



Q3 2006

Nine months ended  
September 30, 2006

## Company Definition

Throughout this interim report, Terra Energy Corp. is referred to as “Terra Energy”, the “Company” or the “Corporation”.

## Volume Definition Reporting

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. Please note that the term, boe, may be misleading, particularly if used in isolation. A boe conversion ration of six thousand cubic feet per barrel is based on an energy equivalency method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead.

## Directors

Ted S. Anderson (1)(2)  
Ralph G. Evans(3)(4)  
Anthony R. Harvey(1)  
Colin MacDonald(2)  
Cas H. Morel(2)(3)(4)  
Robert D. Penner(1)(2)

1. Member of the Audit Committee
2. Member of the Corporate Governance, Compensation and Nominating Committee
3. Member of the Engineering Reserves Committee
4. Member of the Safety and Environment Committee

## Officers

Tim Beatty	Vice President, Drilling
John Behr	Vice President, Exploration
Timothy Blair	Vice President, Land
Diana Horsman	Corporate Secretary
Bud Love	Vice President, Finance and Chief Financial Officer
Rosa Lyngberg	Controller
Cas Morel	President and Chief Executive Officer

# Management's Discussion & Analysis

This Management's Discussion and Analysis ("MD&A") of financial condition and results of operations of Terra Energy Corp. ("Terra Energy" or the "Corporation") is dated November 28, 2006. It should be read in conjunction with the unaudited interim consolidated financial statements and corresponding notes for the 3-month and 9-month periods ended September 30, 2006 and September 30, 2005 and with the audited year end consolidated financial statements of the Corporation for the years ended December 31, 2005 and December 31, 2004.

Terra Energy's Board of Directors and Audit Committee have reviewed and approved the September 30, 2006 interim consolidated financial statements and related MD&A.

All references to dollar values refer to Canadian dollars unless otherwise stated.

This MD&A provides certain financial measures that do not have a standardized meaning prescribed by Canadian generally accepted accounting principles ("GAAP"). These non-GAAP financial measures may not be comparable to similar measures presented by other issuers.

This MD&A contains the terms "cash flow from operations" and "cash flow from operations per share", 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 as an indicator of the Corporation's performance. Cash flow from operations per share is calculated using the same weighted average basic and diluted number of shares outstanding used in the calculation of net income (loss) per share. All references to cash flow throughout this MD&A are based on cash flow before changes in non-cash working capital.

Petroleum and natural gas volumes are converted to an equivalent measurement basis referred to as a "barrel of oil equivalent" ("boe") using a conversion rate of six thousand cubic feet of natural gas to one barrel of oil ("6:1"). The 6:1 conversion ratio is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead. Readers are cautioned that boe figures may be misleading, particularly if used in isolation.

The continuous disclosure materials of the Corporation, including its annual MD&A and audited financial statements, Information Circular and Proxy Statement, material change reports and press releases issued by the Corporation are available through the SEDAR system at [www.sedar.com](http://www.sedar.com).

## FORWARD LOOKING ADVISORY

Statements in this document may contain forward-looking information. Such information is subject to known and unknown risks, uncertainties and other factors that could influence actual results or events, and cause actual results or events to differ materially from those stated, anticipated or implied in the forward looking information. As such, readers are cautioned not to place undue reliance on the forward- looking information, as no assurances can be provided as to future results, levels of activity or achievements. Terra Energy assumes no obligation to update forward-looking statements should circumstances or management's estimates change. In addition, the reader is cautioned that historical results are not necessarily indicative of future performance.

## DISCLOSURE CONTROLS AND PROCEDURES

Disclosure controls and procedures are designed to provide reasonable assurance that information required to be disclosed is recorded, processed, summarized and reported with the time periods specified by securities regulations and that information required to be disclosed is accumulated and communicated to management.

The Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of the Corporation's disclosure controls and procedures as of September 30, 2006 and have concluded that they are adequate and effective to ensure accurate and complete disclosure.

# Management's Discussion & Analysis

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

## SELECTED QUARTERLY INFORMATION

### Financial

<i>Three months ended September 30</i>	<b>2006</b>	2005	% Growth
Revenue	<b>\$10,994,495</b>	\$10,514,578	4.6%
Cash Flow From Operations	<b>\$4,601,864</b>	\$3,931,050	17.1%
Earnings	<b>\$(244,582)</b>	\$604,997	(140.4%)
Weighted Average Shares – Basic	<b>69,556,475</b>	62,579,599	11.1%
Weighted Average Shares – Diluted	<b>70,646,020</b>	67,278,966	5.0%
Shares at Quarter End – Basic	<b>70,393,633</b>	66,776,847	5.4%

### Operational

<i>Three months ended September 30</i>	<b>2006</b>	2005	% Growth
Production			
Average Daily Production (boe/d)	<b>2,931</b>	1,929	51.9%
Wells Drilled			
Gross	<b>5.0</b>	13.0	(61.5%)
Net	<b>5.0</b>	11.5	(56.5%)

<i>Nine months ended September 30</i>	<b>2006</b>	2005	% Growth
Production			
Average Daily Production (boe/d)	<b>2,894</b>	2,131	35.8%
Wells Drilled			
Gross	<b>12.0</b>	17.0	(29.4%)
Net	<b>11.0</b>	13.6	(19.1%)

# Management's Discussion & Analysis

## RESULTS OF OPERATIONS

### Production

<i>Three months ended September 30</i>	<b>2006</b>	2005	% Growth
	<b>Average</b>	Average	
Oil (bbl/d)	<b>396</b>	452	(12.4%)
Natural Gas (mcf/d)	<b>13,676</b>	7,672	78.3%
Liquids (bbl/d)	<b>256</b>	198	29.1%
Combined (boe/d)	<b>2,931</b>	1,929	51.9%

<i>Nine months ended September 30</i>	<b>2006</b>	2005	% Growth
	<b>Average</b>	Average	
Oil (bbl/d)	<b>371</b>	534	(30.5%)
Natural Gas (mcf/d)	<b>13,329</b>	8,476	57.2%
Liquids (bbl/d)	<b>301</b>	184	63.6%
Combined (boe/d)	<b>2,894</b>	2,131	35.8%

The prior year's production volumes have been restated to be consistent with current year's method of using sales volumes.

### Operations

<i>Three months ended September 30</i>	<b>2006</b>	2005	<b>2006</b>	2005	% Growth
			<b>(\$ / boe)</b>	(\$ / boe)	(\$ / boe)
Revenues	<b>\$10,994,495</b>	\$10,514,578	<b>\$40.77</b>	\$59.26	(31.2%)
Royalties	<b>\$2,027,512</b>	\$1,732,077	<b>\$7.52</b>	\$9.76	(23.0%)
Production Expenses	<b>\$3,123,725</b>	\$4,130,800	<b>\$11.58</b>	\$23.29	(50.3%)
Operating Netback	<b>\$5,843,258</b>	\$4,651,701	<b>\$21.67</b>	\$26.22	(17.4%)
General & Administrative Expenses	<b>\$730,754</b>	\$642,144	<b>\$2.71</b>	\$3.62	(25.1%)
Interest Expense	<b>\$666,064</b>	\$78,507	<b>\$2.47</b>	\$0.44	461.3%
Realized Foreign Exchange (Gain)	<b>\$(502,836)</b>	-	<b>(\$1.86)</b>	-	n/a
Non-cash Expenses	<b>\$4,918,998</b>	\$2,460,441	<b>\$18.24</b>	\$13.87	31.5%
Income Before Income Taxes	<b>\$30,278</b>	\$1,470,609	<b>\$0.11</b>	\$8.29	(98.6%)
Income Tax Expense	<b>\$274,860</b>	\$865,612	<b>\$1.02</b>	\$4.88	79.1%
Net Income (Loss)	<b>\$(244,582)</b>	\$604,997	<b>(\$0.91)</b>	\$3.41	(126.6%)
Per Share – Basic	<b>(\$0.00)</b>	\$0.01			
Per Share - Diluted	<b>(\$0.00)</b>	\$0.01			

## Management's Discussion & Analysis

<i>Nine months ended September 30</i>	<b>2006</b>	2005	<b>2006</b>	2005	% Growth
			<b>(\$ / boe)</b>	<b>(\$ / boe)</b>	<b>(\$ / boe)</b>
Revenues	<b>\$35,687,750</b>	\$26,860,101	<b>\$45.18</b>	\$46.17	(2.2%)
Royalties	<b>\$6,837,832</b>	\$5,264,095	<b>\$8.66</b>	\$9.04	(4.3%)
Production Expenses	<b>\$9,671,401</b>	\$10,136,673	<b>\$12.24</b>	\$17.43	(29.8%)
Operating Netback	<b>\$19,178,517</b>	\$11,459,333	<b>\$24.28</b>	\$19.70	23.2%
General & Administrative Expenses	<b>\$2,943,947</b>	\$2,673,750	<b>\$3.73</b>	\$4.59	(18.8%)
Interest Expense	<b>\$1,621,528</b>	\$645,716	<b>\$2.05</b>	\$1.11	84.9%
Realized Foreign Exchange Gain	<b>(\$794,077)</b>	-	<b>(\$1.01)</b>	-	n/a
Non-cash Expenses	<b>\$13,106,403</b>	\$10,635,903	<b>\$16.59</b>	\$18.28	(9.2%)
Income Before Income Taxes	<b>\$2,300,716</b>	(\$2,496,036)	<b>\$2.91</b>	(\$4.29)	n/a
Income Tax Expense (Recovery)	<b>\$1,797,158</b>	(\$266,119)	<b>\$2.27</b>	(\$0.46)	n/a
Net Income (Loss)	<b>\$503,558</b>	(\$2,229,917)	<b>\$0.64</b>	(\$3.83)	n/a
Per Share – Basic	<b>\$0.01</b>	(\$0.04)			
Per Share - Diluted	<b>\$0.01</b>	(\$0.04)			

### Revenue

<i>Three months ended September 30</i>	<b>2006</b>	2005	<b>2006</b>	2005	% Change
			<b>(\$ / boe)</b>	<b>(\$ / boe)</b>	<b>(\$ / boe)</b>
Revenue	<b>\$10,994,495</b>	\$10,514,578	<b>\$40.77</b>	\$59.26	(31.2%)

Revenues increased by 4.6% to \$10,994,495 for the three month period ended September 30, 2006 compared to \$10,514,578 for the same period ended September 30, 2005 as a result of a 51.9% increase in production and a 31.2% decrease in realized commodity prices. During the first half of 2006, Terra Energy completed three key infrastructure projects, the combination of which added approximately 800 boe/d of production. Terra Energy realized an all in price per unit of production for the three month period ended September 30, 2006 of \$40.77 per boe, down 31.2% compared to the realized price per unit of production of \$59.26 per boe for the same period ended September 30, 2005. Revenue on a per unit of production basis fell 6.3% compared to the quarter ended June 30, 2006 as a result of lower natural gas prices realized during the quarter ended September 30, 2006.

<i>Nine months ended September 30</i>	<b>2006</b>	2005	<b>2006</b>	2005	% Change
			<b>(\$ / boe)</b>	<b>(\$ / boe)</b>	<b>(\$ / boe)</b>
Revenue	<b>\$35,687,750</b>	\$26,860,101	<b>\$45.18</b>	\$46.17	(2.2%)

Revenues increased by 32.9% to \$35,687,750 for the nine month period ended September 30, 2006 compared to \$26,860,101 for the same period ended September 30, 2005 as a result of a 35.8% increase in production. Terra Energy realized an all in price per unit of production of \$45.18 per boe, down 2.2% compared to the same period ended September 30, 2005.

## Management's Discussion & Analysis

Below is a breakdown of prices realized by the Corporation for the three month and nine month periods ended September 30, 2006:

<i>Three month period ended September 30</i>	<b>2006</b>	2005	% Change
Crude Oil (\$ / bbl)	<b>\$74.46</b>	\$47.45	56.9%
Natural Gas Liquids (\$ / bbl)	<b>\$62.28</b>	\$25.98	139.7%
Natural Gas (\$ / mcf)	<b>\$5.71</b>	\$10.07	(43.3%)

<i>Nine month period ended September 30</i>	<b>2006</b>	2005	% Change
Crude Oil (\$ / bbl)	<b>\$71.69</b>	\$49.29	45.4%
Natural Gas Liquids (\$ / bbl)	<b>\$54.17</b>	\$32.77	65.3%
Natural Gas (\$ / mcf)	<b>\$6.54</b>	\$7.88	(16.9%)

Factors affecting Terra Energy's third Quarter realized prices include:

- Terra Energy's natural gas weight is approximately 77.7%. While crude oil prices experienced record highs during the quarter, natural gas prices weakened during the quarter as a result of a mild summer not generating sufficient demand for natural gas to reduce storage levels which reached record levels during the quarter.
- In the first half of 2006, Terra Energy had several in the money commodity product hedges in place, all of which increased the realized price for natural gas. Terra Energy did not have any natural gas commodity product hedges in place during the quarter and as a result, all products were sold for market prices.
- In December 2003, the Corporation entered into two financial contracts to hedge a total of 200 barrels of crude oil per day at an average price of \$36.00 per barrel for a period from January 1, 2005 to Dec. 31, 2005.

### Royalties

<i>Three months ended September 30</i>	<b>2006</b>	2005	<b>2006</b>	2005	% Change
			<b>(\$ / boe)</b>	<b>(\$ / boe)</b>	<b>(\$ / boe)</b>
Royalties	<b>\$2,027,512</b>	\$1,732,077	<b>\$7.52</b>	\$9.76	(23.0%)

For the three month period ended September 30, 2006, royalties increased 17.1% to \$2,027,512 compared to \$1,732,077 for the same period in 2005 as a result of higher revenues during the quarter. The effective royalty rate increased to 18.4% from 16.5% for the respective periods. On a per unit of production basis, royalties decreased 23.0% to \$7.52 per boe from \$9.76 per boe for the same periods. Royalties on a per unit of production basis were 8.8% lower compared to the previous quarter as a result of higher crude oil and liquids price realized during the three month period ended September 30, 2006. Royalties fell on a per unit of production basis as a result of lower commodity price during the quarter and a reclassification of certain natural gas wells located in BC to a lower royalty rate regime.

<i>Nine months ended September 30</i>	<b>2006</b>	2005	<b>2006</b>	2005	% Change
			<b>(\$ / boe)</b>	<b>(\$ / boe)</b>	<b>(\$ / boe)</b>
Royalties	<b>\$6,837,832</b>	\$5,264,095	<b>\$8.66</b>	\$9.04	(4.3%)

Royalties increased 29.9% to \$6,837,832 for the nine month period ended September 30, 2006 compared to \$5,264,095 for the nine month period ended September 30, 2005 as a result of higher revenues. The effective royalty rate decreased to 19.2% from 19.6%. On a per unit of production basis, royalties decreased 4.3% to \$8.66 per boe compared to \$9.04 per boe for the corresponding periods as a result of lower commodity prices and due to certain wells in BC being reclassified to a lower royalty rate regime.

# Management's Discussion & Analysis

## Production Expenses

Three months ended September 30	2006	2005	2006	2005	% Change
			(\$ / boe)	(\$ / boe)	(\$ / boe)
Production Expenses	\$3,123,725	\$4,130,800	\$11.58	\$23.29	(50.3%)

Production expenses decreased 24.4 % to \$3,123,725 for the three month period ended September 30, 2006 compared to \$4,130,800 for the same period in 2005 as a result of operating efficiencies at several of Terra Energy's facilities even with a production increase of 51.9% year over year. Over the past 12 month period, Terra Energy has embarked on a cost reduction campaign which has demonstrated a steady improvement in production expenses. Further, well work-over and plant turn-around expenditures incurred in the third quarter of 2006 were significantly less than the third quarter 2005.

On a per unit of production basis, production expenses fell 50.3% to \$11.58 per boe compared to \$23.29 per boe for the corresponding period last year. Coupled with the reduction in costs as described in the preceding paragraph, production expenses were reduced on a per unit basis as a result of higher production volumes year over year. The Septimus pipeline project completed in March 2006 added approximately 500 boe/d at Terra Energy's Wilder facility and several Boudreau wells were tied into the Red Creek facility with a negligible increase in production expenses.

Production expenses on a per unit of production basis fell compared to previous quarters. Total production expenses fell 11.4% during the quarter compared to the three month period ended June 30, 2006. Production expenses on a per unit of production basis also fell 2.6% compared to the previous quarter. The third quarter represents the fourth consecutive quarter of lower production expenses on a per unit of production basis. Terra Energy expects production expenses on a per unit of production basis to continue to improve as existing behind pipe production is brought on-stream.

Nine months ended September 30	2006	2005	2006	2005	% Change
			(\$ / boe)	(\$ / boe)	(\$ / boe)
Production Expenses	\$9,671,401	\$10,136,673	\$12.24	\$17.43	(29.8%)

Production expenses decreased 4.6% to \$9,671,401 for the nine month period ended September 30, 2006 compared to \$10,136,673 for the nine month period ended September 30, 2005. Production expenses on a per unit of production basis fell 29.8% to \$12.24 per boe from \$17.43 for the same period as a result of higher production volumes and increased operating efficiencies from processing the incremental production additions at Company owned facilities.

## General and Administrative Expenses

Three months ended September 30	2006	2005	2006	2005	% Change
			(\$ / boe)	(\$ / boe)	(\$ / boe)
General & Administrative Expenses	\$730,754	\$642,144	\$2.71	\$3.62	(25.1%)

General & administrative expenses increased by 13.8% to \$730,754 for the three month period ended September 30, 2006 compared to \$642,144 for the same period ended September 30, 2005. On a per unit of production basis, general & administrative expenses decreased by 25.1% to \$2.71 per boe compared to \$3.62 per boe for the same periods. The decrease in general and administrative expenses on a per unit of production basis was a result of higher production volumes during the quarter being managed by similar staff levels as compared to previous quarters. General and administrative expenses decreased 30.0% from \$1,084,129 compared to the three month period ended June 30, 2006 as a result of lower accounting and audit fees and regulatory administrative costs quarter over quarter. General and administrative expenses on a per unit of production basis have decreased for the previous three quarters as a result of higher production volumes and stable general and administrative costs. As production continues to grow, Terra Energy expects general and administrative costs to continue to fall on a per unit of production basis.

## Management's Discussion & Analysis

Nine months ended September 30	2006	2005	2006	2005	% Change
			(\$ / boe)	(\$ / boe)	(\$ / boe)
General & Administrative Expenses	<b>\$2,943,947</b>	\$2,673,750	<b>\$3.73</b>	\$4.59	(18.8%)

General and administrative expenses increased by 10.1% to \$2,943,947 for the nine month period ended September 30, 2006 compared to \$2,673,750 for the nine month period ended September 30, 2005. General and administrative expenses increased as a result of higher staffing levels required to manage Terra Energy's growing production volumes. On a per unit of production basis, general and administrative expenses fell 18.8% to \$3.73 per boe from \$4.59 per boe for the same period.

### Interest Expense

Three months ended September 30	2006	2005	2006	2005	% Change
			(\$ / boe)	(\$ / boe)	(\$ / boe)
Interest Expenses	<b>\$666,064</b>	\$78,507	<b>\$2.47</b>	\$0.44	461.1%

Interest expenses increased 748.4% to \$666,064 for the three month period ended September 30, 2006 compared to \$78,507 for the same period ended September 30, 2005. Interest expenses increased as a result of higher indebtedness required to fund Terra Energy's capital expenditure program and higher interest rates compared to last year. On a per unit of production basis, interest expenses increased by 461.1% to \$2.47 per boe compared to \$0.44 per boe in the third quarter 2005. Interest expenses rose 24.0% compared to the three month period ended June 30, 2006 as a result of higher indebtedness quarter over quarter.

Nine months ended September 30	2006	2005	2006	2005	% Change
			(\$ / boe)	(\$ / boe)	(\$ / boe)
Interest Expenses	<b>\$1,621,528</b>	\$645,716	<b>\$2.05</b>	\$1.11	84.9%

Interest expenses increased 151.1% to \$1,621,528 for the nine month period ended September 30, 2006 compared to \$645,716 for the nine month period ended September 30, 2005. On a per unit of production basis, interest expenses rose 84.9% to \$2.05 per boe from \$1.11 per boe for the same period.

### Non Cash Expenses

Three months ended September 30	2006	2005	2006	2005	% Growth
			(\$ / boe)	(\$ / boe)	(\$ / boe)
Depletion and Amortization	<b>\$3,678,673</b>	\$2,200,000	<b>\$13.64</b>	\$12.40	10.0%
Accretion Expense	<b>\$133,730</b>	\$119,144	<b>\$0.50</b>	\$0.67	(26.0%)
Stock Based Compensation	<b>\$686,778</b>	\$141,000	<b>\$2.55</b>	\$0.79	222.4%
Unrealized Foreign Exchange loss	<b>\$419,817</b>	-	<b>\$1.56</b>	-	n/a
Total Non Cash Items	<b>\$4,918,998</b>	\$2,460,441	<b>\$18.24</b>	\$13.87	31.5%

Non cash items increased 99.9% to \$4,918,998 for the three month period ended September 30, 2006 compared to \$2,460,441 for the same period in 2005. On a per unit of production basis, non cash items increased 31.5% to \$18.24 per boe for the three month period ended September 30, 2006 compared to \$13.87 per boe for the same period in 2005. Non cash items increased 44.6% from the second quarter on a per unit of production basis as a result of an unrealized foreign exchange loss and higher depletion and amortization.

Depletion and Amortization increased in the third quarter compared to the same period in 2005 as a result of higher production volumes and capital additions during the quarter which are added to the Company's depletion base. Stock based compensation increased during the quarter as a result of Terra Energy granting replacement stock options to employees for options exercised

## Management's Discussion & Analysis

during the quarter and the granting of new stock options as part of Terra Energy's annual compensation review. The exercise price of the replacement options reflected the closing price of Terra Energy's shares at the date of issue as in accordance with the Corporation's stock option plan. Although the total number of options granted does not increase, the replacement stock options are exercisable immediately, therefore, requiring the Corporation to expense the total non cash value of the stock options using the Black-Scholes pricing model in the period the replacement options are granted.

During 2006, Terra Energy diversified its debt by borrowing by way of Canadian and US dollar Banker's Acceptances. Terra Energy entered into forward foreign exchange contracts to crystallize the foreign exchange gain associated with the US dollar Banker's Acceptances. As the result of these forward exchange contracts, the Corporation crystallized \$794,077 in foreign exchange gain for the nine month ended September 30, 2006. At each balance sheet date the unrealized foreign exchange gain/loss fluctuates with the exchanges rate as the Corporation records the fair market value of the outstanding forward exchange contracts and the foreign exchange gain or loss due to the foreign exchange translation of the outstanding US Banker's Acceptances. The Corporation recorded an unrealized foreign exchange loss of \$419,817 for the three month period September 30, 2006. As the US Banker's Acceptances matured during the third quarter, the previous quarter's unrealized foreign exchange gain was reversed and actual foreign exchange gain was recorded.

<i>Nine months ended September 30</i>	<b>2006</b>	2005	<b>2006</b>	2005	% Growth
			<b>(\$ / boe)</b>	<b>(\$ / boe)</b>	<b>(\$ / boe)</b>
Depletion and Amortization	<b>\$10,181,237</b>	\$6,600,000	<b>\$12.89</b>	\$11.35	13.6%
Accretion Expense	<b>\$351,250</b>	\$308,403	<b>\$0.44</b>	\$0.53	(15.1%)
Stock Based Compensation	<b>\$2,600,080</b>	\$758,000	<b>\$3.29</b>	\$1.30	153.1%
Unrealized Foreign Exchange Gain	<b>(\$26,164)</b>	-	<b>(\$0.03)</b>	-	n/a
Financing Fee Amortization	-	\$2,969,500	-	\$5.10	n/a
<b>Total Non Cash Items</b>	<b>\$13,106,403</b>	\$10,635,903	<b>\$16.59</b>	\$18.28	<b>(9.2%)</b>

Non cash items increased 23.2% to \$13,106,403 for the nine month period ended September 30, 2006 compared to \$10,635,903 for the nine month period ended September 30, 2005. On a per unit of production basis non cash items decreased 9.2% to \$16.59 per boe from \$18.28 per boe for the same time period. Non-Cash Expenses were higher in 2005 as a result of a \$2,969,500 financing fee required to be expensed by the Corporation during the first quarter 2005 relating to the repayment of a standby mezzanine credit facility put in place to assist with the purchase of assets. This was a one-time fee and is not expected to reoccur.

### Income Taxes

<i>Three months ended September 30</i>	<b>2006</b>	2005	<b>2006</b>	2005	% Change
			<b>(\$ / boe)</b>	<b>(\$ / boe)</b>	<b>(\$ / boe)</b>
Current Tax	<b>\$1,391</b>	-	<b>\$0.01</b>	\$0.00	n/a
Future Tax	<b>\$273,469</b>	\$865,612	<b>\$1.01</b>	\$4.88	(79.2%)
<b>Total Income Taxes</b>	<b>\$274,860</b>	\$865,612	<b>\$1.02</b>	\$4.88	<b>(79.1%)</b>

The provision for current and future income taxes decreased to \$274,860 for the three month period ended September 30, 2006 from \$865,612 during the third quarter 2005. Future income taxes decreased as a result of Terra Energy generating lower pre-tax profits during the quarter compared to the same period last year. On a per unit of production basis, Terra Energy's income tax expense decreased to \$1.02 per boe for the three month period ended September 30, 2006 compared to a expense of \$4.88 per boe for the same period in 2005. Income taxes decreased 67.2% during the quarter compared to the three month period ended June 30, 2006 as a result of lower pre-tax income. Income taxes on a per unit of production basis fell 64.0% for the same time period.

## Management's Discussion & Analysis

Nine months ended September 30	2006	2005	2006	2005	% Change
			(\$ / boe)	(\$ / boe)	(\$ / boe)
Current Tax	\$32,345	\$34,547	\$0.04	\$0.06	(33.3%)
Future Tax (Recovery)	\$1,764,813	(\$300,666)	\$2.24	(\$0.52)	n/a
Total Income Taxes	\$1,797,158	(\$266,119)	\$2.28	(\$0.46)	n/a

The provision for current and future income taxes increased to \$1,797,158 for the nine month period ended September 30, 2006, compared to a recovery of \$266,119 for the nine month period ended September 30, 2005. The profitability, combined with the inability to deduct stock based compensation from income for tax purposes, contributed to the increase in the future tax liability. Income taxes on a per unit of production basis increased to \$2.28 per boe from a recovery of \$0.46 per boe for the same period in 2005.

With approximately \$106 million in tax pools (net of deferred partnership income of \$18 million) available to shelter future earning at September 30, 2006, the Corporation does not expect to incur any material cash taxes in 2006.

### LIQUIDITY AND FINANCIAL CONDITION

	September 30, 2006	Dec 31, 2005
Working Capital	(\$13,911,818)	\$(759,450)
Oil and gas properties	\$135,228,068	\$103,561,874

The working capital deficit at September 30, 2006 was \$13,911,818 compared to a deficit of \$759,450 at December 31, 2005. Terra Energy's working capital deficit increased as a result of capital expenditures during the quarter and an approximate \$9.0 million in capital accruals as at September 30, 2006 related to capital expenditures incurred during the quarter, where invoices have yet to be received by the Corporation and approximately \$3,875,000 in cheques which are classified as short-term liabilities until they are cashed. When the cheques are cashed, the liabilities will convert to long-term financings.

Terra Energy's bank credit facility is structured as a \$55 million 364 day revolving credit facility with a one year term-out. If the credit facility is not renewed at maturity, the Corporation has the ability to repay any amounts outstanding on the credit facility one year from maturity. As a result of this one year repayment feature, Terra Energy has classified its bank credit facility as a long-term financial obligation.

Capitalized resource properties as at September 30, 2006 were \$135,228,068 net of accumulated depletion, compared to \$103,561,874 as at December 31, 2005. Oil and gas properties increased as a result of continued developments of oil and gas properties as well as the acquisition of undeveloped Crown land. For the three and nine month periods ended September 30, 2006, Terra Energy incurred \$5,582,112 and \$41,359,199 in net capital expenditures broken down as:

Three months ended September 30	2006
Exploration	\$0
Development	\$12,623,681
Undeveloped Land	\$263,364
Geological / Geotechnical	\$118,150
Facilities	\$1,273,401
Other Assets	\$276,850
Total Capital Expenditures	\$14,555,446
Net Property Acquisitions	(\$8,973,514)
Net Capital Expenditures	\$5,582,112

## Management's Discussion & Analysis

<i>Nine months ended September 30</i>	<i>2006</i>
Exploration	\$2,624,934
Development	\$25,602,666
Undeveloped Land	\$11,112,497
Geological / Geotechnical	\$628,315
Facilities	\$9,310,494
Other Assets	\$1,053,807
Total Capital Expenditures	\$50,332,713
Net Property Acquisitions	(\$8,973,514)
Net Capital Expenditures	\$41,359,199

Terra Energy incurred capital expenditures of \$14,555,446 during the third quarter 2006 and \$50,332,713 for the nine month period ended September 30, 2006. Terra Energy drilled five wells in the third quarter and is exiting the quarter with two wells in progress.

With weaker natural gas prices, Terra Energy has scaled back its fourth quarter 2006 capital expenditures program. Terra Energy is planning to spud two new wells during the fourth quarter, using the services of one drilling rig. Should commodity prices show strength, Terra Energy will review its drilling program to ensure it has sufficient liquidity to finance any incremental drilling during the quarter.

Terra Energy financed the third quarter capital expenditures program through a combination of cash flow, non-core asset rationalizations and bank financing. On August 23, 2006, Terra Energy closed the disposition of approximately 125 boe/d for gross proceeds of \$9 million. Terra Energy will continue to examine its non-core asset base with a view towards identifying assets for disposition, with the objective of maximizing shareholder value and redeploying the proceeds into ongoing capital expenditure programs.

With steady production and cash flow forecasted for the balance of 2006, proceeds from the rationalization of non-core assets, future rationalizations of non-core assets, the ability to scale-back the Corporation's 2006 capital expenditure program and the recently announced \$15.7 million flow-through equity issue (including the additional \$2.0 million underwriters option amount), Terra Energy is confident in its ability to finance the day to day operations of the Corporation as well as the balance of its 2006 Capital Expenditures program.

At September 30, 2006, the Corporation was in compliance with all banking covenants.

### Cash Flow

For the quarter ended September 30, 2006, the Corporation generated cash flows from operations of \$4,601,864 (\$0.07 per basic share), an increase of 17.1% compared to \$3,931,050 for the period ended September 30, 2005 (\$0.06 per basic share). For the nine month period ended September 30, 2006, the Corporation generated cash flows from operations of \$15,652,457 (\$0.22 per basic share), an increase of 93.1% compared to \$8,105,320 (\$0.14 per basic share) for the nine month period ended September 30, 2005.

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 presents the non-GAAP financial measure "cash flow from operations".

## Management's Discussion & Analysis

<i>Three months ended September 30</i>	<b>2006</b>	<i>2005</i>
Net income (loss) for the period	<b>(\$244,582)</b>	604,997
Future income tax provision	<b>\$273,469</b>	\$865,612
Accretion expense	<b>\$133,730</b>	\$119,441
Stock based compensation	<b>\$686,778</b>	\$141,000
Unrealized loss on financial instruments	<b>\$90,401</b>	-
Amortization of deferred charges	<b>(16,605)</b>	-
Depletion and amortization	<b>\$3,678,673</b>	\$2,200,000
Cash flow from operations	<b>\$4,601,864</b>	\$3,931,050

<i>Nine months ended September 30</i>	<b>2006</b>	<i>2005</i>
Net income (loss) for the period	<b>\$503,558</b>	(\$2,229,917)
Future tax provision (recovery)	<b>\$1,764,813</b>	(\$300,666)
Accretion expense	<b>\$351,250</b>	\$308,403
Stock based compensation	<b>\$2,600,080</b>	\$758,000
Financing fee amortization	-	\$2,969,500
Unrealized gain on financial instruments	<b>(\$7,389)</b>	-
Realized loss on financial instruments	<b>\$275,513</b>	-
Amortization of deferred charges	<b>(16,605)</b>	-
Depletion and amortization	<b>\$10,181,237</b>	\$6,600,000
Cash flow from operations	<b>\$15,652,457</b>	\$8,105,320

### Capital Resources

The Corporation's share capital is as follows:

	<b>September 30, 2006</b>		<i>December 31, 2005</i>	
	<b>No. of Shares</b>	<b>Amounts</b>	<i>No. of Shares</i>	<i>Amounts</i>
Common Shares	<b>70,393,633</b>	<b>\$59,112,261</b>	68,083,993	\$57,375,841

During the nine months ended September 30, 2006 2,102,000 employee / agent options and 2,286,650 warrants were exercised generating approximately \$2,484,245 and \$3,269,485 in proceeds, respectively. During the nine months ended September 30, 2006, 2,088,900 common shares were repurchased by the Corporation for \$3,816,888 at an average price of \$1.83 per common share. The Corporation recorded \$1,752,470 as a reduction of share capital and the excess of \$2,064,418 being charged to deficit. During the quarter 1,213,500 purchased shares were cancelled. As at September 30, 2006 1,768,800 repurchased shares are held for cancellation.

### Preferred Shares

<i>Date</i>	<i>Series</i>	<i>Shares Outstanding</i>	<i>Dollar Value</i>
September 30, 2006	Series I to V	1,148,641	\$1,148,641
December 31, 2005	Series I to V	1,148,641	\$1,148,641

## Management's Discussion & Analysis

The holder of these shares has agreed to waive his right to redeem the shares until October 1, 2007. Subsequent to September 30, 2006, the board of directors approved the repurchase of the Series I to V, 8% preferred shares at face value. The preferred shares were since repurchased for cancellation for \$1,148,641.

### COMMITMENTS AND CONTINGENCIES

The Corporation had outstanding letters of credit to various parties for a total of \$395,000 (2005- \$408,000). The amounts expire at various dates during 2007.

The Corporation is involved in various claims and litigations arising in 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 favour, the Corporation does not currently believe that the outcome of adverse decisions in any proceedings related to these matters or any amount which it may be required to pay, would have a material adverse impact on its financial position, results of operations or liquidity.

At September 30, 2006, the Corporation has incurred the required qualifying exploration expenditure obligations arising from the flow-through shares issued in 2005.

The Corporation has firm transportation and processing contracts expiring between October 31, 2006 and 2009. The monthly transportation and processing fees pursuant to the contacts are approximately \$239,000 until October 31, 2006 and \$230,000 thereafter.

### OFF-BALANCE SHEET ARRANGEMENTS

As at September 30, 2006, the Corporation had the following financial commodity contracts outstanding:

<i>Contract Type</i>	<i>Floor Price</i>	<i>Ceiling Price</i>	<i>Volumes Per Day</i>	<i>Contract Term</i>
Financial	Sell \$79.60 per Bbl	N/A	100 Bbls	March 1, 2006 to December 31, 2006
Financial	Buy \$76.20 per Bbl	N/A	100 Bbls	March 1, 2006 to December 31, 2006
Financial	Sell \$86.00 per Bbl	N/A	200 Bbls	June 1, 2006 to May 31, 2007
Financial	Buy \$80.65 per Bbl	N/A	200 Bbls	June 1, 2006 to May 31, 2007
Financial	Sell US\$77.25 per Bbl	N/A	100 Bbls	January 1, 2007 to December 31, 2007
Financial	Buy US\$76.40 per Bbl	N/A	100 Bbls	January 1, 2007 to December 31, 2007

The fair market value of these contracts has been recorded as an asset in the amount of \$29,725.

The Corporation has the following forward foreign exchange contracts for the US dollar LIBOR outstanding as at September 30, 2006.

<i>Contract Type</i>	<i>Value</i>	<i>Maturity Date</i>	<i>Forward Exchange Rate</i>
Financial	US\$ 2,500,000	October 23, 2006	\$0.8881

The fair market value of the above forward foreign exchange contract of \$22,336 has been recorded as a liability and unrealized foreign exchange loss. The conversion of the outstanding US dollar Banker's Acceptances at September 30, 2006 resulted in unrealized foreign exchange gain of \$48,500. The Corporation also recorded \$794,077 of realized foreign exchange gain during the nine months as US dollar Banker's Acceptances matured and forward exchange contracts were settled.

# Management's Discussion & Analysis

## SUBSEQUENT EVENTS

On November 21, 2006, the Corporation issued 7,900,000 flow-through common shares for proceeds of \$15,010,000. The related after tax share issue cost was \$641,520. In addition, the officers, directors, consultants and associates of the Corporation purchased 370,000 flow-through shares for proceeds of \$703,000. Terra Energy intends to use the proceeds from the above to fund its exploration program focused on the Fort St. John core area where Terra Energy holds an average 85% working interest in 243 sections of land and has identified over 20 exploration drilling locations.

Subsequent to September 30, 2006, the board of directors approved the repurchase of the Series I to V, 8% preferred shares at face value. The preferred shares have since been repurchased for cancellation for \$1,148,641.

## OUTLOOK

The natural gas sector of the industry currently finds itself in a challenging business environment with rapidly inflating capital costs and high commodity price volatility. As a result of these considerations Terra Energy has scaled back its capital expenditure program for 2006 in order to allow the Company to continue to focus its attention on key infrastructure projects.

Terra Energy has two key pipeline projects to complete in 2007, to bring on-stream approximately 2,000 boe/d of existing "behind pipe" natural gas. Terra Energy has approximately 500 boe/d of "behind pipe" capability awaiting infrastructure in East Boudreau. The Company has proposed a gathering line be constructed from East Boudreau to the Company's Red Creek gas plant. Subject to the existing mediation and arbitration processes, the pipeline construction is scheduled to proceed in February of 2007.

Terra Energy has in excess of 1,500 boe/d of sustainable production capability awaiting infrastructure in Tower. The Company has previously announced its plan to build a crossing of the Peace River in order that its raw gas south of the Peace River, including both the Tower Field and the Eight Mile Field, is able to be processed at the McMahon Plant. Depending upon regulatory processes, Terra Energy anticipates construction to take place in June and July of 2007, with a commissioning date in August 2007. At such time, all existing wells in the Tower Field will be placed on production, and any additional new wells drilled can be immediately tied-in.

With our continued drilling success, strong land position and advancing infrastructure projects, Terra Energy remains confident in its direction and in its ability to build value for its shareholders.

## 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.

### Proved Oil and Gas Reserves

Under Canadian Securities Regulations National Instrument 51-101 "Standards of Disclosure for Oil and Gas Activities" (NI 51-101), "proved" reserves are those reserves that can be estimated with a high degree of certainty to be recoverable (it is likely that the actual remaining quantities recovered will exceed the estimated proved reserves). In accordance with this definition, the level of certainty targeted by the reporting company should result in at least a 90% probability that the quantities actually recovered will equal or exceed the estimated reserves. There was no such consideration of probability under National Policy 2B (NP 2B). In the case of "probable" reserves, which are obviously less certain to be recovered than proved reserves, NI 51-101 states that it must be equally likely that the actual remaining quantities recovered will be greater or less than the sum of the estimated proved plus probable reserves. With respect to the consideration of certainty, in order to report reserves as proved plus probable, the reporting company must believe that there is at least a 50% probability that the quantities actually recovered will equal or exceed the sum of the estimated proved plus probable reserves. The implementation of NI 51-101 has resulted in a more rigorous and uniform standardization of reserve evaluation.

# Management's Discussion & Analysis

The oil and gas reserve estimates are made using all available geological, reservoir and historical production data. Estimates are reviewed and revised as appropriate. Revisions may occur as a result of changes in prices, costs, fiscal regimes, reservoir performance or a change in the Corporation's plans.

## Ceiling Test

Under the Canadian Institute of Chartered Accountants (CICA) full cost accounting guidelines, the Corporation 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. At December 31, 2005, 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

CICA Handbook Section 3110 "Asset Retirement Obligations" 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.

## Depletion and Depreciation Expense

Terra Energy uses the full cost method of accounting for exploration and development activities whereby all costs associated with these activities are capitalized, whether successful or not. The aggregate of capitalized costs, net of certain costs related to unproved properties, and estimated future development costs is amortized using the unit-of-production method based on estimated proved reserves. Changes in estimated proved reserves or future development costs have a direct impact on depletion and depreciation expense. Certain costs related to unproved properties and major development projects may be excluded from costs subject to depletion until proved reserves have been assigned, at which point they would be included in the depletion calculation, or for impairment, for which any write-down would be charged to depletion and depreciation expense.

## Stock Based Compensation and Share Purchase Warrants

The Corporation calculates the fair value of the options granted and share purchase warrants issued. This calculation is based on estimates which could differ significantly from actual results. This could have a significant impact on the financial statements.

## Income Taxes

The determination of Terra Energy's income and other tax liabilities requires interpretation of complex laws and regulations often involving multiple jurisdictions. All tax filings are subject to audit and potential reassessment after the lapse of considerable time. Accordingly, the actual income tax liability may differ significantly from that estimated and recorded.

## Financial Instruments

The Corporation's 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.

# Management's Discussion & Analysis

## **RISK FACTORS RELATING TO OIL AND GAS EXPLORATION, DEVELOPMENT AND PRODUCTION**

### **Uncertain Discovery of Viable Commercial Prospects**

The Corporation's future success may be dependent upon its ability to economically locate commercially viable oil or gas deposits. The Corporation can make no representations, warranties or guaranties that it will be able to consistently identify viable prospects, or that such prospects will be commercially exploitable. An inability of the Corporation to consistently identify and exploit commercially viable hydrocarbon deposits would have a material and adverse effect on the Corporation's business and financial position. Exploratory drilling is subject to numerous risks, including the risk that no commercially productive oil and gas reservoirs will be encountered. The cost of drilling, completing and operating wells is often uncertain, and drilling operations may be curtailed, delayed or canceled as a result of a variety of factors, including unexpected formation and drilling conditions, pressure or other irregularities in formations, blowouts, equipment failures or accidents, as well as weather conditions, compliance with governmental requirements and/or shortages or delays in the delivery of equipment. The inability to successfully locate and drill wells that will economically produce commercial quantities of oil and gas could have a material adverse effect on the Corporation's business and financial position. The Corporation's properties are in various stages of exploration and development. Whether the Corporation ultimately drills a property may depend on a number of factors including funding, the receipt of additional seismic data or reprocessing of existing data, material changes in oil or gas prices, the costs and availability of drilling equipment, success or failure of wells drilled in similar formations or which would use the same production facilities, changes in estimates of costs to drill or complete wells, the Corporation's ability to attract industry partners to acquire a portion of its working interest to reduce exposure to drilling and completion costs, decisions of the Corporation's joint working interest owners, and/or restrictions under provincial regulators.

### **Volatility of Oil and Natural Gas Contracts**

The ultimate profitability, cash flow and future growth of the Corporation will be affected by changes in prevailing oil and gas prices. Oil and gas prices have been subject to wide fluctuations in recent years in response to changes in the supply and demand for oil and natural gas, market uncertainty, competition, regulatory developments and other factors which are beyond the control of the Corporation. It is impossible to predict future oil and natural gas price movements with any certainty. An extended or substantial decline in oil and gas prices would have a material adverse effect on (i) the Corporation's access to capital, and (ii) the Corporation's financial position and results of operations.

### **Increased Operating Costs**

Higher operating costs for our underlying properties will directly decrease the amount of cash flow received by the Corporation. Electricity, chemicals, supplies, reclamation and abandonment, and labour costs are a few of the operating costs that are susceptible to material fluctuation.

### **Title of Assets**

Although the Corporation conducts title reviews in accordance with industry practice prior to any purchase of resource assets, such reviews do not guarantee that an unforeseen defect in the chain on title will not arise and defeat our title to the purchased assets. If such a defect were to occur, our entitlement to the production from such purchased assets could be jeopardized.

### **Uncertainty of Estimates of Reserves and Future Events**

Certain statements included in this report contain estimates of the Corporation's oil and gas reserves and the discounted future net revenues from those reserves, as prepared by independent petroleum engineers. There are numerous uncertainties inherent in such estimates including many factors beyond the control of the Corporation. The estimates are based on a number of assumptions including constant oil and gas prices, and assumptions regarding future production, revenues, taxes, operating expenses, development expenditures and quantities of recoverable oil and gas reserves. Such estimates are inherently imprecise indications of future net revenues, and actual results might vary substantially from the estimates based on these assumptions. Any significant variance in these assumptions could materially affect the estimated quantity and value of reserves. In addition, the Corporation's reserves might be subject to revisions based upon future production, results of future exploration and development, prevailing oil and gas prices and other factors. More over, estimates of the economically recoverable oil and gas reserves, classifications of such reserves and estimates of future net cash flows prepared by independent engineers at different

# Management's Discussion & Analysis

times may vary substantially. Information about reserves constitutes forward-looking statements. Further, the future success of the Corporation depends upon its ability to find, develop and acquire oil and gas reserves that are economically recoverable. As a result, the Corporation must locate, acquire and develop new oil and gas reserves to replace those being depleted by production. Without successful funding for acquisitions and exploration and development activities, the Corporation's reserves will decline. No assurances can be made that the Corporation will be able to find and develop or acquire additional reserves at an acceptable cost.

## Competition

The Corporation engages in the highly competitive industry of exploration for and production of oil and gas. The Corporation competes directly and indirectly with major and independent oil and gas companies in its exploration for and development of desirable oil and gas properties. Many companies and individuals are engaged in the business of acquiring interests in and developing oil and gas properties in Canada, and the industry is not dominated by any single competitor or a small number of competitors. Many of such competitors have substantially greater financial, technical, sales, marketing and other resources, as well as greater historical market acceptance than does the Corporation. The Corporation will compete with numerous industry participants for the acquisition of land and rights to prospects, and for the equipment and labor required to operate and develop such prospects. Competition could materially and adversely affect the Corporation's business, operating results and financial condition. Such competitive disadvantages could adversely affect the Corporation's ability to participate in projects with favorable rates of return.

## Shortage of Supplies and Equipment

The Corporation's ability to conduct operations in a timely and cost effective manner is subject to the availability of natural gas and crude oil field supplies, rigs, equipment and service crews. Although none are expected currently, any shortage of certain types of supplies and equipment could result in delays in our operations as well as in higher operating and capital costs.

## Interruption From Severe Weather

The Corporation's operations are conducted principally in the central region of Alberta, northeastern British Columbia and Saskatchewan. The weather in these areas can be extreme and can cause interruption or delays in our drilling and construction operations.

## Dependence on Third-Party Pipelines

In fiscal 2006, substantially all of Terra Energy's sales of natural gas production were through deliveries to local third-party gathering systems to processing plants. In addition, the Corporation relies on access to interprovincial pipelines for the sale and distribution of substantially all of our gas. As a result, a curtailment of our sale of natural gas by pipelines or by third-party gathering systems, an impairment of our ability to transport natural gas on interprovincial pipelines or a material increase in the rates charged to us for the transportation of natural gas by reason of a change in federal or provincial regulations or for any other reason, could have a material adverse effect upon us. In such event, we would have to obtain other transportation arrangements. There can be no assurance that we would have economical transportation alternatives or that it would be feasible for us to construct pipelines. In the event such circumstances were to occur, our netbacks from the affected wells would be suspended until, and if, such circumstances could be resolved.

## Operating Hazards and Uninsured Risks

The oil and gas business involves a variety of operating risks, including fire, explosion, pipe failure, casing collapse, abnormally pressured formations, adverse weather conditions, governmental and political actions, premature reservoir declines and environmental hazards such as oil spills, gas leaks and discharges of toxic gases. The occurrence of any of these events with respect to any property operated or owned (in whole or in part) by us could have a material adverse impact on us. The Corporation and the operators of our properties, maintain insurance in accordance with customary industry practices and in amounts that we believe to be reasonable. However, insurance coverage is not always economically feasible and is not obtained to cover all types of operational risks. The occurrence of a significant event that is not insured or insured fully could have a material adverse effect on our financial condition.

# Management's Discussion & Analysis

## Restoration, Safety and Environmental Risks

Our operations are in Saskatchewan, Alberta and British Columbia. Certain laws and regulations exist that require companies engaged in petroleum activities to obtain necessary safety and environmental permits to operate. Such legislation may restrict or delay us from conducting operations in certain geographical areas. Further, such laws and regulations may impose liabilities on us for remedial and clean-up costs, personal injuries related to safety and environmental damages, such liabilities collectively referred to as "asset retirement obligations".

## Expiration of Licenses and Leases

The Corporation's properties are held in the form of licenses and leases and working interests in licenses and leases. If the Corporation or the holder of the license or lease fails to meet the specific requirement of a license or lease, the license or lease may terminate or expire. There can be no assurance that any of the obligations required to maintain each license or lease will be met. The termination or expiration of the Corporation's licenses or leases or the working interests relating to a license or lease may have a material adverse effect on the Corporation's results of operations and business.

## Canadian Government Regulation and Industry Conditions

The Kyoto protocol, ratified by the Canadian federal government in December 2002, came into force on February 16, 2005. The protocol commits Canada to reducing greenhouse gas emissions to six percent below 1990 levels over the period 2008-2012. The Canadian government released a framework outlining its Climate Change action plan on April 13, 2005. The plan contains few technical details regarding the implementation of the government's greenhouse gas reduction strategy. The Climate Change Working Group of the Canadian Association of Petroleum Producers continues to work with the Canadian and Alberta governments to develop an approach for implementing targets and enabling greenhouse gas control legislation, which protects the industry's competitiveness, limits the cost and administrative burden of compliance and supports continued investment in the sector. As the Canadian government has yet to release a detailed Kyoto compliance plan, the Corporation is unable to predict the impact of potential regulations upon its business; however, it is possible that the Corporation would face increases in operating costs in order to comply with the greenhouse gas emissions legislation.

## Canadian Government Regulation and Environmental Matters

The oil and natural gas industry is subject to extensive controls and regulations imposed by various levels of the federal and provincial governments of Canada. It is not expected that any of these controls or regulations will affect the operations of the Corporation in a manner materially different than they would affect other oil and gas companies of similar size. All current legislation is a matter of public record and the Corporation is unable to accurately predict what additional legislation or amendments may be enacted. All of the governmental regulations noted below may be changed from time to time in response to economic or political conditions. The Corporation's management believes that the trend of more expansive and stricter environmental laws and regulations will continue. The implementation of new or modified environmental laws or regulations could have a material adverse impact on the Corporation.

The Corporation is subject to various Canadian federal and provincial laws and regulations relating to the environment. The Corporation believes that it is currently in compliance with such laws and regulations. However, such laws and regulations may change in the future in a manner which will increase the burden and cost of compliance. In addition, the Corporation could incur significant liability under such laws for damages, clean-up costs and penalties in the event of certain discharges into the environment. In addition, environmental laws and regulations may impose liability on the Corporation for personal injuries, clean-up costs, environmental damage and property damage as well as administrative, civil and criminal penalties. The Corporation maintains limited insurance coverage for accidental environmental damages, but does not maintain insurance for the full potential liability that could be caused by such environmental damage. Accordingly, the Corporation may be subject to significant liability, or may be required to cease production in the event of the noted liabilities.

## Provincial Regulation – Royalties Incentives and Land Tenures

In addition to federal regulations, each province has regulations which govern land tenure, royalties, production rates, extra-provincial export, environmental protection and other matters. The royalty regime is a significant factor in the profitability of oil and natural gas production. Royalties payable on production from lands other than Crown lands are determined by negotiations

## Management's Discussion & Analysis

between the mineral owner and the lessee. Crown royalties are determined by government regulation and are generally calculated as a percentage of the value of the gross production. The rate of royalties payable generally depends in part on prescribed reference prices, well productivity, geographical location, field discovery date and the type or quality of the petroleum product produced. From time to time the provincial governments of Canada have established incentive programs which have included royalty rate reductions, royalty holidays and tax credits for the purpose of encouraging oil and natural gas exploration or enhanced planning projects. Crude oil and natural gas located in the western provinces is owned predominantly by the respective provincial governments. Provincial governments grant rights to explore for and produce oil and natural gas pursuant to leases, licenses and permits for varying terms from two years and on conditions set forth in provincial legislation including requirements to perform specific work or make payments. Oil and natural gas located in such provinces can also be privately owned and rights to explore for and produce such oil and natural gas are granted by lease on such terms and conditions as may be negotiated.

**Terra Energy Corp.**  
**Consolidated Interim Financial Statements**  
**For the nine months ended September 30, 2006**  
**(Unaudited)**

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# Consolidated Balance Sheet

(Unaudited)

	September 30, 2006	December 31, 2005
<b>ASSETS</b>		
<b>Current</b>		
Cash and cash equivalents	\$ -	\$ 13,127,316
Accounts receivable	5,803,403	7,972,458
Financial instruments (Note 10)	29,725	275,513
Prepaid expenses and other	1,383,854	810,347
	<b>7,216,982</b>	<b>22,185,634</b>
Oil and gas properties	135,228,068	103,561,874
	<b>\$ 142,445,050</b>	<b>\$ 125,747,508</b>

## LIABILITIES AND SHAREHOLDERS' EQUITY

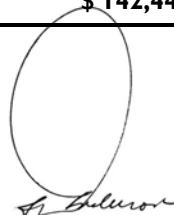
<b>Current</b>		
Bank overdraft	\$ 3,875,492	\$ -
Financial instruments (Note 10)	22,336	-
Accounts payable and accrued liabilities	17,230,972	22,942,084
	<b>21,128,800</b>	<b>22,942,084</b>
<b>Deferred charges</b> (Note 12)	<b>265,694</b>	<b>-</b>
<b>Long-term financing</b> (Note 3)	<b>40,210,749</b>	<b>29,610,391</b>
<b>Asset retirement obligations</b> (Note 7)	<b>5,416,854</b>	<b>4,577,373</b>
<b>Future income taxes</b>	<b>9,953,891</b>	<b>3,934,690</b>
<b>Preferred shares</b>	<b>1,148,641</b>	<b>1,148,641</b>
	<b>78,124,629</b>	<b>62,213,179</b>
<b>SHAREHOLDERS' EQUITY</b>		
<b>Share capital</b> (Note 5)	<b>59,546,519</b>	<b>60,984,212</b>
<b>Contributed surplus</b> (Note 6)	<b>7,593,956</b>	<b>3,809,311</b>
<b>Deficit</b>	<b>(2,820,054)</b>	<b>(1,259,194)</b>
	<b>64,320,421</b>	<b>63,534,329</b>
	<b>\$ 142,445,050</b>	<b>\$ 125,747,508</b>

### Commitments and Contingencies (Note 13)

Approved on behalf of the Board:



Robert Penner, Director



Theodore Anderson, Director

*The accompanying notes are an integral part of these consolidated financial statements.*

# Consolidated Statements of Operations and Deficit

(Unaudited)

	Three months ended September 30		Nine months ended September 30	
	2006	2005	2006	2005
<b>REVENUE</b>				
Petroleum and natural gas revenues (Note 9)	\$ 10,994,495	\$ 10,514,578	\$ 35,687,750	\$ 26,860,101
Royalties	(2,027,512)	(1,732,077)	(6,837,832)	(5,264,095)
	<b>8,966,983</b>	8,782,501	<b>28,849,918</b>	21,596,006
<b>EXPENSES</b>				
Production	3,123,725	4,130,800	9,671,401	10,136,673
Depletion, depreciation and amortization	3,678,673	2,200,000	10,181,237	6,600,000
Financing fee amortization (Note 4)	-	-	-	2,969,500
General and administrative	730,754	642,144	2,943,947	2,673,750
Stock based compensation	686,778	141,000	2,600,080	758,000
Interest charges (Note 8)	666,064	78,507	1,621,528	645,716
Accretion of asset retirement obligation	133,730	119,441	351,250	308,403
Realized foreign exchange gain (Note 10)	(502,836)	-	(794,077)	-
Unrealized foreign exchange loss (gain) (Note 10)	419,817	-	(26,164)	-
	<b>8,936,705</b>	7,311,892	<b>26,549,202</b>	24,092,042
<b>Income (loss) before income taxes</b>	<b>30,278</b>	1,470,609	<b>2,300,716</b>	(2,496,036)
<b>Income taxes (recovery)</b>				
Current tax	1,391	-	32,345	34,547
Future tax (recovery)	273,469	865,612	1,764,813	(300,666)
	<b>274,860</b>	865,612	<b>1,797,158</b>	(266,119)
<b>Net income (loss) for the period</b>	<b>(244,582)</b>	604,997	<b>503,558</b>	(2,229,917)
<b>Deficit, beginning of period</b>	<b>(1,513,006)</b>	(4,662,337)	<b>(1,259,194)</b>	(1,711,273)
<b>Repurchase of common shares</b>	<b>(1,062,466)</b>	(93,009)	<b>(2,064,418)</b>	(209,159)
<b>Deficit, end of period</b>	<b>\$ (2,820,054)</b>	\$ (4,150,349)	<b>\$ (2,820,054)</b>	\$ (4,150,349)
Earnings (loss) per common share – basic and diluted	\$ -	\$ 0.01	\$ 0.01	\$ (0.04)
Weighted average number of shares outstanding – basic	69,556,634	62,579,599	70,944,634	56,224,711
Weighted average number of shares outstanding – diluted	70,646,020	67,278,966	73,141,560	59,773,857

*The accompanying notes are an integral part of these consolidated financial statements.*

## Consolidated Statements of Cash Flows

(Unaudited)

	Three months ended September 30		Nine months ended September 30	
	2006	2005	2006	2005
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>				
Net income (loss) for the period	\$ (244,582)	\$ 604,997	\$ 503,558	\$ (2,229,917)
Items not affecting cash:				
Depletion, depreciation and amortization	3,678,673	2,200,000	10,181,237	6,600,000
Future income taxes (recovery)	273,469	865,612	1,764,813	(300,666)
Stock based compensation	686,778	141,000	2,600,080	758,000
Accretion of asset retirement obligations	133,730	119,441	351,250	308,403
Unrealized loss (gain) on financial instruments	90,401	-	(7,389)	-
Realized gain on financial instruments (note 9)	-	-	275,513	-
Amortization of deferred charges	(16,605)	-	(16,605)	-
Financing fee amortization	-	-	-	2,969,500
Cash flow from operations	4,601,864	3,931,050	15,652,457	8,105,320
Changes in non-cash working capital from operations	3,745,222	(3,247,889)	(511,772)	(911,108)
	8,347,086	683,161	15,140,685	7,194,212
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>				
Issuance of share capital, net of share issuance costs	107,905	23,719,152	5,753,730	36,086,822
Proceeds from long-term financing	(3,705,376)	1,084,292	10,600,358	2,434,409
Repayment of subordinated debt	-	-	-	(10,000,000)
Repurchase of common shares	(2,066,182)	(143,090)	(3,816,888)	(346,348)
	(5,663,653)	24,660,354	12,537,200	28,174,883
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>				
Additions to oil and gas properties	(14,565,285)	(14,663,335)	(50,342,372)	(23,128,830)
Disposition of oil and gas properties	8,983,173	-	8,983,173	-
Reimbursement for leasehold improvements	-	-	282,299	-
Changes in non-cash working capital from investing	4,103,305	2,874,251	(3,603,793)	2,758,164
	(1,478,807)	(11,789,084)	(44,680,693)	(20,370,666)
<b>Increase (decrease) in cash and cash equivalents</b>	<b>1,204,626</b>	<b>13,554,431</b>	<b>(17,002,808)</b>	<b>14,998,429</b>
<b>Cash and cash equivalents (bank overdraft), beginning of period</b>	<b>(5,080,118)</b>	<b>1,148,469</b>	<b>13,127,316</b>	<b>(295,529)</b>
<b>Cash and cash equivalents (bank overdraft), end of period</b>	<b>\$ (3,875,492)</b>	<b>\$ 14,702,900</b>	<b>\$ (3,875,492)</b>	<b>\$ 14,702,900</b>

The accompanying notes are an integral part of these consolidated financial statements.

# Notes to Consolidated Financial Statements

## Note 1 NATURE OF OPERATIONS

Terra Energy Corp. (the "Corporation") was formed on January 30, 2004 as a result of the amalgamation of Rhodes Resources Corp. ("Rhodes"), Terrapet Energy Corp. ("Terrapet"), and Terra Energy Corp ("Terra") pursuant to the Business Corporations Act of Alberta. The amalgamated Corporation operates under the name Terra Energy Corp. The Corporation's principal business is the exploration, development, and production of oil and natural gas in Western Canada. The amalgamation has been recorded as a reverse takeover by Terrapet and the comparative financial statements represent a continuation, for accounting purposes, of the financial statements of Terrapet and its subsidiaries ("Terrapet Consolidated").

These consolidated financial statements include the accounts of the Corporation and its wholly owned subsidiaries, Constar Resources Ltd. and Terra Energy Partnership. The latter is a general partnership between Terra Energy Corp. and Constar Resources Ltd.

## Note 2 SIGNIFICANT ACCOUNTING POLICIES

The interim consolidated financial statements of Terra Energy Corp. have been prepared by management in accordance with Canadian generally accepted accounting principles. The interim consolidated financial statements have been prepared following the same accounting policies and methods of computation as the consolidated financial statements for Terra Energy Corp. for the year ended December 31, 2005. Certain disclosures, which are normally required to be included in the notes to the financial statements, have been condensed or omitted. The interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements of Terra Energy Corp. and the notes thereto for the year ended December 31, 2005.

Deferred lease inducements are accounted for as a reduction of rent expense over the term of the lease.

## Note 3 LONG-TERM FINANCING

The Corporation has a revolving line of credit of up to \$55 million (2005 - \$40.0 million), which bears interest at prime plus 0.25% (2005 - prime plus 0.25%). The facility is secured by a general security agreement, a floating charge debenture in the amount of \$150 million and an unlimited liability guarantee by Terra Energy Corp. and Constar Resources Ltd. At September 30, 2006 the Corporation was indebted on the revolving line of credit in amount of \$40,210,749 (2005 - \$29,610,391) and was in compliance with all loan covenants.

The Corporation's bank credit facility is structured as a 364 day revolving credit facility with a one year term out. If the credit facility is not renewed at maturity, the Corporation is required to pay the outstanding balance one year from the maturity. The credit facility is subject to a renewal in May 2007. As a result the liability has been classified as a non-current liability. In addition, the credit facility includes a change of control clause whereby in the event of any change of control, the creditor, at their discretion, may terminate the credit facility and therefore the entire amount outstanding will be due and payable upon demand.

## Note 4 SUBORDINATED DEBT

During 2004, the Corporation had available a standby mezzanine financing credit facility of \$15.0 million, with an interest rate of 10% per annum. At December 31, 2004, the Corporation had drawn \$10.0 million on this facility. The unadvanced portion of \$5.0 million was cancelled and was no longer available.

The creditor charged a standby fee of 5% on the unadvanced portion of \$5.0 million and a closing fee of 0.75% on the advanced portion of \$10.0 million. The Corporation also issued 5 million warrants to the creditor, with each warrant to purchase one common share, at prices between \$1.20 and \$1.60. These warrants were valued at \$2,307,000. These amounts were fully amortized when the facility was repaid in the first quarter of 2005. The facility was secured by a floating charge debenture on the Corporation's assets, subordinated to the Corporation's existing security issued in relation to the Revolving Loan.

# Notes to Consolidated Financial Statements

## Note 5 SHARE CAPITAL

### a) Authorized

- i) Unlimited number of common voting shares
- ii) Unlimited number of preferred shares

### b) Issued and Outstanding

	<b>2006</b>	
	<b>Number of Shares</b>	<b>Amounts</b>
Opening balance, beginning of period	68,093,883	\$ 57,375,841
Issued on exercise of warrants	2,286,650	3,269,485
Issued on exercise of options	2,102,000	2,484,245
Tax effect of flow-through share renouncement	-	(4,254,388)
Reclassification of warrants	-	873,757
Reclassification of contributed surplus	-	1,115,791
Shares repurchased for cancellation	(2,088,900)	(1,752,470)
<b>Closing balance, common shares</b>	<b>70,393,633</b>	<b>59,112,261</b>
Share purchase warrants		
Opening balance, beginning of period	7,752,277	3,608,371
Expired	(4,469,427)	(2,300,356)
Exercised	(2,189,150)	(873,757)
<b>Closing balance, warrants</b>	<b>1,093,700</b>	<b>434,258</b>
<b>Closing balance, common shares and warrants</b>	<b>71,487,333</b>	<b>\$ 59,546,519</b>

In May 2006, the Corporation obtained permission from the TSX Venture Exchange for a Normal Course Issuer Bid to repurchase for cancellation up to 5,000,000 common shares to May 17, 2007.

During the nine months ended September 30, 2006, the Corporation repurchased 2,088,900 shares for \$3,816,888 at an average price of \$1.83 per common share and recorded \$1,752,470 as a reduction of share capital and the excess of \$2,064,418 being charged to deficit.

During the second quarter of 2006, 1,213,500 repurchased shares were cancelled. As at September 30, 2006, 1,768,800 repurchased shares are held for cancellation.

### c) Stock Options

During 2005, the Corporation amended its Employee Stock Option Plan whereby officers, directors, employees, and consultants may be granted options of up to 10 percent of the issued and outstanding common shares of the Corporation. These options entitle the holder to purchase common shares of the Corporation subject to various vesting periods and other terms and conditions specified in the stock option plan.

## Notes to Consolidated Financial Statements

### Note 5 SHARE CAPITAL (continued)

#### c) Stock Options (continued)

Details of all options outstanding are as follows:

	2006	
	Number of Options	Weighted Average Exercise Price
<b>EMPLOYEE STOCK OPTIONS</b>		
Balance, beginning of period	4,201,000	\$ 1.24
Granted	3,365,500	1.80
Exercised	(1,610,500)	(1.11)
Expired	(86,600)	(1.93)
<b>Balance, end of period</b>	<b>5,869,400</b>	<b>1.58</b>
<b>AGENT OPTIONS</b>		
Balance, beginning of period	1,383,209	1.40
Exercised	(491,500)	(1.40)
<b>Balance, end of period</b>	<b>891,709</b>	<b>1.40</b>
<b>OTHER OPTIONS</b>		
<b>Balance, beginning and end of period</b>	<b>329,730</b>	<b>1.21</b>
<b>Total Options, balance, end of period</b>	<b>7,090,839</b>	<b>\$ 1.54</b>

## Notes to Consolidated Financial Statements

### Note 5 SHARE CAPITAL (Continued)

#### c) Stock Options (continued)

<i>Options Exercise Price</i>	<i>Weighted Average Remaining Contract Life</i>	<b>Outstanding September 30, 2006</b>	<i>Weighted Average Share Price for Outstanding Options</i>	<b>Exercisable September 30, 2006</b>	<i>Weighted Average Share Price for Exercisable Options</i>
\$1.00	2.38 years	768,000		314,000	
\$1.00	2.34 years	222,000		62,000	
\$1.15	3.33 years	245,500		45,500	
\$1.21	0.25 years	329,730		329,730	
\$1.40	0.25 years	236,780		236,780	
\$1.40	0.28 years	654,929		654,929	
\$1.50	3.72 years	60,000		12,000	
\$1.51	3.72 years	1,133,000		314,600	
\$1.66	2.37 years	553,000		553,000	
\$1.66	3.33 years	32,000		32,000	
\$1.70	4.78 years	1,214,000		586,000	
\$1.70	0.17 years	2,400		2,400	
\$1.82	2.42 years	25,000		25,000	
\$1.85	3.30 years	40,000		40,000	
\$1.89	4.00 years	214,000		36,400	
\$1.89	4.36 years	210,000		42,000	
\$1.90	4.25 years	300,000		60,000	
\$1.90	2.37 years	300,000		300,000	
\$1.94	3.70 years	106,000		106,000	
\$1.94	2.37 years	120,000		120,000	
\$2.01	0.17 years	5,000		5,000	
\$2.02	4.13 years	10,000		2,000	
\$2.05	3.73 years	115,000		115,000	
\$2.10	4.54 years	160,000		32,000	
\$2.19	3.30 years	26,500		26,500	
\$2.27	3.73 years	8,000		8,000	
	<b>2.97 years</b>	<b>7,090,839</b>	<b>\$ 1.54</b>	<b>4,060,839</b>	<b>\$ 1.56</b>

#### d) Stock -based Compensation

For stock options granted compensation expense of \$2,600,080 has been recorded for the period ended September 30, 2006 (\$758,000 – 2005) with the offsetting amount recorded in contributed surplus. The fair value of share options issued during first nine months of 2006 was estimated using the Black-Scholes option-pricing model with the following assumptions: Dividend yield (Nil); expected volatility at 66%; risk-free interest rate of 4.0-6.0%; weighted average life of 2.97 years.

# Notes to Consolidated Financial Statements

## Note 5 SHARE CAPITAL (continued)

### e) Warrants

	Balance Dec 31, 2005	Issued	Exercised	Expired	Balance September 30, 2006
The Corporation issued in exchange for warrants previously granted by Rhodes Resources Corp., the following warrants:					
<b>RHODES SERIES C WARRANTS</b>					
These warrants are exercisable at \$1.10 per common share until January 29, 2005 and at \$1.20 per share until January 29, 2006 at which time these warrants expire.	43,000	-	33,000	10,000	-
<b>Total Rhodes warrants</b>	43,000	-	33,000	10,000	-
During 2004, the Corporation issued the following warrants:					
<b>2004 TERRA SERIES B</b>					
These warrants were issued in conjunction with the Subordinated Debt issued on December 30, 2004 and are exercisable at \$1.40 per common share until June 30, 2007 at which time these warrants will expire.	1,250,000	-	-	-	1,250,000
<b>2004 TERRA SERIES C</b>					
These warrants were issued in conjunction with the Subordinated Debt issued on December 30, 2004 and are exercisable at \$1.40 per common share until December 31, 2006 and at \$1.60 per common share until December 31, 2007 at which time these warrants will expire.	2,500,000	-	-	-	2,500,000
<b>2004 TERRA SERIES D</b>					
Two warrants are required for exercise to purchase one common share at \$1.40 until December 30, 2005 and one common share at \$1.60 until December 30, 2006 at which time these warrants will expire.	535,250	-	64,500	-	470,750
During 2005, the Corporation issued the following warrants:					
<b>2005 TERRA SERIES E</b>					
These warrants are exercisable at \$1.40 to purchase one common share until January 26, 2006 and at \$1.60 per one common share until January 26, 2007 at which time these warrants will expire.	3,193,600	-	2,099,900	-	1,093,700
<b>2005 TERRA SERIES F</b>					
One warrant is required to purchase one common share at \$2.10 until July 27, 2006 at which time these warrants will expire.	4,558,677	-	89,250	4,469,427	-
<b>Total Terra Energy warrants</b>	12,037,527	-	2,253,650	4,469,427	5,314,450
<b>Total warrants</b>	12,080,527	-	2,286,650	4,479,427	5,314,450

## Notes to Consolidated Financial Statements

### Note 6 CONTRIBUTED SURPLUS

Contributed surplus consists of the fair value of both share warrants issued for various financing agreements and for the stock based compensation on employee stock options.

The details of contributed surplus are as follows:

	2006	2005
Balance, beginning of period	\$ 3,809,311	\$ 4,196,192
Stock based compensation	2,600,080	940,000
Agent's options granted	-	275,924
Warrants expired	2,300,356	-
Reclassification resulting from exercise of options and warrants	(1,115,791)	(1,602,805)
Balance, end of period	\$ 7,593,956	\$ 3,809,311

### Note 7 ASSET RETIREMENT OBLIGATIONS

The liability for the expected cash flows required to settle the asset retirement obligations, as reflected in the consolidated financial statements, has been discounted at 9% (2005 – 9%) and the inflation rate used is 2%.

The schedule below is a reconciliation of the Corporation's liability for the period ended September 30, 2006:

	2006	2005
Balance, beginning of period	\$ 4,577,373	\$ 4,021,143
Obligations disposed	(138,676)	(923,126)
Revisions to estimates	(31,208)	(810,062)
Obligations incurred	658,115	1,911,470
Accretion expenses	351,250	377,948
Balance, end of period	\$ 5,416,854	\$ 4,577,373

### Note 8 INTEREST CHARGES

Interest charges consist of the following amounts:

<i>Period ended September 30</i>	2006	2005
Interest on revolving line of credit	\$ 130,969	\$ 415,708
Interest on banker's acceptances	1,421,640	-
Interest on preferred shares	68,918	68,916
Interest on subordinated debt	-	161,092
	\$ 1,621,527	\$ 645,716

The interest on preferred shares has been paid to a senior officer of the Corporation.

# Notes to Consolidated Financial Statements

## Note 9 REVENUE

As at September 30, 2006, petroleum and natural gas revenues include a net hedging gain of \$797,884 of which \$29,725 was unrealized gain. The realized gain of \$768,159 included \$275,513 related to 2005.

## Note 10 FINANCIAL INSTRUMENTS

As at September 30, 2006, the Corporation had the following financial commodity contracts outstanding:

<i>Contract Type</i>	<i>Floor Price</i>	<i>Ceiling Price</i>	<i>Volumes Per Day</i>	<i>Contract Term</i>
Financial	Sell \$79.60 per Bbl	N/A	100 Bbls	March 1, 2006 to December 31, 2006
Financial	Buy \$76.20 per Bbl	N/A	100 Bbls	March 1, 2006 to December 31, 2006
Financial	Sell \$86.00 per Bbl	N/A	200 Bbls	June 1, 2006 to May 31, 2007
Financial	Buy \$80.65 per Bbl	N/A	200 Bbls	June 1, 2006 to May 31, 2007
Financial	Sell US\$77.25 per Bbl	N/A	100 Bbls	January 1, 2007 to December 31, 2007
Financial	Buy US\$76.40 per Bbl	N/A	100 Bbls	January 1, 2007 to December 31, 2007

The fair market value of these contracts has been recorded as an asset in the amount of \$29,725.

The Corporation has the following forward foreign exchange contracts for the US dollar LIBOR outstanding as at September 30, 2006.

<i>Contract Type</i>	<i>Value</i>	<i>Maturity Date</i>	<i>Forward Exchange Rate</i>
Financial	US\$ 2,500,000	October 23, 2006	\$ 0.8881

The fair market value of the above forward foreign exchange contract of \$22,336 has been recorded as a liability and unrealized foreign exchange loss. The conversion of the outstanding US dollar Banker's Acceptances at September 30, 2006 resulted in unrealized foreign exchange gain of \$48,500. The Corporation also recorded \$794,077 of realized foreign exchange gain during the nine months (\$502,836 for three months) as US dollar Banker's Acceptances matured and forward exchange contracts were settled.

## Note 11 RELATED PARTY TRANSACTIONS

The Corporation had the following related party transactions except as disclosed elsewhere:

### a) The Corporation entered into transactions with the following related parties:

- Capital Strategies Group (Canada) Corp., controlled by two officers of the Corporation
- Rhodes Petroleum Corp., controlled by an officer of the Corporation
- Terra Capital Corp., a significant shareholder (32%)
- Pioneer Land Services Ltd, a Director is an employee of Pioneer
- Borden Ladner Gervais LLP, a Director is partner with the law firm
- Fasken Martineau DuMoulin LLP, the Corporate Secretary is partner with the law firm

# Notes to Consolidated Financial Statements

## Note 11 RELATED PARTY TRANSACTIONS (continued)

### b) Transactions

<i>Period ended September 30</i>	<b>2006</b>	<b>2005</b>
<b>EXPENSES</b>		
Service fees – Terra Capital Corp	\$ -	\$ 54,000
Consulting – Pioneer Land Services Ltd.	<b>5,277</b>	15,277
Legal Consulting – Fasken Martineau DuMoulin LLP	<b>49,743</b>	-
Legal Consulting – Borden Ladner Gervais LLP	<b>128,022</b>	130,048
	<b>183,042</b>	199,325
<b>OTHER</b>		
Acquisition of P&NG equipment recorded as oil and gas properties	-	60,000
Recorded as part of share issuance cost –Fasken Martineau DuMoulin	-	11,052
Recorded as part of share issuance cost – Borden Ladner Gervais LLP	-	132,946
Recorded as part of oil and gas properties – Pioneer Land Services Ltd.,	<b>32,362</b>	87,007
	<b>\$ 32,362</b>	\$ 291,005

- c) The transactions are in the normal course of operations and have been valued in the consolidated financial statements at the exchange amount which is the amount of consideration established and agreed to by the related parties.

## Note 12 DEFERRED CHARGES

The Corporation was reimbursed \$299,000 of leasehold improvements. The amount is being amortized over the term of the lease, and rent expense has been reduced accordingly.

## Note 13 COMMITMENTS AND CONTINGENCIES

- a) The Corporation had outstanding letters of credit to various parties for a total of \$395,000 (2005- \$408,000). The amounts expire at various dates during 2007.
- b) The Corporation is involved in various claims and litigations arising in 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 favour, the Corporation does not currently believe that the outcome of adverse decisions in any proceedings related to these matters or any amount which it may be required to pay, would have a material adverse impact on its financial position, results of operations or liquidity.
- c) At September 30, 2006, the Corporation has incurred all of its required exploration and development expenditure obligations arising from the flow through shares issued in 2005.
- d) The Corporation has firm transportation and processing contracts expiring between October 31, 2006 and 2009. The monthly transportation and processing fees pursuant to the contacts are approximately \$238,600 until October 31, 2006 and \$230,000 thereafter.

## Notes to Consolidated Financial Statements

### Note 14 SUBSEQUENT EVENTS

a) Subsequent to September 30, 2006, the Corporation entered into the following financial commodity contracts:

<i>Contract Type</i>	<i>Floor Price</i>	<i>Ceiling Price</i>	<i>Volumes Per Day</i>	<i>Contract Term</i>
Financial	Sell \$7.50 per Gj	N/A	1,000 Gj	November 1, 2006 to October 31, 2007
Financial	Sell \$6.50 per Gj	\$8.92 per Gj	1,000 Gj	November 1, 2006 to October 31, 2007
Financial	Sell \$7.50 per Gj	N/A	1,500 Gj	December 1, 2006 to December 31, 2007
Financial	Sell \$7.65 per Gj	N/A	1,000 Gj	December 1, 2006 to October 31, 2007
Financial	Sell \$7.75 per Gj	N/A	1,000 Gj	January 1, 2007 to December 31, 2007

b) Subsequent to the period end, the board of directors approved the repurchase of the Series I to V, 8% preferred shares at face value. The preferred shares have since been repurchased for cancellation.

c) In October 2006, the Corporation cancelled 34,000 repurchased shares.

d) On November 21, 2006, the Corporation issued 7,900,000 flow-through common shares for proceeds of \$15,010,000. The related after tax share issue cost was \$641,520. In addition, the officers, directors, consultants and associates of the Corporation purchased 370,000 flow-through shares for proceeds of \$703,000.



# Corporate Information

## Head Office

Suite 970, 333 Seventh Avenue SW  
Calgary, Alberta T2P 2Z1  
Tel: 403.699.7777; Fax: 403.264.7189

## Solicitor

Borden Ladner Gervais LLP, Calgary, Alberta

## Auditor

Deloitte & Touche, LLP, Calgary, Alberta

## Evaluation Engineers

GLJ Petroleum Consultants Ltd.

## Banker

TD Canada Trust, Calgary, Alberta

## Transfer Agent

Shareholders are encouraged to contact our Registrar and Transfer Agent for information regarding their securities holdings:

Computershare Trust Company  
Suite 600, 530 Eighth Avenue SW  
Calgary, Alberta T2P 3S8  
Tel: 1.800.564.6253  
Fax: 1.888.453.0330  
email: [caregistryinfo@computershare.com](mailto:caregistryinfo@computershare.com)

## Stock Exchange

TSX-Venture

## Stock Symbol

TTR

## Investor Contact

Bud K. Love  
Vice President, Finance & Chief Financial Officer  
Tel: 403.699.7777; Fax: 403.264.7189

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