

# Management's Discussion and Analysis - Second Quarter 2004

## August 9, 2004

The following discussion and analysis as provided by the management of PetroFalcon Corporation (the "Company") should be read in conjunction with the Company's interim consolidated financial statements for the three months ending June 30, 2004 and the audit consolidated financial statements for the year 2003. The discussion in the MD&A focuses on the operating and financial results for those periods. Estimates and forward-looking information are based on assumptions of future events and actual results may vary from these estimates.

MD&A contains the term "cash flow from operations", which should not be considered an alternative to, or more meaningful than, cash flow from operating activities as determined in accordance with Canadian Generally Accepted Accounting Principles (GAAP) as an indicator of the Company's performance. PetroFalcon's determination of "cash flow from operations" may not be comparable to that reported by other companies. The Company 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, unless otherwise noted.

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) unless otherwise stated.

### **Production and Revenue**

For the three months ended June 30, 2004, average production was 766 bbls/d of oil. There was no natural gas produced for the three months ended June 30, 2004. At the end of the second quarter 2004, PetroFalcon had 4 producing oil wells, 8 shut-in gas wells and 4 shut-in oil wells.

PetroFalcon anticipates an increase in production volumes of oil during 2004. The incremental production is dependent on the capital drilling and recompletion program on existing properties. The Company expects a substantial increase in natural gas production in early 2005 from the La Vela and Cumarebo fields.

PetroFalcon recorded revenue in the amount of \$ 1.68 million for the three months

ended June 30, 2004 compared to \$ 0.55 million for the three months ended June 30, 2003. The average price received was \$24.06 per barrel of oil. In the second quarter 2003, the Company's average price for oil was \$18.12 per barrel and the Company had no natural gas production. The Company currently has no hedging contracts and benefited from the strength in oil prices during the quarter. Oil and natural gas production are delivered to Petroleos de Venezuela (PDVSA) and Company receives payment in accordance with its operating service agreement with PDVSA. In its 2004 forecast, PetroFalcon uses commodity prices of \$30.00 per barrel WTI for oil (\$18.30 net to the Company) and \$0.90 per mcf for natural gas. The oil price forecast is a conservative estimate based on actual prices to date and the forward price of light sweet crude oil. The gas price is the contracted price under the Company's contract with PDVSA.

All of the Company's revenues are received in US Dollars.

## Royalties

PetroFalcon's oil and gas production is not subject to any royalties.

## Operating Costs

(\$000s except boe amount)	Second Quarter 2004	Second Quarter 2003
Operating	538	319
Average cost (\$ per boe)	7.72	8.62

On a per unit basis, costs are expected to remain reasonably consistent for the remainder 2004.

## Interest Income and Expense

At June 30, 2004 PetroFalcon had \$26.2 million in cash and short-term deposits compared to \$27.3 million at March 31, 2004. Interest income increased from \$20,973 in the second quarter 2003 to \$120,814 in the second quarter 2004. The increase is due to the receipt of proceeds for the equity issue that increased the cash balance.

In the second quarter 2004, PetroFalcon incurred interest expense of \$.074 million versus \$.150 million in the second quarter 2003. Interest expense is expected to continue declining in 2004 due to lower debt levels.

The Company recorded an exchange loss of \$.6 million on the conversion of Canadian dollars to US dollars. The Company expects to record exchange and bond sale gains in 2004 due to currency controls in Venezuela.

### **General and Administrative Costs**

(\$000s except boe amount)	Second Quarter 2004	Second Quarter 2003
Expenses	569	629
Average cost (\$ per boe)	8.16	17.00

General and administrative costs decreased to \$.569 million in the second quarter from \$ .629 million in the second quarter 2003. Decreased general and administrative costs are due to the absence of additional expenses incurred to complete the Reverse Takeover in the second quarter of 2003

PetroFalcon does not capitalize general and administrative costs.

### **Depletion, Depreciation, and Amortization (DD&A)**

(\$000s except boe amount)	Second Quarter 2004	Second Quarter 2003
Depletion, Depreciation and Accretion	295	173
Depletion rate (\$ per boe)	4.23	4.68

The DD&A expense per unit is expected to remain relatively constant during 2004.

## Income Taxes

(\$000s)	Second Quarter 2004	Second Quarter 2003
Tax expense	0	0

The Company had a loss in the second quarter of 2003 and did not pay income tax in the second quarter 2004 because of a carry forward tax loss and because the gains on financing transaction are not taxable under the current taxation environment in Venezuela.

The Company's taxability in 2004 will depend on a number of factors including the extent of operating expenditures, interest expense, general and administrative costs, and incremental income associated with new production and oil prices.

## Capital Budget 2004

PetroFalcon anticipates a base capital budget of \$28.75 million in 2004.

(\$000s)	2004	2003
Venezuelan development expense		
- Drilling	5,500	787
- Workovers	3,500	594
- Facilities	10,300	1,800
- Pipelines	7,500	500
- Equipment	200	117
Venezuelan exploration expense		0
- Sidetrack	1,000	0
- Seismic	500	0
- Geochemical Study	250	0
Total	28,750	3,798

As of June 30, 2004, the Company has spent 2.5 million of its Capital Budget.

## Cash Flow from Operations and Net Earnings

(\$000s except per share data)	Second Quarter <b>2004</b>	Second Quarter <b>2003</b> <small>*restated</small>
Cash flow from operations	19	(212)
Cash flow		
Per basic share	0.00	0.00
Per diluted share	0.00	0.00
Net earnings		
Net loss	(455)	(445)
Per basic share	(0.01)	(0.01)
Per diluted share	(0.01)	(0.01)

## Operating Netback

(\$ per boe)	Second Quarter <b>2004</b>	Second Quarter <b>2003</b>
Sales price	24.06	18.12
Royalties	0	0
Operating	(7.72)	(8.62)
Operating netback	16.34	9.50

## Quarterly Information

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

(\$000s, except per share amounts)	2004		2003				2002	
	Q2	Q1	Q4	Q3	Q2	Q1	Q4	Q3
				*restated	*restated	*restated	*restated	*restated
Gross Revenue	1,677	1,373	1,314	1,053	548	328	575	568
Net earnings (loss)	(455)	1,411	558	645	(445)	(225)	(95)	(542)
Net income (loss) per share basic	(0.01)	0.03	0.01	0.01	(0.01)	(0.01)	0.00	(0.01)
Net income (loss) per share diluted	(0.01)	0.03	0.01	0.01	(0.01)	(0.01)	0.00	(0.01)

\* restated for change in accounting policy for stock based compensation and asset retirement obligation.

## **Liquidity and Capital Resources**

PetroFalcon completed a private placement of 10,240,000 Special Warrants in March 2004 at a price of CND\$2.20 per special warrant for gross proceeds of CND\$22.5 million. In March 2004, the Company received CND\$.46 million from the exercise of 455,160 warrants issued pursuant to the Special Warrant financing. PetroFalcon expects to utilize these combined proceeds, working capital and cash flow from operations to fund 2004 capital expenditures.

At June 30, 2004, PetroFalcon had 71,553,842 outstanding and issued common shares, 81,613,228 shares on a diluted basis including 3,584,386 outstanding US warrants. At the end of the first quarter 2004, PetroFalcon had 71,083,682 outstanding and issued common shares, 79,363,228 shares on a diluted basis and 4,039,546 outstanding warrants.

At March 31, 2004, PetroFalcon had \$27.3 million in cash and short term deposits and a working capital surplus of \$ 27.2 million. At March 31, 2004, total debt was \$ 2.2 million. At June 30, 2004, PetroFalcon had \$26.2 million in cash and short term deposits and a working capital surplus of \$ 25.4 million. At June 30, 2004, PetroFalcon had total debt of \$ 1.7 million.

## **Related Party Transactions**

The Company paid \$.165 million in the second quarter 2004 (\$.165 million in the second quarter 2003) to Pacific Petroleum, LLC, a company controlled by senior management, for services provided to support the Company. These charges are based on actual expenditures by Vinccler and Pacific for engineering, geological, geophysical, logistical, administrative and financial support of PetroFalcon.

## **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 our projections for 2004:

Approximate impact in 2004	Cash Flow	
	\$000s	\$/ share
<u>Natural gas</u> -		
Change of \$0.10 per mcf in average price	NM	NM
Change of 1,000 mcf day of production	328	0.004
<u>Oil</u> -		
Change of \$1.00 per barrel in WTI average	148	0.002
Change of 100 bbls/d of production	668	0.009

### **Additional Information**

Additional information regarding the Company, including the annual information form, may be found on SEDAR at [www.sedar.com](http://www.sedar.com).