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**2004**

Year ended December 31, 2004

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## **Management's Discussion & Analysis**

**Year Ended December 31, 2004 as compared to December 31, 2003**

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This Management Discussion and Analysis should be read in conjunction with Terra Energy Corp.'s ("Terra Energy" or the "Corporation") audited consolidated financial statements and corresponding notes for the years ended December 31, 2004 and December 31, 2003. This commentary is based on information available at April 8, 2005. Additional information relating to Terra Energy is available on SEDAR at [www.sedar.com](http://www.sedar.com).

For the purposes of calculating unit costs, natural gas has been converted to a barrel of oil equivalent ("BOE") using six thousand cubic feet equal to one barrel of oil unless otherwise stated. This conversion conforms to Canadian Securities Regulators National Instrument 51-101 – Standards of Disclosure for Oil and Gas Activities. BOE's are a very approximate comparative measure that, in some cases, could mislead particularly if used in isolation.

Certain measures in this MD&A do not have any standardized meaning as prescribed by Canadian generally accepted accounting principles ("Canadian GAAP") such as cash flow, cash flow per share - basic, cash flow from operations, and netback from operations. Therefore, they are considered non-GAAP measures and may not be comparable to similar information presented by other issuers. These measures have been described and presented in order to provide shareholders and potential investors with additional information regarding the Corporation's liquidity and its ability to generate funds to finance its operations. Management's use of these measures has been disclosed further in this MD&A as they are discussed and presented.

### **Corporate History**

Terra Energy is a publicly traded corporation, amalgamated under the Business Corporations Act of Alberta, and formed as a result of the amalgamation of Terra Energy Corp., Terrapet Energy Corp., and Rhodes Resources Corp. on January 30, 2004. This Management Discussion and Analysis along with the associated financial statements referenced above include the accounts of the Corporation and its wholly-owned subsidiary Constar Resources Ltd. and Terra Energy, a general partnership between Terra Energy Corp. and Constar Resources Ltd. The comparative information is for Terrapet Energy Corp. (consolidated).

The Corporation's principal business is the exploration, development and production of petroleum and natural gas in Western Canada.

**Highlights**

| <b>Operations</b>                          | <b>2003</b>  | <b>2004</b>  | <b>% Growth</b> |
|--------------------------------------------|--------------|--------------|-----------------|
| <i>Proved Reserves (boe)</i>               | 2,287,617    | 6,334,583    | 176.9%          |
| <i>Proved Plus Probable Reserves (boe)</i> | 3,287,550    | 8,402,067    | 155.6%          |
| <i>Reserve Value (P+P PV 10%)</i>          | \$37,411,200 | \$97,148,500 | 159.7%          |
| <i>Net Asset Value Per Share (Diluted)</i> | \$1.36       | \$1.72       | 26.5%           |
| <i>Average Daily Production</i>            | 891          | 1,096        | 23.0%           |
| <i>Exit Production (BOE/D)</i>             | 902          | 2,059        | 128.3%          |
| <i>Undeveloped Land (Net Acres)</i>        | 8,423        | 76,317       | 806.1%          |

| <b>Financial</b>                  | <b>2003</b>  | <b>2004</b>  | <b>% Growth</b> |
|-----------------------------------|--------------|--------------|-----------------|
| <i>Revenue</i>                    | \$12,114,261 | \$16,470,399 | 36.0%           |
| <i>Cashflow From Operations</i>   | \$3,406,633  | \$4,886,218  | 43.4%           |
| <i>Cashflow Per Share - basic</i> | \$0.18       | \$0.17       | (5.5)%          |
| <i>Revenue per BOE</i>            | \$37.25      | \$41.06      | 10.2%           |
| <i>Operating Netback per BOE</i>  | \$17.98      | \$19.78      | 10.0%           |
| <i>Cashflow per BOE</i>           | \$10.47      | \$12.18      | 16.4%           |
| <i>Share Capital</i>              | \$3,429,753  | \$20,780,818 | 505.9%          |
| <i>Capital Expenditures</i>       | \$2,202,642  | \$52,639,135 | 2289.8%         |

## **2004 Operations**

Since the amalgamation on January 30, 2004, the Corporation focused its efforts on carrying out the 2004 operations program proving up reserves and enhancing production. The 2004 program included both tie-in projects and drilling. A significant part of the program was focused on the Boudreau and Sextet areas of British Columbia and Dimsdale in Northern Alberta.

### **Boudreau, BC**

In Boudreau, one formerly abandoned well (11-18-84-20W6M) and two formerly suspended wells (10-14 and 01-23-84-21W6M) were re-entered and completed. The 01-23 well was a Belloy (oil/solution gas) recompletion, and the 11-18 and 10-14 wells were Baldonnel gas recompletions. The 06-13-84-21W6M suspended well was reactivated as a Belloy (oil/solution gas) well. In addition to these operations, Terra Energy acquired the pipeline infrastructure with a view towards lowering long term operating costs.

The successful recompletions and drilling results necessitated the construction of a multi-well oil battery to handle the new production. The Battery consists of 3-phase inlet separation, dehydration and compression of the natural gas, and water disposal facilities. The oil is currently trucked to a third party facility, however future plans are to upgrade the Terra operated West Stoddart Oil Facility to treat and ship the oil and thus further reduce operating costs. The Boudreau construction was substantially completed at the end of the third quarter.

### **Sextet, BC**

In Sextet, the Corporation completed an acquisition of suspended wells and pipeline from an industry partner. Three Sextet wells were tested in the 4<sup>th</sup> quarter of 2004 and resulted in each well flowing at rates greater than two mmcf/day. The wells were put on production at the end of Q1 2005 and are currently producing at approximately 500 boe/d.

### **Godin, BC**

In the Godin area of Northern Alberta, the leases for two new wells and a third re-entry well were constructed but due to winter access only conditions and the availability of a rig, the project will be delayed until the 4<sup>th</sup> quarter of 2005. The existing well that will be re-entered was previously tested at over 1.0 mmcf/d of gas.

### **Bow Island, AB**

Producing properties were acquired in the Bow Island area of South East Alberta. During the year two shallow exploration oil targets were drilled but the zones would not deliver an economic amount of oil to justify casing, completing and tie-in, hence the wells were abandoned. Subsequent to the year end a 3<sup>rd</sup> well was drilled and cased as a potential oil well with several potential up hole shallow gas zones which could lead to several follow up locations being drilled.

### **Dimsdale, AB**

An exploration well was drilled and completed in the Dimsdale area in the 4<sup>th</sup> quarter. The well was completed as a flowing oil well and further delineation drilling is required to determine the extent of the prospect. Terra has approximately 4500 acres of on trend undeveloped land in this play which may yield substantial upside for Terra.

### **Fort St. John Acquisition**

On December 31, 2004, Terra Energy closed a strategic acquisition in our core area of Fort St. John, BC. The acquisition solidified our position in north east BC and provided significant drilling locations and opportunities for 2005. The acquisition included approximately 800 boe/d of production, the majority of which is sweet natural gas. Terra Energy is planning to spend the majority of our 2005 CAPEX budget focusing on developing and exploiting reserves and production in the Fort St. John area.

### Annual Comparative Summary

| Period Ended                            | Year ended December 31, 2004 | Year ended December 31, 2003 | Year ended December 31, 2002 |
|-----------------------------------------|------------------------------|------------------------------|------------------------------|
| Revenues                                | \$16,470,399                 | \$12,114,261                 | \$5,706,466                  |
| Cash flow from operations               | \$4,886,218                  | \$3,406,633                  | \$1,562,797                  |
| Per Share - basic                       | \$0.17                       | \$0.18                       | \$0.08                       |
| Income                                  | \$1,301,881                  | \$800,454                    | \$318,110                    |
| Per share - basic                       | \$0.05                       | \$0.04                       | \$0.01                       |
| Total Assets                            | \$70,563,864                 | \$15,623,945                 | \$14,452,556                 |
| Cash dividends declared on common share | \$0.04                       | \$0.192                      | \$0.006                      |

The Corporation earned higher revenues as a result of increased production and improved commodity prices as compared to 2003. The full effect of higher commodity prices was tempered by the Corporation's forward contractual arrangements. The increased total assets are due to continued growth through strategic acquisitions.

All dividends were declared by Terrapet Energy Corp. to prior to the amalgamation with Rhodes Resources Corp. and Terra Energy Corp.

### 2004 Production

The average daily production rate for the years ended December 31, 2004 is set out below, and expressed in barrel of oil equivalents.

| Period Ended        | Year ended December 31, 2004 |             | Year ended December 31, 2003 |             | Percent Growth |             |
|---------------------|------------------------------|-------------|------------------------------|-------------|----------------|-------------|
|                     | <i>Average</i>               | <i>Exit</i> | <i>Average</i>               | <i>Exit</i> | <i>Average</i> | <i>Exit</i> |
| Oil (bbl/d)         | 333                          | 585         | 251                          | 243         | 33%            | 140%        |
| Natural Gas (mcf/d) | 4,314                        | 8,562       | 3,498                        | 3,582       | 23%            | 139%        |
| Liquids (bbl/d)     | 44                           | 47          | 57                           | 49          | (23%)          | (4%)        |
| Total (boe/d)       | 1,096                        | 2,059       | 891                          | 889         | 23%            | 132%        |

The majority of Corporation's drilling and acquisition activity was focused in the fourth quarter of 2004. Due to adverse weather, poor road conditions and a lack of available drilling and completion crews in Q4 2004, many of the projects originally scheduled for Q4 2004 were completed in Q1 – 2005. The reserves associated with many of the projects were booked at year end, but the Corporation was unable to benefit from the increased production until Q1 – 2005.

The Corporation exit production for 2004 was 2,059 barrels equivalent per day, up 131% from 2003. The increase of production was due to the acquisition of approximately 800 boe/d in our core area of Fort St. John at year end. The 2,059 barrels equivalent per day of production did not include several projects which were waiting to be tied in (i.e. – Sextet which was tied in Q1 –

2005 and is currently producing approximately 500 boe/d) but were unable to be brought on stream in 2004 due to issues with weather, road conditions and lack of available drilling crews.

**Results of Operations**

| Period Ended                                   | Year ended December 31, 2004 | Year ended December 31, 2003 | Year ended December 31, 2004 | Year ended December 31, 2003 | Percent Growth |
|------------------------------------------------|------------------------------|------------------------------|------------------------------|------------------------------|----------------|
|                                                |                              |                              | <b>(\$ / BOE)</b>            | <b>(\$ / BOE)</b>            |                |
| Revenues                                       | \$16,470,399                 | \$12,114,261                 | \$41.06                      | \$37.26                      | 36.0%          |
| Royalties                                      | \$3,047,851                  | \$2,601,836                  | \$7.60                       | \$7.99                       | 17.1%          |
| Production Expenses                            | \$5,489,997                  | \$3,658,864                  | \$13.68                      | \$11.25                      | 50.0%          |
| General & administrative and interest expenses | \$3,039,244                  | \$2,718,385                  | \$7.58                       | \$8.35                       | 11.8%          |
| Other income                                   | -                            | \$308,039                    | \$0.00                       | \$0.95                       | N/A            |
| Non-cash expenses                              | \$4,702,012                  | \$2,127,000                  | \$11.72                      | \$6.53                       | 121%           |
| Income before income taxes                     | \$191,295                    | \$1,316,233                  | \$0.48                       | \$4.04                       | -85.5%         |
| Income tax expense (recovery)                  | (\$1,110,586)                | 515,779                      | (\$2.77)                     | \$1.58                       | -315.6%        |
| Net Income                                     | \$1,301,881                  | \$800,454                    | \$3.25                       | \$2.46                       | 62.6%          |

The Corporation earned higher revenues as a result of increased production and improved commodity prices as compared to 2003. The full effect of higher commodity prices were tempered by the Corporation's forward contractual arrangements. As at December 31, 2004 most of these contracts had expired which will allow the Corporation to take advantage of the current high commodity prices.

Production expenses per BOE were as follows:

| Period Ended        | Year ended December 31, 2004 | Year ended December 31, 2003 | Year ended December 31, 2004 | Year ended December 31, 2003 | Percent Change    |
|---------------------|------------------------------|------------------------------|------------------------------|------------------------------|-------------------|
|                     |                              |                              | <b>(\$ / BOE)</b>            | <b>(\$ / BOE)</b>            | <b>(\$ / BOE)</b> |
| Production Expenses | \$5,489,997                  | \$3,658,864                  | \$13.68                      | \$11.25                      | 21.6%             |

The increased production costs per BOE during the year are primarily due to one time costs associated with workovers being performed on recently acquired producing properties. With the completion of the production optimization activities and a significant increase in production, it is anticipated that production costs per BOE will decrease in 2005. With the acquisition at year end in the Corporations core area of Fort St. John, the increased low cost production is expected to reduce production expenses per barrel equivalent to approximately \$10.00.

Net revenues per BOE were as follows:

| Period Ended        | Year ended December 31, 2004 | Year ended December 31, 2003 | Year ended December 31, 2004 | Year ended December 31, 2003 | Percent Change |
|---------------------|------------------------------|------------------------------|------------------------------|------------------------------|----------------|
|                     |                              |                              | (\$ / BOE)                   | (\$ / BOE)                   | (\$ / BOE)     |
| Gross Revenue       | \$16,470,399                 | \$12,114,261                 | \$41.06                      | \$37.26                      | 10%            |
| Royalties           | \$3,047,851                  | \$2,601,836                  | \$7.60                       | \$7.99                       | -5%            |
| Production Expenses | \$5,489,997                  | \$3,658,864                  | \$13.68                      | \$11.25                      | 22%            |
| Net Revenue         | \$7,932,551                  | \$5,853,561                  | \$19.78                      | \$17.98                      | 10%            |

Higher net revenues per BOE for the year ending December 31, 2004 are largely due to improved commodity prices and an increase in production. In 2004, the Corporation had a number of hedges which reduced our gross revenue per barrel equivalent. Effective December 31, 2004, all but three hedges representing 200 bbls/d of crude oil and 1.0 mmcf/d of natural gas remains. The rest of the Corporation's production will be sold into the spot market.

With the acquisition in the Corporation's core area of Fort St. John, production expenses per boe are expected to significantly decrease, further increasing the expected net revenue of the Corporation.

#### **Summary of Quarterly Results**

| Period Ended                 | Period ended March 31, 2004 | Period ended June 30, 2004 | Period ended September 30, 2004 | Period ended December 31, 2004 |
|------------------------------|-----------------------------|----------------------------|---------------------------------|--------------------------------|
| Total Revenues               | \$3,762,921                 | \$4,723,264                | \$3,941,307                     | \$4,042,907                    |
| Net Income (loss)            | \$351,540                   | 395,301                    | (\$264,828)                     | 819,868                        |
| Earnings per share - basic   | \$0.01                      | \$0.02                     | (\$0.01)                        | \$0.03                         |
| Earnings per share - diluted | \$0.01                      | \$0.02                     | (\$0.01)                        | \$0.03                         |

| Period Ended                    | Period ended<br>March 31, 2003 | Period ended<br>June 30, 2003 | Period ended<br>September 30,<br>2003 | Period ended<br>December 31,<br>2003 |
|---------------------------------|--------------------------------|-------------------------------|---------------------------------------|--------------------------------------|
| Total Revenues                  | \$3,000,664                    | \$2,669,156                   | \$3,306,387                           | \$3,138,054                          |
| Net Income (loss)               | \$429,436                      | 337,741                       | \$218,344                             | (\$185,067)                          |
| Earnings per share - basic      | \$0.01                         | \$0.02                        | \$0.01                                | (\$0.01)                             |
| Earnings per share -<br>diluted | \$0.01                         | \$0.02                        | \$0.01                                | (\$0.01)                             |

The Corporation earned higher revenues as a result of increased production and improved commodity prices as compared to 2003. There were increased production costs in the later part of 2004 as a result of one-time workovers. There was also increased general and administrative costs as a result staff additions to manage the Corporation's increased production capabilities.

#### **General and Administrative Expenses**

| Period Ended                            | Year ended<br>December<br>31, 2004 | Year ended<br>December<br>31, 2003 | Year ended<br>December 31,<br>2004 | Year ended<br>December 31,<br>2003 | Percent<br>Change |
|-----------------------------------------|------------------------------------|------------------------------------|------------------------------------|------------------------------------|-------------------|
|                                         |                                    |                                    | <b>(\$ / BOE)</b>                  | <b>(\$ / BOE)</b>                  | <b>(\$ / BOE)</b> |
| General &<br>Administrative<br>Expenses | \$2,753,486                        | \$2,183,813                        | \$6.87                             | \$6.71                             | 2%                |

The increase in general & administrative expenses in 2004 is attributable to an increase in technical personnel to manage the Corporation's increased production. Cost in the second half of 2004 increased significantly compared to the first half as the Corporation began to increase staff levels and insurance costs in anticipation of the growth the Corporation is currently experiencing. As a result of many of the Corporation's 2004 drilling projects not coming on stream until Q1-2005, the general & administrative costs were unable to be spread over a larger production base. As a result of the strategic acquisition completed on December 31, 2004 and successful drilling, production will increase in 2005 resulting in a reduction of general & administrative expenses on a per barrel equivalent basis. The increase in production as a result of the acquisition and increased production through development and exploration drilling is expected to decrease general & administrative expense per barrel equivalent to \$2.50.

#### **Interest Expense**

| Period Ended      | Year ended<br>December<br>31, 2004 | Year ended<br>December 31,<br>2003 | Year ended<br>December 31,<br>2004 | Year ended<br>December<br>31, 2003 | Percent<br>Change |
|-------------------|------------------------------------|------------------------------------|------------------------------------|------------------------------------|-------------------|
|                   |                                    |                                    | <b>(\$ / BOE)</b>                  | <b>(\$ / BOE)</b>                  | <b>(\$ / BOE)</b> |
| Interest Expenses | 285,758                            | 534,572                            | \$0.71                             | \$1.64                             | -57%              |

Interest expense both on an aggregate and per barrel equivalent decreased by 57% to \$285,758 or \$0.71 per barrel equivalent. The decrease is due a decrease in the rate of interest charged on the Corporation senior credit facility as well as a reduction in average debt outstanding during the year. The interest expense per boe is expected to remain constant in 2005.

**Non-Cash Items**

| Period Ended               | Year ended<br>December 31,<br>2004 | Year ended<br>December 31,<br>2003 | Year ended<br>December 31,<br>2004 | Year ended<br>December 31,<br>2003 | Percent<br>Change |
|----------------------------|------------------------------------|------------------------------------|------------------------------------|------------------------------------|-------------------|
|                            |                                    |                                    | <b>(\$ / BOE)</b>                  | <b>(\$ / BOE)</b>                  | <b>(\$ / BOE)</b> |
| Depletion and Amortization | \$3,870,000                        | \$2,050,622                        | \$9.65                             | \$6.30                             | 53%               |
| Accretion Expense          | \$270,012                          | \$76,378                           | \$0.67                             | \$0.23                             | 191%              |
| Stock Based Compensation   | \$562,000                          | \$0                                | \$1.40                             | \$0.00                             | N/A               |
| Total Non Cash Items       | \$4,702,012                        | \$2,127,000                        | \$11.72                            | \$6.53                             | 79%               |

Depletion and amortization increased on a barrel equivalent due to an increase in costs associated with finding and developing the Corporations reserves. The Corporation's 2004 CAPEX program targeted developing undeveloped reserves into proved producing reserves. The majority of the 2004 CAPEX was spent in Q4 2004 while the majority of the new production did not come on stream until late 2004 or early 2005.

The increased amortization and depletion per barrel equivalent is in part due to the requirement by the Canadian Institute of Chartered Accountants that the estimated present value of future costs to retire an asset be recorded as part of the oil and gas properties (CICA Handbook section 3110 – Asset Retirement Obligations). During the current year approximately \$3.0 million in estimated asset retirement costs was included in oil and gas properties and, thus, subject to depletion. The change in the accounting requirement represents approximately 50% of the increase in depletion and amortization on a barrel equivalent.

As the Corporation realizes the increased production from the 2004 CAPEX and 2005 CAPEX program, depletion and amortization on a barrel equivalent are expected to decrease

The strategic acquisition at the end of 2004 increased the Corporation's depletion and amortization. The depletion and amortization on a barrel equivalent is expected to stay flat in 2005 as the Corporation focuses our 2005 CAPEX budget on developing new reserves in our core area of Fort St. John.

Through the amalgamation in early 2004, Terra Energy became a publicly traded company. As is standard with public companies, Terra Energy has provided stock options to employees and consultants as part of their compensation. The Corporation intends to continue to provide additional stock options to employees and consultants to ensure the Corporation is able to continue to attract the best employees and consultants.

### **Financial Condition**

| Period Ended           | December 31, 2004 | December 31, 2003 |
|------------------------|-------------------|-------------------|
| Current Assets         | \$3,286,086       | \$3,078,365       |
| Current Liabilities    | \$21,449,670      | \$10,570,606      |
| Oil and gas properties | \$64,308,278      | \$12,530,580      |

The increase in current assets is primarily due to an increase in Crown royalty security deposits required by the Province of Alberta. The increase in current liabilities is due to the entire subordinated debt facility (mezzanine financing) being recorded as a current liability as the amount is required to be paid by June 30, 2005. The debt facility was repaid in its entirety during the first quarter of 2005. Accounts payable and accrued liabilities increased as a result of capital projects in progress at year end. Offsetting the increase in accounts payable and the subordinated debt facility is the reclassification of the revolving line of credit to non-current liabilities. The Corporation received notification from its bank to indicate that payment of the revolving line of credit will not be required without one year's notice. The Corporation had a working capital deficiency of \$18,163,584 at December 31, 2004 compared to surplus of \$74,913 at December 31, 2003.

Capitalized resource properties as at December 31, 2004 are \$64,308,278 net of depletion, compared with \$12,530,580 as at December 31, 2003. Oil and gas properties increased as a result of continued acquisitions, including the amalgamation with Rhodes Resources Corp and the purchase of strategic properties near Fort St. John, British Columbia, as well as continued development of oil and gas properties.

### **Liquidity and Capital Resources**

The Corporation's share capital is as follows:

#### **Common Shares**

| Date              | Shares Outstanding | Dollar Value |
|-------------------|--------------------|--------------|
| December 31, 2004 | 42,008,611         | \$20,780,818 |
| December 31, 2003 | 18,547,304         | \$1          |

During the year ended December 31, 2004, as part of the amalgamation with Terra Energy Corp. and Rhodes Resources Corp, the 22.5 million common shares of Terrapet Energy Corp. were exchanged for 18,547,304 common shares of Terra Energy Corp. 3,429,752 preferred shares from Terrapet Energy Corp. were converted to 3,429,752 common shares. 5,345,944 common shares were issued to the former shareholders of Rhodes Resources Corp. An additional 220,000 common shares were issued as part of the purchase of certain oil and gas properties and the exercising of options.

During the period ended December 31, 2004 the Corporation obtained permission from the TSX Venture Exchange for a Normal Course Issuer Bid to repurchase for cancellation up to 250,000 common shares to April 22, 2005. During the period ended December 31, 2004, 249,400 common shares were purchased.

During the year ended December 31, 2004 the Corporation issued 10,121,854 flow through common shares for net proceeds of \$12,788,350. As a result of these shares the Corporation is required to incur certain exploration and development activities of approximately \$13,915,600 by December 31, 2005. As at December 31, 2004, the Corporation has incurred qualifying expenditures of approximately \$1,466,000.

The Corporation, through the amalgamation had a 2003 flow-through commitment of \$2,300,000. At December 31, 2004 the Corporation has satisfied this obligation.

### Preferred Shares

| Series        | At December 31, 2004 |              | At December 31, 2003 |              |
|---------------|----------------------|--------------|----------------------|--------------|
|               | Shares Outstanding   | Dollar Value | Shares Outstanding   | Dollar Value |
| Series I to V | 1,148,641            | \$1,148,641  | 1,148,641            | \$1,148,641  |
| Series VI     | nil                  | nil          | 3,429,752            | \$3,429,752  |

Upon the amalgamation of the Corporation, the Series VI preferred shares were converted to common shares as part of the amalgamation between Terra Energy Corp., Terrapet Energy Corp., and Rhodes Resources Corp.

For the year ended December 31, 2004, the Corporation has generated cash flows from operations of \$4,886,218 (\$3,406,633 for the year ended December 31, 2003).

Cash flow from operations ("Cash Flow"), representing cash generated from operating activities before changes in non-cash working capital items, is a non-GAAP measure. Management utilizes Cash Flow as a key measure to assess the ability of the Corporation to finance operating activities and capital expenditures. Additionally, Cash Flow has been described and presented in order to provide shareholders and potential investors with information regarding the Corporation's liquidity and its ability to generate funds to finance its operations. This performance indicator may not be comparable to similar measures used by other companies.

The following table reconciles the non-GAAP financial measure "cash from operations".

| Year Ended                      | December 31, 2004 | December 31, 2003 |
|---------------------------------|-------------------|-------------------|
| Net income for the year         | \$1,301,881       | \$800,454         |
| Future tax provision (recovery) | (\$1,117,675)     | \$479,179         |
| Accretion expense               | \$270,012         | \$76,378          |
| Stock based compensation        | \$562,000         | -                 |
| Depletion and amortization      | \$3,870,000       | \$2,050,622       |
| Cash flow from operations       | \$4,886,218       | \$3,406,633       |

For the period December 31, 2004, the Corporation renegotiated its credit facility resulting in an increase in available credit from \$8.0 million to \$18.0 million. The swap facility was increased from \$2.5 million to \$3.0 million. The Corporation credit facility has a 1-year term out feature which provides the Corporation 1-year to repay our credit facility at the expiry of our credit facility as long as certain financial and operational conditions are met. At December 31, 2004 all conditions had been met and as such, our credit facility is classified as a long-term liability. As a result the credit facility payable balance of \$15,862,373 has been presented as part of non-current liabilities.

### **Off-Balance Sheet Arrangements**

The Corporation has entered into a 3 way collar financial gas contract with delivery between November, 2004 and October, 2005 of 365,000 GJ with a price cap of \$8.95 per GJ and a price floor of \$6.00 per GJ. The Corporation has also entered into various fixed-price financial oil contracts with delivery for 2005 of 73,000 barrels at prices between \$35.35 and \$36.65 per barrel.

The purpose of these contracts is to ensure a minimum level of cash flow for continued operations, and, as such, have been accounted for as hedges in accordance with CICA guidelines.

### **Transactions with Related Parties**

- (a) The Corporation entered into transactions with the following related parties:  
 Capital Strategies Canada Corp., controlled by the officers of the Corporation  
 Rhodes Resources Corp., related due to common control  
 Rhodes Resources Inc., related due to common control  
 Rhodes Petroleum Corp., related due to common control  
 Terra Capital Corp., parent company  
 Forterra Properties Inc., related due to common control  
 Pioneer Land Services Ltd. – a director, is an employee of Pioneer  
 Borden Ladner Gervais LLP – Corporate Secretary and director are partners with the law firm

- (b) Transactions

|                                                                         | <u>2004</u>       | <u>2003</u>        |
|-------------------------------------------------------------------------|-------------------|--------------------|
| Interest revenue – Rhodes Resources Inc.                                | \$ -              | \$ 46,452          |
| Expenses                                                                |                   |                    |
| Management fee – Terra Capital Corp. (ii)                               | 619,431           | 1,397,453          |
| Consulting – Pioneer Land Services Ltd.                                 | 13,676            |                    |
| Legal Consulting – Borden Ladner Gervais LLP                            | 115,406           |                    |
| Compressor Rental – Rhodes Petroleum Corp.                              | 37,050            |                    |
| Rent – Capital Strategies Canada Corp.                                  | 3,750             | 26,673             |
|                                                                         | <u>\$ 789,313</u> | <u>\$1,424,126</u> |
| Other                                                                   |                   |                    |
| Recorded as part of Oil and Gas Properties – Pioneer Land Services Ltd. | 79,105            |                    |
| Recorded as part of Share issuance cost – Borden Ladner Gervais LLP     | 123,787           |                    |
|                                                                         | <u>\$ 202,892</u> | <u>\$ -</u>        |

- (i) Revenue and expense transactions are in the normal course of operations and have been valued in these consolidated financial statements at the exchange amount which is the amount of consideration established and agreed to by the related parties.
- (ii) Management fees have been paid to Terra Capital Corp. for management personnel services, vehicles, office furniture and equipment leasing. Prior to the amalgamation and up to March 31, 2004 all personnel were employees of Terra Capital Corp. Subsequent to amalgamation, new employment contracts were implemented with all employees and effective April 1, 2004 employees were paid by The Corporation. The amount of management fees relating personnel services is approximately \$327,000. Any continuing management fees will be for vehicle, office furniture, and equipment leasing at the rate of \$6,000 per month. All management fees are determined on a cost recovery basis.
- (iii) During 2003, the Corporation declared a dividend in kind to its common shareholder for certain petroleum and natural gas properties with a carrying value of \$296,697. The transaction has been recorded at carrying values of the assets conveyed. No gain or loss has been recognized.
- (iv) During 2003 the Corporation issued 2,500,000 preferred shares at \$1 per share in consideration for a cash payment by its parent company, Terra Capital Corp. These shares are redeemable by the Corporation at \$1 per share. Subsequent to year end, these preferred shares were converted to common shares upon amalgamation with Rhodes Resources Corp.
- (v) During 2003, the Corporation purchased all the outstanding shares of Rhodes Resources Inc., a company under common control. The assets consisted of oil and gas properties with a net book value of \$100,000. A note payable for \$100,000 by the Corporation to Rhodes Petroleum Corp. was issued for consideration of this transaction. Rhodes Resources Inc. was immediately wound up into the Corporation

#### **Fourth Quarter**

Revenues for the three month period ended December 31, 2004 were \$4,042,907 (\$3,138,054 three months ended December 31, 2003). Improved revenues were due to improved commodity prices and increased production. Royalties were for the three months ended December 31, 2004 were \$665,166 (\$607,619 three months ended December 31, 2003). Operating costs were \$2,379,408 for the three months ended December 31, 2004 (\$1,229,521 three months ended December 31, 2003). The increased prices were due to workovers on properties acquired during the year. General and administrative expenses were \$1,229,712 (\$1,129,143 three months ended December 31, 2003). Non-cash expenses were \$1,499,012 for the period ended December 31, 2004 (\$700,257 three months ended December 31, 2003). The primary reason for the increased non-cash expense was due to required provision for stock based compensation for employee stock options and an increased accretion provision for the final quarter of 2004.

### **Critical Accounting Estimates**

In preparing financial statements in accordance with generally accepted accounting principles, management undertakes certain judgments and estimates. Changes in these judgments and estimates could have a material impact on the financial results and condition. The following discussion outlines accounting policies and practices that are critical to determining the Corporation's financial results.

Reserves are critical to several accounting estimates, affecting net income through depletion and the ceiling test calculation. Estimating reserves is very complex, requiring many judgments based on available geological, geophysical, engineering, and economic data. Estimated reserves also utilized by the Corporation's bank in determining credit facilities. Changes in these judgments could have a material impact on the estimated reserves, and subsequently the Corporation's financial results and financial condition.

#### *Ceiling Test*

Under the Canadian Institute of Chartered Accountants (CICA) full cost accounting guidelines, the Company calculates a ceiling test annually whereby the carrying value of petroleum and natural gas properties is compared to estimated future cash flow from the production of proved reserves. The Corporation has early adopted the requirement of CICA Accounting Guideline 16 "Oil and Gas Accounting - Full Cost" ("AcG 16"). The requirements of the guideline were to be followed for all fiscal years beginning on or after January 1, 2004 but early adoption was encouraged.

At December 31, 2004, the Corporation calculated the ceiling test using AcG 16 without any material adverse impact on the Corporation's financial position or results of operations.

#### *Asset Retirement Obligation*

The Corporation early adopted the CICA Handbook Section 3110 – Asset Retirement Obligations. The section requires accrued reclamation and abandonment obligations be recognized on the balance sheet by increasing oil and gas properties offset by a liability of an equal amount. Estimates are required to determine the future obligation. The asset and liability are initially measured at fair value, being the discounted future value of the liability, and then capitalized as part of the cost of the asset and subsequently amortized over the life of the asset. The liability then accretes until the retirement obligation is settled.

#### *Litigation*

The Corporation is involved in various claims and litigation arising from the normal course of business. While the outcome of these matters is uncertain and there can be no assurance that such matters will be resolved in the Corporation's favor, the Corporation does not currently believe that the outcome of adverse decisions in any pending or threatened proceeding related to these and other matters or any amount which it may be required to pay by reason thereof would have a material adverse effect on its financial position or results of operations.

### **Change in Accounting Policies**

In 2002 the Canadian Institute of Chartered Accountants ("CICA") approved Section 3063, "Impairment of Long-Lived Assets" (S. 3063), establishing standards for the recognition, measurement, and disclosure of the impairment of long-lived assets, and applies to long-lived assets held for use. An impairment loss is recognized when the carrying value exceeds its fair value and is not recoverable. This standard is effective for fiscal years beginning on or after April 1, 2003 with early adoption being encouraged. Accounting Guideline 16, "Oil and Gas Accounting Full Cost" (AcG-16), issued in September, 2003 includes this section in the application of the impairment test for oil and gas companies using the full cost method of accounting. The carrying value for oil and gas properties is limited to their fair value, which is

equal to estimated future cash flows from proved and probable reserves, calculated future price forecasts and costs discounted at the risk-free rate. AcG-16 is required for all fiscal years beginning on or after January 1, 2004 with early adoption being encouraged. Terra has early adopted the requirements of AcG-16 at December 31, 2003. There has been no material adverse impact on the Company's financial position or results of operations.

For fiscal years commencing on or after July 1, 2003 the CICA's new accounting pronouncement Accounting Guideline 13 "Hedging Relationships" (AcG-13) is in effect. This guideline sets out certain conditions when hedge accounting may be applied; otherwise the fair values of derivative financial instruments are recorded as an asset or liability on the balance sheet. It is management's opinion that all financial contracts satisfy the necessary criteria to be designated hedges. The purpose of the hedges is to ensure a minimum level of cash flow.

The Corporation has early adopted the CICA's section on "Asset Retirement Obligations" (S. 3110). The section is required to be adopted for fiscal years beginning on or after January 1, 2004 with early adoption being encouraged. S. 3110 requires accrued reclamation and abandonment obligations be recognized on the balance sheet by increasing oil and gas properties offset by a liability of an equal amount. The asset and liability are initially measured at fair value, being the discounted future value of the liability, and then capitalized as part of the cost of the asset and subsequently amortized over the life of the asset. The liability then accretes until the retirement obligation is settled. Comparative amounts for 2003 have been restated with an immaterial impact on the results of operations.

Transportation Costs - Effective for fiscal years beginning on or after October 1, 2003, the CICA issued Handbook Section 1100 "Generally Accepted Accounting Principles" which defines the sources of GAAP that companies must use and effectively eliminates industry practice as a source of GAAP. In prior years, it had been industry practice for companies to net transportation charges against revenue rather than showing transportation charges as a component of operating expense on the consolidated statement of income. Effective January 1, 2003, the Company has recorded revenue gross of transportation charges and has recorded transportation charges as an operating expense on the consolidated statement of income. This adjustment of \$655,885 (2003 - \$482,364) has no impact on net earnings, per common share calculations, or cash flow for the Company.

### **Financial Instruments**

The Corporation results are impacted by external market risks associated with fluctuations in commodity prices, operational and safety and environmental risks. The Corporation partially mitigates its exposure to market risks through the use of various financial instruments and physical contracts.

The Corporation does not utilize derivative instruments for speculative purposes.

### **Business Acquisitions**

On November 25, 2003 Terrapet Energy Corp. purchased all the outstanding shares of Constar Resources Ltd. in exchange for the issuance of 929,752 Series VI preferred shares. The purchase has resulted in increased proven and probable reserves of approximately 231,000 barrels equivalent.

On January 30, 2004, Terrapet amalgamated with Rhodes Resources Corp. ("Rhodes") and Terra Energy Corp. to form a new company Terra Energy Corp ("Terra"). The common shareholders of Terrapet Energy Corp. received 18,547,304 common shares of Terra, with the Series VI preferred shareholders of Terrapet receiving 3,429,752 common shares of Terra. The shareholders of Rhodes received 5,345,944 common shares of Terra. The share allocation has been based upon the relative valuations for oil and gas properties as determined by independent evidence adjusted for various other assets and liabilities. The purchase increased oil and gas properties by approximately \$2.4 million. Oil and gas reserves have increased by approximately

271,000 barrels equivalent as compared to Terrapet's reserves. The amalgamation constitutes a reverse takeover as defined by Policy 5.2 of the TSX-V and is subject to Policy 5.9 of the TSX-V regarding related party transactions. The transaction will be recorded at the exchange value of the assets received from Rhodes as there is sufficient independent evidence available and there is a substantive change in the ownership interests.

On December 28, 2004 the Corporation purchased all of the outstanding shares of Fossil Bay Resources Ltd. ("Fossil Bay"), through a wholly owned subsidiary, Terra Resources Inc. ("Terra Resources"). Fossil Bay and Terra Resources immediately amalgamated to form Terra Resources Inc. Terra Resources Inc. was then wound up into Terra Energy Corp. The consideration paid consisted of the issuance of 616,113 common shares and cash of \$255,000. The assets of Fossil Bay consisted primarily of certain oil and gas properties and non-capital loss carryforwards that can be utilized by Terra Energy Corp.

On December 31, 2004 the Corporation acquired certain oil and gas properties from another company for consideration of \$31,547,844 in cash. The purchase resulted in additional proven and probable reserves of 2.8 million barrels equivalent. The properties comprise approximately 75 sections of developed and undeveloped lands which complement the Company's existing core properties of Stoddart and Boudreau. These properties are currently producing approximately 840 barrels equivalent comprised of 4,100 Mcf/d of natural gas and 170 bbls/d of oil and condensate. The acquisition includes primarily operated properties with significant facilities and pipeline infrastructure. Most of the properties have year round access. The acquisition also includes a significant amount of 2-D and 3-D seismic information.

The acquisition solidified the Corporation's core area of Fort St. John. To ensure value is maximized from the acquisition, the Corporation is focusing the majority of the 2005 CAPEX budget in Fort St. John

### **Outlook 2005**

The primary focus of the Company during 2005 will be on the growth of its reserves base. The Company is targeting an exit rate of 4,000 BOED for 2005, excluding any corporate and major property acquisitions. As some of the development drilling will be directed towards opportunities which will simply change the category of reserves from Non-Producing or Probable into the Proved Producing category, the aggressive exploration program is intended to ensure that our Total Proved + Probable reserves will increase at least in proportion to our overall production rate.

### **DETAILS**

Below is a summary of our forecasted activity for the year. Terra Energy is planning to drill 15 (gross) wells in northeast British Columbia and the remaining 13 (gross) wells in Alberta and Saskatchewan. Based upon success and upon an increase in the Budget by the Board of Directors, many follow-up locations will be drilled to increase the reserves and the production in the latter part of the year and into 2006. The specific details of our CAPEX Plan cannot be disclosed for competitive reasons, but the general highpoints are as follows:

#### **Fort Saint John, British Columbia**

Fort Saint John is the Company's Core Area, and it is comprised of several fields. Starting with the Eagle Field, and moving in a counter-clockwise fashion, are the Stoddart Field, the Red Creek Field, the Boudreau Field, the Wilder/Monias Field, the Septimus Field, the Tower Field, the Eight Mile Field and the Mica Field.

*Eagle Field* – Terra Energy is planning three wells for the Eagle Field in 2005. These wells are predominantly development wells offsetting production from the Halfway and Belloy formations in the area. The Company has working interests ranging from 22% to 100%.

*Stoddart Field* – Terra Energy is planning only modest capital expenditures at Stoddart. Work will be carried out to convert an existing suspended well into a water disposal well for use in conjunction with our oil battery and plant site.

*Red Creek Field* – At Red Creek, Terra Energy will drill one (100%) exploratory well targeting a new horizon which appears to be prospective. If successful, the Company will benefit from already having tremendous infrastructure in place for handling production. In addition, the Company will re-complete two existing wells (100%) to increase current production rates.

*Boudreau Field* – Terra Energy will drill and/or re-enter as many as four wells in 2005, to pursue Charlie Lake, Belloy, Baldonnel and Halfway potential. There are plans to re-complete as many as two wells to further optimize production from this field. The Company has various interests in this field ranging from 50% to 100%.

*Monias/Wilder Field* – The Company is targeting several recompletions in the Monias/Wilder area. The field is located on an anticline and has seen production from five different formations, including the Halfway, Charlie Lake and Belloy. The Company plans to shoot a 2D seismic program across two sections which it owns in order to firm up locations for the 2006 winter drilling season.

*Septimus Field* – The secondary target in this play is the Halfway formation. There is current production offsetting our lands and our technical analysis indicates a very favourable chance of encountering the same or similar Halfway reservoir. Our first well, the 15-34-81-19W6M, is located on the apex of a seismically defined anticline, structurally higher than the offsetting producer. Our primary target and tertiary targets make this an exciting opportunity. Upon success, the Company will proceed with the construction of a new gathering line which will tie the field into the production facilities at Monias/Wilder, and the Company will proceed with two additional development wells into the same reservoir. There will be secondary targets associated with these drilling operations.

*Tower Field* – Terra Energy is licensing a well in Section 25-81-17W6M with the Halfway formation as its secondary target. There is currently offsetting Halfway production both east and west of the Company's lands. The primary target is confidential and there are several tertiary targets for this well. Based upon success, as many as three follow up wells may be drilled during 2005. Infrastructure is available in the immediate vicinity.

*Eight Mile Field* – Terra Energy has several exploration plays across its Eight Mile acreage. The field consists of 30 sections of land (predominantly 100%), with offsetting production in two different horizons. The Company is planning four exploration wells during 2005. With success, there is potential for several development wells in 2006.

*Mica Field* – The Company has plans to recomplete one well during 2005. Depending upon further investigations an additional well may be drilled targeting a new horizon which is prospective.

#### **Grande Prairie, Alberta**

Terra Energy will follow up its 2004 drilling program with three additional wells and one re-entry in 2005. The Company has an undeveloped land position of nine sections (60% to 100%) in this area. The Company will license a well for Section 15-71-6W6M, which will target no fewer than three different horizons.

#### **Heathdale, Alberta**

At Heathdale, the Company has an undeveloped land position of ten sections of land, in addition to its developed lands and production. The Company is targeting three wells in Heathdale for 2005, with multiple zones being targeted in each well.

**Tableland, Saskatchewan**

Terra Energy has four separate Winnipegosis reef structures which have been identified on its lands with the benefit of 3D seismic which was shot during 2004. These four structures are proximal to existing oil pools.

**Bow Island, Alberta**

Terra Energy is planning to drill one well in Bow Island targeting the Sawtooth and the Bow Island formations. The Company is also planning to tie-in two gas wells in this field.

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***Certain statements contained in the above Management's Discussion and Analysis, including, without limitation, statements containing the words believes, anticipates, estimates, expects, and words of similar import, constitute forward-looking statements. Forward looking statements are not guarantees of future performance and involve risks and uncertainties, which could cause actual results to differ materially from those anticipated in these forward-looking statements. Among the key factors that could cause such differences are: fluctuations in petroleum and natural gas prices, and/or changes in petroleum and natural gas reservoir performance.***

***We disclaim any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, unless required to do so by applicable securities law.***