



August 29, 2005

## **RALLY ENERGY ACHIEVES RECORD PRODUCTION, RECORD REVENUES AND RECORD CASH FLOW IN THE SECOND QUARTER OF 2005**

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### **REPORT TO OUR SHAREHOLDERS**

Results for the second quarter of 2005 reflect substantial progress in our efforts to increase production in Egypt and to bring on-stream a meaningful Western Canada production base. Oil sales averaged 2,774 boe/d in the second quarter, up 26.6% from the first quarter. Combined with materially higher oil prices, our higher oil sales resulted in record quarterly revenue of \$8.81 million and record quarterly cash flow of \$3.23 million. Highlights of the second quarter are as follows:

- Second quarter revenue of \$8.81 million (\$34.91/boe) was up 64% compared to the first quarter of 2005 (\$5.37 million, \$27.23/boe).
- Sales averaged 2,774 boe/d, up 26.6% compared to first quarter 2005 average sales of 2,191 boe/d.
- The average realized wellhead price of \$34.91/boe in the second quarter was up 28.2% from the first quarter wellhead price of \$27.23/boe.
- Cash flow from operations increased to \$3.23 million (\$0.04/share), up 278% from \$0.86 million (\$0.01/share) reported in the first quarter of 2005.
- Operating expense declined to \$6.12/boe in the second quarter, a 14% decline compared to the first quarter \$7.12/boe.
- Net income of \$483,546 (\$0.01/share) was achieved in the second quarter of 2005 compared to a net loss of \$895,067 ((\$0.01)/share) in the first quarter of 2005.

Rally Energy’s operating and financial results for the second quarter reflect the strength and momentum of our efforts to substantially increase production. As the year progresses, we expect to add significant additional production in Egypt and Canada and we expect to be able to

more fully evaluate the tremendous economic potential of our Pakistan discovery. This, combined with high oil prices, leads us to reasonably expect further improvements in the Corporation's operating and financial results for the remainder of 2005. Coincident with the escalation in global oil prices, we are seeing a continued trend of significant strengthening in Egypt's Ras Gharib oil prices. This is evident in our receipt of an Issaran wellhead price of \$39.61/boe in July 2005, up 16.7% from our average realized second quarter wellhead price of \$33.95/boe.

In 2005, Rally Energy's capital expenditures for the second quarter were \$5.62 million and \$5.88 million in the first quarter of 2005. Capital expenditures of \$3.0 million in Egypt represented the largest portion of these expenditures, with \$1.82 million spent on Canadian programs and \$0.80 million spent in Pakistan.

## **Operations Report**

### **Egypt**

In the Issaran Oilfield, oil sales averaged 2,624 bbls/d in the second quarter, up 21.7% compared to the first quarter of 2005. Three successful oil wells were drilled during the second quarter and two additional wells have been drilled since the end of the quarter. New well production, combined with continuing workover and optimization design operations, is steadily increasing the Corporation's Issaran production base.

During the last two months, a significant effort has been devoted to completing a global field development plan for Issaran. This plan has now been finalized and has been presented for approval to Egyptian authorities in Cairo. The plan includes specific vertical and horizontal well locations for 2005, 2006 and 2007 and detailed plans for continuing evaluation of the Upper and Lower Dolomite thermal recovery pilot project.

### **Pakistan**

The Rodho 2 well was re-entered and deepened as a follow-up to the Rodho 3 Discovery well. The Rodho 2 deepening activities encountered a package of four Lower Goru Sands. Due to mechanical problems only the upper most sand package (21 meters) of the four present was logged, cased and tested 1.28 MMcf/d of gas. The four Goru Sands present in Rodho 2 appear to be similar to those encountered in Rodho 3.

As with the Rodho 3 well which tested 5.0 MMcf/d, the analysis of Rodho 2 test information indicated significant formation damage. An appraisal program for the Rodho 2 and 3 discoveries on the Safed Koh Block is being finalized for submission to the Ministry of Petroleum. The plan includes fracture stimulation and production testing of both the Rodho 3 and the Rodho 2 wells commencing in the fourth quarter of this year.

At this time, plans are also being discussed to drill a third well on the Rodho structure and a new well on the large Afiband structure in 2006.

### **Western Canada**

Total Canadian production in the second quarter averaged 150 boe/d, up over four-fold from 35 boe/d in the first quarter. The most significant contribution to this increase resulted from

the commencement of Harmattan production during the quarter. Current Harmattan production from the 9-32 well has stabilized at 290 bbls/d and 930 Mcf/d (223 boe/d net).

Follow-up Harmattan well location 7-29 was cased and tested during the second quarter. The well did not encounter Glauconite channel sands, however, it tested significant amounts of gas from another formation. Additional work is required prior to announcing detailed results of this well. Several additional wells are expected to be drilled in Harmattan this year.

### **Outlook**

As we progress into the third quarter, we expect to continue to strengthen our Egyptian and Canadian production. We also expect to obtain approval for a new operating environment in Egypt under the umbrella of a global field development plan for Issaran that covers operating activities to the end of 2007. Similar plans are being developed for Pakistan and Canada to support a new three year financial plan for the Corporation. This plan has already been approved by the board of directors, and we expect to publish details of the financial plan after partner approvals are secured.

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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 plans to participate in the development of large natural gas/condensate discoveries. In Canada, Rally Energy is active in Alberta and Saskatchewan with varied working interests in several producing properties.

### **FORWARD-LOOKING STATEMENTS**

*This press release may contain forward-looking statements including expectations of future production, cash flow and earnings. These statements are based on current expectations that involve a number of risks and uncertainties, which could cause actual results to differ from those anticipated. These risks include, but are not limited to: the risks associated with the oil and gas industry (e.g., operational risks in development, exploration and production; delays or changes in plans with respect to exploration or development projects or capital expenditures; the uncertainty of reserve estimates; the uncertainty of estimates and projections relating to production, costs and expenses, and health, safety and environmental risks), commodity price, price and exchange rate fluctuation and uncertainties resulting from potential delays or changes in plans with respect to exploration or development projects or capital expenditures. Additional information on these and other factors that could affect the Corporation's operations or financial results are included in the Corporation's reports on file with Canadian securities regulatory authorities: [www.sedar.com](http://www.sedar.com).*

*The TSX Venture Exchange has not reviewed and does not accept responsibility for the adequacy or accuracy of this release.*

**RALLY ENERGY CORP.**  
**Management's Discussion and Analysis ("MD&A")**  
**For the Six Months ended June 30, 2005**

This discussion and analysis outlines management's assessment of the consolidated financial and operating results of Rally Energy Corp. ("Rally Energy" or the "Corporation") and its subsidiaries, including its future opportunities and risks, and should be read in conjunction with the audited consolidated financial statements and MD&A for the year ended December 31, 2004. Additional information regarding the Corporation can be found at [www.sedar.com](http://www.sedar.com) and [www.rallyenergy.com](http://www.rallyenergy.com).

The financial information contained herein has been prepared by management of Rally Energy 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 29, 2005.

**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, 2004 MD&A and Annual Information Form.

## Sales, Revenue and Netback

(thousands of dollars, unless otherwise stated)

	For the six months ended June 30			
	2005		2004	
<b>Daily Sales:</b>				
Oil (bbls/d)	2,457		1,765	
Natural gas (mcf/d)	162		114	
Total BOE (boe/d)	2,484		1,784	
		\$/boe		\$/boe
Gross revenue	\$ 14,182	\$31.54	\$ 9,859	\$30.37
Production entitlement – GPC (Egypt)	(3,945)	(8.77)	(1,889)	(5.82)
Royalty (Egypt)	(905)	(2.01)	-	-
Marketing fees	(360)	(0.80)	(241)	(0.74)
Royalties (Canada)	(10)	(0.03)	(27)	(0.08)
Operating expenses	(2,949)	(6.56)	(1,884)	(5.80)
<b>Netback from operations</b>	<b>\$ 6,013</b>	<b>\$13.37</b>	<b>\$ 5,818</b>	<b>\$17.93</b>

	2005		2005		2004		2004	
	Second Quarter		First Quarter		Fourth Quarter		Third Quarter	
<b>Daily Sales:</b>								
Oil (bbls/d)	2,734		2,177		2,206		2,092	
Natural gas (mcf/d)	240		84		192		60	
Total BOE (boe/d)	2,774		2,191		2,238		2,102	
		\$/boe		\$/boe		\$/boe		\$/boe
Gross revenue	\$8,813	\$34.91	\$5,369	\$27.23	\$5,790	\$28.12	\$6,743	\$34.87
Production entitlement								
- GPC (Egypt)	(2,380)	(9.43)	(1,565)	(7.94)	(1,978)	(9.62)	(1,272)	(6.58)
Royalty (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>

	2004		2004		2003		2003	
	Second Quarter		First Quarter		Fourth Quarter		Third Quarter	
<b>Daily Sales:</b>								
Oil (bbls/d)	1,794		1,735		1,648		865	
Natural gas (mcf/d)	210		24		-		-	
Total BOE (boe/d)	1,829		1,739		1,648		865	
		\$/boe		\$/boe		\$/boe		\$/boe
Gross revenue	\$5,400	\$32.45	\$4,459	\$28.18	\$4,076	\$26.89	\$2,086	\$26.22
Production entitlement								
- GPC (Egypt)	(1,027)	(6.18)	(862)	(5.45)	(752)	(4.97)	(443)	(5.56)
Marketing fees	(141)	(0.85)	(100)	(0.63)	(48)	(0.32)	(27)	(0.34)
Royalties (Canada)	(21)	(0.12)	(6)	(0.04)	12	0.08	-	-
Operating expenses	(1,026)	(6.16)	(858)	(5.43)	(573)	(3.78)	(697)	(8.76)
<b>Netback from operations</b>	<b>\$3,185</b>	<b>\$19.14</b>	<b>\$2,633</b>	<b>\$16.63</b>	<b>\$2,715</b>	<b>\$17.90</b>	<b>\$919</b>	<b>\$11.56</b>

Gross revenue for the second quarter of 2005 increased 63% to \$8.8 million from \$5.4 million for the second quarter of 2004 as a result of a 52% increase in oil and gas production (2,774 boe/d compared to 1,829 boe/d), along with an 8% increase in oil and gas prices (\$34.91/boe up from \$32.45/boe). For the six months ended June 30, 2005, gross revenue increased 44% to \$14.2 million (\$31.54/boe; production of 2,484 boe/d), from \$9.9 million (\$30.37/boe; production of 1,784 boe/d) for the comparable 2004 period. The revenue increase is primarily attributable to additional oil sales from the Issaran oilfield in Egypt along with an average 93 boe/d of Canadian production for the 2005 six month period associated primarily with the commencement of Harmattan production. The Brent oil price differential for heavy oil produced from the Issaran oilfield (marketed as the Ras Gharib blend) has steadily improved in 2005. In

the second quarter of 2005 the realized wellhead oil price represented 53% of the Brent oil price, up from 46% in the 2005 first quarter, and 67% in the comparable 2004 quarter.

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

For the quarter ended June 30, 2005, the production entitlement of The General Petroleum Co. SAE ("GPC") totaled \$2.4 million (\$9.43/boe), representing 27% of gross revenue. As a percentage of gross revenue, this represented a reduction from 29% in the first quarter of 2005 (\$1.6 million; \$7.94/boe). For the 2004 second quarter, GPC's entitlement was \$1.0 million (\$6.18/boe), representing 19% of gross revenue. GPC's reported entitlement increased during the fourth quarter of 2004 as a result of GPC's position that "payout" under the terms of the Petroleum Service Agreement had been reached on September 1, 2004. The GPC entitlement from all new wells is 27% on a post-payout basis; on old wells, GPC's average entitlement is 54%. Based on current production levels, the aggregate GPC entitlement is approximately 30%. The Corporation does not agree with GPC's position regarding payout since nearly US\$3.0 million of drilling-related costs have still not been recognized by GPC for inclusion in the payout calculation. This issue is under discussion with GPC, however, the outcome of this review is not determinable at this time and any adjustments will be reflected as reductions in future GPC production entitlements.

Effective January 1, 2005, the Corporation is required to make revenue-based royalty payments from the Issaran Oilfield to Gemini Oil and Gas Limited, an independent oil and gas investment fund. The revenue-based royalty of 10% is reduced to 2.6% of the Issaran oil revenues (net of marketing fees and GPC entitlements, derived from a maximum of 7,000 bbls/d of production) once royalties of US\$3.0 million have been paid, and this continues until December 31, 2012. Royalty payments made for the six months ended June 30, 2005 were \$905,000 (2004 - nil), comprised of \$558,000 for the second quarter and \$347,000 for the first quarter.

Pursuant to the terms of certain marketing agreements pertaining to Issaran oil sales, marketing fees of \$186,000 (\$0.74/boe) linked to realized oil prices and production were paid during the second quarter of 2005 as compared to \$174,000 (\$0.88/boe) in the first quarter of 2005 and \$141,000 (\$0.85/boe) in the 2004 second quarter. For the six month periods ended June 30, marketing fees were \$360,000 (\$0.80/boe) and \$241,000 (\$0.74/boe) for 2005 and 2004, respectively.

Royalties incurred on Canadian properties are reported net of the Alberta Royalty Tax Credit and were \$5,000 and \$21,000 for the 2005 and 2004 second quarter periods, respectively. Production from the new Harmattan well benefits from a one-year royalty holiday (to a maximum of \$1.0 million gross).

### **Operating Expenses**

Operating expenses for the six months ended June 30, 2005 were \$2.9 million (\$6.56/boe) as compared to \$1.9 million (\$5.80/boe) for the comparable 2004 period. Operating expenses were \$1.5 million (\$6.12/boe) in the second quarter of 2005 compared to \$1.0 million (\$6.16/boe) for the same period in 2004. On an overall basis, costs have increased commensurate with the higher oil production in 2005. Even though total operating expenses have increased, operating costs per barrel of \$6.12/boe in the second quarter represent a significant reduction from \$7.12/boe reported for the 2005 first quarter. A significant contributor to operating expenses relates to higher diesel fuel costs. Diesel fuel is used to power electricity generators for field operations in our Issaran Oilfield. The Corporation is exploring access to natural gas from nearby sources as an alternative to diesel fuel for generators. Included in the six month operating cost amount is \$66,000 (2004 - \$25,000) of costs pertaining to Canadian production.

## 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>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>
<b>2004</b>					
	Canada	\$ 539	\$ 82	\$ 457	\$2.75
	Egypt	275	-	275	1.65
	Pakistan	138	-	138	0.83
	Other	(17)	-	(17)	(0.10)
	<b>Total</b>	<b>\$ 935</b>	<b>\$ 82</b>	<b>\$ 853</b>	<b>\$5.13</b>

		Six months ended June 30			
		<u>Total</u>	<u>Capitalized</u>	<u>Expensed</u>	<u>\$/boe</u>
<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>
<b>2004</b>					
	Canada	\$ 978	\$ 150	\$ 828	\$2.55
	Egypt	513	-	513	1.58
	Pakistan	230	-	230	0.71
	Other	84	-	84	0.26
	<b>Total</b>	<b>\$ 1,805</b>	<b>\$ 150</b>	<b>\$ 1,655</b>	<b>\$5.10</b>

For the quarter ended June 30, 2005, consolidated general and administrative (“G&A”) expenses were \$990,000 (\$3.92/boe) as compared to \$853,000 (\$5.13/boe) for the same quarter in 2004 and \$904,000 (\$4.59/boe) for the 2005 first quarter. For the six month period ended June 30, consolidated G&A expenses increased by 14% to \$1.9 million (\$4.21/boe) in 2005 as compared to \$1.7 million (\$5.10/boe) in 2004. The increased cost is primarily attributable to increased charges related to non-cash stock-based compensation, staff additions and annual wage increases. Non-cash expenses related to the valuation of share options granted during the six months ended June 30, 2005 were \$339,000 as compared to \$33,000 for the comparable period in 2004.

## Interest and Finance Charges

(thousands of dollars, unless otherwise stated)

	Three months ended June 30		Six months ended June 30	
	2005	2004	2005	2004
Interest expense	\$ 167	\$ 199	\$ 370	\$ 406
Accretion expense on debentures	127	36	163	72
Amortization of deferred charge	14	36	50	72
Total expense	<b>308</b>	271	<b>583</b>	550
Interest income	8	16	17	25
Gain (loss) on foreign exchange	106	41	(15)	111
Total income (expense)	<b>114</b>	57	<b>2</b>	136
Net expense	<b>\$ 194</b>	\$ 214	<b>\$ 581</b>	\$ 414
\$/boe	<b>\$0.77</b>	\$1.29	<b>\$1.29</b>	\$1.27

Total interest and finance charges increased to \$581,000 during the first six months of 2005 from \$414,000 in the comparable 2004 period. On a quarterly basis, interest and finance charges were \$194,000 for the second quarter of 2005, as compared to \$387,000 for the 2005 first quarter and \$214,000 for the second quarter of 2004. During the first six months of 2005, \$4.7 million of the Corporation's 12% unsecured convertible debentures were converted into common shares. This resulted in lower interest expense associated with the debentures, partially offset by increased utilization of a bank credit facility. Included in the 2005 six-month amount is \$213,000 (2004 - \$144,000) of non-cash charges pertaining to the convertible debentures issued in 2003. Additional details are disclosed in Note 5 of the consolidated financial statements.

### Depletion, Depreciation and Accretion

(thousands of dollars, unless otherwise stated)

	Three months ended		Six months ended	
	June 30		June 30	
	2005	2004	2005	2004
Depletion and depreciation	\$ 2,467	\$ 2,127	\$ 3,940	\$ 4,312
Accretion	5	19	10	24
Total	\$ 2,472	\$ 2,146	\$ 3,950	\$ 4,336
\$/boe	\$9.79	\$12.90	\$8.79	\$13.36

Total depletion, depreciation and accretion ("DD&A") charges for the first six months of 2005 were \$4.0 million (\$8.79/boe), of which depletion pertaining to producing properties in Egypt represented \$2.9 million. The remainder represents depletion charges of \$764,000 for Canadian production and fixed asset depreciation of \$252,000. DD&A charges for the first six months of 2004 were \$4.3 million (\$13.36/boe). The significant increase in our proved reserve base at December 31, 2004, as evaluated by DeGolyer and MacNaughton Canada Limited, an independent reservoir evaluation firm, resulted in a lowering of the 2005 depletion rate per produced barrel of oil. On a quarterly basis, the 2005 second quarter DD&A was \$2.5 million (\$9.79/boe) as compared to \$2.1 million (\$12.90/boe) for the 2004 second quarter and \$1.5 million (\$7.49/boe) for the first quarter of 2005.

### Cash Flow from Operations

Cash flow represents funds from operations as detailed on the Corporation's consolidated statements of cash flows. For the six months ended June 30, 2005, Rally Energy's cash flow from operations was \$4.1 million (\$0.05/share) as compared to \$3.9 million (\$0.05/share) for the comparable 2004 period. For the second quarter of 2005, cash flow was \$3.2 million (\$0.04/share) as compared to \$900,000 (\$0.01/share) in the first quarter of 2005 and \$2.2 million (\$0.03/share) in the second quarter of 2004.

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 Loss

Rally Energy recorded net income of \$484,000 (\$0.01/share) for the second quarter of 2005 as compared to a net loss of \$28,000 (\$nil/share) for the comparable 2004 quarter and a net loss of \$895,000 ((\$0.01)/share) for the 2005 first quarter. For the six months ended June 30, 2005 the net loss was \$412,000 ((\$0.01)/share) as compared to a net loss of \$586,000 ((\$0.01)/share) for the six months ended June 30, 2004.

## SUMMARY OF QUARTERLY RESULTS

(thousands of dollars, unless otherwise stated)

	Revenue	Cash flow from operations		Income (loss)	
		\$/share - basic		\$/share - basic	
<b>2005: Q2</b>	<b>\$8,813</b>	<b>\$3,235</b>	<b>\$0.04</b>	<b>\$ 484</b>	<b>\$ 0.01</b>
Q1	\$5,369	\$ 856	\$0.01	\$ (895)	\$(0.01)
<b>2004: Q4</b>	<b>\$5,790</b>	<b>\$1,170</b>	<b>\$0.02</b>	<b>\$ 1,138</b>	<b>\$ 0.02</b>
Q3	\$6,743	\$3,187	\$0.05	\$ 687	\$ 0.01
Q2	\$5,400	\$2,202	\$0.03	\$ (28)	\$ 0.00
Q1	\$4,459	\$1,724	\$0.02	\$ (559)	\$(0.01)
<b>2003: Q4</b>	<b>\$4,076</b>	<b>\$1,635</b>	<b>\$0.03</b>	<b>\$(1,850)</b>	<b>\$(0.03)</b>
Q3	\$2,086	\$ 126	\$0.00	\$(1,259)	\$(0.02)

### Capital Expenditures

During the first six months of 2005, Rally Energy drilled 3 wells (3 net) in Egypt, three wells (1.5 net) in Canada and one well (0.2 net) in Pakistan. Capital expenditures totaled \$11.5 million during the first six months of 2005, up from \$5.5 million (before dispositions) for the comparable 2004 period.

(thousands of dollars)	Three months ended June 30		Six months ended June 30	
	2005	2004	2005	2004
<b>Egypt</b>				
Drill, complete and workovers	\$ 2,216	\$ 1,536	\$ 5,353	\$ 4,374
Seismic, evaluation and other	662	539	933	644
Inventory change	110	185	(19)	91
Property acquisition (disposition)	-	(3,910)	-	(3,910)
Capitalized admin. costs	-	-	-	-
<b>Total</b>	<b>\$ 2,988</b>	<b>\$ (1,650)</b>	<b>\$ 6,267</b>	<b>\$ 1,199</b>
<b>Canada</b>				
Drill, complete and workovers	\$ 1,680	\$ 11	\$ 3,144	\$ 104
Seismic, evaluation and other	66	75	297	114
Property acquisition (disposition)	-	-	467	-
Capitalized admin. costs	78	82	188	150
<b>Total</b>	<b>\$ 1,824</b>	<b>\$ 168</b>	<b>\$ 4,096</b>	<b>\$ 368</b>
<b>Pakistan</b>				
Drill and complete	\$ 686	\$ -	\$ 983	\$ -
Seismic, evaluation and other	21	-	21	-
Capitalized admin. costs	97	-	132	-
<b>Total</b>	<b>\$ 804</b>	<b>\$ -</b>	<b>\$ 1,136</b>	<b>\$ -</b>
<b>Grand Total</b>				
Drill, complete and workovers	\$ 4,582	\$ 1,547	\$ 9,480	\$ 4,478
Seismic, evaluation and other	749	614	1,251	758
Inventory change	110	185	(19)	91
Property acquisition (disposition)	-	(3,910)	467	(3,910)
Capitalized admin. costs	175	82	320	150
<b>Total</b>	<b>\$ 5,616</b>	<b>\$ (1,482)</b>	<b>\$ 11,499</b>	<b>\$ 1,567</b>

Included in the above amounts are casing and tubing inventory costs of \$551,000 at June 30, 2005 (2004 - \$1.2 million) to be used in future Issaran drilling programs.

On February 24, 2005, the Corporation completed a transaction with Shannon International Resources Inc. ("Shannon"), whereby the Corporation disposed of its remaining interests in the Prince Edward Island project in exchange for 2.5 million common shares and 500,000 warrants, exercisable at US\$0.85 per share with a term of one year, of Shannon. The value associated with the Shannon equity instruments received, after taking into account required hold periods, fair value discounts and transaction costs, was estimated at \$650,000.

At June 30, 2005 the Corporation continued to meet the asset impairment test for the Egyptian and Canadian capitalized costs and no ceiling test write-down was required. The capitalized Pakistan costs are considered to be in the pre-production stage.

### **Liquidity and Capital Resources**

At June 30, 2005, Rally Energy had bank indebtedness of \$3.2 million and \$1.3 million principal amount of convertible debentures, as compared to no bank debt and \$6.0 million principal amount of convertible debentures at December 31, 2004. The working capital shortfall at June 30, 2005 was \$5.0 million, as compared to a working capital shortfall of \$345,000 at December 31, 2004. Increased drilling activity during 2005 has resulted in a higher level of accounts payable.

During the first six months of 2005, Rally Energy received proceeds of \$882,000 from the exercise of an aggregate 1.5 million common share options at an average price of \$0.57/share. Additionally, on May 13, 2005, the Corporation realized gross proceeds of \$2.0 million from a private placement of 1.1 million flow-through common shares issued at \$1.80/share. Net proceeds were \$1.9 million, after payment of commissions and estimated transaction fees.

During the six months ended June 30, 2005, \$4.7 million of the 12% unsecured convertible subordinated debentures were converted into common shares, leaving a balance of \$1.3 million at period end, down from \$6.0 million at December 31, 2004. The remaining debentures are currently convertible, at the option of the holder, into common shares at a conversion price of \$1.10 per common share at any time prior to their maturity on July 1, 2006.

Rally Energy has a US\$4.5 million credit facility from its primary banker, secured by trade receivable insurance, to cover working capital requirements. At June 30, 2005, US\$1.9 million remained available from this facility.


On August 2, 2005, Rally Energy closed a \$966,240 non-brokered private placement of common shares priced at \$1.32 per share (732,000 common shares). A company controlled by an insider of the Corporation subscribed for 155,000 shares (\$204,600) of these common shares.

Currently, Rally Energy is pursuing additional debt financing alternatives.

## NOTICE TO READER OF THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

The financial statements of Rally Energy Corp. (the Corporation) and the accompanying interim consolidated balance sheet as at June 30, 2005 and the interim consolidated statements of operations and deficit and cash flows for the six month period then ended are the responsibility of the Corporation's management.

These consolidated financial statements have not been reviewed on behalf of the shareholders by the independent external auditors of the Corporation, BDO Dunwoody LLP. The interim consolidated financial statements have been prepared by management and include the selection of appropriate accounting principles, judgments and estimates necessary to prepare these financial statements in accordance with Canadian generally accepted accounting principles.



Abby Badwi  
Chief Executive Officer  
Calgary, Canada  
August 29, 2005



Douglas C. Urch, B.Comm., CMA  
Chief Financial Officer  
Calgary, Canada  
August 29, 2005

**Rally Energy Corp.  
Consolidated Balance Sheets**

	<b>June 30, 2005</b>	December 31, 2004
	(unaudited)	(audited)
<b>Assets</b>		
<b>Current</b>		
Cash	\$ -	\$ 358,245
Accounts receivable	7,838,270	6,503,769
Cash calls receivable	3,605	104,499
Notes receivable (Note 2)	-	740,270
Inventory (Note 3)	294,144	540,447
Prepaid expenses and deposits	252,152	266,361
	<b>8,388,171</b>	<b>8,513,591</b>
<b>Assets held for sale (Note 4)</b>	<b>650,000</b>	650,000
<b>Property and equipment</b>	<b>41,371,232</b>	33,737,226
<b>Deferred charges (Note 5)</b>	<b>52,882</b>	215,466
	<b>\$ 50,462,285</b>	<b>\$ 43,116,283</b>

**Liabilities and Shareholders' Equity**

<b>Current</b>		
Bank indebtedness (Note 6)	\$ 3,155,418	\$ -
Accounts payable – trade	4,501,902	3,137,551
Accounts payable – capital	5,709,027	5,053,800
Cash call obligations	32,951	184,478
Deferred revenue (Note 2)	-	483,000
	<b>13,399,298</b>	<b>8,858,829</b>
<b>Asset retirement obligations (Note 1)</b>	<b>375,057</b>	289,846
<b>Convertible debentures (Note 5)</b>	<b>1,261,107</b>	5,784,486
	<b>15,035,462</b>	<b>14,933,161</b>
<b>Shareholders' equity</b>		
Equity instruments (Note 7(a))	45,159,263	37,673,762
Contributed surplus (Note 7(b))	1,113,908	944,187
Deficit	(10,846,348)	(10,434,827)
	<b>35,426,823</b>	<b>28,183,122</b>
	<b>\$ 50,462,285</b>	<b>\$ 43,116,283</b>

**UNAUDITED INTERIM FINANCIAL STATEMENTS**

In Accordance with National Instrument 51-102 released by the Canadian Securities Administrators, the Corporation discloses that its auditors have not reviewed the unaudited financial statements for the period ended June 30, 2005.

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

**Rally Energy Corp.**  
**Consolidated Statements of Operations and Deficit**

	Three months ended June 30		Six months ended June 30	
	2005 (unaudited)	2004	2005 (unaudited)	2004 (unaudited)
<b>Oil and gas revenue</b>	<b>\$ 8,812,726</b>	\$ 5,400,035	<b>\$ 14,182,311</b>	\$ 9,859,458
Less: Royalties and related credits	<b>(3,128,841)</b>	(1,188,937)	<b>(5,220,006)</b>	(2,157,017)
	<b>5,683,885</b>	4,211,098	<b>8,962,305</b>	7,702,441
Operating expenses	<b>1,544,588</b>	1,025,616	<b>2,948,982</b>	1,884,170
<b>Netback from oil and gas operations</b>	<b>4,139,297</b>	3,185,482	<b>6,013,323</b>	5,818,271
<b>Expenses</b>				
Administrative expenses:				
Legal, professional and audit	<b>49,606</b>	35,543	<b>118,858</b>	76,810
Shareholder reporting and communication	<b>83,308</b>	99,411	<b>87,987</b>	117,698
Administration	<b>685,820</b>	586,358	<b>1,303,395</b>	1,113,653
Pakistan administrative costs	<b>32,752</b>	137,202	<b>44,313</b>	229,543
Project evaluation costs	-	(16,601)	-	84,440
Stock-based compensation	<b>137,910</b>	11,223	<b>339,304</b>	32,639
	<b>989,396</b>	853,136	<b>1,893,857</b>	1,654,783
Interest expense	<b>167,646</b>	198,595	<b>370,336</b>	405,971
Depletion, depreciation and accretion	<b>2,472,416</b>	2,146,371	<b>3,950,477</b>	4,336,204
Accretion expense on convertible debentures	<b>126,702</b>	35,919	<b>162,621</b>	71,838
Amortization of deferred charge	<b>14,029</b>	35,910	<b>49,939</b>	71,820
	<b>3,770,189</b>	3,269,931	<b>6,427,230</b>	6,540,616
<b>Income (loss) before under noted items</b>	<b>369,108</b>	(84,449)	<b>(413,907)</b>	(722,345)
<b>Other items</b>				
Interest income	<b>8,104</b>	15,145	<b>17,382</b>	24,608
Gain (loss) on foreign exchange	<b>106,334</b>	41,439	<b>(14,996)</b>	111,275
	<b>114,438</b>	56,584	<b>2,386</b>	135,883
<b>Income (loss) for the period</b>	<b>483,546</b>	(27,865)	<b>(411,521)</b>	(586,462)
Deficit, beginning of period	<b>(11,329,894)</b>	(12,231,914)	<b>(10,434,827)</b>	(11,673,317)
<b>Deficit, end of period</b>	<b>\$ (10,846,348)</b>	\$ (12,259,779)	<b>\$ (10,846,348)</b>	\$ (12,259,779)
<b>Income (loss) per share (Note 7(a))</b>				
Basic	<b>\$ 0.005</b>	\$ (0.000)	<b>\$ (0.006)</b>	\$ (0.008)
Diluted	<b>\$ 0.005</b>	\$ (0.000)	<b>\$ (0.005)</b>	\$ (0.007)

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

**Rally Energy Corp.**  
**Consolidated Statements of Cash Flows**

	Three months ended June 30		Six months ended June 30	
	2005 (unaudited)	2004	2005 (unaudited)	2004
<b>Cash flows from operating activities</b>				
Income (loss) for the period	\$ 483,546	\$ (27,865)	\$ (411,521)	\$ (586,462)
Non-cash items:				
Stock-based compensation	137,910	11,223	339,304	32,639
Accretion expense on convertible debentures	126,702	35,919	162,621	71,838
Amortization of deferred charges	14,029	35,910	49,939	71,820
Depletion, depreciation and accretion	2,472,416	2,146,371	3,950,477	4,336,204
<b>Cash flow from operations</b>	<b>3,234,603</b>	<b>2,201,558</b>	<b>4,090,820</b>	<b>3,926,039</b>
Changes in non-cash working capital balances:				
Accounts receivable	(2,325,836)	(558,455)	(1,334,501)	(1,991,003)
Notes receivable	-	-	257,270	-
Inventory	95,317	103,618	246,303	148,967
Prepaid expenses and deposits	52,565	74,111	14,209	13,819
Accounts payable	2,633,276	(139,278)	4,368,242	240,233
	<b>3,689,925</b>	<b>1,681,554</b>	<b>7,642,343</b>	<b>2,338,055</b>
<b>Cash flows from investing activities</b>				
Oil and gas assets, net	(5,616,213)	(2,428,797)	(11,499,272)	(5,477,412)
Proceeds from sale of oil and gas interests	-	3,909,985	-	3,909,985
Changes in non-cash working capital	(4,258)	(803,113)	756,121	(322,374)
	<b>(5,620,471)</b>	<b>678,075</b>	<b>(10,743,151)</b>	<b>(1,889,801)</b>
<b>Cash flows from financing activities</b>				
Issuance of equity instruments, net	1,930,546	130,000	2,742,563	149,004
	<b>1,930,546</b>	<b>130,000</b>	<b>2,742,563</b>	<b>149,004</b>
<b>Increase (decrease) in cash</b>	<b>-</b>	<b>2,489,629</b>	<b>(358,245)</b>	<b>597,258</b>
Cash, beginning of period	-	368,055	358,245	2,260,426
<b>Cash, end of period</b>	<b>\$ -</b>	<b>\$ 2,857,684</b>	<b>\$ -</b>	<b>\$ 2,857,684</b>

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

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**Rally Energy Corp.**  
**Selected Notes to Consolidated Financial Statements**  
**Six months ended June 30, 2005 (unaudited)**

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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, 2004, unless otherwise stated below. The disclosure which follows is incremental to the disclosure included with the annual consolidated financial statements. The interim consolidated financial statements 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, 2004.

### **1. Asset Retirement Obligations**

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The Corporation's asset retirement obligations in Egypt result from the Petroleum Service Agreement ("PSA") terms related to interests in petroleum assets including well sites and roads. The Corporation estimates the total undiscounted amount of cash flows required to settle its asset retirement obligations is approximately \$771,202, which can reasonably be expected to be incurred between 2005 and 2017. The majority of these costs will be incurred between 2010 and 2017. 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.

The Corporation's asset retirement obligations in Canada result from net ownership interests in petroleum and natural gas assets including well sites, gathering systems and processing facilities. The Corporation estimates the total undiscounted amount of cash flows required to settle its asset retirement obligations is approximately \$79,584, which can reasonably be expected to be incurred between 2005 and 2016. The majority of these costs will be incurred between 2006 and 2016. 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.

The Corporation's asset retirement obligations in Pakistan result from net ownership interests in petroleum and natural gas assets including well sites, gathering systems and processing facilities. The Corporation estimates the total undiscounted amount of cash flows required to settle its asset retirement obligations is approximately \$22,057.

A reconciliation of the asset retirement obligations is provided below:

<i>Asset retirement obligations</i>	<b>Six months ended June 30</b>	
	<b>2005</b>	<b>2004</b>
Balance, beginning of period	\$ 289,846	\$ 169,958
Liabilities incurred in period	74,746	17,839
Accretion expense	10,465	5,949
Balance, end of period	<b>\$ 375,057</b>	<b>\$ 193,746</b>

### **2. Notes Receivable**

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

### **3. Inventory**

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At June 30, 2005, the Corporation held \$845,329 (June 30, 2004 - \$1,477,850) of inventory available for use in the Issaran oilfield in Egypt. Of this amount, (i) \$551,185 relates to capital equipment, primarily pipe, and is included in Property and Equipment and (ii) \$294,144 represents consumable supplies to be used in oilfield operations and is recorded as inventory under current assets.

### **4. Assets Held for Sale**

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On February 24, 2005, the Corporation completed a transaction with Shannon International Resources Inc. ("Shannon"), whereby the Corporation disposed of its remaining interests in the PEI project in exchange for 2.5 million common shares and 500,000 warrants, exercisable at US\$0.85 per share with a term of one year, of Shannon. The value associated with the Shannon equity instruments received, after taking into account required hold periods in order to register the equity instruments, related fair value discounts and estimated transaction costs, is estimated at \$650,000.

### **5. Convertible Debentures**

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

As the convertible debentures are considered to be compound financial instruments, the principal amount has been allocated between liability and equity components, which are then classified separately on the balance sheet. The liability component has been determined using an interest rate for comparable debt instruments having no conversion rights. The difference between the liability component and the principal amount of the notes has been allocated to equity. The equity component is accreted over the term of the notes such that at maturity the liability will be equivalent to the principal amount.

The equity portion of the convertible note is recorded as contributed surplus and represented \$437,000 as determined using a Black-Scholes model. The fair value of the conversion right was estimated using the following assumptions: Dividend yield (nil), volatility (0.18), risk-free interest rate (5%), and weighted average life of 1.5 years.

During the first six months of 2005, \$4,686,000 of the 12% Convertible Debentures were converted to an equal number of common shares of the Corporation at \$1.00 per share, pursuant to the conversion terms contained therein. Accordingly, \$112,645 of deferred charges related to the issuance of the converted debentures have been reclassified as share issue costs.

**Rally Energy Corp.**  
**Selected Notes to Consolidated Financial Statements**  
**Six months ended June 30, 2005 (unaudited)**

**6. Bank Indebtedness**

At June 30, 2005, the Corporation has utilized \$3,155,418 (US\$2,575,011) (June 30, 2004 – nil) of the US\$4.5 million credit facility with a major Canadian bank which is secured by trade receivable insurance provided by Export Development Canada ("EDC"). Funds drawn on this facility bear interest at the US prime rate and a standby fee of 0.25% per annum applies to the unused portion of the facility. On March 30, 2005, the Corporation received approval for its secured credit facility to be increased to US\$4.5 million from US\$3.0 million, until March 30, 2006.

**7. Equity Instruments**

(a) Issued and outstanding

	<u>Number of Shares</u>	<u>Amounts</u>
<b>Common shares</b>		
Balance, December 31, 2004	74,350,379	\$ 38,452,376
Private placement – flow-through shares (Note 7(c))	1,120,000	2,016,000
Stock options exercised	1,541,667	1,051,240
Debentures converted (Note 5)	4,686,000	4,686,000
	<u>81,698,046</u>	<u>46,205,616</u>
Less: Share issue costs	-	(1,046,353)
Balance, June 30, 2005	<u>81,698,046</u>	<u>\$ 45,159,263</u>

Weighted average number of common shares for the six months ended June 30, 2005	<u>77,239,186</u>
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(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 Corporation recorded an expense of \$339,304 for options issued in the first six months of 2005 (June 30, 2004 – \$32,639). The stock-based compensation expense associated with the value ascribed to options granted is recorded as contributed surplus.

	<u>Share Options</u>	<u>Weighted Average Exercise Price</u>
Outstanding, beginning of year	6,327,757	\$0.63
Granted	1,008,000	\$1.74
Exercised	(1,541,667)	\$0.57
Cancelled	(141,666)	\$0.72
Outstanding, end of period	<u>5,652,424</u>	<u>\$0.84</u>

**7. Equity Instruments (continued)**

(c) Private placement – flow-through common shares

On May 13, 2005, the Corporation completed the closing of an agency private placement of 1,120,000 common shares issued on a flow-through basis at a price of \$1.80 per share. Net proceeds were \$1.9 million, after payment of commissions and estimated transaction fees. Directors and Officers of the Corporation, or companies controlled by them, subscribed for an aggregate 69,555 flow-through common shares (\$125,199). As at June 30, 2005, the Corporation is required to expend additional qualifying expenditures of \$727,000 prior to December 31, 2006 to meet its commitments under the flow-through agreements.

**8. Related Party Transactions**

For the six months ended June 30, 2005, 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.

	<b>Six months ended June 30</b>	
	<b>2005</b>	<b>2004</b>
Included in general and administrative expenses	<b>\$ 260,160</b>	\$ 172,637
Capitalized	<b>256,189</b>	155,863
	<b>\$ 516,349</b>	\$ 328,500

**9. Comparative Amounts**

Certain comparative amounts have been reclassified to conform to the presentation adopted for the current year.

**10. 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 proved 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.

**11. Segmented Information**

The Corporation operates in the oil and gas industry and has operations in Egypt, Pakistan and Canada. Its reportable segments are identified on a geographic basis. Gross revenue for the six months ended June 30 and capital assets are summarized on a country basis below:

**Rally Energy Corp.**  
**Selected Notes to Consolidated Financial Statements**  
**Six months ended June 30, 2005 (unaudited)**

**11. Segmented Information (continued)**

<b>June 30, 2005</b>	<b>Egypt</b>	<b>Canada</b>	<b>Pakistan</b>	<b>Total</b>
Gross revenue	\$ 13,318,545	\$ 863,766	\$ -	\$ 14,182,311
Property and equipment	\$ 20,291,651	\$ 19,891,955	\$ 1,187,626	\$ 41,371,232
<hr/>				
June 30, 2004	Egypt	Canada	Pakistan	Total
Gross revenue	\$ 9,706,692	\$ 152,766	\$ -	\$ 9,859,458
Property and equipment	\$ 12,040,843	\$ 14,213,600	\$ -	\$ 26,254,443

**12. Subsequent Events**

- (a) Subsequent to June 30, 2005, the following changes occurred with respect to the Corporation's stock options:

	<b>Number of Options</b>	<b>Exercise Price</b>
Exercised	(78,000)	\$0.60
Granted	500,000	\$1.32
Net Change	<b>422,000</b>	

- (b) On August 2, 2005, Rally Energy closed a \$966,240 non-brokered private placement of common shares priced at \$1.32 per share (732,000 common shares). A company controlled by an insider of the Corporation subscribed for 155,000 shares (\$204,600) of these common shares.

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

During the first six months of 2005, \$4,686,000 of the 12% Convertible Debentures were converted to an equal number of common shares of the Corporation at \$1.00 per share, pursuant to the conversion terms contained therein.