



*Building Value in Venezuela*

## MANAGEMENT DISCUSSION & ANALYSIS

### FIRST QUARTER 2006

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May 15, 2006

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 interim financial statements for the three months ended March 31, 2006, and 2005 together with the audited consolidated financial statements for the years ended December 31, 2005, and December 31, 2004. These financial statements have been prepared in accordance with Canadian Generally Accepted Accounting Principles (“Canadian 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” is defined as cash from operating activities before changes from non-cash working capital items and “operating netback” is defined as revenue less operating, maintenance and transportation expenses and 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. Transactions and balances using the Venezuelan Bolivar (“Bs.”) are converted into U.S. dollars using the temporal method at the official exchange rate (currently Bs. 2,150/US\$).

For the purposes of calculating unit costs, unit netbacks and combined production and revenue, natural gas has been converted to a barrel of oil equivalent (“boe”) using a conversion rate of six thousand cubic feet equal to one barrel (6:1).

### **CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION**

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Except for statements of historical fact, all statements in this MD&A, including, without limitation, statements with respect to royalty payments; oil and natural gas production; general and administrative expenses; future income tax; future drilling; planned growth and

development; contractual obligations; new projects; forecasted production; future plans; objectives and results constitute forward-looking information within the meaning of applicable Canadian securities legislation which involve risks, uncertainties and assumptions including, without limitation, risks associated with operating exclusively in a foreign jurisdiction; changes to operating services agreements in Venezuela; the imposition of royalties and income taxes; the impact of general economic conditions in Venezuela and world-wide; industry conditions including the adoption of environmental, tax and other laws and changes in how they are interpreted and enforced; the existence of operating risks in finding, developing and producing oil and natural gas; volatility of oil and natural gas prices; oil and natural gas product supply and demand; processing facility access; risks inherent in the ability to generate sufficient cash flow from operations to meet current and future obligations; stock market volatility; commodity prices; interest rates; opportunities available to or pursued by the Company; and other factors, many of which are beyond our control. All such forward-looking information is based on certain assumptions and analyses made by us in light of our experience and perception of historical trends, current conditions and expected future developments, as well as other factors we believe are appropriate in the circumstances. The foregoing factors are not exhaustive and are further discussed in the Annual Information Form of PetroFalcon available on SEDAR at [www.sedar.com](http://www.sedar.com). Actual results, performance or achievements could differ materially from those expressed in, or implied by, such forward-looking information and, accordingly, no assurance can be given that any of the events anticipated by the forward-looking information will transpire or occur, or if any of them do so, what benefits will be derived there from. Investors should not place undue reliance on forward-looking information. Statements relating to “reserves” or “resources” are also deemed to be forward-looking information 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. Except as required by law, PetroFalcon Corporation and its subsidiaries expressly disclaim any intention or obligation to update or revise any forward-looking information, whether as a result of new information, future events or otherwise. In the event subsequent events prove past statements about current trends to be materially different, we may choose to issue a news release explaining the reasons for the difference and update the guidance on the anticipated impact on revenue, earnings and other key events.

The information contained in this MD&A is expressly qualified by this cautionary statement.

## RESULTS OF OPERATIONS

### EAST FALCON BLOCK

For the three months ended March 31, 2006, average production from the East Falcon Block was 1,182 boe/d. On December 19, 2005, the Company commenced delivering natural gas to Petroleos de Venezuela, S.A. (“PDVSA”) through the Interconnection Centro Occidente Pipeline (the “ICO Pipeline”) at an exit rate of 4 mmcf/d of natural gas. For the three months ended March 31, 2005, average production was 917 boe/d.



During the three months ended March 31, 2006, the East Falcon Block had 16 producing oil wells, 1 producing natural gas well, 2 shut-in natural gas wells and 2 shut-in oil wells.

The Company expects an increase in oil and natural gas production during 2006 from the La Vela and Cumarebo fields through development drilling, expansion of the facilities at La Vela, the new natural gas facility construction at Cumarebo, and future development in the West Falcon Block.

### ACQUISITION OF WEST FALCON BLOCK



Effective March 21, 2006, the Company's wholly owned subsidiary, Vincler Oil and Gas, C.A. ("VOG") completed the acquisition of a subsidiary from Samson International, LLC. VOG now owns West Falcon Samson Hydrocarbons, S.R.L. ("Samson"). Samson owns 100% of the West Falcon Operating Service Agreement ("West Falcon Block") in Venezuela. The purchase price consisted of a cash payment of \$2.5 million. In addition, PetroFalcon issued 1.75 million common shares of PetroFalcon.

For the three months ended March 31, 2006, average production from the West Falcon Block was 377 boe/d.

During the three months ended March 31, 2006, the West Falcon Block had 15 producing oil wells, 4 producing natural gas wells and 5 shut-in oil wells.

The production from the West Falcon Block is delivered into PDVSA's oil and gas pipelines which serve the Paraguaná Refining Complex. The West Falcon Block covers a large portion of the western part of Falcon State immediately adjacent to VOG's East Falcon Block. The West Falcon Block also contains exploration and exploitation projects which include shut in oil and gas fields and seismically defined high potential drilling targets located near the pipeline transport system. The Company plans to test the shut in wells and begin the permitting process for at least one 4,500 foot exploration well in 2006.

The acquisition of the West Falcon Block raises the daily average production for the East and West Falcon blocks to approximately 1,600 boe/d.

### EMPRESA MIXTA

On March 31, 2006, VOG reached initial agreement with the Venezuelan government with respect to its oil and natural gas rights in Venezuela. VOG signed a memorandum of understanding with PDVSA and its affiliated entity, Corporacion Venezolana de Petroleo ("CVP") to create a jointly owned entity which would hold all operating rights to the West Falcon Block and the East Falcon Block (the "Empresa Mixta"). It was determined that the ownership structure of the Empresa Mixta would be 40% held by VOG and 60% held by CVP. The impact of the Empresa Mixta is that it converts VOG's interests in the East Falcon Block and West Falcon Block into a single development entity, of which VOG will hold 40%, and

gives the Empresa Mixta the exclusive right to produce and sell oil and associated natural gas from the two Blocks.

The Empresa Mixta contract has not yet been executed and the final agreements have not yet been fully negotiated between the parties, however, VOG has been advised by PDVSA and CVP that it is intended to have an April 1, 2006 effective date. Therefore, the Company has determined that it is prudent to govern their actions in accordance with the following intended general structure of the Empresa Mixta:

- The Empresa Mixta will pay a royalty at the rate of 33.3% on the oil and natural gas production
- The Empresa Mixta will have an applicable income tax rate of 50%
- The Empresa Mixta will have a term of 20 years
- VOG will receive dividends from the Empresa Mixta on a quarterly basis derived from its 40% participation in the Empresa Mixta
- VOG will be responsible for 40% of the approved 2006 capital expenditure budget of \$40.7 million and 40% of the operating costs.

## REVENUES

For the three months ended March 31, 2006, the Company recorded revenue from the East Falcon Block in the amount of \$3.1 million, compared to \$2.5 million for the three months ended March 31, 2005. The average price received for the three months ended March 31, 2006 was \$39.08 per bbl of oil and \$1.33 per mcf of natural gas. The combined average price received for the three months ended March 31, 2006 was \$29.41 per boe. For the three months ended March 31, 2005, the average price was \$30.83 per bbl of oil.

	<b>Three months ended March 31, 2006</b>	<b>Three months ended March 31, 2005</b>
<b>Daily production / sales volumes</b>		
Oil – bbl/d	815	917
Natural gas - mcf/d	2,205	-
Total - boe/d	<b>1,182</b>	<b>917</b>
<b>Product pricing (\$)</b>		
Oil – per bbl	39.08	30.83
Natural gas - mcf/d	1.33	-
Revenue per boe	<b>29.41</b>	<b>30.83</b>
<b>Total Revenues (\$000s)</b>	<b>3,129</b>	<b>2,545</b>

The increase in revenue during the three months ended March 31, 2006, occurred due to higher levels of production in boe basis, 106,394 boe for the three months ended March 31, 2006, as compared to 82,562 boe for the three months ended March 31, 2005, as well as higher average oil prices, \$39.08 per bbl of oil for the three months ended March 31, 2006, as compared to \$30.83 per bbl of oil for the three months ended March 31, 2005.

The Company had no derivative contracts and consequently benefited from strong oil prices during the three months ended March 31, 2006. Oil and natural gas production is delivered to PDVSA, and VOG, will receive payment for the production during the three months ended March 31, 2006, in accordance with its Operating Service Agreement (“OSA”) and Transitory Agreement with PDVSA for the East Falcon and West Falcon blocks.

The Company did not record revenues from the Samson acquisition for the three months ended March 31, 2006, as the acquisition closed at the end of the period. The Company did record in its consolidated balance sheet the account receivable for Samson’s first quarter revenues in the amount of \$1.4 million.

Payment from PDVSA under the OSA was 75% in US Dollars and 25% in Bolivars. Dividends from the Empresa Mixta are expected to be 100% in US Dollars.

## ROYALTIES

The Company’s oil and natural gas production was not subject to any royalties for the oil and gas production delivered during the three months ended March 31, 2006 (*See Section “Empresa Mixta”*).

## OPERATING EXPENSES

(\$000s except boe amount)	Three months ended March 31, 2006	Three months ended March 31, 2005
Operating Expenses (including maintenance and transportation)	964	624
Average expense (\$ per boe)	9.07	7.56

For the three months ended March 31, 2006, operating expenses were \$964,459 as compared to \$623,935 during the three months ended March 31, 2005. Increased operating expenses are due to higher trucking expenses for the oil production at the Cumarebo and La Vela fields and higher compressor expense incurred with the start of natural gas production in the East Falcon Block. In addition, the Company has increased the number of employees, incurred higher salaries and increased consultants usage, all of which are required to implement the Company’s growth strategy. The Company expects an overall increase in operating expenses from the acquisition of

the West Falcon Block, as well as, increased oil and natural gas production in 2006. Operating expenses per boe are expected to decline during 2006.

## GENERAL AND ADMINISTRATIVE EXPENSES

(\$000s except boe amount)	Three months ended March 31, 2006	Three months ended March 31, 2005
Expenses	923	877
Average expense (\$ per boe)	8.67	10.63

General and administrative expenses were \$922,508 during the three months ended March 31, 2006, as compared to \$877,494 during the three months ended March 31, 2005. General and administrative expenses were higher during the three months ended March 31, 2006, as compared to the same period in 2005. The overall increase in general and administrative expenses during the three months ended March 31, 2006, is related to an increase in legal fees incurred for the migration to the Empresa Mixta and settlement of tax issues, and an increase in the number of employees, higher salaries and increased consultants usage, all of which are required to implement the Company's growth strategy. Lower general and administrative expense per boe during the three months ended March 31, 2006, is due to commencement of natural gas production from East Falcon Block during the period. The Company does not expect a significant impact in general administrative expense with the acquisition of the West Falcon Block and anticipates general and administrative expenses per boe to continue to decline as production increases during 2006.

PetroFalcon does not capitalize general and administrative expenses.

## AMORTIZATION, DEPLETION AND ACCRETION ("AD&A")

(\$000s except boe amount)	Three months ended March 31, 2006	Three months ended March 31, 2005
Amortization, Depletion and Accretion	513	410
Depletion Rate (\$ per boe)	4.82	4.96

For the three months ended March 31, 2006, AD&A was \$512,688 as compared to \$409,560 for three months ended March 31, 2005. The AD&A expense during the three months ended March 31, 2006, was higher compared to the three months ended March 31, 2005. For the three months ended March 31, 2006, AD&A expense was lower on a per boe basis as a result of the commencement of natural gas production from the East Falcon Block. AD&A per boe is expected to remain relatively constant during 2006.

## **INTEREST INCOME AND EXPENSE**

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At March 31, 2006, PetroFalcon had \$10.5 million in cash and short-term deposits compared to \$19.51 million at March 31, 2005. During the three months ended March 31, 2006, the Company recorded interest income in the amount of \$43,615 as compared to \$98,537 during the three months ended March 31, 2005. Interest income was lower during the three months ended March 31, 2006, compared to the three months ended March 31, 2005, due to lower average cash deposits.

PetroFalcon incurred interest expense of \$813,509 during the three months ended March 31, 2006, as compared to \$98,478 during the three months ended March 31, 2005. The increase in interest expense in the three months ended March 31, 2006, is detailed below:

- (i) Additional interest payable to the International Finance Corporation (“IFC”) based on 3% of VOG’s earnings before interest, depreciation, amortization and exploration costs;
- (ii) Interest of \$111,000 under the IFC long term borrowing facility which loan was not effective as of March 31, 2005;
- (iii) Increased interest of \$310,360 paid to local banks due to higher average short term debt of \$8 million as of March 31, 2006, versus \$2 million as of March 31, 2005; and
- (iv) An additional \$236,977 of interest paid by VOG for the Venezuelan Tax Assessment

PetroFalcon recorded a loss in exchange rate fluctuations of \$7,771 during the three months ended March 31, 2006.

## **STOCK-BASED COMPENSATION**

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During the three months ended March 31, 2006, the Company recorded \$590,000 in stock-based compensation expense as compared to \$444,000 during the three months ended March 31, 2005. Higher stock-based compensation during the three months ended March 31, 2006, was due to a greater number of stock options outstanding during the three months ended March 31 2006; 10,548,694 options were outstanding at March 31, 2006, as compared to 7,263,427 options outstanding at March 31, 2005.

## INCOME TAXES

During the three months ended March 31, 2006, the Company recorded a current income tax expense of \$542,389 as compared to \$301,069 during the three months ended March 31, 2005.

During 2005, VOG received tax assessments from the National Integrated Customs and Tax Administration Service (“SENIAT”), the Venezuelan tax authorities, with respect to the income tax returns for the years ended December 31, 2001 to 2004 for a total of \$3.3 million (Bs. 7.7 billion), payable in nominal Bolivars. The revised tax assessment was mainly due to the SENIAT’s reinterpretation of VOG’s business purpose. The SENIAT stresses that under its income tax laws, VOG is an oil and gas producing company instead of an operating service company. Thus, the income tax expense for the audited years had to be recalculated at the rate of 50% (rather than the previous rate of 34%). On January 26, 2006, VOG filed a discharge claim with SENIAT. During the three months ended March 31, 2006, Vincler Venezuela received the final settlement resulting in an additional income tax expense of \$542,389 for the period December 31, 2001 to December 31, 2004.

(\$000s)	Three months ended March 31, 2006	Three months ended March 31, 2005
Consolidated Current Income Tax Expense	542	301

## ANALYSIS OF CAPITAL EXPENDITURES

The following table outlines the Capital Budget for the year ended December 31, 2006 and expenditures for the three months ended March 31, 2006.

(\$000s)	2006 Annual Budget	2006 Revised Annual Budget*	Actual Incurred First Quarter 2006**
<b>Drilling and Workovers</b>			
- La Vela	12,500	20,261	115
- Cumarebo	5,500	5,332	12
- West Falcon Block	-	2,533	
- Total Drilling and Workovers	<b>18,000</b>	<b>28,126</b>	<b>127</b>
<b>Processing Facilities and Infrastructure</b>			
- La Vela	3,100	4,948	692
- Cumarebo	4,200	4,310	235
- West Falcon Block	-	3,300	
- Total Central Processing Facilities	<b>7,300</b>	<b>12,558</b>	<b>927</b>
<b>Total Capital Budget</b>	<b>25,300</b>	<b>40,684</b>	<b>1,054</b>

\* The 2006 Revised Annual Budget represents the gross budget of the Empresa Mixta, for which VOG will be responsible for 40% (See Section "Empresa Mixta"). \*\* The Actual Incurred First Quarter 2006 represents the aggregate dollars expended by the Company because during the first quarter of 2006 the Company was operating pursuant to the Operating Services Agreement.

PetroFalcon has initiated a comprehensive development and exploitation program designed to increase natural gas and oil reserves, production, earnings, cash flow and net asset value.

## PROCESSING FACILITIES AND INFRASTRUCTURE

During the three months ended March 31, 2006, the Company started the construction of the second phase of facilities at the La Vela Field. These facilities will include compression and dew point processing equipment allowing VOG to produce natural gas from various proven reservoirs for up to 20 MMcf/d of gas and 1,500 bbls/d of oil. At the Cumarebo Field, VOG will also begin expansion and upgrades of existing facilities designed to process 15 MMcf/d of natural gas and 5,000 bbls/d of oil. The expansion and tie-in to the ICO pipeline at the Cumarebo Field is expected to be completed by July 2006. At the West Falcon, the Company plans to build a 12 kilometer gas pipeline between Los Moroches Field and the main PDVSA's pipeline to initially deliver approximately 2.7 MMcf/d of natural gas and 570 bbls/d of oil by the end of 2006.

## DRILLING AND WORKOVERS

Upon the finalization of the Empresa Mixta, it is intended that a drilling rig will be mobilized in the East Falcon Block to commence a development and exploratory drilling program. The Company is currently permitting and building locations for 11 wells at the La Vela Field to develop the shallow oil and natural gas discovery in 2005 offsetting the LV-10 well. The Company is currently permitting and building locations for 1 development well and 1

appraisal well at the Cumarebo Field, targeting proven natural gas reservoirs as well as proven, probable and possible oil reserves. In addition, the Company is currently permitting and building locations for 1 exploration well at the West Falcon Block. The capital drilling and workovers budget is currently \$28.126 million.

Continued re-processing and mapping of the 85 km 2-d seismic program acquired by VOG in 2005 has delineated several new structural prospects in the area around Cumarebo. These, along with the Corporation's existing prospect portfolio and the additional opportunities from the Samson acquisition, will be prioritized, permitted and slated for drilling in late 2006 early 2007.

The approved 2006 Empresa Mixta Capital Budget of \$40.684 million is expected to increase production for the East and West Falcon blocks from present levels of approximately 1,600 boe/d to 7,000 boe/d by the fourth quarter of 2006 on a gross basis (40% net to VOG).

### CASH FLOW FROM OPERATIONS

(\$000s except per share data)	Three months ended March 31, 2006	Three months ended March 31, 2005
Cash flow from operations	(78)	1,475
Per basic share	0.00	0.02
Net (loss) income	(1,181)	622
Per basic share	(0.02)	0.01
Working capital	5,252	12,404

### OPERATING NETBACK\*

(\$ per boe)	Three months ended March 31, 2006	Three months ended March 31, 2005
Sales price	29.41	30.83
Operating expenses	(9.07)	(7.56)
Operating netback*	20.35	23.27

\* This is a non-GAAP measure of profitability

## LIQUIDITY AND CAPITAL RESOURCES

As of March 31, 2006, PetroFalcon had 79,381,407 issued and outstanding common shares and 90,030,101 common shares on a fully diluted basis. As at the end of 2005, PetroFalcon had 77,631,407 issued and outstanding common shares and 86,527,601 common shares on a fully diluted basis.

<b>Beginning of 2006</b>	
Shares Outstanding	77,631,407
Options Outstanding/ Warrants	8,996,194
<b>Outstanding (fully diluted)</b>	<b>86,627,601</b>
Shares Issued - West Falcon Acquisition	1,750,000
Options Granted	1,660,000
Options Exercised	None
Options Cancelled	(7,500)
<b>End of March 31, 2006</b>	
Shares Outstanding	79,381,407
Options Outstanding/ Warrants	10,648,694
<b>Outstanding (fully diluted)</b>	<b>90,030,101</b>

As of March 31, 2006, PetroFalcon had \$10.5 million in cash and short term deposits and working capital of \$5.3 million. As of March 31, 2006, PetroFalcon's total current debt was \$12.1 million and total long term debt was \$4 million. At December 31, 2005, PetroFalcon had \$9.3 million in cash and short term deposits and working capital of \$10.3 million. At December 31, 2005, PetroFalcon had total current debt of \$10.1 million and total long term debt of \$8 million.

As of March 31, 2006, PetroFalcon had \$8.3 million in accounts receivable of which \$2.6 million represents an IVA (Value Added Taxes) credit incurred as a result of the Company's investments during the period. As of March 31, 2006, the Company had \$3.4 million in accounts payable of which \$53,496 represents the accrued portion of capital expenditures not yet billed.

During 2005, the Company has reached an agreement with the IFC, pursuant to which the IFC will provide up to \$36 million in loans to VOG for the development of the Corporation's oil and gas properties. During the second quarter of 2005, the IFC disbursed \$12 million from the "C" Loan. Principal repayments on the "C" Loan are due in 2011. Interests are payable semi-annually on May 15 and November 15 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 cash flow as Additional Interest so long as it does not

exceed 10% per annum of the principal amount of the "C" loan on an aggregate accumulated basis (See Section "Subsequent Events").

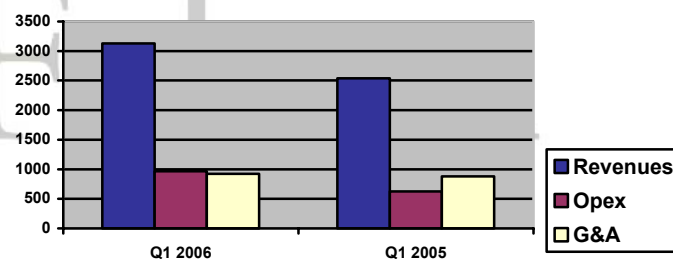
The planned growth and development activities for the next twelve months will require additional funds. Management of PetroFalcon anticipates that these funds will be obtained from cash flow from operations, lines of credit and the IFC loan facility. However, in the event that additional funds are required,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

## SUMMARY OF QUARTERLY RESULTS

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

(\$000s, except per share amounts)	2004			2005				2006
	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Revenue	1,677	2,082	2,864	2,545	2,469	3,055	3,256	3,129
Net income (loss)	(455)	193	964	622	428	1,087	(1,128)	(1,181)
Earnings (loss) per share basic and diluted	(0.01)	0.00	0.01	0.01	0.01	0.01	(0.01)	(0.02)

Increased revenue was due to higher production levels: 106,394 boe during the three months ended March 31, 2006 as compared to 82,562 boe in the three months ended March 31, 2005, and higher average oil prices of \$39.08 per bbl of oil during the three months ended March 31, 2006 as compared to \$30.83 per bbl of oil during the three months ended March 31, 2005.



## RELATED PARTY TRANSACTIONS

For the three months ended March 31, 2006 the Company paid \$210,000 (\$210,000 during the three months ended March 31, 2005) to Pacific Oil and Gas, LLC ("Pacific"), a company controlled by PetroFalcon's Chief Financial Officer, Clarence Cottman and the Company's President, William Gumma, for professional services provided to PetroFalcon.

For the three months ended March 31, 2005, the Company incurred expenses of \$11,619 (\$800,000 during the three months ended March 31, 2005) to Venezolana de Inversiones y Construcciones Clerico, C.A., an independent operating construction company controlled by the Company's Chairman of the Board and Chief Executive Officer, Juan Francisco Clerico. The charges were for construction work at the La Vela central processing facility, as well as drilling locations and road repair.

## **CRITICAL ACCOUNTING ESTIMATES**

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The Company makes assumptions in applying the following critical accounting estimates that are uncertain at the time the accounting estimate is made and may have a significant effect on the financial statements of the Company.

### **PROVED OIL AND NATURAL GAS RESERVES AND FULL COST ACCOUNTING**

The Company follows the Canadian full cost method of accounting whereby all costs related to the exploration and development of oil and natural gas reserves are initially capitalized and are depleted and depreciated using the unit-of-production method based upon proved oil and natural gas reserves as determined by independent engineers. In applying the full cost method, the Company performs a cost recovery ceiling test that places a limit on the carrying value of property and equipment. The carrying value is considered recoverable when the fair value, calculated as the sum of the undiscounted value of future net revenues from proved reserves, the lower of cost and market of unproved properties and the cost of major development properties, exceeds the carrying value.

The amounts recorded for depletion and depreciation of exploration and development costs and the ceiling test are based on estimates of proved reserves, producing rates, future oil and natural gas prices and future costs, which are all subject to measurement uncertainties and various interpretations. The Company expects that its estimates of reserves will be revised, upwards or downwards over time, based on future changes to those variables.

Reserve estimates can have a material impact on the depletion and depreciation expense and the carrying value of property and equipment. Revisions to reserves estimates could increase or decrease depletion and depreciation expense charged to net income and decrease in estimated reserves could result in a write-down of property and equipment based on the ceiling test.

### **ASSET RETIREMENT OBLIGATION**

The Company recognizes the fair value of an asset retirement obligation with a corresponding amount capitalized to property and equipment. The liability increases and accretion expense is recognized each period due to the passage of time. The capitalized portion is depleted based on the unit-of-production method.

The asset retirement obligation is based on factors including current regulations, abandonment costs, technologies, industry standards and obligations in the Company's agreements. The fair value calculation takes into account estimated timing of abandonment, inflation and credit-adjusted risk free interest rate. Changes in any of the factors and revision to any of the estimates used in calculating the obligation may result in a material impact to the carrying value of property and equipment, asset retirement obligation and depletion expense charged to net income. The Company expects that its estimates of its asset retirement obligations will be revised, upwards or downwards over time, based on future changes to the factors and estimates involved.

## **STOCK-BASED COMPENSATION**

The Company uses the fair value method of accounting for its stock-based compensation expense associated with its stock option plan. Compensation expense is based on the fair value of stock options at the grant date using the Black-Scholes option pricing model. The Black-Scholes model requires estimates for the expected volatility of the Company's stocks, a risk-free interest rate, expected dividends on the stock and expected life of the option. Changes in these estimates may result in the actual compensation expense being materially different than the compensation expense recognized; however, this expense is not subsequently adjusted for changes in these factors.

## **EMPRESA MIXTA**

The establishment of the Empresa Mixta will have a significant impact on the consolidated financial statements of the Company in future periods. However, at this time, the exact terms and conditions of the structure and management of the Empresa Mixta entity have not yet been finalized. As a result, management is unable to determine how the entity will be accounted for by the Company under Canadian GAAP. The accounting will ultimately depend on a number of different factors, including the level of control that VOG will have over the entity.

## **CONCLUSION REGARDING EFFECTIVENESS OF DISCLOSURE CONTROLS AND PROCEDURES**

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The Chief Executive Officer and Chief Financial Officer of PetroFalcon have carried out an evaluation of the effectiveness of PetroFalcon's disclosure controls and procedures for the period ended March 31, 2006. Based on the evaluation conducted, the Chief Executive Officer and Chief Financial Officer have concluded that the design and operation of PetroFalcon's disclosure controls and procedures were effective as at the end of the period ended March 31, 2006 to provide reasonable assurance that material information relating to PetroFalcon and its consolidated subsidiaries would be made known to the Chief Executive Officer and Chief Financial Officer by others within those entities in order to complete an analysis and review of the financial position and results of operations of PetroFalcon for the quarter ended March 31, 2006.

## **SUBSEQUENT EVENTS**

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On April 5, 2006, the IFC provided notice pursuant to the terms of the "C" Loan Agreement, of its intention to convert \$4 million of its outstanding loan into common shares of PetroFalcon Corporation. The IFC received 2,639,651 shares of PFC at a price of CDN \$1.77 per share based on the market weighted average share price over the previous 20 trading days to the notice date. The IFC has now converted \$8 million of the original \$12 million disbursed in 2005 into common shares of PetroFalcon Corporation. With this conversion, the remaining outstanding principal due to IFC is \$4 million.

On May 5, 2006 in its Official Gazette, the National Assembly of Venezuela published the Accord which authorizes the incorporation of the Empresa Mixta and the conversion of the

operating services agreements for both the East Falcon Block and the West Falcon Block. The Accord also confirmed the 40% proposed ownership of VOG.

## **ADDITIONAL INFORMATION**

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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 by visiting [www.petrofalcon.com](http://www.petrofalcon.com).

