



*Building Value in Venezuela*

## MANAGEMENT'S DISCUSSION & ANALYSIS

### SECOND QUARTER 2005

---

August 12, 2005

The following management discussion and analysis (“MD&A”), as provided by the management of PetroFalcon Corporation (“PetroFalcon” or the “Company”), should be read in conjunction with the Company's unaudited interim consolidated financial statements for the three and six months ended June 30, 2005, and the audited consolidated financial statements for the year ended December 31, 2004. Those financial statements have been prepared in accordance with Canadian Generally Accepted Accounting Principles (“GAAP”) Estimates and forward-looking information are based on assumptions of future events and actual results may vary from these estimates.

This MD&A contains the terms “cash flow from operations” and “operating netback”, which should not be considered alternatives to, or more meaningful than cash flow from operating activities and net income as determined in accordance with Canadian GAAP as an indicator of the Company's performance. PetroFalcon's determination of “cash flow from operations” and “operating netback” may not be comparable to that reported by other companies. PetroFalcon also presents cash flow from operations per share whereby per share amounts are calculated using weighted average shares outstanding consistent with the calculation of earnings per share. All dollar amounts are expressed in US Dollars.

### FORWARD-LOOKING STATEMENTS & ESTIMATES

---

Certain statements contained in this MD&A constitute forward-looking statements. These statements relate to future events of PetroFalcon's future performance. All statements other than statements of historical fact may be forward-looking statements and may include statements pertaining to projections of market prices and costs, supply and demand for oil and natural gas, the quantity of reserves, oil and natural gas production levels, capital expenditure programs, treatment under governmental regulatory, taxation regimes and exchange rates, and expectations regarding PetroFalcon's ability to raise capital and to continually add to reserves through acquisitions and developments. Statements regarding these matters involve known and unknown risks, uncertainties and other factors that may cause actual results or events to differ materially from those anticipated in such forward-looking statements. PetroFalcon believes that the expectations reflected in its forward-looking statements are reasonable but no assurance can be given that expectations will prove to be correct and forward-looking statements included in this MD&A should not be unduly relied upon. Forward-looking statements speak only as of the date

of this MD&A and actual results could differ materially from those anticipated in forward-looking statements.

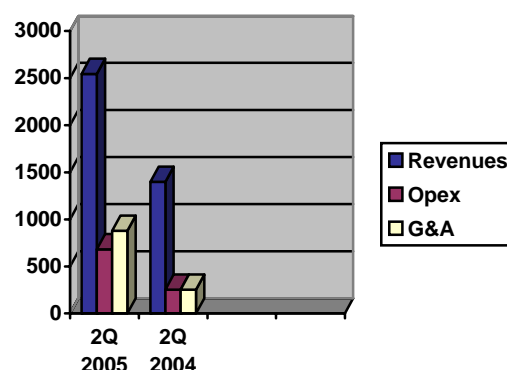
Investors should not place undue reliance on forward-looking statements as the plans, intentions or expectations upon which they are based may not occur. Statements relating to “reserves” or “resources” are deemed to be forward-looking statements, as they involve the implied assessment, based on certain estimates and assumptions that the resources and reserves described can be profitably produced in the future. The forward-looking statements contained herein are expressly qualified by this cautionary statement.

## PRODUCTION AND REVENUE

For the three months ended June 30, 2005, average production was 808 bbls/d of oil. The gas produced during the three months ended June 30, 2005, was used only for operations including fuel and gas lift. For the three months ended June 30, 2004, average production was 766 bbls/d of oil.

During the three months ended June 30, 2005, PetroFalcon had 9 producing oil wells, 3 shut-in gas wells and 6 shut-in oil wells. The Company also had two new wells at the La Vela field currently being tested for production.

The Company expects an increase in oil and natural gas production in 2005 from the La Vela and Cumarebo fields due to development drilling activity scheduled for both fields.



PetroFalcon recorded revenue in the amount of \$2.47 million for the three months ended June 30, 2005, compared to \$1.68 million for the three months ended June 30, 2004. The average price received for the three months ended June 30, 2005 was \$33.59 per barrel of oil. For the three months ended June 30, 2004, the average price for oil was \$24.06 per barrel.

The increase in revenue during the three months ended June 30, 2005, was due to higher levels of production, 73,521 bbls for the period ended June 30, 2005, as compared to 69,725 bbls for the period ended June 30, 2004, as well as higher average prices, \$33.59 per bbl for the period ended June 30, 2005 as compared to \$24.06 per bbl for the period ended June 30, 2004.

The Company had no derivative contracts and consequently benefited from strong oil prices during the three months ended June 30, 2005. Oil and natural gas production are delivered to Petroleos de Venezuela S.A. (“PDVSA”) and the Company receives payment in accordance with its operating service agreement with PDVSA.

On May 13, 2005 PetroFalcon’s wholly owned subsidiary, Vinccler Oil and Gas, C.A. (“VOG”) received notice from the Ministry of Energy and Petroleum in Venezuela (“MEP”) and PDVSA that existing relationships governed by operating services agreements are to be migrated into joint ventures pursuant to the 2001 Venezuelan Organic Hydrocarbon Law (“OHL”) through

negotiations with the various operating service agreement parties. It is the understanding of the Company that pursuant to the OHL, (i) VOG will transfer its operating service agreement for the East Falcon Unit ("VOG OSA") to an "Empresa Mixta" or mixed company incorporated pursuant to the laws of Venezuela in exchange for a 49% interest in the Empresa Mixta; and (ii) PDVSA will obtain the remaining 51% interest in the Empresa Mixta in exchange for contributing other oil and gas interests and assets to it. The Company understands that this restructuring may also include the issuance of a gas license to the Empresa Mixta or VOG. It is currently contemplated that a technical and economical evaluation of the East Falcon Unit and other fields and assets will be conducted on a joint basis by MEP, PDVSA and VOG and will commence during the third quarter. The Company has been advised that PDVSA intends to conclude the OHL negotiations within the next six months.

The Company signed an agreement on August 4, 2005, with PDVSA agreeing to migrate the VOG OSA to a mixed company.

On May 27, 2005, VOG signed a Gas Addendum (the "Addendum") with Corporacion Venezolana de Petroleo ("CVP"), a subsidiary of PDVSA, for the production of up to 249 billion cubic feet of gas and 11 million barrels of liquids from Cumarebo and La Vela fields. The Company will be paid US\$1.33 per mcf for gas and the maximum total fee (being approximately 66.66% of the value of the oil produced by the Company) for the liquids.

All of the Company's revenues are to be received in US Dollars. Payment from PDVSA for the first quarter of 2005 was one-half in US Dollars and one-half in Bolivars (the official Venezuelan currency). VOG utilizes these Bolivars in its operations.

## ROYALTIES

---

The Company's oil and gas production is not subject to any royalties. In the future, when the Company migrates to a mixed company, its share of oil and gas production will become subject to royalty payment.

## OPERATING EXPENSES

---

(\$000s except boe amount)	Second Quarter 2005	Second Quarter 2004
Operating Expenses (including-maintenance and transportation)	683	538
Average expense (\$ per boe)	9.29	7.72

For the three months ended June 30, 2005, operating expenses were higher, compared to the three months ended June 30, 2004, due to increased volumes of oil production at Cumarebo and La Vela Fields as compared to production being exclusively at Cumarebo Field during the

second quarter 2004. The Company expects to continue increasing oil production and commence natural gas sales in 2005. Higher production levels are expected to decrease per boe operating expenses in 2005 as fixed costs are spread over greater boe production.

## **INTEREST INCOME AND EXPENSE**

At June 30, 2005, PetroFalcon had \$25.66 million in cash and short-term deposits (\$3.82 million of which is considered restricted) compared to \$26.2 million at June 30, 2004. Interest income decreased to \$56,328 in the three months ended June 30, 2005, compared to \$120,814 in the three months ended June 30, 2004, due to lower average balances in the second quarter of 2005.

During the three months ended June 30, 2005, PetroFalcon incurred interest expense of \$162,613 as compared to \$73,538 during the three months ended June 30, 2004. The increase in interest expense is due to higher average debt during the second quarter 2005.

During the three months ended June 30, 2005, PetroFalcon recorded an exchange loss of \$2,977 on the conversion in foreign currencies to US dollars, and a gain on bond sales of \$680,233.

During the year ended December 31, 2004, Vinccler Oil and Gas, C.A. (“VOG”), PetroFalcon’s wholly owned operating subsidiary, secured a line of credit of five billion Bolivars (\$2.6 million) from Banco Occidental del Descuento (“BOD”). This line of credit is secured by an irrevocable Letter of Credit (“LC”) issued by HSBC Bank in favour of BOD which is 100% cash collateralized. VOG also secured a five billion Bolivars (\$2.6 million) line of credit with Banco Exterior (“BE”) which requires that VOG maintain a balance of \$1 million with BE. As of June 30, 2005, the BOD line of credit had an available balance of \$895,000 and the BE line of credit had an available balance of \$105,000. The \$2.6 million LC and the \$1 million deposit with BE are considered restricted cash.

## **GENERAL AND ADMINISTRATIVE EXPENSES**

<b>(\$000s except boe amount)</b>	<b>Second Quarter 2005</b>	<b>Second Quarter 2004</b>
Expenses	958	569
Average expense (\$ per boe)	13.03	8.15

General and administrative costs increased to \$957,911 during the three months ended June 30, 2005, from \$568,507 during the three months ended June 30, 2004. The increase in general and administrative costs during the three months ended June 30, 2005 is related to an increase in the number of employees and third party consultants required to effect the Company’s growth strategy. The Company also granted one time bonus payments totalling \$280,000 during the second quarter of 2005. Without this non-recurring expense, general and administrative costs would have been \$677,911 or \$9.22 per boe for the second quarter 2005. General and administrative costs per boe are expected to decline as production increases in 2005.

PetroFalcon does not capitalize general and administrative costs.

## DEPLETION, DEPRECIATION, AMORTIZATION AND ACCRETION ("DDA&A")

(\$000s except boe amount)	Second Quarter 2005	Second Quarter 2004
Depletion, Depreciation, Amortization and Accretion	385	295
Depletion Rate (\$ per boe)	5.23	4.23

The DDA&A expense per unit during the three months ended June 30, 2005 was higher compared to the three months ended June 30, 2004, due to an increase in projected capital expenditures which commenced in 2005. DDA&A is expected to remain relatively constant during 2005.

## INCOME TAXES

(\$000s)	Second Quarter 2005	Second Quarter 2004
Consolidated Tax Expense	133	0

VOG accrued Venezuelan income taxes in the amount of \$133,080 for the three months ended June 30, 2005. VOG's taxability depends on a number of factors including the extent of operating expenditures, interest expensed, general and administrative costs and incremental income associated with new production and oil prices.

The Company has been advised that the SENIAT, the Venezuelan income tax authority, has stated that the income tax rates for activities conducted under the various operating service agreements in Venezuela, including the VOG OSA, will increase from 34% to 50%. The SENIAT is currently auditing VOG, however, the timing or impact of such audit is unknown at this time.

## CAPITAL BUDGET FOR 2005

The following table outlines the Capital Budget for 2005. There may be circumstances, where for sound business reasons, a reallocation of funds may be necessary in order for the Company to achieve its stated business objectives.

(\$000s)	2005 (Revised end 1 <sup>st</sup> Quarter)	2005 (Revised end 2 <sup>nd</sup> Quarter)	Incurred As of June 30, 2005
Drilling			
- La Vela	10,000	13,000	11,900
- Cumarebo	9,000	3,600	808
- Prospects	6,000	1,800	-
- Total Drilling	<b>25,000</b>	<b>18,400</b>	<b>12,708</b>
Central Processing Facilities			
- La Vela	7,000	8,500	8,742
- Cumarebo	3,000	2,000	120
- Total Central Processing Facilities	<b>10,000</b>	<b>10,500</b>	<b>8,862</b>
- Seismic Acquisition	<b>2,200</b>	<b>2,200</b>	<b>2,215</b>
<b>Total Capital Budget</b>	<b>37,200</b>	<b>31,100</b>	<b>23,785</b>

### DRILLING

The Company has set pipe to 7,200 feet on the LV-9 well, an offset to the LV-8X, and is currently production testing the well. The LV-9 well encountered approximately 60 feet of prospective carbonate reservoir in the Miocene Agua Clara formation, the same reservoir which is currently producing in the LV-8X, and which interval showed excellent reservoir potential on both electric logs and RFT data. In addition, the LV-9 well encountered approximately 75 feet of Agua Clara sandstone in the base of the formation. This same interval produced in the LV-8X and appears prospective in the LV-9 based on electric logs, RFT data and sidewall cores.

During the second quarter 2005, the Company commenced and completed drilling to LV-10 well in the southern part of the La Vela Field. The well was planned to drill “up-dip” of the producing LV-6X well and test the same productive Miocene Pedregoso and Cerro Pelado reservoirs. The LV-10 well was drilled and pipe was set to a total depth of 9,990 feet. Based on electric logs, the well encountered approximately 240 feet of potentially productive reservoir in the deep portion of the well. This potential pay is in addition to the approximately 150 feet of potential reservoir encountered in the shallow Caujarao and Socorro formations. The well is currently testing.

The drilling schedule for 2005 consists of five locations, two of which are located in the Cumarebo Field and three of which are located in the La Vela Field.

### CENTRAL PROCESSING FACILITIES

PetroFalcon has commenced the construction of an early production facility at the La Vela Field which will initially be capable of processing 20 mmcf/d of natural gas and 5,000 bbls/d of oil. Permanent facilities will be installed in 2006 which will be capable of 50 mmcf/d and 7,500 bbls/d of oil and expandable to 150 mmcf/d and 20,000 bbls/d of oil. The Company plans to upgrade the existing facilities at the Cumarebo Field to process 20 mmcf/d of natural gas. The Cumarebo Field facilities are capable of processing up to 10,000 bbls/d of oil.

The purpose of installing and upgrading the central processing facilities is to gather the natural gas and oil production from La Vela and Cumarebo Fields and deliver natural gas produced into the PDVSA's ICO gas pipeline. Oil will continue to be delivered by trucks to PDVSA's Paraguana Refinery Complex.

### SEISMIC ACQUISITION

Seismic data acquisition at Cumarebo and La Vela Fields and adjacent prospects was completed in the first quarter of 2005. The seismic data processing was completed during the second quarter of 2005 and is currently being interpreted. The new seismic data is expected to better define the Company's prospects and delineate drilling locations at the two existing fields.

### FUNDS FROM OPERATIONS

(\$000s except per share data)	Second Quarter 2005	Second Quarter 2004
Cash flow from operations	1,266	19
Per basic share	0.02	0.00
Net income	428	(455)
Per basic share	0.01	(0.01)
Working capital	14,775	25,407

## OPERATING NETBACK

(\$ per boe)	Second Quarter 2005	Second Quarter 2004
Sales price	33.59	24.06
Operating expenses	(9.29)	(7.72)
Operating netback*	24.30	16.34

\* This is a non-gaap measure of profitability

## QUARTERLY INFORMATION

The following table sets forth selected consolidated financial information of PetroFalcon for the last eight quarters:

(\$000s, except per share amounts)	2005		2004				2003	
	Q2	Q1	Q4	Q3	Q2	Q1	Q4	Q3
Revenue	2,469	2,545	2,864	2,082	1,677	1,373	1,314	1,053
Net income (loss)	428	622	964	193	(455)	1,411	558	645
Earnings (loss) per share basic	0.01	0.01	0.01	0.00	(0.01)	0.03	0.01	0.01
Earnings (loss) per share diluted	0.01	0.01	0.01	0.00	(0.01)	0.03	0.01	0.01

\* restated for change in accounting policy for asset retirement obligations.

Increased revenue was due to higher levels of production, 73,521 bbls in the second quarter of 2005 as compared to 69,725 bbls in the second quarter of 2004, and higher average prices of \$33.59 in the second quarter of 2005 as compared to \$24.06 in the second quarter of 2004.

## LIQUIDITY AND CAPITAL RESOURCES

As June 30, 2005, PetroFalcon had 77,513,074 outstanding and issued common shares, and 86,378,001 common shares on a fully diluted basis. At the end of the first quarter of 2005, PetroFalcon had 75,334,801 outstanding and issued common shares, and 82,598,228 common shares on a fully diluted basis.

As June 30, 2005, PetroFalcon had \$25.66 million in cash and short term deposits, including \$3.82 million in restricted cash and a working capital surplus of \$14.78 million. At June 30, 2005, PetroFalcon's total current debt was \$5.97 million and total long term debt was \$8 million. At March 31, 2005, PetroFalcon had \$19.51 million in cash and short term deposits, including \$3.6 million in restricted cash and a working capital surplus of \$12.40 million. At March 31, 2005, PetroFalcon had total current debt of \$2.0 million and no long term debt.

At June 30, 2005, PetroFalcon had \$11.38 million in accounts payable of which \$5.55 million represent the accrued portion of capital expenditures not yet billed.

The Company has reached an agreement with the International Finance Corporation (“IFC”), the private sector arm of the World Bank, pursuant to which the IFC will provide up to \$36 million in loans to VOG for the development of the Company’s oil and gas properties. During the second quarter of 2005, the IFC disbursed \$12 million from the “C” Loan. The disbursement of the remaining \$24 million (the “A” Loan) is subject to the completion of certain technical tests. Principal repayments on the \$12 million are due in 2011. Interest will be payable semi-annually on May 15 and November 15 and will accrue at the London Inter Bank Offered Rate (“Libor”) plus 1% for the “C” Loan from June 27, 2005, the date of the full disbursement of the “C” loan. IFC is also entitled to receive three percent of VOG's cash flow so long it does not exceed 10% per annum of the principal amount of the "C" loan on an aggregate accumulated basis. At June 30, 2005, the outstanding principal due to IFC was \$8 million as a result of IFC’s conversion of \$4 million of debt into 2,078,273 common shares of PetroFalcon. IFC has the option, commencing December 27, 2005, until December 27, 2008, to convert all or portion of the \$8 million “C” loan into shares of PetroFalcon at the market price at the time of conversion. The facility contains a number of covenants that VOG must fulfill including the satisfaction of minimum financial tests, compliance with IFC and World Bank environmental and social policies and compliance with restrictions on the use and application of the proceeds.

The planned growth and development activities for the next twelve months will require additional funds. Management of PetroFalcon anticipates that these funds will be obtained from cash flow from operations, lines of credit and the IFC loan facility, however, in the event that additional funds are required, the Company may determine that it is in the best interest to raise capital by way of completing debt or equity securities financings.

## **RELATED PARTY TRANSACTIONS**

---

For the three months ended June 30, 2005 the Company paid \$210,000 (\$165,000 during the three months ended June 30, 2004) to Pacific Oil and Gas, LLC (“Pacific”), a company controlled by the Company’s Chief Financial Officer, Clarence Cottman and the Company’s President William Gumma, for professional services provided to PetroFalcon. Charges from related parties are based on actual expenditures by Pacific for engineering, geological, geophysical, logistical, administrative and financial support provided to PetroFalcon and VOG.

For the three months ended June 30, 2005 the Company incurred expenses to Venezolana de Inversiones y Construcciones Clerico, C.A., an independent operating construction company controlled by the Company’s Chairman Juan Francisco Clerico, \$378,994. These charges are for construction work at the La Vela central processing facility, drilling locations and road repair.

## CASH FLOW SENSITIVITIES

The following table sets out the sensitivity of PetroFalcon's cash flow from operations to changes in key operational assumptions, based on management's projections for 2005:

Approximate impact for year ending December 31, 2005	Cash Flow	
	\$000s	\$/share
<b><u>Natural Gas</u></b>		
Change of \$0.10 per mcf in average price	N/A	N/A
Change of 1,000 mcf day of production	478	0.006
<b><u>Oil</u></b>		
Change of \$1.00 per barrel in WTI average	428	0.006
Change of 100 bbls/d of production	1,059	0.014

## SUBSEQUENT EVENTS

VOG has increased its line of credit with Banco Exterior to ten billion Bolivars (US\$4.65 million). VOG utilizes lines of credit with Venezuelan banks to meet its short term working capital and local currency financing needs.

On August 10, 2005, the Company repaid the BOD line of credit and had the related Letter of Credit for \$2.6 million (restricted cash) released.

## ADDITIONAL INFORMATION

Additional information regarding the Company, including its annual information form, reserves information and annual report may be found on SEDAR at [www.sedar.com](http://www.sedar.com) or visit [www.petrofalcon.com](http://www.petrofalcon.com).