



November 9, 2006

## RALLY ENERGY REPORTS RECORD PRODUCTION, REVENUE AND CASH FLOW FOR THIRD QUARTER 2006

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Rally Energy (the "Corporation") is pleased to announce record operational and financial results for the Third Quarter of 2006:

### HIGHLIGHTS

	<u>Quarter ended September 30</u>		
	<u>2006</u>	<u>2005</u>	<u>Change</u>
Production (boe/d)	<b>5,716</b>	2,613	+119%
Average Price (\$/boe)	<b>48.89</b>	44.51	+10%
Revenue (\$ million)	<b>25.7</b>	10.7	+140%
Cash Flow (\$ million)	<b>13.1</b>	4.4	+198%
Capital Expenditures (\$ million)	<b>16.8</b>	5.0	+234%

In the third quarter, production from the Issaran oilfield in Egypt averaged 5,595 boe/d with an additional 121 boe/d contributed from production in Canada. During the third quarter, the Corporation drilled nine wells in Egypt resulting in nine oil wells. One new well will be utilized for steam injection as the first of seven new steam injection wells to be drilled in 2006.

Net Income for the nine months ended September 30, 2006 was \$4.6 million, as compared to \$0.9 million for the comparable 2005 period. Net Income for the 2006 nine month period was reduced by a \$9.7 million write-down taken in the third quarter. At September 30, 2006, the Corporation recorded this write-down due to valuation impairments associated with Canadian petroleum and natural gas assets, primarily related to costs originally incurred during 2001 to 2004 resulting from the Corporation's abandoned Prince Edward Island oil and gas exploration programs.

Working capital at the end of the third quarter was \$19.1 million, of which \$8.1 million was cash and short-term cash investments. At September 30, 2006, long-term debt drawn under the new US\$25 million loan facility from the International Finance Corporation was \$16.8 million (US\$15 million).

The Safed Koh joint venture partners held a technical committee meeting on November 6 and the operator advised that the Salsabil pipeline is 70% complete and production will start with minimal processing facilities in late January 2007 until completion of the main gas processing plant in March. There has not yet been any decision rendered on the enhanced gas price currently under review by the Attorney General's office. Additionally, the operator advises that the next development well is now expected to be drilled in mid-March 2007 due to delays in the drill rig manufacturing.

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

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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 Nine Months ended September 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 September 30, 2006 and the interim consolidated statements of income and deficit and cash flows for the three and nine 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 November 9, 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)

### Nine Month Comparison

	For the nine months ended September 30			
	2006		2005	
<b>Production:</b>				
Oil (bbls/d)	4,292		2,491	
Natural gas (mcf/d)	378		216	
Total BOE (boe/d)	4,355		2,527	
		<u>\$/boe</u>		<u>\$/boe</u>
Gross revenue	\$ 55,375	\$46.58	\$ 24,880	\$36.06
Production entitlement – GPC (Egypt)	(15,677)	(13.19)	(6,843)	(9.92)
Overriding royalty (Egypt)	(1,672)	(1.41)	(1,534)	(2.22)
Marketing fees	(642)	(0.54)	(463)	(0.67)
Royalties (Canada)	(355)	(0.30)	(114)	(0.16)
Operating expenses	(8,621)	(7.25)	(4,621)	(6.70)
<b>Netback from operations</b>	<b>\$ 28,408</b>	<b>23.89</b>	<b>\$ 11,305</b>	<b>\$16.39</b>

### Quarterly Comparison

	2006				2005			
	Third Quarter	Second Quarter	First Quarter	Fourth Quarter	Third Quarter	Second Quarter	First Quarter	Fourth Quarter
<b>Production:</b>								
Oil (bbls/d)	5,658	4,509	2,676	2,656				
Natural gas (mcf/d)	348	396	388	462				
Total BOE (boe/d)	5,716	4,575	2,741	2,733				
		<u>\$/boe</u>	<u>\$/boe</u>	<u>\$/boe</u>	<u>\$/boe</u>	<u>\$/boe</u>	<u>\$/boe</u>	<u>\$/boe</u>
Gross revenue	\$25,708	\$48.89	\$19,605	\$47.09	\$10,061	\$40.79	\$10,019	\$39.85
Production entitlement								
- GPC (Egypt)	(7,397)	(14.08)	(5,585)	(13.41)	(2,695)	(10.93)	(2,631)	(10.47)
Overriding royalty (Egypt)	-	-	(1,061)	(2.55)	(611)	(2.48)	(255)	(1.02)
Marketing fees	(257)	(0.49)	(213)	(0.51)	(171)	(0.69)	(159)	(0.63)
Royalties (Canada)	(108)	(0.21)	(105)	(0.25)	(142)	(0.57)	(143)	(0.57)
Operating expenses	(3,601)	(6.85)	(2,898)	(6.96)	(2,122)	(8.60)	(2,098)	(8.35)
<b>Netback from operations</b>	<b>\$14,345</b>	<b>\$27.26</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>

	2005				2004			
	Third Quarter	Second Quarter	First Quarter	Fourth Quarter	Third Quarter	Second Quarter	First Quarter	Fourth Quarter
<b>Production:</b>								
Oil (bbls/d)	2,558	2,734	2,177	2,206				
Natural gas (mcf/d)	330	240	41	192				
Total BOE (boe/d)	2,613	2,774	2,191	2,238				
		<u>\$/boe</u>	<u>\$/boe</u>	<u>\$/boe</u>	<u>\$/boe</u>	<u>\$/boe</u>	<u>\$/boe</u>	<u>\$/boe</u>
Gross revenue	\$10,698	\$44.51	\$8,813	\$34.91	\$5,369	\$27.23	\$5,790	\$28.12
Production entitlement								
- GPC (Egypt)	(2,898)	(12.07)	(2,380)	(9.43)	(1,565)	(7.94)	(1,978)	(9.62)
Overriding royalty (Egypt)	(629)	(2.62)	(558)	(2.21)	(347)	(1.76)	-	-
Marketing fees	(103)	(0.43)	(186)	(0.74)	(174)	(0.88)	(161)	(0.78)
Royalties (Canada)	(104)	(0.43)	(5)	(0.01)	(5)	(0.03)	(25)	(0.12)
Operating expenses	(1,672)	(6.96)	(1,545)	(6.12)	(1,404)	(7.12)	(1,296)	(6.29)
<b>Netback from operations</b>	<b>\$5,292</b>	<b>\$22.00</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>

Gross revenue for the third quarter of 2006 was \$25.7 million (\$48.89/boe; production of 5,716 boe/d), up 140% from \$10.7 million (\$44.51/boe; production of 2,613 boe/d) for the third quarter of 2005. For the nine months ended September 30, 2006, gross revenue increased 123% to \$55.4 million (\$46.58 boe; production of 4,355 boe/d) from \$24.9 million (\$36.06/boe; production of 2,527 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 2006 third quarter was 121 boe/d (\$52.44/boe) as compared to 203 boe/d (\$63.58/boe) for the 2005 third quarter. For the nine month periods ended September 30, 2006 and 2005 the Canadian production was 144 boe/d (at an average commodity price of \$53.31) and 129 boe/d (at \$57.78 boe/d), respectively.

Heavy oil produced from the Issaran oilfield is marketed as Ras Gharib blend. For the nine months ended September 30, 2006, the Corporation's realized wellhead oil price represented 61% of the Brent oil price as compared to 53% for the comparable 2005 period. The heavy oil price differential improved further in the third quarter of 2006 to a wellhead price representing 62% of the Brent oil price as compared to 58% for the 2005 third quarter.

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

For the quarter ended September 30, 2006, the production entitlement of The General Petroleum Co. S.A.E. ("GPC") totaled \$7.4 million (\$14.08/boe), representing 29% of gross revenue. For the corresponding 2005 quarter, GPC's entitlement was \$2.9 million (\$12.07/boe), representing 27% of gross revenue. GPC's production entitlement was consistent at 28% for the respective nine month periods ended September 30, 2006 and 2005, totaling \$15.7 million (\$13.19/boe) and \$6.8 million (\$9.92/boe) in each period. Under the terms of the Petroleum Service Agreement ("PSA"), GPC's production entitlement changes on an incremental basis as production levels increase, as disclosed in the Corporation's Annual Report and Annual Information Form. This production entitlement satisfies all obligations with respect to government royalties and corporate income tax.

No revenue-based overriding royalty payment obligations were required in the 2006 third quarter compared to \$628,000 in the 2005 third quarter. For the nine months ended September 30, 2006, the obligations totaled \$1.7 million (US\$1.5 million) as compared to \$1.5 million for the comparable 2005 period. The capped 2006 revenue-based entitlement (10%, net of GPC's entitlement and marketing fees) of US\$1.5 million was reached in June 2006. As a result, no further obligations will be incurred on 2006 production; the royalty obligation will resume in January 2007 at the lower rate of 2.6%, under the terms of the royalty agreement. The royalty obligation is capped at 7,000 boe/d and expires on December 31, 2012. 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 \$257,000 (\$0.49/boe) were paid during the third quarter of 2006 as compared to \$103,000 (\$0.43 boe) for the comparable 2005 quarter. For the nine months ended September 30, 2006, marketing fees totaled \$642,000 (\$0.54/boe) as compared to \$463,000 (\$0.67/boe) for the 2005 nine month period. Obligations under one marketing agreement were fully satisfied on February 28, 2006 which has resulted in lower per-unit marketing costs for the balance of 2006.

Royalty obligations on Canadian production for the third quarter of 2006 were \$108,000 (net of the Alberta Royalty Tax Credit) increasing from \$104,000 for the 2005 third quarter. For the nine month periods ended September 30, 2006 and 2005, Canadian royalties were \$355,000 and \$114,000, respectively. During 2005, production from the primary producing property benefited from a one-year oil royalty holiday which expired in January 2006.

### **Operating Expenses**

For the third quarter of 2006, operating expenses were \$3.6 million (\$6.85/boe), up from \$1.7 million (\$6.96/boe) for the 2005 third quarter. Operating expenses for the nine months ended September 30, 2006 were \$8.6 million (\$7.25/boe) as compared to \$4.6 million (\$6.70/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 commence utilization of natural gas from nearby sources as an alternative to diesel fuel for generators by the end of 2006 and expects to incur lower operating costs per boe after this conversion.

## General and Administrative Expenses

(thousands of dollars, unless otherwise stated)

		Three months ended September 30			
		<u>Total</u>	<u>Capitalized</u>	<u>Expensed</u>	<u>\$/boe</u>
<b>2006</b>					
	Canada	\$ 1,048	\$ 223	\$ 825	\$1.57
	Egypt	\$ 431	\$ -	\$ 431	\$0.82
	Pakistan	\$ 199	\$ 145	\$ 54	\$0.10
	<b>Total</b>	<b>\$ 1,678</b>	<b>\$ 368</b>	<b>\$ 1,310</b>	<b>\$2.49</b>
<b>2005</b>					
	Canada	\$ 834	\$ 94	\$ 740	\$3.08
	Egypt	\$ 338	\$ -	\$ 338	\$1.41
	Pakistan	\$ 127	\$ 101	\$ 26	\$0.10
	<b>Total</b>	<b>\$ 1,299</b>	<b>\$ 195</b>	<b>\$ 1,104</b>	<b>\$4.59</b>
		Nine months ended September 30			
		<u>Total</u>	<u>Capitalized</u>	<u>Expensed</u>	<u>\$/boe</u>
<b>2006</b>					
	Canada	\$ 4,292	\$ 619	\$ 3,673	\$3.09
	Egypt	\$ 1,076	\$ -	\$ 1,076	\$0.91
	Pakistan	\$ 411	\$ 302	\$ 109	\$0.09
	<b>Total</b>	<b>\$ 5,779</b>	<b>\$ 921</b>	<b>\$ 4,858</b>	<b>\$4.09</b>
<b>2005</b>					
	Canada	\$ 2,149	\$ 282	\$ 1,867	\$2.71
	Egypt	\$ 1,061	\$ -	\$ 1,061	\$1.54
	Pakistan	\$ 303	\$ 233	\$ 70	\$0.09
	<b>Total</b>	<b>\$ 3,513</b>	<b>\$ 515</b>	<b>\$ 2,998</b>	<b>\$4.34</b>

For the nine months ended September 30, 2006, consolidated general and administrative (“G&A”) expenses were \$4.9 million (\$4.09/boe) as compared to \$3.0 million (\$4.34/boe) for the comparable 2005 period. For the third quarters, G&A costs were \$1.3 million (\$2.49/boe) and \$1.1 million (\$4.59/boe) for 2006 and 2005, respectively. Increased G&A cost is primarily attributable to staff additions, options expensing and annual wage increases. For the nine months ended September 30, 2006, non-cash costs of \$1.8 million in expensed G&A related to vesting of share options granted as compared to \$677,000 for the 2005 comparable period. Exclusive of the non-cash component, G&A costs for the nine months ended September 30, 2006 were \$3.0 million (\$2.54/boe) down 24% on a boe basis from \$2.3 million (\$3.36/boe) for the comparable 2005 period.

## Interest and Finance Charges

(thousands of dollars, unless otherwise stated)

	Three months ended September 30		Nine months ended September 30	
	2006	2005	2006	2005
Interest expense	\$ 298	\$ 129	\$ 461	\$ 499
Accretion expense on debentures	-	13	26	176
Amortization of deferred charge	259	13	378	63
Total expense	557	155	865	738
Interest income	55	6	77	23
Gain (loss) on foreign exchange	41	(15)	(64)	(30)
Gain (loss) on asset disposition	-	-	(36)	-
Total income (expense)	96	(9)	(23)	(7)
Net expense	\$ 461	\$ 164	\$ 888	\$ 745
\$/boe	\$0.88	\$0.69	\$0.75	\$1.08

Total interest and finance charges increased to \$888,000 for the nine months ended September 30, 2006 from \$745,000 for the comparable 2005 period primarily as a result of amortization of deferred charges associated with the International Finance Corp. financing. During the third quarter of 2006, none of the Corporation's 12% unsecured convertible debentures were outstanding as compared to an average of \$1.3 million during the comparable 2005 quarter.

### Depletion, Depreciation and Accretion

(thousands of dollars, unless otherwise stated)

	Three months ended		Nine months ended	
	September 30		September 30	
	2006	2005	2006	2005
Depletion, depreciation and accretion	\$ 3,410	\$ 2,190	\$ 8,418	\$ 6,140
\$/boe	\$6.48	\$9.11	\$7.08	\$8.90

Total depletion, depreciation and accretion ("DD&A") charges for the nine months ended September 30, 2006 were \$8.4 million (\$7.08/boe), of which depletion pertaining to producing properties in Egypt represented \$6.0 million. The remainder represents depletion charges of \$2.0 million for Canadian production and fixed asset depreciation of \$378,000. DD&A charges for the third quarter of 2006 were \$3.4 million (\$6.48/boe) and \$2.2 million (\$9.11/boe) for the 2005 third quarter. Overall, depletion rates have declined due to reserve additions in Egypt achieved through the Corporation's \$31.1 million capital expenditure investment for the nine months ended September 30, 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 September 30, 2006, Rally Energy's cash flow from operations was \$13.1 million (\$0.14/share) an increase of 198% over \$4.4 million (\$0.05/share) for the 2005 third quarter. For the nine months ended September 30, 2006, Rally Energy's cash flow from operations increased by 194% to \$24.9 million (\$0.27/share) as compared to \$8.5 million (\$0.11/share) for the comparable 2005 period.

### Net Income

At September 30, 2006, the Corporation recorded a write-down of \$9.7 million related to valuation impairments associated with the carrying value of Canadian petroleum and natural gas assets. This write-down relates primarily to costs originally incurred during 2001 to 2004 resulting from the Corporation's abandoned Prince Edward Island oil and gas exploration programs. As a result of the write-down, Rally Energy recorded a net loss of \$505,000 (\$0.005/share) for the third quarter of 2006, as compared to net income of \$1.3 million (\$0.02/share) for the comparable 2005 quarter. For the nine months ended September 30, 2006, Rally Energy's net income was \$4.6 million (\$0.049/share) as compared to \$923,000 (\$0.01/share) for the comparable 2005 period.

### SUMMARY OF QUARTERLY RESULTS

(thousands of dollars, unless otherwise stated)

	Revenue	Cash flow from operations	\$/share - basic	Income (loss)	\$/share - basic
2006: Q3	\$25,708	\$13,092	\$0.14	\$ (505)	\$(0.00)
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 nine months ended September 30, 2006, Rally Energy drilled 20 successful oil wells (20 net) in Egypt and participated in the drilling of two successful oil and gas wells (0.62 net) in Canada. Total capital expenditures for the nine months ended September 30, 2006 totaled \$31.1 million, up from \$16.5 million for the comparable 2005 period.

(thousands of dollars)	Three months ended September 30		Nine months ended September 30	
	2006	2005	2006	2005
<b>Egypt</b>				
Drill, complete and workovers	\$ 5,621	\$ 1,954	\$ 15,812	\$ 7,307
Facilities, equipment and other	2,394	1,233	3,463	2,166
Thermal project	2,206	-	2,910	-
Inventory change	1,481	1,346	1,497	1,327
Capitalized admin. costs	-	-	-	-
<b>Total</b>	<b>\$ 11,702</b>	<b>\$ 4,533</b>	<b>\$ 23,682</b>	<b>\$ 10,800</b>
<b>Canada</b>				
Drill, complete and workovers	\$ 688	\$ 102	\$ 2,233	\$ 3,246
Facilities, equipment and other	66	79	185	376
Property acquisition (disposition)	-	(45)	-	422
Capitalized admin. costs	223	94	619	282
<b>Total</b>	<b>\$ 977</b>	<b>\$ 230</b>	<b>\$ 3,037</b>	<b>\$ 4,326</b>
<b>Pakistan</b>				
Drill and complete	\$ -	\$ 182	\$ -	\$ 1,165
Facilities, equipment and other	4,013	(6)	4,040	15
Capitalized admin. costs	145	101	302	233
<b>Total</b>	<b>\$ 4,158</b>	<b>\$ 277</b>	<b>\$ 4,342</b>	<b>\$ 1,413</b>
<b>Grand Total</b>				
Drill, complete and workovers	\$ 6,309	\$ 2,238	\$ 18,045	\$ 11,718
Facilities, equipment and other	6,473	1,306	7,688	2,557
Thermal project	2,206	-	2,910	-
Inventory change	1,481	1,346	1,497	1,327
Property acquisition (disposition)	-	(45)	-	422
Capitalized admin. costs	368	195	921	515
<b>Total</b>	<b>\$ 16,837</b>	<b>\$ 5,040</b>	<b>\$ 31,061</b>	<b>\$ 16,539</b>
<b>Write-down of assets</b>				
Canada	\$ (9,569)	\$ -	\$ (9,569)	\$ -
<b>Net Additions</b>	<b>\$ 7,268</b>	<b>\$ 5,040</b>	<b>\$ 21,492</b>	<b>\$ 16,539</b>

Included in the above amounts are casing and tubing inventory costs of \$3.3 million at September 30, 2006 (December 31, 2005 - \$571,000) for use in future Issaran drilling programs.

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

On October 24, 2006, the Corporation announced it had signed an agreement with an independent private company to dispose of certain Canadian oil and gas properties for a purchase price of \$6.9 million (\$5.5 million in cash and \$1.4 million in common shares of the private company). The agreement has an effective date of November 1, 2006 and closing is scheduled for November 30, 2006, subject to certain conditions.

At September 30, 2006, the Corporation continued to meet the asset impairment test for capitalized costs related to oil and gas investments in Egypt and Pakistan, and no ceiling test write-down was required. At September 30, 2006, the Corporation recorded a write-down of \$9.7 million related to valuation impairments associated with the carrying value of the Canadian petroleum and natural gas assets. The write-down primarily relates to costs originally incurred during 2001 to 2004 resulting from the Corporation's abandoned Prince Edward Island oil and gas exploration programs.

## **Liquidity and Capital Resources**

At September 30, 2006, the Corporation had a cash position of \$8.1 million, of which \$1.5 million represented funds on deposit to secure letters of credit. Working capital at September 30, 2006 was \$19.1 million, a substantial increase from \$699,000 at December 31, 2005 and from \$11.4 million at June 30, 2006. Increased accounts receivable from higher production levels were partially offset by increased liabilities associated with the Corporation's higher activity level. Additionally, the Corporation secured long-term debt to replace short-term borrowings, received proceeds from warrant and option exercises (\$7.3 million) and converted debentures to equity.

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, all borrowings are now classified as long-term. At September 30, 2006, Rally Energy had drawn US\$15 million on the IFC credit facility. All 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 nine months ended September 30, 2006, Rally Energy received proceeds of \$905,000 from the exercise of an aggregate of 1,217,000 common share options and \$6.4 million from the exercise of an aggregate of four million common share purchase warrants (at \$1.60 per share).

On May 19, 2006, the Corporation finalized agreements with the IFC for a US\$25 million of long-term financing facilities. The facilities are comprised of a US\$5 million Term Loan ("Term") to the Corporation and a US\$20 million Revolving Credit Facility ("Revolving") to two of its wholly-owned subsidiaries, Scimitar Production Egypt Ltd. and Rally Energy Safed Koh Ltd. The facilities are intended to fund working capital requirements and 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 above \$2.95 for ten consecutive trading days.

On November 3, 2006 the Corporation announced that the expiry date for the 3,000,000 warrants issued to the IFC has been accelerated to December 4, 2006 from May 18, 2009 after the Corporation's shares closed above \$2.95 for ten consecutive trading days. The \$5.8 million warrant exercise proceeds will be satisfied by reducing outstanding debt to the IFC by US\$5.0 million with the remaining \$81,000 paid in cash.

## 2006 OUTLOOK

Based on successful results from the existing steam injection program in Egypt, the Corporation intends to drill six wells for use in the expanded steam injection program during the fourth quarter. Updated thermal recovery models, based on the better-than-expected steam pilot results, now show potential for expansion to other areas of the oilfield. The successful thermal program results and the active 20 well program during the nine months ended September 30, create the potential for significant independently-recognized reserves additions at year-end. Additionally, facilities currently under construction will result in improved oil processing and delivery logistics in 2007. Production from existing wells will continue to benefit from 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 additional Egyptian concessions, which, if successfully secured, will further enhance opportunities for reserves and production growth in Egypt.

The Safed Koh joint venture partners held a technical committee meeting on November 6 and the operator advised that the Salsabil pipeline is 70% complete and production will start with minimal processing facilities in late January 2007 until completion of the main gas processing plant in March. There has not yet been any decision rendered on the enhanced gas price currently under review by the Attorney General's office. Additionally, the operator advises that the next development well is now expected to be drilled in mid-March 2007 due to delays in the drill rig manufacturing. One development well is expected to be drilled on the Salsabil (Rodho) discovery structure to increase deliverability from recognized recoverable reserves and to test deeper reservoir horizons. Exploration wells will follow immediately thereafter on the Afiband and Zindapir structures. Closing of the announced acquisition of an additional 7.5% working interest in Safed Koh is expected later this year and will increase the Corporation's working interest to 30% (see "Capital Expenditures").

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

**September 30,**  
**2006**                      **December 31,**  
**2005**

**Assets**

**Current**

Cash	\$ 6,521,788	\$ 801,639
Restricted cash (Note 1)	1,534,098	-
Accounts receivable	23,929,945	8,906,244
Inventory (Note 3)	362,110	305,061
Prepaid expenses and deposits	473,607	468,943
	<b>32,821,548</b>	<b>10,481,887</b>

Future income tax asset (Note 8)	-	705,000
Long-term investments (Note 2)	50,000	150,000
Property and equipment (Note 3)	61,593,229	48,334,494
Deferred charges (Note 5)	2,643,732	26,440
	<b>\$ 97,108,509</b>	<b>\$ 59,697,821</b>

**Liabilities and Shareholders' Equity**

**Current**

Accounts payable – operations	\$ 5,096,080	\$ 4,572,583
Accounts payable – capital	8,623,908	3,922,935
Convertible debentures	-	1,287,555
	<b>13,719,988</b>	<b>9,783,073</b>

Asset retirement obligations (Note 4)	774,545	590,382
Long-term debt (Note 5)	16,765,500	-
	<b>31,260,033</b>	<b>10,373,455</b>

**Shareholders' equity**

Equity instruments (Note 6(a))	67,193,536	56,249,969
Contributed surplus (Note 6(d))	2,974,199	1,968,082
Deficit	(4,319,259)	(8,893,685)
	<b>65,848,476</b>	<b>49,324,366</b>
	<b>\$ 97,108,509</b>	<b>\$ 59,697,821</b>

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

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

	Three months ended September 30		Nine months ended September 30	
	2006	2005	2006	2005
<b>Oil and gas revenue</b>	<b>\$ 25,708,368</b>	\$ 10,697,788	<b>\$ 55,374,947</b>	\$ 24,880,099
Less: Royalties and related credits	<b>(7,761,986)</b>	(3,733,625)	<b>(18,345,503)</b>	(8,953,631)
	<b>17,946,382</b>	6,964,163	<b>37,029,444</b>	15,926,468
Operating expenses	<b>3,601,305</b>	1,672,027	<b>8,621,171</b>	4,621,009
	<b>14,345,077</b>	5,292,136	<b>28,408,273</b>	11,305,459
<b>Expenses</b>				
Administrative expenses:				
Administration	<b>1,050,295</b>	766,430	<b>3,024,652</b>	2,320,983
Stock-based compensation	<b>258,783</b>	337,263	<b>1,832,693</b>	676,567
	<b>1,309,078</b>	1,103,693	<b>4,857,345</b>	2,997,550
Interest expense	<b>298,003</b>	129,091	<b>461,355</b>	499,427
Depletion, depreciation and accretion	<b>3,409,778</b>	2,189,079	<b>8,418,119</b>	6,139,556
Accretion expense on convertible debentures	-	13,224	<b>26,445</b>	175,845
Amortization of deferred charges	<b>259,521</b>	13,221	<b>378,372</b>	63,160
Write-down of assets (Note 2,3)	<b>9,668,841</b>	500,000	<b>9,668,841</b>	500,000
	<b>14,945,221</b>	3,948,308	<b>23,810,477</b>	10,375,538
<b>Income (loss) before under noted items</b>	<b>(600,144)</b>	1,343,828	<b>4,597,796</b>	929,921
<b>Other items</b>				
Interest income	<b>54,295</b>	5,249	<b>76,763</b>	22,631
Gain (loss) on foreign exchange	<b>40,937</b>	(14,973)	<b>(64,277)</b>	(29,969)
Gain (loss) on asset disposition	-	-	<b>(35,856)</b>	-
	<b>95,232</b>	(9,724)	<b>(23,370)</b>	(7,338)
<b>Net income (loss) for the period</b>	<b>(504,912)</b>	1,334,104	<b>4,574,426</b>	922,583
Deficit, beginning of period	<b>(3,814,347)</b>	(10,846,348)	<b>(8,893,685)</b>	(10,434,827)
<b>Deficit, end of period</b>	<b>\$ (4,319,259)</b>	\$ (9,512,244)	<b>\$ (4,319,259)</b>	\$ (9,512,244)
<b>Income (loss) per share (Note 6(e))</b>				
Basic	<b>\$ (0.005)</b>	\$ 0.016	<b>\$ 0.049</b>	\$ 0.012
Diluted	<b>\$ (0.005)</b>	\$ 0.015	<b>\$ 0.047</b>	\$ 0.011

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

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

	Three months ended September 30		Nine months ended September 30	
	2006	2005	2006	2005
<b>Cash flows from operating activities</b>				
Net income (loss) for the period	\$ (504,912)	\$ 1,334,104	\$ 4,574,426	\$ 922,583
Non-cash items:				
Stock-based compensation	258,783	337,263	1,832,693	676,567
Accretion expense on convertible debentures	-	13,224	26,445	175,845
Amortization of deferred charges	259,521	13,221	378,372	63,160
Depletion, depreciation and accretion	3,409,778	2,189,079	8,418,119	6,139,556
Write-down of assets	9,668,841	500,000	9,668,841	500,000
	<u>13,092,011</u>	<u>4,386,891</u>	<u>24,898,896</u>	<u>8,477,711</u>
Changes in non-cash working capital balances:				
Accounts receivable	(6,612,394)	(2,037,848)	(15,023,701)	(3,372,349)
Notes receivable	-	-	-	257,270
Inventory	137,147	(24,103)	(57,049)	222,200
Prepaid expenses and deposits	37,970	39,894	(4,664)	54,103
Accounts payable - operations	(323,004)	1,012,082	523,497	2,376,433
	<u>6,331,730</u>	<u>3,376,916</u>	<u>10,336,979</u>	<u>8,015,368</u>
<b>Cash flows from investing activities</b>				
Oil and gas assets	(16,837,285)	(5,039,957)	(31,061,532)	(16,539,229)
Changes in accounts payable - capital	1,902,932	(1,238,999)	4,813,892	(647,670)
	<u>(14,934,353)</u>	<u>(6,278,956)</u>	<u>(26,247,640)</u>	<u>(17,186,899)</u>
<b>Cash flows from financing activities</b>				
Issuance of common shares, net of share issue costs	5,917,108	1,287,243	7,297,124	4,029,806
Increase in restricted cash	(781,480)	-	(1,534,098)	-
Bank debt increase	-	1,624,126	-	4,779,544
Long-term debt increase	5,571,000	-	16,765,500	-
Increase in deferred financing charges	(79,781)	-	(777,791)	-
Redemption of convertible debentures	-	-	(7,006)	-
	<u>10,626,847</u>	<u>2,911,369</u>	<u>21,743,729</u>	<u>8,809,350</u>
<b>Foreign exchange gain (loss) on cash held in a foreign currency</b>	<u>(19,777)</u>	<u>(9,329)</u>	<u>(112,919)</u>	<u>3,936</u>
<b>Increase (decrease) in cash</b>	<b>2,004,447</b>	<b>-</b>	<b>5,720,149</b>	<b>(358,245)</b>
Cash, beginning of period	<u>4,517,341</u>	<u>-</u>	<u>801,639</u>	<u>358,245</u>
<b>Cash, end of period</b>	<b>\$ 6,521,788</b>	<b>\$ -</b>	<b>\$ 6,521,788</b>	<b>\$ -</b>

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

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, \$1,534,098 is held on deposit with Canadian and Foreign chartered banks. The funds are invested in interest-bearing revolving term deposits. A letter of credit for \$412,207 expired on October 16, 2006 and the funds have been released. The remaining letters of credit for \$1,121,891, related to equipment orders in Egypt and exploration activities in Pakistan, will expire on or before July 31, 2007.

### **2. Long-term investments**

The Corporation holds a minority equity position in a registered public company resulting from an asset disposition in February 2005. At September 30, 2006 the valuation was reviewed and it was determined that the carrying value should be written-down by \$100,000 as a result of a non-temporary decline in the company's common share price.

### **3. 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:

	<b>September 30, 2006</b>	December 31, 2005
Petroleum and natural gas assets	<b>\$ 95,502,183</b>	\$ 69,248,722
Furniture, machinery and equipment	<b>7,828,603</b>	2,855,712
	<b>103,330,786</b>	72,104,434
Accumulated depletion, depreciation and write-downs	<b>(41,737,557)</b>	(23,769,940)
Net book value	<b>\$ 61,593,229</b>	\$ 48,334,494

The Corporation has recorded deferred exploration expenditures of \$5,980,727 in Pakistan. When production commences, these costs will be depleted on a unit-of-production basis thereafter. At September 30, 2006, the Corporation recorded a write-down of \$9,568,841 related to valuation impairments associated with the carrying value of Canadian petroleum and natural gas assets. The write-down primarily relates to costs originally incurred during 2001 to 2004 resulting from the Corporation's abandoned Prince Edward Island oil and gas exploration programs.

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

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

	Three months ended		Nine months ended	
	September 30		September 30	
	2006	2005	2006	2005
Canada	\$ 223,416	\$ 94,659	\$ 619,341	\$ 282,356
Pakistan	145,299	101,154	302,127	233,164
	<b>\$ 368,715</b>	<b>\$ 195,813</b>	<b>\$ 921,468</b>	<b>\$ 515,520</b>

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

At September 30, 2006, the Corporation held \$3,679,991 (September 30, 2005 - \$2,215,107) of inventory available for future capital expenditures in the Issaran oilfield in Egypt. Of this amount, (i) \$3,317,881 relates to capital equipment, primarily pipe, and is included in property and equipment and (ii) \$362,110 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.

**4. Asset Retirement Obligations**

The Corporation has asset retirement obligations in Egypt (resulting from the Petroleum Service Agreement ("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:

	<u>September 30, 2006</u>	<u>Cost Incurrence</u>		<u>December 31, 2005</u>
		<u>Range</u>	<u>Majority</u>	
Egypt	\$ 917,352	2015-2017	2017	\$684,740
Pakistan	37,722	2015-2020	2020	39,251
Canada	279,500	2006-2019	2019	209,500
	<b>\$1,234,574</b>			<b>\$933,491</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:

	<u>Nine months ended</u> <u>September 30, 2006</u>	<u>Year ended</u> <u>December 31, 2005</u>
<i>Asset retirement obligations</i>		
Balance, beginning of period	\$ 590,382	\$ 289,846
Liabilities incurred in period	156,312	277,554
Accretion expense	27,851	22,982
Balance, end of period	<b>\$ 774,545</b>	<b>\$ 590,382</b>

## 5. Long-term Debt

On May 19, 2006, the Corporation finalized agreements with the International Finance Corporation ("IFC"), (a member of the World Bank Group) for US\$25 million of long-term financing facilities. The facilities are comprised of a US\$5 million Term Loan ("Term") to the Corporation and a US\$20 million Revolving Credit Facility ("Revolving") to two of its wholly-owned subsidiaries, Scimitar Production Egypt Ltd. ("SPEL") and Rally Energy Safed Koh Ltd. ("RESK"). The Term loan matures in its entirety on October 15, 2010 and requires semi-annual interest payments calculated at LIBOR plus 2.75%. The Revolving loan matures on October 15, 2009 and requires semi-annual interest payments at LIBOR plus 2.625%. A 1.3125% 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. Setup costs of \$2,995,664 pertaining to these facilities, including the value attributed to the share purchase warrants (Note 6(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 the Safed Koh Concession Agreement. Additionally, SPEL and RESK, collectively, have provided a US\$20 million debenture creating first ranking fixed and floating charges, along with a guarantee from the Corporation.

At September 30, 2006, US\$15 million was drawn under these facilities (US\$5 million from the Term loan and US\$10 million from the Revolving loan). The Corporation's previous US\$7 million credit facility with a major Canadian bank was paid out and all related security was discharged on June 30, 2006.

## 6. Equity Instruments

### (a) Issued and outstanding

	Nine months ended September 30, 2006		Year ended December 31, 2005	
	Number of Shares	Amounts	Number of 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	1,217,426	1,294,408	2,137,000	1,811,673
Warrants exercised	4,000,000	7,304,242	-	-
Debentures converted	1,188,176	1,743,993	4,686,000	4,686,000
	<u>97,430,981</u>	<u>67,251,257</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>64,975,663</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	<u>(4,000,000)</u>	<u>(904,242)</u>	-	-
	<u>3,000,000</u>	<u>2,217,873</u>	<u>4,000,000</u>	<u>904,242</u>
<b>Balance, end of period, all equity instruments</b>		<u>\$67,193,536</u>		<u>\$56,249,969</u>

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

**6. 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 September 30		Nine months ended September 30	
	2006	2005	2006	2005
Stock-based compensation expense	\$ 258,783	\$ 337,263	\$ 1,832,693	\$ 676,567

	Nine months ended September 30, 2006		Year ended December 31, 2005	
	Share Options	Weighted Average Exercise Price	Share Options	Weighted Average Exercise Price
Outstanding, beginning of period	7,356,759	\$1.02	6,327,757	\$0.63
Granted	1,105,000	\$2.30	3,361,000	\$1.48
Cancelled	(175,000)	\$1.34	(194,998)	\$0.93
Exercised	(1,217,426)	\$0.74	(2,137,000)	\$0.60
Outstanding, end of period	7,069,333	\$1.26	7,356,759	\$1.02

Exercise Price	Options Outstanding					
	September 30, 2006			December 31, 2005		
	Number of Options		Weighted Average Years to Expiry	Number of Options		Weighted Average Years to Expiry
	Outstanding	Exercisable		Outstanding	Exercisable	
\$0.54	150,000	150,000	2.67	200,000	150,000	2.76
\$0.60	1,493,000	1,493,000	0.95	2,245,000	2,170,000	1.60
\$0.61	307,000	307,000	2.08	451,667	451,667	2.38
\$0.76	815,000	815,000	2.92	865,000	793,334	3.49
\$0.80	240,000	240,000	1.50	240,000	240,000	2.25
\$0.88	-	-	-	34,091	34,091	0.25
\$1.32	500,000	500,000	3.79	500,000	250,000	4.54
\$1.34	958,000	441,500	4.25	1,208,000	604,000	5.00
\$1.40	243,333	140,001	3.96	310,000	103,334	4.71
\$1.54	250,000	166,668	3.58	250,000	83,334	4.33
\$1.55	318,333	95,003	4.08	335,000	111,670	4.83
\$1.79	514,667	348,672	3.29	543,001	211,008	3.77
\$1.85	175,000	116,667	3.46	175,000	58,334	4.21
\$2.30	1,105,000	865,000	4.75	-	-	-
	7,069,333	5,678,511	2.78	7,356,759	5,260,772	3.27

**6. 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 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

	Nine months ended September 30, 2006	Year ended December 31, 2005
Balance, beginning of period	\$ 1,968,082	\$ 1,063,620
Stock-based compensation expense	1,832,693	1,435,925
Options exercised	(389,576)	(531,463)
Debentures exercised	(437,000)	-
Balance, end of period	<u>\$ 2,974,199</u>	<u>\$ 1,968,082</u>

(e) Per share amounts

The income (loss) 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 (loss) and diluted net income (loss) per share.

	Three months ended September 30	
	2006	2005
Net income (loss) available to common shareholders	<u>\$(504,912)</u>	<u>\$1,334,104</u>
Weighted-average number of common shares outstanding – basic	96,511,870	82,356,650
Dilution effect of stock options	3,704,075	2,630,437
Dilution effect of warrants	913,043	-
Dilution effect of convertible debentures	-	1,194,545
Weighted-average number of common shares outstanding – diluted	<u>101,128,988</u>	<u>86,181,632</u>
Net income (loss) per share (\$/share)		
Basic	<u>(\$0.005)</u>	<u>\$0.016</u>
Diluted	<u>(\$0.005)</u>	<u>\$0.015</u>

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

**6. Equity Instruments (continued)**

	<b>Nine months ended September 30</b>	
	<b>2006</b>	<b>2005</b>
Net income available to common shareholders	<b>\$4,574,426</b>	\$ 922,583
Weighted-average number of common shares outstanding – basic	<b>93,387,869</b>	78,963,750
Dilution effect of stock options	<b>2,990,339</b>	2,630,437
Dilution effect of warrants	<b>190,137</b>	-
Dilution effect of convertible debentures	-	1,194,545
Weighted-average number of common shares outstanding – diluted	<b>96,568,345</b>	82,788,732
Net income per share (\$/share)		
Basic	<b>\$0.049</b>	\$0.012
Diluted	<b>\$0.047</b>	\$0.011

Outstanding stock options and common share purchase warrants are the only instruments that are currently dilutive to earnings per share. At September 30, 2006, no stock options, warrants or convertible debentures (September 30, 2005 – 751,334) were antidilutive and excluded from the computation of diluted earnings per share.

**7. Related Party Transactions**

For the three and nine months ended September 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.

	<b>Three months ended September 30</b>		<b>Nine months ended September 30</b>	
	<b>2006</b>	2005	<b>2006</b>	2005
Administrative expenses	<b>\$ 20,625</b>	\$ 130,553	<b>\$ 115,300</b>	\$ 390,713
Capitalized	<b>20,625</b>	129,874	<b>122,250</b>	386,063
	<b>\$ 41,250</b>	\$ 260,427	<b>\$ 237,550</b>	\$ 776,776

**8. 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 nine months ended September 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**  
**Nine months ended September 30, 2006 (unaudited)**

**9. Commitments**

During the nine months ended September 30, 2006, the Corporation and two wholly-owned subsidiaries entered into operating leases for office premises, requiring the following payments:

	<b>Canada</b>	<b>Egypt</b>	<b>Pakistan</b>	<b>Total</b>
2006	\$ 34,763	\$ 63,000	\$ 4,500	<b>\$ 102,263</b>
2007	208,576	108,000	13,500	<b>330,076</b>
2008	208,576	111,500	-	<b>320,076</b>
2009	208,576	114,000	-	<b>322,576</b>
2010	208,576	114,000	-	<b>322,576</b>
2011	173,813	47,500	-	<b>221,313</b>
	<b>\$ 1,042,880</b>	<b>\$ 558,000</b>	<b>\$ 18,000</b>	<b>\$ 1,618,880</b>

**10. 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 nine months ended September 30 and capital assets are summarized on a country basis below:

	<b>Egypt</b>	<b>Canada</b>	<b>Pakistan</b>	<b>Total</b>
<b>Three months ended September 30, 2006</b>				
Gross revenue	<b>\$ 25,127,446</b>	<b>\$ 580,922</b>	<b>\$ -</b>	<b>\$25,708,368</b>
Income (loss)	<b>\$ 10,527,526</b>	<b>\$(11,024,154)</b>	<b>\$ (8,284)</b>	<b>\$ (504,912)</b>
<b>Three months ended September 30, 2005</b>				
Gross revenue	\$ 9,515,690	\$ 1,182,098	\$ -	\$10,697,788
Income (loss)	\$ 2,402,959	\$ (1,048,062)	\$ (20,793)	\$ 1,334,104
<b>Nine months ended September 30, 2006</b>				
Gross revenue	<b>\$ 53,284,060</b>	<b>\$ 2,090,887</b>	<b>\$ -</b>	<b>\$55,374,947</b>
Income (loss)	<b>\$ 18,998,438</b>	<b>\$(14,373,422)</b>	<b>\$ (50,590)</b>	<b>\$ 4,574,426</b>
<b>Nine months ended September 30, 2005</b>				
Gross revenue	\$ 22,834,235	\$ 2,045,864	\$ -	\$24,880,099
Income (loss)	\$ 3,623,637	\$ (2,663,400)	\$ (37,654)	\$ 922,583
<b>Property and equipment</b>				
<b>September 30, 2006</b>	<b>\$ 47,598,333</b>	<b>\$ 8,014,169</b>	<b>\$ 5,980,727</b>	<b>\$61,593,229</b>
December 31, 2005	\$ 30,153,344	\$ 16,542,512	\$ 1,638,638	\$48,334,494

**11. Subsequent Events**

- (a) On October 24, 2006, the Corporation announced it had signed an agreement to increase its working interest in the Safed Koh Concession from 22.5% to 30%. The US\$11.4 million Offer to Purchase the additional 7.5% working interest is with one of Rally Energy's existing Safed Koh Block partners (a private company). Upon receipt of required approvals from relevant Pakistan government agencies, the purchase price of US\$11.4 million will be paid by way of US\$8.55 million in cash and 1,372,846 common shares of Rally Energy Corp. The shares were reserved for issuance in June 2006 at a price of \$2.30 per share. There can be no assurance the transaction will be completed or completed as described.
- (b) On November 3, 2006, the Corporation notified the holder of 3,000,000 share purchase warrants, exercisable at \$1.92 per share, that, under the terms contained therein, the expiry date had been accelerated to December 4, 2006 from May 18, 2009.
- (c) On October 24, 2006, the Corporation announced it had signed an agreement with an independent private company to dispose of certain Canadian oil and gas properties for a purchase price of \$6.9 million (\$5.5 million in cash and \$1.4 million in common shares of the private company). The agreement has an effective date of November 1, 2006 and closing is scheduled for November 30, 2006, subject to certain conditions. There can be no assurance the transaction will be completed or completed as described.

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

	<b>Three months ended September 30</b>		<b>Nine months ended September 30</b>	
	<b>2006</b>	2005	<b>2006</b>	2005
Interest paid	<b>\$ 38,277</b>	\$ 302,319	<b>\$ 267,704</b>	\$ 882,236
Taxes paid	<b>\$ -</b>	\$ -	<b>\$ -</b>	\$ -