



May 30, 2005

## Rally Energy Announces First Quarter Results and Production Targets

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### Annual Meeting

Rally Energy wishes to inform shareholders and other interested parties of a change of meeting location for the Corporation's Annual Meeting due to a fire at the Calgary Petroleum Club. The Annual Meeting, originally scheduled for 3:00 pm on Thursday, June 16, 2005, will now be held in the offices of McCarthy Tétrault LLP, 33<sup>rd</sup> Floor, 421 - 7th Avenue S.W., Calgary, Alberta. The Corporation expects to start the meeting at 3:15 p.m. to allow enough time for attendees to make their way to the new location.

### Report to our Shareholders

In the first quarter of 2005, while our primary efforts were focused on Egypt, significant progress was made in proving-up our assets in Pakistan and in developing our Western Canada production base.

- In Egypt, we concentrated on implementing drilling, completion and production techniques best suited to achieving optimal production. These efforts have resulted in a material increase in Issaran oil sales through April and into May with current sales of approximately 2,800 bbls/d.
- In Pakistan, initial testing of the first Safed Koh Block re-entry well, Rodho 3, established the presence of significant natural gas accumulations in the Cretaceous Lower Goru Sandstones of the large Rodho structure.
- In Canada, we production tested our 50% working interest, multi-zone oil and gas discovery in the Harmattan area at an average gross flow rate of 600bbls/d of oil and 900 mmcf/d of gas.

During the first quarter of 2005, oil equivalent sales increased to 2,184 bbls/d, up 26% from 1,739 bbls/d reported in the first quarter of 2004. Sales for the first quarter of 2005, although significantly above levels reported for the same period in 2004, do not reflect the strength and momentum of our efforts to substantially increase production. Our current production, in excess of 2,900 bbls/d, is well above reported first quarter average daily production. As the year progresses, we expect to add significant additional production increases in Egypt and Canada and we expect to be able to more fully delineate the tremendous economic potential of our Pakistan holdings.

Revenue in the first quarter increased 20% to \$5.37 million from \$4.46 million in the same period in 2004, however, cash flow from operations declined to \$0.90 million compared to \$1.7 million in the first quarter of 2004. This performance reflects a combination of four adverse factors:

- temporary production curtailments of Issaran wells in close proximity to wells being drilled;
- a widened differential between heavy and light oil prices that severely impacted pricing of January and February deliveries. (Ras Gharib prices averaged only US\$26.48 in the first quarter; March 2005 pricing averaged US\$33.40);
- An increase in the value of the Canadian dollar; and
- Increased operating expense related to higher diesel fuel costs for field electricity generators.

Operating expense of \$1.4 million in the first quarter of 2005 increased 63% from \$0.86 million reported for the same period in 2004 due primarily to large diesel fuel cost increases.

In the first quarter of 2005, Rally Energy's capital expenditures increased to \$5.88 million, up 93% from 2004 expenditures of \$3.05 million. Capital expenditures of \$3.4 million in Egypt represented the largest portion of these expenditures, with \$2.2 million spent on Canadian programs and the remainder spent in Pakistan. In Egypt, we drilled three wells in the Issaran field and continued to upgrade equipment and facilities. In Western Canada, we production tested our successful Harmattan well and installed production facilities and pipelines to allow production to commence on April 15. In Pakistan, we participated in the Rodho 3 re-entry, on a partially-carried basis, and announced that initial testing had established the presence of significant natural gas accumulations.

### **Outlook for 2005 – Exit Target of 6,000 boe/d**

We intend to achieve significant production growth in Egypt and Canada during 2005 with a base plan target of exiting the year with production of 6,000 boe/d.

In Egypt, we intend to increase production during 2005 through:

- an active drilling program in the Issaran oilfield;
- twinning of up to six existing wellbores for production from different formations;
- co-mingling of production from different formations in up to nine existing wellbores, good oilfield practice permitting; and
- utilization of more aggressive production practices using existing equipment and, in particular, through the installation of larger capacity pumps and equipment on several existing wellsites.

Drilling during 2005 will be focused primarily in the Northern Area of the Issaran oilfield targeting multi-layered, fracture enhanced pay zones.

In Western Canada, we commenced drilling of our third Harmattan well, located approximately 1.6 kilometres east of our first discovery well, in mid-May. We intend to drill at least two additional wells on our Harmattan holdings during 2005. We expect that our active drilling program, focused on the Harmattan area, will add significant new reserves and production during 2005.

In Pakistan, re-entry of the Rodho 2 well commenced on April 10, 2005 and logging operations are currently underway. Drilling results indicate the presence of a full, gas-charged Goru section. Following testing of Rodho 2, we expect to stimulate the Goru formation in the Rodho 2 and Rodho 3 wells through fracing to test the production capability of the Lower Goru formation. In addition, plans are being discussed to drill a new well on the extremely large Afiband structure in the third quarter of this year. We expect to see the Safed Koh Block emerge as an important contributor to our future production and reserves increases.

*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 Three Months ended March 31, 2005**

This discussion and analysis outlines management's assessment of the consolidated financial and operating results of Rally Energy Corp. ("Rally Energy" or the "Corporation") and its subsidiaries, including its future opportunities and risks, and should be read in conjunction with the audited 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 ("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 May 30, 2005.

**Non-GAAP Measures**

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

**Forward-Looking Statements**

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 achievement 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.

## Sales, Revenue and Netback

(thousands of dollars, unless otherwise stated)

	2005		2004					
	First Quarter		Fourth Quarter		Third Quarter		Second Quarter	
<b>Daily Sales:</b>								
Oil (bbls/d)	2,177		2,206		2,092		1,794	
Natural gas (mcf/d)	41		192		60		210	
Total BOE (boe/d)	2,191		2,238		2,102		1,829	
		\$/boe		\$/boe		\$/boe		\$/boe
Gross revenue	\$5,370	\$27.23	\$5,790	\$28.12	\$6,743	\$34.87	\$5,400	\$32.45
Production entitlement								
- GPC (Egypt)	(1,565)	(7.93)	(1,978)	(9.62)	(1,272)	(6.58)	(1,027)	(6.18)
Overriding royalty	(347)	(1.76)						
Marketing fees	(174)	(0.88)	(161)	(0.78)	(124)	(0.64)	(141)	(0.85)
Royalties (Canada)	(5)	(0.03)	(25)	(0.12)	(12)	(0.06)	(21)	(0.12)
Operating expenses	(1,405)	(7.12)	(1,296)	(6.29)	(961)	(4.97)	(1,026)	(6.16)
<b>Netback from operations</b>	<b>\$1,874</b>	<b>\$9.51</b>	<b>\$2,330</b>	<b>\$11.31</b>	<b>\$4,374</b>	<b>\$22.62</b>	<b>\$3,185</b>	<b>\$19.14</b>

	2004		2003					
	First Quarter		Fourth Quarter		Third Quarter		Second Quarter	
<b>Daily Sales:</b>								
Oil (bbls/d)	1,735		1,648		865		896	
Natural gas (mcf/d)	24		-		-		-	
Total BOE (boe/d)	1,739		1,648		865		896	
		\$/boe		\$/boe		\$/boe		\$/boe
Gross revenue	\$4,459	\$28.18	\$4,076	\$26.89	\$2,086	\$26.22	\$1,837	\$22.53
Production entitlement								
- GPC (Egypt)	(862)	(5.45)	(752)	(4.97)	(443)	(5.56)	(380)	(4.66)
Marketing fees	(100)	(0.63)	(48)	(0.32)	(27)	(0.34)	(27)	(0.33)
Royalties (Canada)	(6)	(0.04)	12	0.08	-	-	-	-
Operating expenses	(858)	(5.43)	(573)	(3.78)	(697)	(8.76)	(702)	(8.61)
<b>Netback from operations</b>	<b>\$2,633</b>	<b>\$16.63</b>	<b>\$2,715</b>	<b>\$17.90</b>	<b>\$919</b>	<b>\$11.56</b>	<b>\$728</b>	<b>\$8.93</b>

Gross revenue for the first quarter 2005 was \$5.4 million (\$27.23/boe; production of 2,191 boe/d), up 20% from \$4.5 million (\$28.18/boe; production of 1,739 boe/d) for the comparable 2004 period. The revenue increase is primarily attributable to additional oil sales from the Issaran oilfield in Egypt offset slightly by lower average oil prices. The heavy oil produced from the Issaran oilfield is marketed as the Ras Gharib blend. An increased price differential from Brent oil prices experienced in the first quarter lead to a reduction in realized wellhead oil price in 2005 compared to 2004. In the first three months of 2005 the realized wellhead oil price represented 46% (52% for March) of the Brent oil price as compared for 67% for the comparable 2004 quarter.

### Production Entitlements, Marketing Costs and Royalties

For the quarter ended March 31, 2005, the production entitlement of The General Petroleum Co. SAE ("GPC") totaled \$1.6 million (\$7.94/bbl), representing 29% of gross revenue. For the corresponding 2004 period, GPC's entitlement was \$0.9 million (\$5.44/bbl), 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 average GPC entitlement from all wells, at current production levels, is 30% on a post-payout basis. The corporation disagrees with GPC's position since nearly US\$3.0 million of drilling related costs have 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 (overriding royalty) payments from the Issaran oilfield to Gemini Oil and Gas Limited, an independent oil and gas investment fund. The maximum revenue-based entitlement will be US\$1.5 million in each of 2005 and 2006 with no minimum payments required. Upon investment payout (US\$3.0 million), and continuing until December 31, 2012, the Corporation is required to pay 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.

Pursuant to the terms of certain marketing agreements pertaining to Issaran oil sales, marketing fees, linked to realized oil prices and production, of \$174,000 (\$0.88/bbl) were paid during the first quarter of 2005 as compared to \$100,000 (\$0.63/bbl) for the comparable 2004 period as a result of higher oil production.

The royalties incurred on Canadian properties are reported net of the Alberta Royalty Tax Credit; \$5,000 and \$6,000 for 2005 and 2004 first quarter periods, respectively.

### Operating Expenses

Operating expenses for the three months ended March 31, 2005 were \$1.4 million (\$7.12/boe) as compared to \$0.9 million (\$5.43/bbl) for the comparable 2004 period. On a general basis, costs have increased commensurate with the higher oil production in 2005. 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 is exploring access to natural gas from nearby sources as an alternative to diesel fuel for generators.

### General and Administrative Expenses

(thousands of dollars, unless otherwise stated)

	Three months ended March 31			
	Total	Capitalized	Expensed	\$/boe
<b>2005</b>				
Canada	\$ 628	\$ 110	\$ 518	\$2.63
Egypt	\$ 375	-	\$ 375	\$1.90
Pakistan	\$ 46	\$ 35	\$ 11	\$0.06
<b>Total</b>	<b>\$ 1,049</b>	<b>\$ 145</b>	<b>\$ 904</b>	<b>\$4.59</b>
<b>2004</b>				
Canada	\$ 439	\$ 68	\$ 371	\$2.34
Egypt	\$ 238	-	\$ 238	\$1.50
Pakistan	\$ 92	-	\$ 92	\$0.59
Other	\$ 101	-	\$ 101	\$0.64
<b>Total</b>	<b>\$ 870</b>	<b>\$ 68</b>	<b>\$ 802</b>	<b>\$5.07</b>

For the quarter ended March 31, 2005, consolidated general and administrative expenses were \$904,000 (\$4.59/boe) as compared to \$802,000 (\$5.07/bbl) for the comparable 2004 quarter. The increased cost is primarily attributable to increased charges related to stock-based compensation, staff additions and annual wage increases. Non-cash expenses related to the valuation of share options granted during the first quarter of 2005 were \$201,000 as compared to \$21,000 for 2004 comparable period.

## Interest and Finance Charges

(thousands of dollars, unless otherwise stated)

	Three months ended March 31	
	2005	2004
Interest expense	\$ 203	\$ 207
Accretion expense on debentures	36	36
Amortization of deferred charge	36	36
Total expense	275	279
Interest income	9	9
Gain (loss) on foreign exchange	(121)	70
Total income (expense)	(112)	79
Net expense	\$ 387	\$ 200
\$/boe	\$1.96	\$1.26

Total interest and finance charges increased to \$387,000 during the first quarter of 2005 from \$200,000 in the comparable 2004 quarter primarily as a result of fluctuations in foreign exchange rates. During the first quarter of 2005, \$2.2 million of the Corporation's 12% unsecured convertible debentures were converted into common shares. This resulted in lower interest expense associated with the debentures, however, increased utilization of the bank credit facility contributed to the interest amount being similar on a quarterly basis. Included in the 2005 amount is \$72,000 (2004 - \$72,000) of non-cash charges pertaining to the convertible debentures issued in 2003. Additional details are disclosed in Note 7 of the consolidated financial statements.

## Depletion, Depreciation and Accretion

(thousands of dollars, unless otherwise stated)

	Three months ended March 31	
	2005	2004
Depletion and depreciation	\$ 1,473	\$ 2,185
Accretion	5	5
Total	\$ 1,478	\$ 2,190
\$/boe	\$7.49	\$13.83

Total depletion, depreciation and accretion ("DD&A") charges for the first quarter of 2005 were \$1.5 million (\$7.49/boe), of which depletion pertaining to producing properties in Egypt represented \$1.2 million. The remainder represents depletion charges of \$135,000 for the Canadian production and fixed asset depreciation of \$119,000. DD&A charges for the first quarter of 2004 were \$2.2 million (\$13.83/bbl). 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 lower 2005 depletion rate.

## Cash Flow from Operations

Cash flow represents funds from operations as detailed on the consolidated statements of cash flows. For the quarter ended March 31, 2005, Rally Energy's cash flow from operations was \$0.9 million (\$0.01/share) as compared to \$1.7 million (\$0.02/share) for the 2004 first quarter.

## Net Loss

Rally Energy recorded a net loss of \$895,000 (\$0.01/share) for the first quarter of 2005 as compared to a net loss of \$559,000 (\$0.01/share) for the comparable 2004 quarter.

## SUMMARY OF QUARTERLY RESULTS

(thousands of dollars, unless otherwise stated)

	Revenue		Cash flow from operations		Income (loss)	
				\$/share - basic		\$/share - basic
2005: Q1	\$5,370		\$ 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
Q2	\$5,400		\$2,202	\$0.03	\$ (28)	\$ 0.00
Q1	\$4,459		\$1,724	\$0.02	\$ (559)	\$(0.01)
2003: Q4	\$4,076		\$1,635	\$0.03	\$ (1,850)	\$(0.03)
Q3	\$2,086		\$ 126	\$0.00	\$ (1,259)	\$(0.02)
Q2	\$1,837		\$ 106	\$0.00	\$(1,208)	\$(0.02)

## Capital Expenditures

During the 2005 first quarter, Rally Energy drilled 3 wells (3 net) in Egypt and participated in the drilling of one wells (0.7 net) in Canada. Capital expenditures totaled \$5.9 million during the first quarter of 2005, up from \$3.0 million for the comparable 2004 period.

(thousands of dollars)	Three months ended	
	March 31	
	2005	2004
<b>Egypt</b>		
Drill, complete and workovers	\$3,137	\$2,743
Seismic, evaluation and other	272	106
Inventory change	(129)	-
Capitalized admin. costs	-	-
<b>Total</b>	<b>3,280</b>	<b>\$2,849</b>
<b>Canada</b>		
Drill and complete	\$1,464	\$93
Seismic, evaluation and other	230	39
Lease acquisition	467	-
Capitalized admin. costs	110	68
<b>Total</b>	<b>\$2,271</b>	<b>\$ 200</b>
<b>Pakistan</b>		
Drill and complete	297	-
Capitalized admin. costs	35	-
<b>Total</b>	<b>332</b>	<b>-</b>
<b>Grand Total</b>		
Drill, complete and workovers	\$4,898	\$2,836
Seismic, evaluation and other	502	145
Lease acquisition	467	-
Inventory change	(129)	-
Capitalized admin. costs	145	68
<b>Total</b>	<b>\$5,883</b>	<b>\$3,049</b>

Included in the above amounts are casing and tubing inventory costs of \$441,000 at March 31, 2005 (2004 - \$1.1 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, related fair value discounts and estimated transaction costs, is estimated at \$650,000.

At March 31, 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 March 31, 2005, Rally Energy had bank indebtedness of \$1.2 million, as compared to cash of \$358,000 at December 31, 2004. The working capital shortfall at March 31, 2004 was \$4.6 million, as compared to a working capital shortfall of \$345,000 at December 31, 2004. Increased drilling activity in the first quarter of 2005, both in Egypt and Canada, resulted in a higher level of accounts payable.

During the 2005 first quarter, Rally Energy received proceeds of \$812,000 from the exercise of an aggregate 1.4 million common share options at an average price of \$0.57/share.

During the quarter ended March 31, 2005, \$2.2 million of the 12% unsecured convertible subordinated debentures were converted into common shares, leaving a balance of \$3.8 million at period end, down from \$6.0 million at December 31, 2004. The debentures are convertible, at the option of the holder, into common shares at a conversion price of \$1.00 per common share (\$1.10 per common share subsequent to July 1, 2005).

On March 30, 2005, Rally Energy received approval from its primary banker that its secured credit facility has been increased to US\$4.5 million from US\$3.0 million to cover working capital requirements.

On May 13, 2005, the Corporation completed the closing of a 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 agents' commissions and estimated transaction fees.

**Rally Energy Corp.**  
**Consolidated Balance Sheets**

	<b>March 31,</b> <b>2005</b>	December 31, 2004
	(unaudited)	(audited)
<b>Assets</b>		
<b>Current</b>		
Cash	\$ -	\$ 358,245
Accounts receivable	5,616,933	6,503,769
Cash calls receivable	-	104,499
Notes receivable	483,000	740,270
Inventory	389,461	540,447
Prepaid expenses and deposits	304,717	266,361
	6,794,111	8,513,591
<b>Assets held for sale (Note 3)</b>	<b>650,000</b>	<b>650,000</b>
<b>Property and equipment</b>	<b>38,176,484</b>	<b>33,737,226</b>
<b>Deferred charges (Note 4)</b>	<b>114,556</b>	<b>215,466</b>
	\$ 45,735,151	\$ 43,116,283
<b>Liabilities and Shareholders' Equity</b>		
<b>Current</b>		
Bank indebtedness	\$ 1,219,614	\$ -
Accounts payable – trade	3,476,564	3,137,551
Accounts payable – capital	5,814,179	5,053,800
Cash call obligations	360,817	184,478
Deferred revenue	483,000	483,000
	11,354,174	8,858,829
<b>Asset retirement obligations (Note 1)</b>	<b>324,106</b>	<b>289,846</b>
<b>Convertible debentures (Note 4)</b>	<b>3,648,405</b>	<b>5,784,486</b>
	15,326,685	14,933,161
<b>Shareholders' equity</b>		
Equity instruments (Note 6(a))	40,910,346	37,991,329
Contributed surplus (Note 6(b))	828,014	626,620
Deficit	(11,329,894)	(10,434,827)
	30,408,466	28,183,122
	\$ 45,735,151	\$ 43,116,283

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



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

	Three months ended March 31	
	2005	2004
	(unaudited)	(unaudited)
<b>Oil and gas revenue</b>	<b>\$ 5,369,585</b>	\$ 4,459,423
Less: Royalties and related credits	<b>(2,091,165)</b>	(968,080)
	<b>3,278,420</b>	3,491,343
Operating expenses	<b>1,404,394</b>	858,554
<b>Netback from oil and gas operations</b>	<b>1,874,026</b>	2,632,789
<b>Expenses</b>		
Administrative expenses:		
Legal, professional and audit	<b>69,252</b>	41,267
Shareholder reporting and communication	<b>4,679</b>	18,287
Administration	<b>617,575</b>	527,295
Pakistan administrative costs	<b>11,561</b>	92,341
Project evaluation costs	<b>-</b>	101,041
Stock-based compensation	<b>201,394</b>	21,416
	<b>904,461</b>	801,647
Interest expense	<b>202,690</b>	207,376
Depletion, depreciation and accretion	<b>1,478,061</b>	2,189,833
Accretion expense on convertible debentures	<b>35,919</b>	35,919
Amortization of deferred charge	<b>35,910</b>	35,910
	<b>2,657,041</b>	3,270,685
<b>Income (loss) before under noted items</b>	<b>(783,015)</b>	(637,896)
<b>Other items</b>		
Interest income	<b>9,278</b>	9,463
Gain (loss) on foreign exchange	<b>(121,330)</b>	69,836
	<b>(112,052)</b>	79,299
<b>Loss for the period</b>	<b>(895,067)</b>	(558,597)
Deficit, beginning of period	<b>(10,434,827)</b>	(11,673,317)
<b>Deficit, end of period</b>	<b>\$ (11,329,894)</b>	\$ (12,231,914)
<b>Loss per share (Note 6(a))</b>	<b>\$ (0.01)</b>	\$ (0.01)

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

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

	Three months ended March 31	
	2005	2004
	(unaudited)	(unaudited)
<b>Cash flows from operating activities</b>		
Loss for the period	\$ (895,067)	\$ (558,597)
Non-cash items:		
Stock-based compensation	201,394	21,416
Accretion expense on convertible debentures	35,919	35,919
Amortization of deferred charges	35,910	35,910
Depletion, depreciation and accretion	1,478,061	2,189,833
Cash flow from operations	856,217	1,724,481
Changes in non-cash working capital balances		
Accounts receivable	991,335	(1,432,548)
Notes receivable	257,270	
Inventory	150,986	45,349
Prepaid expenses and deposits	(38,356)	(60,292)
Accounts payable	1,734,966	379,511
	3,952,418	656,501
<b>Cash flows from investing activities</b>		
Oil and gas assets, net	(5,883,059)	(3,048,615)
Changes in non-cash working capital	760,379	480,739
	(5,122,680)	(2,567,876)
<b>Cash flows from financing activities</b>		
Issuance of equity instruments, net	2,984,017	19,004
Debentures converted	(2,172,000)	-
	812,017	19,004
<b>Decrease in cash</b>	(358,245)	(1,892,371)
Cash, beginning of period	358,245	2,260,426
<b>Cash, end of period</b>	\$ -	\$ 368,055

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**

**Three months ended March 31, 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 Services 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 \$\_\_\_\_\_, 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 \$47,917, 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.

A reconciliation of the asset retirement obligations is provided below:

<i>Asset retirement obligations</i>	<b>Three months ended March 31</b>	
	<b>2005</b>	<b>2004</b>
Balance, beginning of period	<b>289,846</b>	168,128
Liabilities incurred in period	<b>29,094</b>	-
Accretion expense	<b>5,166</b>	4,804
Balance, end of period	<b>324,106</b>	172,932

### **2. Inventory**

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At March 31, 2005, the Corporation held \$830,688 (March 31, 2004 - \$1,396,000) of inventory available for use in the Issaran oilfield in Egypt. Of this amount, (i) \$441,227 relates to capital equipment, primarily pipe, and is included in Property and Equipment and (ii) \$389,461 represents consumable supplies to be used in oilfield operations and is recorded as inventory under current assets.

### **3. 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.

### **4. 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 are 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 increases to \$1.10 per common share. The debentures are not redeemable by the Corporation prior to January 1, 2005. Thereafter, the debentures are redeemable at par, in whole or in part, if the closing price of the Corporation's common shares are at or above \$2.00 for 30 consecutive trading days. An agent's commission of \$420,000 was paid in relation to debenture subscriptions. The legal fees and cash commissions incurred to secure the debenture financing were recorded as deferred charges 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 represents \$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 three months of 2005, \$2,172,000 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, \$65,000 of deferred charges related to the issuance of the converted debentures have been reclassified as share issue costs.

### **5. Credit Facility**

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At March 31, 2005, the Corporation has utilized \$1,219,614 (US\$1,008,000) (March 31, 2004 – nil) of the US\$3.0 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, Rally Energy received approval for its secured credit facility to be increased to US\$4.5 million from US\$3.0 million until March 30, 2006.

## 6. Equity Instruments

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(a) Issued and outstanding

	Number of Shares	Amounts
<b>Common shares</b>		
Balance, December 31, 2004	74,350,379	\$ 38,332,943
Stock options exercised	1,425,667	812,017
Debentures converted (Note 4)	2,172,000	2,172,000
Balance, March 31, 2005	77,948,046	41,316,960
Add: Equity portion of convertible debentures	-	437,000
Less: Share issue costs	-	(843,614)
Balance, Common stock	77,948,046	\$ 40,910,346

Weighted average number of common shares  
for the three months ended March 31, 2005 75,799,306

(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 \$201,394 for options issued in the first quarter of 2005 (March 31, 2004 – \$21,416). The stock-based compensation expense associated with the value ascribed to options granted is recorded as contributed surplus.

	Share Options	Weighted Average Exercise Price
Outstanding, beginning of year	6,327,757	\$0.63
Granted	758,000	\$1.80
Exercised	(1,425,667)	\$0.57
Outstanding, end of period	5,660,090	\$0.80

## 7. Related Party Transactions

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For the three months ended March 31, 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.

	Three months ended March 31	
	2005	2004
Included in general and administrative expenses	\$ 82,349	\$
Capitalized	124,226	
	\$ 206,575	\$ 150,600

## 8. Comparative Amounts

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

## 9. Measurement Uncertainty

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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.

## 10. Segmented Information

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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 months ended March 31 and capital assets are summarized on a country basis below:

<b>March 31, 2005</b>	<b>Egypt</b>	<b>Canada</b>	<b>Pakistan</b>	<b>Total</b>
Gross revenue	<u>\$ 5,212,429</u>	<u>\$ 157,156</u>	<u>-</u>	<u>\$ 5,369,585</u>
Property and equipment	<u>\$</u>	<u>\$</u>	<u>\$</u>	<u>\$ 38,176,484</u>
<b>March 31, 2004</b>	<b>Egypt</b>	<b>Canada</b>	<b>Pakistan</b>	<b>Total</b>
Gross revenue	<u>\$ 4,421,377</u>	<u>\$ 38,046</u>	<u>\$ -</u>	<u>\$ 4,459,423</u>
Property and equipment	<u>\$</u>	<u>\$</u>	<u>\$ -</u>	<u>\$ 33,737,226</u>

## 11. Subsequent Events

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- (a) Subsequent to March 31, 2005, the following changes occurred with respect to the Corporation's stock options:

	<b>Number of Options</b>	<b>Exercise Price</b>
Exercised	<u>(56,000)</u>	<u>\$0.60</u>
Granted	<u>250,000</u>	<u>\$1.54</u>
Net Change	<u>194,000</u>	

- (b) On May 13, 2005, the Corporation completed the closing of a 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 agents' commissions and estimated transaction fees.