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Rally Energy Corp. Reports Third Quarter Profit and Significant Production Gains

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Rally Energy's financial results for the third quarter of 2004 reflect continued success in increasing oil production in Egypt. Oil sales averaged 2,102 in the third quarter and, combined with higher oil prices, resulted in significant increases in revenue and cash flow from operations. Positive net income of \$687,000 in the third quarter represents the first profitable quarter of operations since the acquisition of Scimitar Hydrocarbons Corporation in July of 2002. Several management changes were made early in the third quarter to better position the Corporation to address challenges related to the expanding Issaran development program. The appointments of Lamont Tolley, as President and CEO, and Ian McMurtrie, as Vice-President, Exploration, have added additional planning and technical depth to our management team. Highlights of the third quarter are as follows:

- Oil sales averaged 2,102 bbls/d, up 15% from the second quarter (1,829 bbls/d) and up 143% compared to the third quarter of 2003 (865 bbls/d).
- Revenue at \$6.7 million (\$34.87/bbl), was up 25% compared to the second quarter (\$5.4 million, \$32.45/bbl) and up 223% compared to the third quarter of 2003 (\$2.1 million, \$26.22/bbl).
- Cash flow from operations increased to \$3.2 million (\$0.05 per share), up 45% from \$2.2 million (\$0.03 per share) reported in the second quarter of 2004. Compared to \$138,000 reported in the third quarter of 2003, cash flow from operations increased over 23 fold in the third quarter of 2004.
- Operating expense per barrel of oil sold declined to \$4.97/bbl in the third quarter, a 19% decline compared to the second quarter (\$6.16/bbl) and a 43% decline compared to the per barrel operating cost of \$8.76 reported in the third quarter of 2003.
- Net income of \$687,000 (\$0.01 per share) was achieved in the third quarter compared to a nominal loss of \$28,000 (\$nil per share) in the second quarter and a loss of \$1.3 million (\$0.02 per share) reported in the third quarter of 2003.
- Capital expenditures were \$4.0 million in the third quarter compared to \$2.4 million in the second quarter and \$4.2 million in the third quarter of 2003.

Rally Energy ended the third quarter with a working capital position of \$2.7 million. This working capital position, combined with increased cash generated from operations and with \$949,000 in capital inventory in the Issaran field, positions the Corporation to continue to proceed actively with development of its core producing assets in Egypt. Rally Energy's current oil sales now exceed 2,650 bbls/d, up approximately 17% from average October oil sales of 2,269 bbls/d, and are expected to increase further as additional wells are brought on-production prior to year-end.

For the nine month period ending September 30, 2004, Rally Energy's daily oil sales averaged 1,891 bbls/d compared to 962 bbls/d for the same period in 2003, a 97% increase. Revenue increased to \$16.6 million (\$32.05/bbl), up 132% compared to revenue of \$7.2 million (\$27.27/bbl) reported in the corresponding nine months of 2003. Cash flow from operations was \$7.1 million (\$0.10 per share), a nine fold increase over cash flow from operations of \$767,000 (\$0.01 per share) reported for the same time period in 2003. Even though average oil sales for the first nine months of 2004 increased 97% to 1,891 bbls/d compared to the same period in 2003, operating costs of \$2.9 million (\$5.49/bbl) increased only 7% from the \$2.7 million (\$10.10/bbl) reported for the same period in 2003. Net income of \$100,000 was achieved for the 2004 nine month period compared to a loss of \$3.4 million reported for the same time period in 2003. Total capital expenditures for the nine month period were \$9.4 million with \$8.6 million spent in Egypt and the remainder in Western Canada.

Issaran Oilfield, Egypt

During the third quarter of 2004, six new wells were drilled in the Issaran field. In the Northern Area of the field four new oil wells were drilled, three targeting the Nukhul Formation one targeting substantial thicknesses of heavily fractured Dolomite Formations. In the Southern Area, two new wells were drilled to function as injectors/producers for the Upper Dolomite Steam Pilot Project.

Northern Area

In the heavily fractured section of the Northern Area of the Issaran field, production to date is extracted primarily from the Lower Dolomite Formation. Well #25 continues to produce in excess of 800 bbls/d of oil and well #42, despite only penetrating the upper portion of the Lower Dolomite Formation, is producing in excess of 300 bbls/d of oil.

One Upper Dolomite well, well #49, was drilled in the third quarter. Based on data from logs and drilling, the Corporation has previously expressed optimism that the Upper Dolomite Formation, like the Lower Dolomite Formation, was also fractured and contained significant reserves. This was confirmed in the third quarter with the drilling of well #49. This significant well, recently completed in the Upper Dolomite Formation, has been put on production with initial oil production rates currently varying up to 600 bbls/d. This well is of considerable importance to the Corporation in that wells in the identified fractured portions of the Northern Area can now be twinned targeting both Upper and Lower Dolomite fractured reservoir production.

Three Nukhul oil wells were drilled in the Northern Area during the third quarter. One was a successful infill development well, currently producing approximately 100 bbls/d, and two were drilled on a geophysically defined separate fault block. The first of the wells drilled in the separate fault area has been completed and is currently producing over 150 bbls/d of oil and the second well is currently being completed and production tested. The results of these Nukhul wells confirm that several additional follow-up drilling locations exist on this separate fault block.

Southern Area

As mentioned in previous reports, Rally Energy is committed to testing the production enhancement potential of Thermal Recovery in the Issaran field Upper Dolomites. During the third quarter, the Corporation drilled two Upper Dolomite cyclic steam injection/production wells with a view to commencing Upper Dolomite steaming operations prior to year-end. These two steam injectors/producers, along with the previously drilled observation well, will form the nucleus of the initial pilot program utilizing our steam injection facilities. Steaming in the Upper Dolomite Formation is expected to commence in December. Currently mapped Issaran Upper Dolomite Formations contain in excess of 300 million barrels of original oil-in-place. Our reservoir modeling study indicates that cyclic steam stimulation, followed by steam drive in the Upper Dolomites, could result in the recovery of 24 percent or more of original oil-in-place. A successful steam pilot test can reasonably be expected to have significant positive implications in

connection with Issaran oil production and will result in the expenditure of significant capital to establish full-scale commercial operations.

Western Canada

Rally Energy's Western Canadian production in the third quarter declined to 19 barrels of oil equivalent per day ("boe/d"), from 29 boe/d in the second quarter. This decline was due to work-related shut-ins and natural production declines. Current production is approximately 42 boe/d in Western Canada. The Travers, Alberta gas wells are currently producing natural gas at a rate of approximately 36 boe/d net to Rally Energy. The balance of current production is from the Corporation's Wauchope, Saskatchewan oil well, which produces 6 bbls/d net to Rally Energy's 37.5% interest.

New Western Canadian exploration and development projects are currently in progress focusing on oil in the Carbon area and gas in the Harmattan, Sunburst, Long Coulee and Travers areas of Alberta. Seismic and drilling activities, focused primarily in Alberta, are proceeding within the guidelines of a \$2.3 million Canadian exploration and development budget for 2004.

Prince Edward Island

On Prince Edward Island ("PEI"), Rally Energy now holds a 72% working interest in two oil and natural gas permits encompassing 308,000 acres and a 100% working interest in one oil and natural gas permit encompassing 68,000 acres. On July 21, 2004, seven of Rally Energy's then eight existing permits expired. Major portions of those seven former permits were posted in four newly-configured permits by the Prince Edward Island Department of Environment and Energy. Rally Energy was successful in acquiring a 92% working interest in two of these permit blocks covering an aggregate of 308,000 acres. This working interest was subsequently reduced to 72% with the September transaction noted below. One new block, Permit No. 04-01, is to the east of our existing 100% working interest permit, No. 02-01, and includes lands on which we drilled two exploration wells in 2003. Our new permits, No. 04-01 and No. 04-04, both contain prospects identified through analysis of our seismic data and our aeromagnetic and gravity surveys.

On September 23, 2004, pursuant to a "back-in" agreement, Rally Energy assigned a 20% undivided working interest in permit No. 04-01 and permit No. 04-04 to Shannon International Resources Inc. ("Shannon"), a former working interest partner in the seven expired permits. Under the terms of the agreement, Shannon delivered a promissory note, due December 31, 2004, in the amount of \$169,000. Shannon also agreed to conditions under which the working interests would revert to Rally Energy and acknowledged various assignment and liability provisions.

Safed Koh, Pakistan

On April 20, 2004, Rally Energy announced an agreement had been reached to sell a 57.5% working interest in the Safed Koh license to the Dewan Mushtaq Group of Pakistan in return for their commitment to carry Rally Energy's remaining 22.5% working interest share of Phase II drilling operations expenditures. The agreed effective date of the transaction is May 6, 2004. Finalization of this transaction occurred on August 31, 2004 after receipt of all required consents from the Ministry of Petroleum and Natural Resources. The effect of this agreement is to leave Rally Energy with a 22.5% working interest in the Safed Koh block that is carried for its share of up to US\$2.2 million in Phase II drilling and testing expenditures, with US\$1.6 million allocated to the carried costs to deepen the Rodho #3 well and the remaining carry allocated to an optional re-completion and testing of the shallow zones in the Rodho #2 well. Deepening of the Rodho #3 well is expected to commence prior to year-end and is intended to reach a depth of approximately 10,300 feet. The current AFE for the Rodho #3 well estimates that approximately US\$619,000 of gross costs (US\$139,300 net to Rally Energy) will be incurred in excess of the US\$1.6 million gross expenditure amount on which Rally Energy is to be carried.

Operations Update and Overview

Rally Energy's current oil sales now exceed 2,650 bbls/d, up approximately 17% from average October oil sales of 2,269 bbls/d, and are expected to increase further as additional wells are brought on production prior to year-end. Coupled with strong crude oil prices, increased production is generating increasingly higher levels of cash flow from operations. Recently, we have experienced a disconnect between realized Ras Gharib prices and quoted Brent prices, with Ras Gharib prices failing to closely track Brent in reflecting price increases. It is not clear whether this situation is solely related to a temporary increase in the heavy oil price discount or whether it reflects a market reality when Brent quotes exceed \$40 per barrel. Year to date in 2004, the realized Ras Gharib price has averaged 79% of average Brent quotes. In the third quarter, the average was 77%. October Ras Gharib prices failed to match the significant October gains in Brent pricing. On a positive note, by agreement effective July 1, 2004, the Corporation's Ras Issaran field pricing was revised by The Egyptian General Petroleum Corporation. Under the revised pricing agreement, effective for a period of five years, the Corporation's realized oil price for the first 2,000 bbls/d of oil sales increased from 80% to 82% of the Ras Gharib blend price in July of this year. For monthly production averaging between 2,001 bbls/d and 3,000 bbls/d, the realized oil price increases to 85%. A further increase to 88% of the Ras Gharib blend price occurs for production in excess of 3,000 bbls/d.

At this time we are currently drilling our 14th well of 2004 in the Issaran oilfield. To date in the fourth quarter, we have drilled one Southern Area well that is to be perforated and tested in the Upper Dolomite Formation and we are currently drilling one Northern Area well targeting Gharandal and Dolomite Formations. It is expected that up to two new wells will be drilled prior to year-end in the Northern Area, with both wells directed at Upper and Lower Dolomite targets. Management currently believes that working capital and cash from operations, combined with existing credit facilities, will be sufficient to fund primary production development operations in Egypt. We remain confident that we have accurately mapped major faults and that we have a clear image of the complex, fault controlled carbonate reservoir in the Issaran field. We continue to believe this mapping is our key to succeeding in future efforts to drill successfully to increase both our recognized reserves and our production.

FORWARD LOOKING STATEMENTS

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

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

WARNING

RALLY ENERGY CORP.

Management's Discussion and Analysis ("MD&A")

For the Nine Months ended September 30, 2004

This discussion and analysis for the nine months ended September 30, 2004 outlines management's assessment of the unaudited consolidated financial and operating results of Rally Energy Corp. ("Rally Energy" or the "Corporation") and its subsidiaries, including its future opportunities and risks, and should be read in conjunction with the audited financial statements and related notes for the year ended December 31, 2003. Additional information regarding the Corporation, including our Annual Information Form ("AIF"), can be found at www.sedar.com and www.rallyenergy.com.

The financial information contained herein has been prepared by the management of Rally Energy in accordance with Canadian Generally Accepted Accounting Principles ("GAAP"). Unless otherwise indicated, all dollar amounts in this report are in 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 29, 2004.

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 of 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 on-going ability to obtain financing for its operations. Additional risks include, but are not limited to: the risks associated with the oil and gas industry (e.g., operational risks in development, exploration and production; delays or changes in plans with respect to exploration or development projects or capital expenditures; the uncertainty of reserve estimates; the uncertainty of estimates and projections relating to production, costs and expenses, and health, safety and environmental risks), commodity price, price and exchange rate fluctuation and uncertainties resulting from potential delays or changes in plans with respect to exploration or development projects or capital expenditures. Rally Energy's actual results, performance or achievements could differ materially from those expressed in or implied by these forward looking statements and, 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. Many of these factors are outside the control of the Corporation.

Financial and Operating Review

Revenue for the third quarter of 2004 increased 223% to \$6.7 million from \$2.1 million for the third quarter of 2003 as a result of a 143% increase in oil and gas production (2,102 boe/d as compared to 865 boe/d), along with an increase in oil and gas prices (\$34.87/boe up from \$26.22/boe). For the nine months ended September 30, 2004, revenue increased 132% to \$16.6 million from \$7.2 million for the comparable 2003 period. Oil and gas production for the 2004 nine month period averaged 1,891 boe/d (at an average price of \$32.05/boe), as compared to 962 boe/d (at an average price of \$27.27/boe) for the comparable 2003 period.

The majority of the revenue reported represents heavy oil production from the Issaran oilfield in Egypt. The Canadian sourced revenue represents approximately 1% of total revenue for the 2004 nine month period.

Production, Revenue and Netback

Three months ended September 30				
<i>(thousands of dollars, unless otherwise stated)</i>				
	2004		2003	
Daily Production:				
Oil (bbls/d)	2,092		865	
Natural gas (mcf/d)	60		n/a	
Total BOE (boe/d)	2,102		865	
		<i>\$/boe</i>		<i>\$/boe</i>
Gross revenue	\$ 6,743	\$ 34.87	\$ 2,086	\$ 26.22
Production entitlement - GPC	(1,272)	(6.58)	(443)	(5.56)
Marketing fees	(124)	(0.64)	(27)	(0.34)
Royalties (Canada)	(12)	(0.06)	-	-
Operating expenses	(961)	(4.97)	(697)	(8.76)
Netback from operations	\$ 4,374	\$ 22.62	\$ 919	\$ 11.56
Nine months ended September 30				
<i>(thousands of dollars, unless otherwise stated)</i>				
	2004		2003	
Daily Production:				
Oil (bbls/d)	1,879		962	
Natural gas (mcf/d)	72		n/a	
Total BOE (boe/d)	1,891		962	
		<i>\$/boe</i>		<i>\$/boe</i>
Gross revenue	\$ 16,602	\$ 32.05	\$ 7,162	\$ 27.27
Production entitlement - GPC	(3,161)	(6.10)	(1,461)	(5.56)
Marketing fees	(365)	(0.70)	(91)	(0.35)
Royalties (Canada)	(39)	(0.08)	-	-
Operating expenses	(2,845)	(5.49)	(2,652)	(10.10)
Netback from operations	\$ 10,192	\$ 19.68	\$ 2,958	\$ 11.26

Netback from operations represents funds available to the Corporation after satisfying all royalty burdens, production fees, marketing costs and operating costs. For the third quarter of 2004, Rally Energy's netback from operations was \$4.4 million (\$22.62/boe), representing 65% of gross revenue. For the comparable 2003 quarter, netback from operations was \$919,000 (\$11.56/boe), representing 45% of gross revenue. The netback from operations for the nine months ended September 30, 2004 was \$10.2 million (\$19.68/boe) a 245% increase from \$3.0 million (\$11.26/boe) for the nine months ended September 30, 2003.

The 2004 netback from operations increases are primarily related to higher oil prices and a lower percentage of production entitlement of The General Petroleum Co. S.A.E. ("GPC") associated with Issaran oil production from new wells. For the nine months ended September 30, 2004, new oil sales represented 86% of total sales as compared to 82% in the comparable 2003 period. This resulted in an average GPC production interest of 19% during 2004, compared to 20% in the same period in 2003. Additionally, economies of scale associated with oil production increases resulted in lower operating expense on a per unit basis.

The Corporation has expensed \$372,000 (\$0.72/boe) of workover activity costs during the 2004 nine month period that, at this time, cannot be linked to identifiable reserve additions.

Effective July 1, 2004, a revised pricing agreement was negotiated for oil sales from the Issaran oilfield in Egypt for a five year period ending June 30, 2009. Previously, the realized oil sales price represented 80% of the Ras Gharib blend price. Under the new pricing formula, for average monthly sales less than 2,000 bopd, the Corporation's realized oil price is 82% of the Ras Gharib blend price. For average monthly sales between 2,001 and 3,000 bopd, the realized oil sales price increases to 85% of the Ras Gharib blend price. The realized oil sales price increases again to 88% of the Ras Gharib blend price for monthly sales in excess of 3,000 bopd.

Recently, the Corporation has experienced a disconnect between realized Ras Gharib prices and quoted Brent prices, with Ras Gharib prices failing to closely track Brent in reflecting price increases. It is not clear whether this situation is solely related to a temporary increase in the heavy oil price discount or whether it reflects a market reality when Brent quotes exceed \$40 per barrel. Year to date in 2004, the realized Ras Gharib price has averaged 79% of average Brent quotes. In the third quarter, the average was 77%. October Ras Gharib prices failed to match the significant October gains in Brent pricing.

Production Entitlements, Marketing Costs and Royalties

Under the terms of the Issaran oilfield Petroleum Service Agreement ("PSA"), as amended, 15% of new oil well production and 45% of production from old oil wells is credited to the account of The General Petroleum Co. S.A.E. ("GPC") representing their production entitlement. This payment satisfies the Corporation's entire tax and government royalty liability for Issaran oil production in Egypt. For the quarter ended September 30, 2004, GPC payments totaled \$1.3 million (\$6.58/boe), representing 19% of gross revenue. For the corresponding 2003 period, the GPC payments were \$443,000 (\$5.56/boe), representing 21% of gross revenue. GPC payments for the nine months ended September 30, 2004 and 2003 were \$3.2 million and \$1.5 million, respectively.

Pursuant to the terms of certain marketing agreements, marketing fees, linked to realized oil prices and production, of \$124,000 (\$0.64/boe) were paid during the third quarter of 2004. For the third quarter of 2003, marketing fees were \$27,000 (\$0.34/boe). Marketing fees paid for the nine months ending September 30, 2004 were \$365,000 (\$0.70/boe) and \$91,000 (\$0.35/boe) for the comparable 2003 period. The increased marketing fees in 2004 are a result of higher oil production, as required under the terms of existing agreements. Marketing fees are included in royalties and related credits on the consolidated statements of operations and deficit. Royalties paid on Canadian production are reported net of the Alberta Royalty Tax Credit.

Operating Expenses

Operating expenses for the third quarter of 2004 were \$961,000 (\$4.97/boe; 14% of gross revenue) as compared to \$697,000 (\$8.76/boe; 33% of gross revenue) for the third quarter of 2003. Higher oil sales during the current quarter have contributed to significantly lower operating costs per barrel of oil produced since approximately 45% of the operating expenses are fixed. For the nine months ended September 30, 2004, operating expenses were \$2.9 million (\$5.49/boe; 17% of gross revenue) as compared to \$2.7 million (\$10.10/boe; 37% of gross revenue) for the comparable 2003 period.

On a per unit basis, higher oil production can reasonably be expected to continue to lower per unit costs as increased production can still be accommodated within our existing fixed cost structure. Included in the 2003 operating costs are \$306,000 of expensed workover costs that were subsequently capitalized in the fourth quarter of 2003. If these amounts had been capitalized during the 2003 nine month period, reported operating expenses would have been \$2.4 million (\$8.93/boe; 33% of gross revenue).

General and Administrative Expenses (thousands of dollars, unless otherwise stated)

	Three months ended September 30, 2004			Nine months ended September 30, 2004		
	Expensed	Capitalized	Total	Expensed	Capitalized	Total
Egypt	\$ 232	\$ -	\$ 232	\$ 745	\$ -	\$ 745
Canada (a)	696	(93)	789	1,524	(243)	1,767
Pakistan	60	-	60	290	-	290
Other	61	-	61	145	-	145
Total	\$ 1,049	\$ (93)	\$ 1,142	\$ 2,704	\$ (243)	\$ 2,947
\$/boe	\$ 5.43	\$ 0.48	\$ 5.91	\$ 5.22	\$ 0.47	\$ 5.69

	Three months ended September 30, 2003			Nine months ended September 30, 2003		
	Expensed	Capitalized	Total	Expensed	Capitalized	Total
Egypt	\$ 220	\$ -	\$ 220	\$ 745	\$ -	\$ 745
Canada	410	(77)	487	1,433	(242)	1,675
Pakistan	63	(125)	188	120	(361)	481
Total	\$ 693	\$ (202)	\$ 895	\$ 2,298	\$ (603)	\$ 2,901
\$/boe	\$ 8.71	\$ 2.56	\$ 11.27	\$ 8.75	\$ 2.30	\$ 11.05

- (a) Includes non-cash items of \$ 271,000 for the third quarter of 2003 and \$304,000 for the nine months ended September 30, 2004.

Consolidated general and administrative expenses were \$1.0 million for the third quarter of 2004 as compared to \$693,000 for the corresponding quarter in 2003. Of these amounts, non-cash expenses related to the valuation of share options granted during the third quarter of 2004 were \$271,000 as compared to \$34,000 for the third quarter of 2003. Rally Energy capitalizes those portions of general and administrative expenses that relate to exploration projects in Canada. Currently, all general and administrative costs related to Egypt are associated with development activities and, accordingly, to date none have been capitalized. For the quarter ended September 30, 2004, \$93,000 (8%) of general and administrative costs were capitalized, as compared to \$202,000 (23%) of general and administrative costs for the comparative 2003 period.

For the nine months ended September 30, 2004, consolidated general and administrative expenses were \$2.7 million (\$5.22/boe) as compared to \$2.3 million (\$8.75/boe) for the nine months ended September 30, 2003. Included in the 2004 expensed general and administrative amount are \$145,000 of costs associated with international project evaluations that do not have a high probability of resulting in project concession interests or licenses. Primarily as a result of the increased "non-cash" option expense and other one-time charges, expensed general and administrative costs increased to \$1.0 million (\$5.43/boe) for the third quarter of 2004 as compared to \$853,000 (\$5.13/boe) for the second quarter.

General and administrative costs associated with our Pakistan activities during the nine months ended September 30, 2004 totalled \$264,000 and were expensed. These costs have declined significantly during the third quarter of 2004 due to the disposition transaction which resulted in Rally Energy having a partially-carried working interest. For the comparable 2003 period total general and administrative costs for the Pakistan operations were \$417,000, of which \$333,000 was capitalized. Ongoing costs are expected to be minimal for the remainder of 2004.

Interest and Finance Charges

(thousands of dollars, unless otherwise stated)

	Three months ended		Nine months ended	
	September 30		September 30	
	2004	2003	2004	2003
Interest expense	\$ 208	\$ 216	\$ 614	\$ 313
Accretion expense on debenture	36	36	108	42
Amortization of deferred charge	36	35	108	41
Total expense	\$ 280	\$ 287	\$ 830	\$ 396
Interest income	11	29	36	69
Gain (loss) on foreign exchange	(212)	53	(101)	230
Total income (loss)	\$ (201)	\$ 82	\$ (65)	\$ 299
Net expense	\$ 481	\$ 205	\$ 895	\$ 97
\$/boe	\$2.49	\$2.58	\$1.73	\$0.37

Total interest and finance charges decreased to \$280,000 during the third quarter of 2004 from \$287,000 for the third quarter of 2003, primarily as a result of interest accruals on the \$6.0 million, 12% unsecured convertible debentures that were issued on June 13, 2003. Included in the third quarter 2004 amount is \$72,000 in amortization of non-cash finance charges pertaining to the issue of convertible debentures. \$36,000 relates to quarterly accretion of the difference between the book value of outstanding convertible debentures and the \$6.0 million maturity amount. The remaining \$36,000 relates to amortization of deferred issue expense charges. For the nine months ended September 30, 2004, a provision has also been made for \$70,000 of interest costs associated with unspent 2003 flow-through share obligations. The Corporation is required to incur \$2.1 million of qualifying exploration and development expenses after September 30, 2004 and before December 31, 2004 to fully discharge these obligations. These obligations were incurred in December 2003 with the issuance of \$2.4 million in flow-through shares at \$0.70 per share. Interest accrues monthly on the unspent balance of 2003 flow-through obligations from February 2004 onwards.

In the normal course of business, the Corporation earns interest from invested funds and records a foreign exchange gain or loss. Typically, the Corporation reports a gain/loss equal to the difference between US\$ denominated accrued receivables/payables and actual US/Canadian dollar exchange rates at the time of cash receipts/payments. Currently the Corporation is paid in US dollars and does not hedge exchange rates.

Depletion, Depreciation and Accretion

(thousands of dollars, unless otherwise stated)

	Three months ended		Nine months ended	
	September 30		September 30	
	2004	2003	2004	2003
Depletion, depreciation and accretion	\$ 2,200	\$ 1,280	\$ 6,536	\$ 3,945
\$/boe	\$11.37	\$16.10	\$12.62	\$15.02

The depletion rate for the third quarter of 2004 decreased to \$11.37/boe from \$16.10/boe for the third quarter of 2003 as a result of a \$3.9 million asset disposition that reduced the Corporation's depletion base and reserve additions from current period activity. The 2004 depletion rate is calculated using proved reserves assessed at December 31, 2003, as evaluated by DeGolyer and MacNaughton (an independent engineering evaluation firm specializing in reserves evaluations), updated with internal estimates of proved reserve changes during the period. On a per-unit basis, we expect a continuing trend of lower depletion charges, on a per barrel of oil equivalent basis, in 2004 as a result of the impact of the \$3.9 million asset disposition and the impact of proved reserves additions expected from 2004 drilling activities.

For the nine months ended September 30, 2004, the Corporation recorded depletion and depreciation charges of \$207,000 with respect to Canadian operations. Of this amount, \$185,000 represented the depletion expense related to Western Canadian sourced production which averaged 19 bbls/d for the nine months ended September 30, 2004.

On Prince Edward Island ("PEI"), Rally Energy now holds a 72% working interests in two oil and natural gas permits encompassing 308,000 acres and a 100% working interests in one oil and natural gas permit encompassing 68,000 acres. On July 21, 2004, seven of Rally Energy's then eight existing permits expired. Major portions of those seven former permits were posted in four newly-configured permits by the Prince Edward Island Department of Environment and Energy. Rally Energy was successful in acquiring a 92% working interest in two of these permit blocks covering an aggregate of 308,000 acres. This working interest was subsequently reduced to 72% with the September transaction noted below. One new block, Permit No. 04-01, is to the east of our existing 100% working interest permit, No. 02-01, and includes lands on which we drilled two exploration wells in 2003. Our new permits, No. 04-01 and No. 04-04, both contain prospects identified through analysis of our seismic data and our aeromagnetic and gravity surveys.

On September 23, 2004, pursuant to a "back-in" agreement, Rally Energy assigned a 20% undivided working interest in permit No. 04-01 and permit No. 04-04 to Shannon International Resources Inc. ("Shannon"), a former working interest partner in the seven expired permits. Under the terms of the agreement, Shannon delivered a promissory note, due December 31, 2004, in the amount of \$169,000. Shannon also agreed to conditions under which the working interests would revert to Rally Energy and acknowledged various assignment and liability provisions.

The Corporation intends to undertake a review of its PEI interests and activities that will include a valuation of the PEI investment and related opportunities.

With respect to the Pakistan properties, Rally Energy recently announced that it had reduced its holdings to a partially-carried position (22.5% working interest) and has not committed any additional capital to the project at this time. At December 31, 2003, management determined that it was prudent to write-down the existing investment in Pakistan due primarily to uncertainties, at that time, related to closing of the announced disposition of a major portion of the Corporation's 80% working interest position in the Safed Koh Block. Under the terms of the announced partial disposition, Rally Energy, through a wholly-owned subsidiary, retains a 22.5% partially carried working interest in this concession but chose to completely write-off the historic investment expenditures as an impaired asset. All the necessary approvals for this transaction were received on August 31, 2004. Future Pakistan revenues are still contingent on: (i) confirmation of commercial viability through Phase II activities, and (ii) construction of gathering infrastructure to deliver produced natural gas and liquids.

Net Income and Cash Flow from Operations

Earnings for the third quarter of 2004 were \$687,000 (\$0.01/share) compared to a loss of \$1.3 million (\$0.02/share) for the comparable 2003 quarter. This represents a marked improvement from a loss of \$28,000 (\$nil/share) for the second quarter of 2004. For the nine months ended September 30, 2004, earnings were \$100,000 (\$nil/share) as compared to a net loss of \$3.4 million (\$0.06/share) for the comparable 2003 period.

For the nine months ended September 30, 2004, Rally Energy's cash flow from operations increased to \$7.1 million (\$0.10/share) up from \$767,000 (\$0.01/share) for the comparable 2003 period. On a quarterly basis, cash flow from operations for the 2004 third quarter was \$3.2 million (\$0.05/share) up from \$138,000 (\$nil/share) for the comparable 2003 quarter and \$2.2 million (\$0.03/share) for the second quarter of 2004.

Cash flow from operations ("Cash Flow"), representing cash generated from operating activities before changes in non-cash working capital items, is a non-GAAP measure. Management utilizes Cash Flow as

a key measure to assess the ability of the Corporation to finance operating activities and capital expenditures. Additionally, Cash Flow has been described and presented in order to provide shareholders and potential investors with information regarding the Corporation's liquidity and its ability to generate funds to finance its operations. The consolidated statements of cash flows provide a reconciliation between net earnings (loss) and cash flow from operations. The Corporation also presents cash flow from operations on a per share basis whereby per share amounts are calculated using the weighted average number of shares outstanding in a manner consistent with the calculation of earnings (loss) per share. This performance indicator may not be comparable to similar measures used by other companies.

Capital Expenditures

During the nine months ended September 30, 2004, Rally Energy drilled twelve wells (twelve net wells) in Egypt. In Canada, one (25% net) gas well was drilled in the Carmangay area and the necessary permits were acquired and work was completed to equip and tie-in a gas well in the Travers area that was drilled late in 2003. During 2004, the Corporation entered into a transaction whereby net proceeds of \$3.9 million were received as a result of a royalty disposition (expiring on December 31, 2012) related to the Issaran oilfield. This transaction is more fully described in the Liquidity and Capital Resources section.

	Three months ended		Nine months ended	
	September 30		September 30	
	(thousands of dollars)		(thousands of dollars)	
	2004	2003	2004	2003
Egypt				
Drill, complete and workovers	\$ 3,526	\$ 2,719	\$ 7,900	\$ 4,473
Seismic, evaluation and other	314	210	958	764
Pipe inventory	(338)	(327)	(247)	585
Property disposition	(12)	-	(3,922)	-
Total	\$ 3,490	\$ 2,602	\$ 4,689	\$ 5,822
Canada				
Drill, complete and workovers	\$ 320	\$ 770	\$ 424	\$ 1,538
Seismic, evaluation and other	50	619	164	677
Property disposition	(169)	-	(169)	(50)
Capitalized admin costs	93	77	243	242
Total	\$ 294	\$ 1,466	\$ 662	\$ 2,407
Pakistan				
Seismic, evaluation and other	\$ -	\$ 14	\$ -	\$ 71
Capitalized admin costs	-	125	-	361
Total	\$ -	\$ 139	\$ -	\$ 432
Grand Total				
Drill, complete and workovers	\$ 3,846	\$ 3,489	\$ 8,324	\$ 6,011
Seismic, evaluation and other	364	843	1,122	1,512
Pipe inventory	(338)	(327)	(247)	585
Property disposition	(181)	-	(4,091)	(50)
Capitalized admin costs	93	202	243	603
Total	\$ 3,784	\$ 4,207	\$ 5,351	\$ 8,661

Liquidity and Capital Resources

At September 30, 2004, Rally Energy had a cash position of \$871,000, as compared to \$2.3 million at December 31, 2003. The Corporation reported working capital of \$2.6 million at September 30, 2004 as compared to working capital of \$499,000 at December 31, 2003. In addition, the Corporation holds \$949,000 in capital inventory in the Issaran oilfield and has access to an undrawn \$3.0 million credit facility.

Increased oil production revenues during the current period resulted in a higher level of accounts receivable at September 30, 2004 of \$6.8 million, up from \$4.5 million at June 30, 2004 and \$2.5 million at December 31, 2003.

As at September 30, 2004, Rally Energy has accrued \$251,000 on account of interest expense, primarily related to the \$6.0 million, 12% unsecured convertible debentures that were issued on June 13, 2003 and require semi-annual interest payments (January and July).

During the nine month period ending September 30, 2004, Rally Energy realized proceeds of \$447,000 from the exercise of 924,833 common share options at an average price of \$0.48 per share. Of this amount, \$60,000 was advanced to an officer and director to exercise 150,000 share purchase options at \$0.40 per share.

On April 30, 2004, the Company, through its wholly-owned subsidiary, Scimitar Production International Ltd, closed a US\$3.0 million unsecured project investment financing to fund further development of the Issaran oilfield. Under the terms of the Investment Agreement, the investor, Gemini Oil & Gas Limited, an independent international oil and gas investment fund, is entitled to revenue-based payments from the Issaran oilfield commencing in 2005. No payments are required in 2004. 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, and continuing until December 31, 2012, the investor is entitled to receive 2.6% of the Corporation's Issaran oil revenues, derived from a maximum of 7,000 bbls/d of production, net of marketing fees and GPC entitlements.

On July 23, 2004, the Corporation finalized a US\$3.0 million credit facility with a major Canadian bank that is secured by trade receivables. 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. No funds have yet been drawn on this credit facility.

Rally Energy currently expects to generate sufficient cash flow from operations to meet its ongoing programs. In addition to internally generated sources, additional funds may be required from time-to-time to fund development activities. General market conditions in effect at the time could impact on the Corporation's ability to raise additional funds either in equity or debt form.

Related Party Transactions

Transactions between the Corporation and related parties occurred during the period, as disclosed in the consolidated financial statement notes. During the nine months ended September 30, 2004, the Corporation paid \$529,000 as consulting fees to related parties in respect of technical and specialized services rendered in the normal course of business operations. The third quarter 2004 fees paid were \$200,000. The consideration established and agreed to by the related parties is similar to amounts negotiated with third parties. Certain of the payments relate to services provided on an as-needed basis. Ongoing contractual commitments with related parties are currently \$69,000 per month. At September 30, 2004, the Corporation has recorded share purchase loans, maturing on December 31, 2004, totaling \$160,000, plus accrued interest, representing funds advanced to certain directors and officers in 2002 and 2004.

CHANGES IN ACCOUNTING STANDARDS

The Canadian Institute of Chartered Accountants (CICA) implemented several changes to accounting standards over the past year. A summary of changes, adoption timeframe and the effect on Rally Energy is summarized below.

New Standards Adopted in 2004

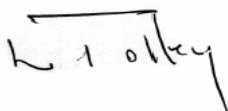
Asset Retirement Obligations

Effective January 1, 2004, the Corporation has adopted CICA Section 3110, "Accounting for Asset Retirement Obligations", requiring the fair value of asset retirement obligations to be recorded when they are incurred rather than merely accumulated or accrued over the useful life of the respective asset. Pursuant to S.3110, the fair value of the future retirement obligation is discounted to present value and is recorded as an increase to the related property, plant and equipment with the corresponding balance recorded as a future asset retirement obligation. The increased asset value is amortized according to our policies for property, plant and equipment and the future liability is accreted to expense until the future retirement obligation is expected to be settled.

NOTICE TO READER OF THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

The financial statements of Rally Energy Corp. (the Corporation) and the accompanying interim consolidated balance sheet as at September 30, 2004 and the interim consolidated statements of operations and deficit and cash flows for the nine month period then ended are the responsibility of the Corporation's management.

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



Lamont Tolley, B.A.Sc., M.S.E..
Chief Executive Officer
Calgary, Canada
November 29, 2004



Douglas C. Urch, B.Comm., CMA
Chief Financial Officer
Calgary, Canada
November 29, 2004

UNAUDITED INTERIM FINANCIAL STATEMENTS

In Accordance with National Instrument 51-102 released by the Canadian Securities Administrators, the Company Disclosed that its auditors have not reviewed the unaudited financial statements for the period ended September 30, 2004.

Rally Energy Corp.
Consolidated Balance Sheets

	September 30, 2004	December 31, 2003
	(unaudited)	(audited) (Restated – Note 1)
Assets		
Current		
Cash	\$ 870,709	\$ 2,260,426
Accounts receivable	6,790,234	2,517,742
Notes receivable (Note 3 (c))	239,707	-
Inventory (Note 2)	288,376	385,884
Prepaid expenses and deposits	205,362	244,727
Short term investments (market value of \$28,130)	32,304	32,304
	<u>8,426,692</u>	<u>5,441,083</u>
Property, plant and equipment (Note 3)	27,922,990	28,999,432
Deferred charges (Note 4)	251,376	359,106
	<u>\$ 36,601,058</u>	<u>\$ 34,799,621</u>
Liabilities and Shareholders' Equity		
Current		
Accounts payable – trade	\$ 2,290,856	\$ 2,388,787
Accounts payable – capital	3,488,671	2,521,000
Large corporation tax payable	-	32,000
	<u>5,779,527</u>	<u>4,941,787</u>
Convertible debentures (Note 4)	5,748,567	5,640,810
Asset retirement obligation (Note 1(a))	235,581	169,958
	<u>11,763,675</u>	<u>10,752,555</u>
Shareholders' equity		
Equity instruments (Note 6)	35,948,973	35,562,644
Stock compensation	461,362	157,739
Deficit	(11,572,952)	(11,673,317)
	<u>24,837,383</u>	<u>24,047,066</u>
	<u>\$ 36,601,058</u>	<u>\$ 34,799,621</u>

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

Rally Energy Corp.
Consolidated Statements of Income and Deficit

	For the three months ended September 30		For the nine months ended September 30	
	2004	2003	2004	2003
	(unaudited)		(unaudited)	
Oil and gas revenue	\$ 6,742,741	\$ 2,086,136	\$ 16,602,199	\$ 7,162,051
Less: Royalties and related credits	(1,406,942)	(469,364)	(3,563,959)	(1,551,245)
	5,335,799	1,616,772	13,038,240	5,610,806
Operating expenses	961,279	696,847	2,845,449	2,652,254
Netback from oil and gas operations	4,374,520	919,925	10,192,791	2,958,552
Expenses				
Administrative expenses:				
Legal, professional and audit	92,148	60,160	168,958	276,868
Shareholder communication	17,219	104,690	134,917	269,710
Administration	575,017	467,917	1,688,670	1,547,089
Pakistan administrative costs (Note 3(a))	34,083	26,638	263,626	84,234
Project evaluation costs (Note 1(b))	60,335	-	144,775	-
Stock compensation expense (Note 6(b))	270,984	33,821	303,623	120,509
	1,049,786	693,226	2,704,569	2,298,410
Interest expense	208,001	216,175	613,972	313,097
Depletion, depreciation and accretion	2,156,951	1,280,771	6,493,155	3,945,495
Accretion on convertible debentures	35,919	35,919	107,757	41,891
Amortization of deferred charge	35,910	34,902	107,730	40,737
	3,486,567	2,260,993	10,027,183	6,639,630
Income (loss) before under noted items	887,953	(1,341,068)	165,608	(3,681,078)
Other items				
Interest income	10,988	29,044	35,596	69,377
Gain (loss) on foreign exchange	(212,114)	52,780	(100,839)	230,197
	(201,126)	81,824	(65,243)	299,574
Earnings (loss) for the period	686,827	(1,259,244)	100,365	(3,381,504)
Deficit, beginning of period	(12,259,779)	(8,630,573)	(11,673,317)	(6,508,313)
Deficit, end of period	\$ (11,572,952)	\$(9,889,817)	\$ (11,572,952)	\$(9,889,817)
Earnings (loss) per share (Note 6(a))	\$ 0.01	\$ (0.02)	\$ 0.00	\$ (0.06)

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

Rally Energy Corp.
Consolidated Statement of Cash Flows

	For the three months ended September 30		For the nine months ended September 30	
	2004	2003	2004	2003
	(unaudited)		(unaudited)	
Cash flows from operating activities				
Earnings (loss) for the period	\$ 686,827	\$(1,259,244)	\$ 100,365	\$(3,381,504)
Non-cash items:				
Stock compensation expense	270,984	33,821	303,623	120,509
Accretion expense on convertible notes	35,919	35,919	107,757	41,891
Amortization of deferred charges	35,910	34,902	107,730	40,737
Depletion and depreciation	2,171,816	1,292,578	6,484,232	3,945,495
Accretion on asset retirement obligation	(14,865)	-	8,923	-
Cash flow from operations	<u>3,186,591</u>	<u>137,976</u>	<u>7,112,630</u>	<u>767,128</u>
Changes in non-cash working capital balances:				
Accounts receivable	(2,281,489)	(106,789)	(4,272,492)	1,832,916
Notes receivable	(239,707)	-	(239,707)	-
Inventory	(51,459)	(535,568)	97,508	(433,252)
Prepaid expenses and deposits	25,546	56,249	39,365	159,480
Large corporation tax payable	-	-	(32,000)	-
Accounts payable	(370,164)	(843,068)	(97,931)	(1,846,125)
	<u>269,318</u>	<u>(1,291,200)</u>	<u>2,607,373</u>	<u>480,147</u>
Cash flows from investing activities				
Oil and gas assets, net	(3,964,723)	(4,207,632)	(9,442,135)	(8,711,218)
Proceeds from sale of oil interests (Note 3(b))	181,060	-	4,091,045	50,000
Changes in non-cash working capital	1,290,045	2,341,785	967,671	1,664,868
	<u>(2,493,618)</u>	<u>(1,865,847)</u>	<u>(4,383,419)</u>	<u>(6,996,350)</u>
Cash flows from financing activities				
Issuance of equity instruments, net	237,325	(1,618)	386,329	2,549,811
Convertible debentures issued, net (Note 4)	-	-	-	5,575,341
	<u>237,325</u>	<u>(1,618)</u>	<u>386,329</u>	<u>8,125,152</u>
Increase (decrease) in cash	(1,986,975)	(3,158,665)	(1,389,717)	1,608,949
Cash, beginning of period	<u>2,857,684</u>	<u>6,579,465</u>	<u>2,260,426</u>	<u>1,811,851</u>
Cash, end of period	\$ 870,709	\$ 3,420,800	\$ 870,709	\$ 3,420,800

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

Rally Energy Corp.
Selected Notes to Consolidated Financial Statements
Nine months ended September 30, 2004 (unaudited)

The interim consolidated financial statements of Rally Energy Corp. (the "Corporation") have been prepared by management in accordance with accounting principles generally accepted in Canada. The interim consolidated financial statements have been prepared following the same accounting policies and methods of computation as the consolidated financial statements for the fiscal year ended December 31, 2003, 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, 2003.

1. Change in Accounting Policy

(a) Asset Retirement Obligations

Effective January 1, 2004, the Corporation adopted the new Canadian accounting standard for asset retirement obligations. The new standard requires the Corporation to record the fair value of an asset retirement obligation as a liability in the period in which it incurs a legal obligation associated with the retirement of tangible long-lived assets that result from the acquisition, construction, development, and/or normal use of the assets. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset and depleted and depreciated using a unit-of-production method over estimated gross proved reserves. Subsequent to the initial measurement of the asset retirement obligations, the obligations are adjusted at the end of each period to reflect the passage of time (accretion) and changes in the estimated future cash flows underlying the obligation.

The effect of this change in accounting policy has been recorded retroactively with restatement of prior periods. The effect of the adoption on the balance sheet is presented below as increases (decreases):

<i>Balance Sheet (\$)</i>	As at December 31, 2003
Asset retirement costs, included in property, plant and equipment	168,128
Asset retirement obligations	169,958
Accumulated future removal and site restoration liability	(66,000)
Accretion expense	1,830
Retained earnings	(67,830)

The Corporation's asset retirement obligations 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 \$296,000, 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 7.0 percent and an inflation rate of 2.0 percent were used to calculate the fair value of the asset retirement obligations.

Rally Energy Corp.
Selected Notes to Consolidated Financial Statements
Nine months ended September 30, 2004 (unaudited)

A reconciliation of the asset retirement obligations is provided below:

<i>Asset retirement obligations</i>	Nine months ended September 30, 2004	Year ended December 31, 2003
Balance, beginning of period	<u>\$169,958</u>	\$109,097
Liabilities incurred in period	56,700	59,031
Liabilities settled in period	-	-
Accretion expense	<u>8,923</u>	1,830
Balance, end of period	<u><u>\$235,581</u></u>	<u><u>\$169,958</u></u>

(b) Project Evaluation Costs

During the nine months ended September 30, 2004, the Corporation incurred costs totaling \$144,775 with respect to international project evaluations that do not have a high probability of resulting in project concession interests or licenses. Accordingly, these costs have been expensed.

(c) Comparative Amounts

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

(d) Measurement Uncertainty

The amounts recorded for depletion and depreciation of property and equipment, the asset retirement obligations and the ceiling test calculation are based on estimates of proved reserves, production rates, commodity prices, future costs, foreign currency exchange rates and other relevant assumptions. By their nature, these estimates are subject to measurement uncertainty and the effect on the consolidated financial statements of changes in such estimates in future periods could be significant.

2. Inventory

At September 30, 2004, the Corporation held \$1,238,000 of inventory available for use in the Issaran oilfield in Egypt. Of this amount, (i) \$949,000 relates to capital equipment, primarily pipe, and is included in Property, Plant and Equipment and (ii) \$289,000 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.

3. Property, Plant and Equipment

(a) On April 20, 2004, the Corporation announced that it intended to participate on a partially-carried interest basis in the Phase II exploration program of the Safed Koh Concession in Pakistan. An agreement has been negotiated whereby a new partner, as operator, will commit to future Phase II expenditures of up to US\$2.2 million. The Corporation will have a 22.5% carried working interest for its share of up to the US\$2.2 million Phase II project expenditure commitment with US\$1.6 million allocated to the carried costs on the first well and the remaining carry allocated to an optional second well. At year-end 2003, due to the uncertainty surrounding the extension period and required commitments, the Corporation's management

Rally Energy Corp.
Selected Notes to Consolidated Financial Statements
Nine months ended September 30, 2004 (unaudited)

determined that the value of the Pakistan property should be accounted for as an impaired asset. Accordingly, the assets were written down at December 31, 2003 and all subsequent costs incurred have been expensed.

- (b) On April 30, 2004, the Corporation, through its wholly-owned subsidiary, Scimitar Production International Ltd., closed a US\$3.0 million unsecured project investment financing to fund further development of the Issaran oilfield.

Under the terms of the Investment Agreement, the investor, an independent international oil and gas investment fund, is entitled to revenue-based payments from the Issaran oilfield commencing in 2005. No payments are required in 2004. 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, and continuing until December 31, 2012, the investor is entitled to receive 2.6% of Issaran oil revenues relating to production of up to 7,000 bbls/d, net of marketing fees and entitlements to The General Petroleum Co. S.A.E. ("GPC").

This transaction has been recorded as a property disposition thereby reducing the capitalized costs of petroleum and natural gas properties by \$3,922,483, net of costs and fees paid.

- (c) On September 23, 2004, pursuant to a "back-in" agreement, Rally Energy assigned a 20% undivided working interest in permit No. 04-01 and permit No. 04-04 to Shannon International Resources Inc. ("Shannon"), a former working interest partner in the seven expired permits. Under the terms of the agreement, Shannon delivered a promissory note, due December 31, 2004, in the amount of \$169,000. Shannon also agreed to conditions under which the working interests would revert to Rally Energy and acknowledged various assignment and liability provisions. Two directors of Rally Energy are, or have been, involved as officers of Shannon and both own securities of Shannon.

4. Convertible Debentures

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 Rally's common share closing price is at or above \$2.00 for 30 consecutive trading days. An agent's commission of \$420,000 was paid in relation to debenture subscriptions. The legal fees and cash commissions incurred to secure the debenture financing are recorded as deferred charges and the related amortization charges, \$108,000 for the period ended September 30, 2004, 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. An amount equal to the equity component is accreted over the term of the notes such that at maturity the liability will be equivalent to the principal amount. \$108,000 of accretion expense on the convertible debentures is included in interest and finance charges for the period ended September 30, 2004.

Rally Energy Corp.
Selected Notes to Consolidated Financial Statements
Nine months ended September 30, 2004 (unaudited)

The equity portion of the convertible note represents \$437,000 as determined using a Black-Scholes model with the following assumptions: dividend yield (nil), volatility (18%), risk-free interest rate (5%), and weighted average life of 1.5 years.

Amortization of an amount equal to the equity component is recognized in the statement of operations over the duration of the debt instrument as interest and related charges. The liability element is subsequently reported as amortized cost and the value of the equity conversion option is not changed in future periods.

5. Credit Facility

On July 23, 2004, the Corporation finalized a US\$3.0 million credit facility with a major Canadian bank which is secured by trade receivables. 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. At September 30, 2004, the entire credit facility remained available.

6. Equity Instruments

(a) Issued and outstanding

	<u>Number of Shares</u>	<u>Amounts</u>
Common shares		
Balance, December 31, 2003	71,389,740	\$ 35,938,359
Stock options exercised	924,833	447,325
Tax effect on flow-through shares ⁽¹⁾	-	-
Balance, September 30, 2004	<u>72,314,573</u>	<u>36,385,684</u>
Add: Equity portion of convertible debentures	-	437,000
Less: Share issue costs	-	(778,614)
Balance, Common stock	<u><u>72,314,573</u></u>	<u><u>\$ 36,044,070</u></u>
Share purchase warrants – common shares		
Balance, December 31, 2003	<u>1,676,470</u>	<u>64,903</u>
Balance September 30, 2004	<u>1,676,470</u>	<u>64,903</u>
Less: Share purchase loans (Note 7)		<u>(160,000)</u>
Balance, end of period, all equity instruments		<u><u>\$ 35,948,973</u></u>
Weighted average number of common shares for the nine months ended September 30, 2004	<u><u>71,618,738</u></u>	

⁽¹⁾ The tax effect of the qualifying expenditures of \$118,000 has been offset by recognition of certain future tax assets available to the Corporation. As at September 30, 2004 the Corporation is required to expend additional qualifying expenditures of \$2.1 million prior to December 31, 2004 to meet its commitments under the 2003 flow-through agreements. These agreements relate to a \$2.4 million placement of flow-through shares in December 2003.

Rally Energy Corp.
Selected Notes to Consolidated Financial Statements
Nine months ended September 30, 2004 (unaudited)

(b) Options

The shareholders of the Corporation 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 3 years, expiration terms varying from 1 to 5 years, and with exercise prices between \$0.50 and \$0.88 per share.

	Share Options	Weighted Average Exercise Price
Outstanding, beginning of year	6,462,530	\$0.62
Granted	1,640,000	\$0.71
Exercised	(924,833)	\$0.48
Cancelled / Expired	(490,606)	\$1.06
	6,687,091	\$0.63
Outstanding, end of period		

(c) Private placement – common shares and purchase warrants

On June 13, 2003, the Corporation issued 2,941,117 units priced at \$0.85 per unit for gross proceeds of \$2,500,000. Each unit consists of one common share and one-half of a common share purchase warrant. Each full warrant is exercisable for \$1.00 per common share on or before December 31, 2004. An agent's commission of \$174,000 was paid in relation to unit subscriptions. In addition, 205,882 warrants were issued to the agent. Agent's warrants are exercisable for \$1.00 per common share on or before December 31, 2004.

7. Related Party Transactions

For the nine months ended September 30, 2004, the Corporation paid \$529,000 of consulting fees to companies, whose principals are directors and officers of the Corporation.

During 2002, the Corporation advanced funds totaling \$100,000 to certain directors and officers to purchase shares in the Corporation at \$0.50 per share. The balance bears interest at prime plus one percent and is due on December 31, 2004. The amount is represented by unsecured promissory notes. On August 12, 2004, the Corporation advanced an additional \$60,000 to a director and officer to exercise 150,000 options at \$0.40 per share. At September 30, 2004, share purchase loans total \$160,000.

Other related party transactions are described in Note 3(c).