | 2005              | 2006              | 2005              |
| Canada   | \$ 201,458         | \$ 77,196         | \$ 395,925        | \$ 187,697        |
| Pakistan | 108,382            | 97,326            | 156,828           | 132,010           |
|          | <u>\$ 309,840</u>  | <u>\$ 174,522</u> | <u>\$ 552,753</u> | <u>\$ 319,707</u> |

The Corporation did not capitalize any general and administrative expenditures related to its Egypt properties. No interest has been capitalized.

**Rally Energy Corp.**  
**Selected Notes to Consolidated Financial Statements**  
**Six months ended June 30, 2006 (unaudited)**

**2. Property and Equipment (continued)**

At June 30, 2006, the Corporation held \$2,336,271 (June 30, 2005 - \$845,329) of inventory available for future capital expenditures in the Issaran oilfield in Egypt. Of this amount, (i) \$1,837,014 relates to capital equipment, primarily pipe, and is included in property and equipment and (ii) \$499,257 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.

Costs of unproved petroleum and natural gas properties, primarily in Canada, at June 30, 2006, amounted to \$65,996 (June 30, 2005 - nil) and have been excluded from the depletion calculation.

**3. 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:

|          | <b>June 30, 2006</b>      | Cost Incurrence |          | <b>December 31, 2005</b> |
|----------|---------------------------|-----------------|----------|--------------------------|
|          |                           | Range           | Majority |                          |
| Egypt    | <b>\$ 799,600</b>         | 2015-2017       | 2017     | \$684,740                |
| Pakistan | <b>37,672</b>             | 2015-2020       | 2020     | 39,251                   |
| Canada   | <b>279,500</b>            | 2006-2019       | 2019     | 209,500                  |
|          | <b><u>\$1,116,772</u></b> |                 |          | <b><u>\$933,491</u></b>  |

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. A reconciliation of the discounted asset retirement obligations is provided below:

|                                     | <b>Six months ended<br/>June 30, 2006</b> | Year ended<br>December 31, 2005 |
|-------------------------------------|---|---------------------------------|
| <i>Asset retirement obligations</i> |   |                                 |
| Balance, beginning of period        | <b>\$ 590,382</b>                         | \$ 289,846                      |
| Liabilities incurred in period      | <b>107,756</b>                            | 277,554                         |
| Accretion expense                   | <b>19,098</b>                             | 22,982                          |
| Balance, end of period              | <b><u>\$ 717,236</u></b>                  | <b><u>\$ 590,382</u></b>        |

**Rally Energy Corp.**  
**Selected Notes to Consolidated Financial Statements**  
**Six months ended June 30, 2006 (unaudited)**

**4. 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 a US\$25 million of long-term financing facilities. The facility is 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 matures on October 15, 2009 and requires semi-annual interest payments at LIBOR plus 2.625%. A 1.31% standby fee on the unused portion of the available Revolving loan is payable semi-annually. The Revolving loan is comprised of two US\$10 million tranches of which the second tranche will become available upon completion of certain documents related to the Pakistan project. All setup costs pertaining to these facilities, along with the value attributed to the share purchase warrants (Note 4(c)), have been recorded as deferred financing charges and will be amortized over the life of the Revolving facility.

These reserve-based facilities are secured by proceeds from oil and gas sales, shares of SPEL and RESK and the Corporation's rights under the Issaran PSA and 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 June 30<sup>th</sup>, 2006, US\$10 million was drawn under these facilities (US\$5 million from the Term loan and US\$5 million from the Revolving loan), at which time the Corporation's previous US\$7 million credit facility with a major Canadian bank was paid out and all related security discharged.

**5. Equity Instruments**

(a) Issued and outstanding

|   | Six months ended<br>June 30, 2006 |                     | Year ended<br>December 31, 2005 |                     |
|---|-----------------------------------|---------------------|---------------------------------|---------------------|
|   | Number of<br>Shares               | Amounts             | Number of<br>Shares             | Amounts             |
| <b>Common shares</b>                                  |                                   |                     |                                 |                     |
| Balance, beginning of period                          | 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                                      | -                                 | -                   | 8,000,000                       | 9,095,758           |
| Stock options exercised                               | 795,758                           | 801,364             | 2,137,000                       | 1,811,673           |
| Warrants exercised                                    | 530,600                           | 970,998             | -                               | -                   |
| Debentures converted                                  | 1,188,176                         | 1,743,993           | 4,686,000                       | 4,686,000           |
|   | <u>93,539,913</u>                 | <u>60,424,969</u>   | <u>91,025,379</u>               | <u>56,908,614</u>   |
| LESS: Share issue costs (net of tax effect)           |                                   | <u>(2,275,594)</u>  |                                 | <u>(1,562,887)</u>  |
|   |                                   | <u>58,149,375</u>   |                                 | <u>55,345,727</u>   |
| <b>Share purchase warrants – common shares</b>        |                                   |                     |                                 |                     |
| Balance, beginning of period                          | 4,000,000                         | 904,242             | -                               | -                   |
| Issued (Note 5(c))                                    | 3,000,000                         | 2,217,873           | 4,000,000                       | 904,242             |
| Exercised   | (530,600)                         | (122,038)           | -                               | -                   |
|   | <u>6,469,400</u>                  | <u>3,000,077</u>    | <u>4,000,000</u>                | <u>904,242</u>      |
| <b>Balance, end of period, all equity instruments</b> |                                   | <u>\$61,149,452</u> |                                 | <u>\$56,249,969</u> |

**Rally Energy Corp.**  
**Selected Notes to Consolidated Financial Statements**  
**Six months ended June 30, 2006 (unaudited)**

**5. Equity Instruments (continued)**

(b) Options

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

The value ascribed to options granted is recorded as contributed surplus. The Corporation recorded stock-based compensation expense for options issued and vested during the periods noted below:

|  | Three months ended<br>June 30    |              | Six months ended<br>June 30 |              |
|--|----------------------------------|--------------|-----------------------------|--------------|
|  | 2006                             | 2005         | 2006                        | 2005         |
|  | Stock-based compensation expense | \$ 1,291,508 | \$ 137,910                  | \$ 1,573,910 |

|                            | Six months ended<br>June 30, 2006 |  | Year ended<br>December 31, 2005 |  |
|----------------------------|-----------------------------------|--|---------------------------------|--|
|                            | Share<br>Options                  | Weighted<br>Average<br>Exercise<br>Price | Share<br>Options                | Weighted<br>Average<br>Exercise<br>Price |
|                            | Outstanding, beginning of period  | 7,356,759                                | \$1.02                          | 6,327,757                                |
| Granted                    | 1,105,000                         | \$2.30                                   | 3,361,000                       | \$1.48                                   |
| Cancelled                  | (175,000)                         | \$1.34                                   | (194,998)                       | \$0.93                                   |
| Exercised                  | (795,758)                         | \$0.68                                   | (2,137,000)                     | \$0.60                                   |
| Outstanding, end of period | 7,491,001                         | \$1.34                                   | 7,356,759                       | \$1.02                                   |

**Options Outstanding**

| Exercise<br>Price | June 30, 2006     |             |   | December 31, 2005 |             |   |
|-------------------|-------------------|-------------|---|-------------------|-------------|---|
|                   | Number of Options |             | Weighted<br>Average<br>Years to<br>Expiry | Number of Options |             | Weighted<br>Average<br>Years to<br>Expiry |
|                   | Outstanding       | Exercisable |   | Outstanding       | Exercisable |   |
| \$0.54            | 150,000           | 150,000     | 2.92                                      | 200,000           | 150,000     | 2.76                                      |
| \$0.60            | 1,743,000         | 1,668,000   | 1.20                                      | 2,245,000         | 2,170,000   | 1.60                                      |
| \$0.61            | 333,667           | 333,667     | 2.33                                      | 451,667           | 451,667     | 2.38                                      |
| \$0.76            | 815,000           | 743,334     | 3.17                                      | 865,000           | 793,334     | 3.49                                      |
| \$0.80            | 240,000           | 240,000     | 1.75                                      | 240,000           | 240,000     | 2.25                                      |
| \$0.88            | -                 | -           | -   | 34,091            | 34,091      | 0.25                                      |
| \$1.32            | 500,000           | 250,000     | 4.04                                      | 500,000           | 250,000     | 4.54                                      |
| \$1.34            | 1,033,000         | 516,500     | 4.50                                      | 1,208,000         | 604,000     | 5.00                                      |
| \$1.40            | 310,000           | 103,334     | 4.21                                      | 310,000           | 103,334     | 4.71                                      |
| \$1.54            | 250,000           | 166,668     | 3.83                                      | 250,000           | 83,334      | 4.33                                      |
| \$1.55            | 318,333           | 95,003      | 4.33                                      | 335,000           | 111,670     | 4.83                                      |
| \$1.79            | 518,001           | 352,006     | 3.54                                      | 543,001           | 211,008     | 3.77                                      |
| \$1.85            | 175,000           | 116,667     | 3.71                                      | 175,000           | 58,334      | 4.21                                      |
| \$2.30            | 1,105,000         | 865,000     | 5.00                                      | -                 | -           | -   |
|                   | 7,491,001         | 5,600,179   | 2.96                                      | 7,356,759         | 5,260,772   | 3.27                                      |

**Rally Energy Corp.**  
**Selected Notes to Consolidated Financial Statements**  
**Six months ended June 30, 2006 (unaudited)**

**5. Equity Instruments (continued)**

(c) In connection with the IFC credit facilities (Note 4), the Corporation issued three million common share purchase warrants to the IFC on May 19, 2006. Each warrant entitles the IFC to purchase one common share of the Corporation at a price of \$1.92 per common share until the earlier of three years from issuance or 30 days after the date on which the Corporation's common shares close at or above \$2.95 for ten consecutive trading days. 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: dividend yield (nil), volatility (50%), and a risk-free interest rate (5%).

(d) Contributed surplus

|                                  | <b>Six months<br/>ended<br/>June 30, 2006</b> | <b>Year ended<br/>December 31, 2005</b> |
|----------------------------------|---|---|
| Balance, beginning of period     | <b>\$ 1,968,082</b>                           | \$ 1,063,620                            |
| Stock-based compensation expense | <b>1,573,910</b>                              | 1,435,925                               |
| Options exercised                | <b>(262,600)</b>                              | (531,463)                               |
| Debentures exercised             | <b>(437,000)</b>                              | -                                       |
| Balance, end of period           | <b>\$ 2,842,392</b>                           | \$ 1,968,082                            |

(e) Per share amounts

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

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

|  | <b>Three months ended<br/>June 30</b> |             |
|--|---------------------------------------|-------------|
|  | <b>2006</b>                           | <b>2005</b> |
| Net income available to common shareholders                    | <b>\$ 4,213,546</b>                   | \$ 483,546  |
| Weighted-average number of common shares outstanding – basic   | <b>92,498,721</b>                     | 78,663,244  |
| Dilution effect of stock options                               | <b>3,198,639</b>                      | 2,426,334   |
| Dilution effect of warrants                                    | <b>1,391,373</b>                      | -           |
| Dilution effect of convertible debentures                      | -                                     | 1,194,545   |
| Weighted-average number of common shares outstanding – diluted | <b>97,088,733</b>                     | 82,284,123  |
| Net income per share (\$/share)                                |                                       |             |
| Basic  | <b>\$0.046</b>                        | \$0.006     |
| Diluted  | <b>\$0.043</b>                        | \$0.006     |

**Rally Energy Corp.**  
**Selected Notes to Consolidated Financial Statements**  
**Six months ended June 30, 2006 (unaudited)**

**5. Equity Instruments (continued)**

|  | Six months ended<br>June 30 |              |
|--|-----------------------------|--------------|
|  | 2006                        | 2005         |
| Net income (loss) available to common shareholders             | <b>\$ 5,079,338</b>         | \$ (411,521) |
| Weighted-average number of common shares outstanding – basic   | <b>91,799,988</b>           | 77,239,186   |
| Dilution effect of stock options                               | <b>2,686,018</b>            | 2,426,334    |
| Dilution effect of warrants                                    | <b>798,176</b>              | -            |
| Dilution effect of convertible debentures                      | -                           | 1,194,545    |
| Weighted-average number of common shares outstanding – diluted | <b>95,284,182</b>           | 80,860,065   |
| Net income (loss) per share (\$/share)                         |                             |              |
| Basic  | <b>\$0.055</b>              | (\$0.005)    |
| Diluted  | <b>\$0.053</b>              | n/a          |

Outstanding stock options and common share purchase warrants are the only instruments that are currently dilutive to earnings per share. At June 30, 2006, no stock options, warrants or convertible debentures were antidilutive and excluded from the computation of diluted earnings per share (June 30, 2005 – 1,008,000).

**6. Related Party Transactions**

For the six months ended June 30, 2006, the Corporation paid consulting fees to companies, whose principals are directors and officers of the Corporation. The 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.

|                         | Three months ended<br>June 30 |            | Six months ended<br>June 30 |            |
|-------------------------|-------------------------------|------------|-----------------------------|------------|
|                         | 2006                          | 2005       | 2006                        | 2005       |
| Administrative expenses | <b>\$ 39,375</b>              | \$ 177,811 | <b>\$ 94,675</b>            | \$ 260,160 |
| Capitalized             | <b>39,375</b>                 | 131,963    | <b>101,625</b>              | 256,189    |
|                         | <b>\$ 78,750</b>              | \$ 309,774 | <b>\$ 196,300</b>           | \$ 516,349 |

**7. Income Taxes**

No provision for taxes has been recorded since the Corporation has adequate tax pools and non-capital loss carry forwards to offset any Canadian tax obligations. In February 2006, the Corporation renounced \$2,016,000 of exploration expenditures, and utilized the \$705,000 future income tax asset that was recorded at December 31, 2005. Accordingly, the \$705,000 is recorded in share issue costs. All production in Egypt is subject to a royalty charge, pursuant to the terms of the PSA, which satisfies all tax liabilities. Upon commencement of production in Pakistan, local taxes will apply and cumulative tax pools will be utilized.

During the six months ended June 30, 2006, the Corporation has fulfilled its commitments under flow-through agreements to incur qualifying expenditures in Canada.

**Rally Energy Corp.**  
**Selected Notes to Consolidated Financial Statements**  
**Six months ended June 30, 2006 (unaudited)**

**8. Commitments**

During the second quarter of 2006, a wholly-owned subsidiary of the Corporation entered into an operating lease for office premises in Cairo, Egypt, requiring the following payments:

|      |                  |
|------|------------------|
| 2006 | \$ 63,000        |
| 2007 | 108,000          |
| 2008 | 111,500          |
| 2009 | 114,000          |
| 2010 | 114,000          |
| 2011 | <u>47,500</u>    |
|      | <u>\$558,000</u> |

**9. Segmented Information**

The Corporation operates in the oil and gas industry. Its reportable segments are identified on a geographic basis.

**Geographic Segments:**

The Corporation has operations in Egypt, Pakistan and Canada. Gross revenue for the three and six months ended June 30 and capital assets are summarized on a country basis below:

|   | Egypt                | Canada                | Pakistan            | Total               |
|---|----------------------|-----------------------|---------------------|---------------------|
| <b>Three months ended June 30, 2006</b> |                      |                       |                     |                     |
| Gross revenue                           | <u>\$ 18,982,754</u> | <u>\$ 622,378</u>     | <u>\$ -</u>         | <u>\$19,605,132</u> |
| Income (loss)                           | <u>\$ 6,375,691</u>  | <u>\$ (2,134,268)</u> | <u>\$ (27,877)</u>  | <u>\$ 4,213,546</u> |
| Three months ended June 30, 2005        |                      |                       |                     |                     |
| Gross revenue                           | <u>\$ 8,106,116</u>  | <u>\$ 706,610</u>     | <u>\$ -</u>         | <u>\$ 8,812,726</u> |
| Income (loss)                           | <u>\$ 1,341,085</u>  | <u>\$ (846,483)</u>   | <u>\$ (11,056)</u>  | <u>\$ 483,546</u>   |
| <b>Six months ended June 30, 2006</b>   |                      |                       |                     |                     |
| Gross revenue                           | <u>\$ 28,156,614</u> | <u>\$ 1,509,965</u>   | <u>\$ -</u>         | <u>\$29,666,579</u> |
| Income (loss)                           | <u>\$ 8,470,912</u>  | <u>\$ (3,349,268)</u> | <u>\$ (42,306)</u>  | <u>\$ 5,079,338</u> |
| Six months ended June 30, 2005          |                      |                       |                     |                     |
| Gross revenue                           | <u>\$ 13,318,545</u> | <u>\$ 863,766</u>     | <u>\$ -</u>         | <u>\$14,182,311</u> |
| Income (loss)                           | <u>\$ 1,220,678</u>  | <u>\$ (1,615,338)</u> | <u>\$ (16,861)</u>  | <u>\$ (411,521)</u> |
| Property and equipment                  |                      |                       |                     |                     |
| <b>June 30, 2006</b>                    | <u>\$ 38,737,045</u> | <u>\$ 17,118,201</u>  | <u>\$ 1,822,008</u> | <u>\$57,677,254</u> |
| June 30, 2005                           | <u>\$ 20,291,651</u> | <u>\$ 19,891,955</u>  | <u>\$ 1,187,626</u> | <u>\$41,371,232</u> |

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**Rally Energy Corp.**  
**Selected Notes to Consolidated Financial Statements**  
**Six months ended June 30, 2006 (unaudited)**

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**10. Subsequent Events**

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- (a) On June 12, 2006, the Corporation announced that it had entered into an agreement to increase its working interest in the Safed Koh Concession from 22.5% to 30%. The Offer to Purchase for the additional 7.5% working interest is with one of Rally Energy's existing Safed Koh Block partners (a private company) for a purchase price of US\$11.4 million and is subject to certain conditions. Rally Energy has reserved for issuance to the vendor 1,372,846 million common shares, at a price of \$2.30 per share, representing 25% of the purchase price. The remaining balance of US\$8.55 million will be paid at closing from existing credit facilities.
- (b) On July 5, 2006, the Corporation notified the holders of the remaining 3,469,400 \$1.60 share purchase warrants that, under the terms contained therein, the expiry date had been accelerated to July 20, 2006 from December 19, 2006. On or before July 20, 2006, all the remaining \$1.60 share purchase warrants were exercised generating proceeds of \$5,551,040.

**11. Statement of Cash Flows and Non-Cash Transactions**

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|               | <b>Three months ended<br/>June 30</b> |           | <b>Six months ended<br/>June 30</b> |            |
|---------------|---------------------------------------|-----------|-------------------------------------|------------|
|               | <b>2006</b>                           | 2005      | <b>2006</b>                         | 2005       |
| Interest paid | <b>\$ 118,012</b>                     | \$ 45,015 | <b>\$ 229,427</b>                   | \$ 579,917 |
| Taxes paid    | <b>\$ -</b>                           | \$ -      | <b>\$ -</b>                         | \$ -       |