



Building Value in Venezuela

MANAGEMENT DISCUSSION & ANALYSIS

SECOND QUARTER 2006

August 14, 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 and six months ended June 30, 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

Except for statements of historical fact, all statements in this MD&A, including, without limitation, statements with respect to the Empresa Mixta; 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. 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.

CURRENT STATUS OF OPERATIONS OF PETROFALCON

As previously announced, PetroFalcon, through its wholly-owned subsidiary, Vinccler Oil and Gas, C.A. (“Vinccler Venezuela”) is currently negotiating with Petróleos de Venezuela, S.A. (“PDVSA”) and its affiliated entity, Corporación Venezolana del Petróleo (“CVP”), on the creation of a jointly-owned entity (the “Empresa Mixta”) that will hold all the operating rights to the West Falcon Block and the East Falcon Block. As of August 14, 2006, the negotiations have not been finalized and the Empresa Mixta, to be named Petrocumarebo, has not yet been incorporated. In addition, PetroFalcon has been advised that the two operating service agreements governing the West Falcon Block and the East Falcon Block (the “Operating Service Agreements”) are no longer in force and as such cannot govern the operations of the West Falcon Block and the East Falcon Block.

Vinccler Venezuela has agreed with PDVSA to continue operating the East Falcon Block and the West Falcon Block during a transitional period starting April 1, 2006, until the Empresa Mixta is incorporated (“Transitional Period Terms”) under the following general terms:

- Vinccler Venezuela will be reimbursed 100% by PDVSA for capital expenditures and expenses incurred related to the East and West Falcon blocks
- Vinccler Venezuela will continue delivering oil and natural gas production from the East Falcon Block and the West Falcon Block to PDVSA, which will be invoiced by the Empresa Mixta once Petrocumarebo is incorporated

However, the Transitional Period Terms do not address the allocation of revenue and, therefore, PetroFalcon, through Vinccler Venezuela, is not yet in a position to record any revenue for the quarter ended June 30, 2006.

Although Management expects that, upon completion of the conversion of the Empresa Mixta, there will be an adjustment between the parties to obtain the same economic result as if the conversion had been completed on April 1, 2006, Management has decided, in consultation with the auditors, that PetroFalcon will not be able to include the results of the Empresa Mixta operations in our consolidated financial statements unless and until the conversion to the Empresa Mixta is complete with Vinccler Venezuela holding an equity interest of 40%. For further information on the Empresa Mixta, please see “Matters Concerning the Empresa Mixta”.

RESULTS OF OPERATIONS

Please see “Current Status of Operations of PetroFalcon”.

For the three months ended June 30, 2006, average gross production from both the East Falcon Block and the West Falcon Block was 1,485 boe/d.

It is expected that oil and natural gas production will increase 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.

EAST FALCON BLOCK

For the three months ended June 30, 2006, average gross production from the East Falcon Block was 1,078 boe/d. For the comparable period ending June 30, 2005, average production was 808 boe/d.

At June 30, 2006, the East Falcon Block had 13 producing oil wells, 2 shut-in oil wells, 1 producing natural gas well, and 2 shut-in natural gas wells.



WEST FALCON BLOCK

Effective March 21, 2006, Vincler Venezuela completed the acquisition of West Falcon Hydrocarbons, S.R.L. (“West Falcon”).

For the three months ended June 30, 2006, average gross production from the West Falcon Block was 406 boe/d.

At June 30, 2006, the West Falcon Block had 16 producing oil wells, 7 shut-in oil wells, 4 producing natural gas wells and no shut-in gas wells.

ROYALTIES

Under the Transitional Period Terms, the Company did not pay any royalties during the three months ended June 30, 2006. The Company’s production was not subject to royalties for the oil and gas production delivered under the former operating service agreement (“OSA”) during the comparable period ending June 30, 2005.

OPERATING EXPENSES

(\$000s except boe amount)	Three months ended June 30, 2006	Three months ended June 30, 2005
Operating Expenses (including maintenance and transportation)	176	683
Average expense (\$ per boe)	NA	9.29

Please see “Current Status of Operations of PetroFalcon”.

PetroFalcon’s operating expenses during the three months ended June 30, 2006, consisted of indirect costs related to engineering and consultancy services for the East and West Falcon blocks. During the three months ended June 30, 2006, operating expenses were \$176,488, which represents the portion of expenses that will not be reimbursed by PDVSA under the Transitional Period Terms. Operating expenses during the previous period were incurred in accordance with the Company’s former OSAs and may not be comparable to this period’s recorded expenses. Operating expenses for the three months ended June 30, 2005 were \$683,191. For the six months ended June 30, 2006, operating expenses were \$1,140,947 as compared to \$1,307,126 in the same period ending June 30, 2005.

GENERAL AND ADMINISTRATIVE EXPENSES

(\$000s except boe amount)	Three months ended June 30, 2006	Three months ended June 30, 2005
Expenses	442	958
Average expense (\$ per boe)	NA	13.03

Please see “Current Status of Operations of PetroFalcon”.

General and administrative expenses were \$442,063 during the three months ended June 30, 2006, as compared to \$957,911 during the three months ended June 30, 2005. During the six months ended June 30, 2006, general and administrative expenses were \$1,364,571 as compared to \$1,835,405 for the same period in 2005.

PetroFalcon does not capitalize general and administrative expenses.

AMORTIZATION, DEPLETION AND ACCRETION (“AD&A”)

(\$000s except boe amount)	Three months ended June 30, 2006	Three months ended June 30, 2005
Amortization, Depletion and Accretion	83	385
Depletion Rate (\$ per boe)	NA	5.23

Please see “Current Status of Operations of PetroFalcon”.

For the three months ended June 30, 2006, AD&A was \$82,698 as compared to \$384,697 for the three months ended June 30, 2005. Note that the most recent quarter only includes depreciation, as Vinccler Venezuela cannot recognize depletion until the Empresa Mixta is incorporated. AD&A for the six months ended June 30, 2006, was \$595,386 compared to \$794,257 for the same period ending June 30, 2005.

INTEREST INCOME AND EXPENSE

At June 30, 2006, PetroFalcon had \$11.0 million in cash and short-term deposits compared to \$21.8 million at June 30, 2005. During the three months ended June 30, 2006, the Company recorded interest income in the amount of \$66,112 as compared to \$56,328 during the three months ended June 30, 2005.

PetroFalcon incurred interest expense of \$474,541 during the three months ended June 30, 2006, as compared to \$162,613 during the three months ended June 30, 2005. The increase in interest expense in the three and six months ended June 30, 2006, is detailed below:

- (i) Accrual of additional interest payable to the International Finance Corporation (“IFC”) of \$16,340 during the three months ended June 30, 2006, based on 3% of Vinccler Venezuela’s estimated earnings before interest, depreciation, amortization and exploration costs;
- (ii) Interest of \$71,133 during the three months ended June 30, 2006, or \$198,473 during the six months ended June 30, 2006, under the IFC long-term borrowing facility;
- (iii) Increased interest of \$387,065 during the three months ended June 30, 2006, paid to local banks due to higher average short-term debt of \$10 million as of June 30, 2006, versus \$6 million as of June 30, 2005. Total interest paid to local banks during the six months ended June 30, 2006, was \$697,425; and
- (iv) An additional \$236,977 of interest paid by Vinccler Venezuela for the Venezuelan Tax Assessment during the first quarter 2006.

PetroFalcon recorded a gain in exchange rate fluctuations of \$96,767 during the three months ended June 30, 2006.

STOCK-BASED COMPENSATION

During the three months ended June 30, 2006, the Company recorded \$687,149 in stock-based compensation expense as compared to \$453,000 during the three months ended June 30, 2005. The Company recorded \$1,277,149 in stock-based compensation expense for the six months ending June 30, 2006, compared to \$897,000 for the same period ending June 30, 2005. Higher stock-based compensation during the three months ended June 30, 2006, was due to a greater number of stock options outstanding during the three months ended June 30, 2006; 10,291,494 options were outstanding at June 30, 2006, as compared to 8,764,927 options outstanding at June 30, 2005.

INCOME TAXES

During the six months ended June 30, 2006, the Corporation recorded a current income tax expense of \$542,389 (\$434,149 during the six months ended June 30, 2005).

During 2005, Vinccler Venezuela 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 Vinccler Venezuela’s business purpose. The SENIAT stresses that under its income tax laws, Vinccler Venezuela 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, Vinccler Venezuela filed a discharge claim with SENIAT. During the three months ended March 31, 2006, Vinccler Venezuela received the final settlement resulting in additional income tax expense of \$542,389 for the years ended December 31, 2001 to 2004.

During the three months ended June 30, 2006, the SENIAT performed a revision to Vinccler Venezuela’s income tax expense for the fiscal year ended December 31, 2005. The revision concluded with nothing due to the SENIAT (see “Subsequent Events”).

(\$000s)	Three months ended June 30, 2006	Three months ended June 30, 2005
Consolidated Current Income Tax Expense	0	133

ANALYSIS OF CAPITAL EXPENDITURES

Please see “Current Status of Operations of PetroFalcon”.

The following table outlines the Capital Budget for the year ended December 31, 2006, and expenditures for the three and six months ended June 30, 2006.

The 2006 Revised Annual Budget represents the gross budget of the Empresa Mixta, of which Vinccler Venezuela will be responsible for 40% (See “Current Status of Operations of PetroFalcon”). The Incurred As of June 30, 2006, amount represents the total amount spent by the Company in the first six months ending June 30, 2006, with subsequent reimbursements expected from PDVSA in the third quarter of 2006 under the Transitional Period Terms. Additional financing will be needed to meet the following budget requirements, but funding may not be available on terms and conditions acceptable to the Company.

(\$000s)	2006 Budget	Revised 2006 Budget	Actual Spending Q1 2006	Incurred As of June 30, 2006
Drilling and Workovers				
- La Vela	12,500	20,261	115	139
- Cumarebo	5,500	5,332	12	30
- West Falcon Block		2,533		
- Total Drilling and Workovers	18,000	28,126	127	169
Processing Facilities and Infrastructure				
- La Vela	3,100	4,948	692	692
- Cumarebo	4,200	4,310	235	1,983
- West Falcon Block		3,300		
- Total Central Processing Facilities	7,300	12,558	927	2,675
Total Capital Budget	25,300	40,684	1,054	2,844

Despite the transitional uncertainty, Vinccler Venezuela has initiated a comprehensive development and exploitation program designed to increase natural gas and oil reserves, production, earnings, cash flow and net asset value. Please see “Matters Concerning the Empresa Mixta”.

PROCESSING FACILITIES AND INFRASTRUCTURE

During the three months ended June 30, 2006, the Company continued the construction of the second phase of facilities at the La Vela Field. These facilities will include compression and dew point processing equipment allowing Vinccler Venezuela 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, Vinccler Venezuela began 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 was completed in early August, resulting in initial additional hydrocarbons production from the Cumarebo field of 10 MMcf/d of gas and 285 bbls/d of associated oil. At the West Falcon Block, the Empresa Mixta plans to build a 12 kilometer gas pipeline between Los Moroches Field and PDVSA’s main 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 finalization of the Empresa Mixta, Petrocumarebo intends to mobilize a drilling rig 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, Vinccler Venezuela is currently permitting and building locations for 1 exploration well at the West Falcon Block.

Continued re-processing and mapping of the 85 km 2-D seismic program acquired by Vinccler Venezuela in 2005 has delineated several new structural prospects in the area around Cumarebo. These prospects, along with the Corporation’s existing prospect portfolio, will be prioritized, permitted and slated for drilling in late 2006 or early 2007.

The completion of the 2006 Empresa Mixta Capital Budget of \$40.7 million is estimated to significantly increase production for the East and West Falcon blocks above the present gross level of approximately 3,200 boe/d (40% net to Vinccler Venezuela). Please see “Matters Concerning the Empresa Mixta”.

Please see “Current Status of Operations of PetroFalcon”.

CASH FLOW FROM OPERATIONS*

(\$000s except per share data)	Three months ended June 30, 2006	Three months ended June 30, 2005
Cash flow from operations	(3,475)	1,266
Per basic share	(0.04)	0.02
Net (loss) income	(1,700)	428
Per basic share	(0.02)	0.01
Working capital	8,652	14,775

* This is a non-GAAP measure of profitability

OPERATING NETBACK*

(\$ per boe)	Three months ended June 30, 2006	Three months ended June 30, 2005
Sales price	NA	33.59
Operating expenses	NA	(9.29)
Operating netback*	NA	24.30

* This is a non-GAAP measure of profitability

During the three months ended June 30, 2006, PetroFalcon did not recognize revenue from the Empresa Mixta and therefore did not have operating expenses associated with revenues.

LIQUIDITY AND CAPITAL RESOURCES

As of June 30, 2006, PetroFalcon had 82,150,758 issued and outstanding common shares and 92,542,252 common shares on a fully diluted basis. As at the end of 2005, PetroFalcon had 77,631,407 issued and outstanding common shares and 86,627,601 common shares on a fully diluted basis.

As of June 30, 2006, PetroFalcon had \$11.0 million in cash and short-term deposits and working capital of \$8.7 million. As of June 30, 2006, PetroFalcon's total current debt was \$10.1 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.

At June 30, 2006, PetroFalcon had \$7.3 million in accounts receivable (compared to \$14.4 million at December 31, 2005), of which \$2 million represents credit for IVA (Value Added Taxes) incurred as a result of the Corporation's expenditures as of June 30, 2006; \$3.8 million represents the reimbursements for expenses and capital investments incurred by Vinccler Venezuela during the Transitional Period for the Empresa Mixta's operations during the three months ended June 30, 2006. Vinccler Venezuela will continue to pay 100% of the operating expenses and capital investments for the East and West Falcon blocks, with subsequent reimbursements expected from PDVSA. As of June 30, 2006, the Company had \$2.4 million in accounts payable compared to \$4.8 million at December 31, 2005.

During 2005, the Company reached an agreement with the IFC, pursuant to which the IFC will provide up to \$36 million in loans to Vinccler Venezuela 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. Interest is 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 Vinccler Venezuela's cash flow as Additional Interest as long as it does not exceed 10% per annum of the principal amount of the "C" loan on an aggregate accumulated basis.

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 an average 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.

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 dividends, lines of credit and, potentially, 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. The Company cannot be certain that capital will be available when needed.

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	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Revenue	2,082	2,864	2,545	2,469	3,055	3,256	3,129	0
Net income (loss)	193	964	622	428	1,087	(1,128)	(1,181)	(1,700)
Earnings (loss) per share basic and diluted	0.00	0.01	0.01	0.01	0.01	(0.01)	(0.02)	(0.02)

Under the Transitional Period Terms, PetroFalcon did not recognize revenue from the Empresa Mixta in the three months ending June 30, 2006, and recorded a net loss of \$1.7 million.

RELATED PARTY TRANSACTIONS

Pacific Oil and Gas, LLC and Venezolana de Inversiones y Construcciones Clerico, C.A. are controlled by officers of PetroFalcon. For the three months ended June 30, 2006, the Corporation paid Pacific Oil and Gas, LLC, controlled by PetroFalcon's Chief Financial Officer, Clarence Cottman and the Corporation's President, William Gumma, \$210,000 for professional services (\$210,000 for the three months ended June 30, 2005). For the six months ended June 30, 2006, the Corporation paid to Pacific Oil and Gas, LLC, \$420,000 (\$420,000 for the six months ended June 30, 2005).

PetroFalcon also receives construction services provided by Venezolana de Inversiones y Construcciones Clerico, C.A., an independent operating construction company controlled by the Corporation's Chairman of the Board and Chief Executive Officer, Juan Francisco Clerico. During the three months ended June 30, 2006, PetroFalcon did not receive services from Venezolana de Inversiones y Construcciones Clerico, C.A. (\$378,994 during the three months ended June 30, 2005). During the six months ended June 30, 2006, the Corporation was invoiced \$11,669 for construction services (\$1.18 million for the six months ended June 30, 2005).

These related party transactions are in the normal course of operations and are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

MATTERS CONCERNING THE EMPRESA MIXTA

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION

Except for statements of historical fact, all statements in this MD&A relating to the Empresa Mixta, including, without limitation, statements with respect to incorporation, structure, terms of ownership, 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 finalizing the terms of the Empresa Mixta, 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, information provided by PDVSA and CVP and expected future developments, as well as other factors we believe are appropriate in the circumstances. The foregoing factors are not exhaustive. 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 section is expressly qualified by this cautionary statement.

MATTERS CONCERNING THE EMPRESA MIXTA – GENERAL

On March 31, 2006, Vinccler Venezuela reached an initial agreement with the Venezuelan government with respect to its oil and natural gas rights in Venezuela. Vinccler Venezuela signed a Memorandum of Understanding (“MOU”) with PDVSA and its affiliated entity, CVP, to create the Empresa Mixta, which will hold all operating rights to the West Falcon Block and the East Falcon Block. It is currently intended that the name of the Empresa Mixta will be Petrocumarebo (recently changed from the previous Petromiranda). The transition to the Empresa Mixta converts Vinccler Venezuela’s interests in the East Falcon Block and West Falcon Block, covering more than 800,000 acres in northwestern Venezuela, into a single development entity, and it gives the Empresa Mixta the exclusive right to produce and sell oil and associated natural gas from the two blocks.

On May 5, 2006, the National Assembly of Venezuela published in its Official Gazette the Accord that 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 Vinccler Venezuela such that the ownership structure of the Empresa Mixta will be 40% held by Vinccler Venezuela and 60% held by CVP.

The contract relating to the Empresa Mixta has not yet been executed, and the final agreements have not yet been fully negotiated between the parties. However, the MOU established the following general structure for the Empresa Mixta:

- the Empresa Mixta will pay a royalty at the rate of 33.3% on 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
- Vinccler Venezuela will receive dividends from the Empresa Mixta in US dollars on a quarterly basis derived from its 40% participation
- The effective date of the Empresa Mixta is April 1, 2006
- Vinccler Venezuela will be responsible for 40% of the Empresa Mixta’s approved 2006 capital expenditure budget of \$40.7 million and 40% of the operating expenses

There can be no assurance that the final incorporation and terms of the Empresa Mixta will be structured in accordance with the MOU or that the Empresa Mixta will be incorporated at all. Vinccler Venezuela cannot recognize its pro rata share of revenues and expenses of the Empresa Mixta until such time as the Empresa Mixta is incorporated and Vinccler Venezuela owns 40% of it. Currently, this incorporation is expected to take place in the third quarter of 2006. Therefore, pursuant to the Transition Period Terms, Vinccler Venezuela will continue to pay 100% of the operating expenses for the East Falcon Block and the West Falcon Block, with subsequent reimbursements expected from PDVSA.

For purposes of information only, in the event that the Corporation is successful in its negotiations with PDVSA and the Empresa Mixta is incorporated and structured in accordance with the terms of the MOU, the following is a comparison of the Empresa Mixta terms and the former OSA terms:

	Current Empresa Mixta	East Falcon OSA
PFC Equity Stake	40%	100%
Contract Expiration	2026	2015
Oil Price Received (% of WTI)	90-95% (est.)	66.67%*
Gas Price Received (\$/mcf)	\$1.50 (est.)	\$1.33
Royalty	33.3%	0%
Income Tax Rate	50%	50%

*Note that the oil price received would have decreased dramatically under the former OSAs after the recovery of capital and interest.

For the purposes of this MD&A, the Company is providing select financial information regarding the Empresa Mixta for the second quarter of 2006 as if the Empresa Mixta had already been incorporated. This is not meant in any way to replace the Company's official financial results, but is provided solely for informational purposes so that readers may compare this quarter's operational performance with previous quarters.

This select pro forma financial information is not necessarily indicative of the financial position that would have resulted had the Empresa Mixta actually been incorporated as of April 1, 2006, in accordance with the terms of the MOU.

PRO FORMA STATEMENT OF OPERATIONS

Management prepared the following estimated summarized pro forma statement of operations for the three months ended June 30, 2006, of which Vinccler Venezuela will hold a 40% interest.

(\$)	Three months ended June 30, 2006	
	Petrocumarebo Pro Forma	PetroFalcon Share (40%)
Revenues	6,560,873	2,624,349
Operating Expenses	1,230,694	492,278
Gen. & Admin. Expenses	458,303	183,321
Royalties	2,186,182	874,473
Amort., Depletion and Accret.	514,739	205,895
Income Before Tax	2,170,955	868,382

EMPRESA MIXTA REVENUES

For the three months ended June 30, 2006, the Company recorded no revenues due to the delay in incorporating the Empresa Mixta. However, despite the legal delay, operations continued at the East and West Falcon blocks. The following estimates are provided for comparison purposes only.

Petrocumarebo's estimated gross revenues from the East and West Falcon blocks for the three months ended June 30, 2006, are expected to be in the amount of \$6.6 million, compared to Vinccler Venezuela's \$2.3 million in revenues for the three months ended June 30, 2005. The average price received by Petrocumarebo for the three months ended June 30, 2006, is estimated at \$66.30 per bbl of oil and \$1.50 per mcf of natural gas. The combined average price received for the three months ended June 30, 2006, is estimated at \$48.55 per boe. For the three months ended June 30, 2005, the average price received by Vinccler Venezuela was \$33.59 per barrel of oil. The gas produced during the comparable time period ending June 30, 2005 was used only for operations, including fuel and gas lift.

	Three months ended June 30, 2006*	Three months ended June 30, 2005
Daily production / sales volumes		
Oil - bbl/d	1,025	808
Natural gas - mcf/d	2,760	-
Total - boe/d	1,485	808
Product pricing (\$)		
Oil - per bbl	66.30	33.59
Natural gas - per mcf	1.50	-
Revenue per boe	48.55	33.59
Total Revenues (\$000s)	6,561	2,469

*Estimated gross numbers for Petrocumarebo. Assumes an average 2006 Q2 WTI oil price of \$71/bbl, of which East Falcon oil is expected to receive 95% and West Falcon oil is expected to receive 90%. Vinccler Venezuela will have a 40% ownership stake in Petrocumarebo.

The estimated increase in revenue during the three months ended June 30, 2006, occurred due to higher levels of production on a boe basis, 135,102 boe for the three months ended June 30, 2006, as compared to 73,528 boe for the three months ended June 30, 2005, as well as higher average estimated oil prices, \$66.30 per bbl of oil for the three months ended June 30, 2006, as compared to \$33.59 per bbl of oil for the three months ended June 30, 2005.

Oil and natural gas production is delivered to PDVSA, and it is intended that once incorporated, the Empresa Mixta will receive payment for the production during the three months ended June 30, 2006, as outlined in the MOU.

Payment from PDVSA under the OSAs was 75% in US Dollars and 25% in Bolivars. Payment from PDVSA to the Empresa Mixta is expected to be 100% in US Dollars. Dividends from the Empresa Mixta to Vinccler Venezuela are also expected to be 100% in US Dollars.

CRITICAL ACCOUNTING ESTIMATES

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

Petrocumarebo's Incorporation Act Project (the "Incorporation Act") in the MOU indicates that both parties agree to contractually share the continuing power to determine its strategic operating, investing and financing policies. When accounting for Vinccler Venezuela's interests in Petrocumarebo, it is essential that the Corporation reflects the substance and underlying economic reality of its interest. Management believes, based on the terms established in the Incorporation Act, that the substance and underlying economic reality of the interest in Petrocumarebo would be best reflected in the financial statements by reporting its interest in the assets, liabilities, revenue and expenses of Petrocumarebo using the proportional consolidation method once Petrocumarebo is officially incorporated.

CONCLUSION REGARDING EFFECTIVENESS OF DISCLOSURE CONTROLS AND PROCEDURES

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 June 30, 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 June 30, 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 June 30, 2006.

SUBSEQUENT EVENTS

On July 26, 2006, Vinccler Venezuela received a resolution from the SENIAT with respect to the review of the income tax return for the years ended December 31, 2005, resulting in nothing due to the SENIAT. The resolution includes SENIAT's objections to items affecting Vinccler Venezuela's outstanding tax credits for \$50,000, which will continue through a revision process.

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 or by visiting www.petrofalcon.com.