

PETRO-REEF RESOURCES LTD.

MANAGEMENT'S DISCUSSION AND ANALYSIS

FORM 51-102F1

ANNUAL REPORT 2005

CONTENTS:

Management's Discussion and Analysis

MANAGEMENT'S DISCUSSION AND ANALYSIS

The following Management's Discussion and Analysis for Petro-Reef Resources Ltd. should be read in conjunction with the audited financial statements and notes, contained in the annual report for 2005 and are based on information available to April 2006. Additional information regarding Petro-Reef is available in the updated Annual Information Form which has been filed electronically, at the same time as this report, on the System for Electronic Document Analysis and Retrieval (SEDAR) at www.sedar.com or on Petro-Reef's website at www.petro-reef.ca.

ABBREVIATIONS

ARTC	Alberta Royalty Tax Credit	Mbbls	thousands of barrels
Bbl	barrel	Mcf	thousand cubic feet
Bbls	barrels	Mcf/d	thousand cubic feet per day
Bcf	billion cubic feet	MMbbls	millions of barrels
BOE	barrel of oil equivalent (1 BOE = 6 Mcf)	MMcf	million cubic feet
Bo/d	Barrels of oil per day	MMcf/d	million cubic feet per day
GJ	Gigajoule	FNR	future net revenue
GJs/d	Gigajoules per day	NGL	natural gas liquids
		NPV	net present value

NOTE: In this report all currency values are in Canadian Dollars.

FORWARD-LOOKING STATEMENTS

Some of the statements contained herein (including without limitation, financial and business prospects and financial outlooks) may be forward-looking statements which reflect management's expectations regarding future plans and intentions, growth, results of operations, performance and business prospects and opportunities. Words such as "may", "will", "should", "could", "anticipate", "believe", "expect", "intend", "plan", "potential", "continue" and similar expressions have been used to identify these forward-looking statements. These statements reflect management's current beliefs and are based on information currently available to management. Forward-looking statements involve significant risk and uncertainties. A number of factors could cause actual results to differ materially from the results discussed in the forward-looking statements including, but not limited to, changes in general economic and market conditions and other risk factors. Although the forward-looking statements contained herein are based upon what management believes to be reasonable assumptions, management cannot assure that actual results will be consistent with these forward-looking statements. Investors should not place undue reliance on forward-looking statements. These forward-looking statements are made as of the date hereof and the Corporation assumes no obligation to update or review them to reflect new events or circumstances.

Forward-looking statements and other information contained herein concerning the oil and gas industry and the Corporation's general expectations concerning this industry is based on estimates prepared by management using data from publicly available industry sources as well as from reserve reports, market research and industry analysis and on assumptions based on data and knowledge of this industry which the Corporation believes to be reasonable. However, this data is inherently imprecise, although generally indicative of relative market positions, market shares and performance characteristics. While the Corporation is not aware of any misstatements regarding any industry data presented herein, the industry involves risks and uncertainties and is subject to change based on various factors.

NOTE:

Petro-Reef cautions that "cash flow from operations" and "netbacks" do not have standardized meanings prescribed by Canadian generally accepted accounting principles and are therefore unlikely to be comparable to similar measures presented by other issuers. Management believes "cash flow from operations," defined as cash provided by operations before changes in non-cash working capital, is a useful indicator of the Company's ability to fund future capital expenditures, Petro-Reef calculates netbacks as net dollars per barrel after Crown Royalties, operating expenses and general and administrative expenses.

Reference is made to barrels of oil equivalent (BOE). Barrels of oil equivalent may be misleading, particularly if used in isolation. In accordance with National Instrument 51-101, a BOE conversion ratio for natural gas of 6 Mcf: 1 Bbl has been used, which is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead.

**PETRO-REEF RESOURCES LTD.
CORPORATE INFORMATION**

DIRECTORS AND OFFICERS

Joseph Werner⁽⁴⁾

Chief Executive Officer
President & Director
Calgary, Alberta

Theodore M. Donhuysen^{(3) (4) (5)}

Vice-President Exploration & Production
Chief Operating Officer & Director
Calgary, Alberta

Alan P. Hallman^{(2) (3)}

Director
Calgary, Alberta

Dennis K. Ulrich

Director
Medicine Hat, Alberta

Jack P. Donhuysen^{(2) (5)}

Director
Calgary, Alberta

Huba A. Sebo^{(1) (5)}

Director
Calgary, Alberta

N. Gary Van Nest^{(1) (3)}

Director
Calgary, Alberta

Richard W. DeVries^{(1) (2)}

Director
Freeport, The Bahamas

Robert N. Maertens-Poole

Chief Financial Officer
Calgary, Alberta

Gary W. Coleman

Assistant Secretary
Calgary, Alberta

R. Greg Powers⁽⁶⁾

Corporate Secretary
Legal Counsel
Calgary, Alberta

Head Office

2020, 800- 5th Avenue S.W.
Calgary, Alberta T2P 3T6
Telephone: +1 (403) 265-6444
Facsimile: +1 (403) 264-1348
E-mail: info@petro-reef.ca
Website: www.petro-reef.ca

Stock Listing

TSX Venture Exchange
Trading Symbol: **PER**

Auditors

PricewaterhouseCoopers LLP
Chartered Accountants
3100, 111 - 5th Avenue S.W.
Calgary, Alberta T2P 5L3

Bank

National Bank of Canada
301 - 6th Avenue S.W.
Calgary, Alberta T2P 4M9

Registrar and Transfer Agent

CIBC Mellon Trust Company
600, 333 - 7th Avenue S.W.
Calgary, Alberta T2P 2Z1

Investor Relations

Iradesso Communications Corp.
400, 805 - 10th Avenue S.W.
Calgary, Alberta T2R 0B4

- (1) Member of the Audit Committee
- (2) Member of the Compensation Committee
- (3) Member of the Corporate Governance Committee
- (4) Member of the Management Committee
- (5) Member of the Reserves Committee
- (6) Baker & McKenzie
2600, 255 - 5th Avenue S.W.
Calgary, Alberta T2P 3G6

THE YEAR 2005 IN REVIEW

Petro-Reef Resources Ltd. (TSX-V: PER), a Calgary based crude oil and natural gas exploration and production company with producing properties in Alberta, Canada, capitalized on its drilling success and strong commodity prices to earn \$248,714 on cash flow from operations of \$2,187,030 in 2005. This compares to a loss of \$542,087 on cash flow from operations of \$1,514,596 in 2004. The Company exited 2005 producing 706 barrels of oil equivalent per day compared to an exit rate of 238 BOE/d.

Total production for 2005 was 66,305 barrels of oil equivalent (BOE), an increase of five percent over the production for 2004 of 62,936 BOE.

Petro-Reef's production in 2005 came from two core properties, Alexander/Qui Barre and Peavey/Morinville, both located near Edmonton, Alberta. Alexander/Qui Barre produced about 83 percent of total production for about 81 percent of the revenue while, Peavey/Morinville, produced about 16 percent of total production for about 18 percent of the revenue. The remaining production came from minor working interest and royalty properties. About 99.9 percent of the production was natural gas with about 0.1 percent as crude oil and natural gas liquids.

Activities during the year included drilling, completions, tie-ins, and work-overs/re-completions. Additional 2-D and 3-D seismic data were acquired, processed and interpreted.

The company continues to use the following exploration criteria on each prospect to assure high profitability and rate of return on capital investment:

- 1) Each exploration prospect must exhibit
 - a) Potential for a minimum of three hydrocarbon zones.
 - b) Potential for:
 - (i) 10:1 profit to capital risk ratio
 - (ii) a minimum of 30 percent rate of return on capital invested
 - (iii) minimum life of 15 years
- 2) Both 2-D and 3-D seismic are used to identify and confirm potential drilling locations using state-of-the-art technology.

Management uses cash flow from operations per share to analyze operating performance. Cash flow from operations per share does not have any standardized meaning prescribed by Canadian Generally Accepted Accounting Principles ("GAAP") and therefore it may not be comparable with the calculation of similar measures for other entities.

PETRO-REEF RESOURCES LTD.

Highlights of Financial and Operations Results for Fiscal Years 2005 and 2004.

Financial	Year Ended December 31, 2005	Year Ended December 31, 2004	<u>% Change</u>
Crude oil and Natural Gas Revenue	\$3,224,567	\$2,162,656	+49
Cash flow from operations	\$2,187,030	\$1,514,596	+45
Net earnings (loss) from operations	\$248,714	(\$542,087)	-
Net earnings (loss) per share	\$0.01	(\$0.03)	-
Capital Expenditures	\$2,374,843	\$1,148,725	+107
Bank Balance (Loan)	\$397,904	(\$700,000)	-
Shareholder's equity	\$6,029,968	\$4,021,269	+50
Common shares outstanding Weighted average	18,994,641	17,701,232	+7
Operations	Year Ended December 31, 2005	Year Ended December 31, 2004	<u>% Change</u>
Daily Average Production			
Crude Oil and NGLs (Bbls/day)	2	13	-85
Natural Gas (mcf/day)	1,080	954	+13
Total BOE/day	182	172	+6
Average Selling Price			
Crude Oil (\$per Bbl)	57.97	45.25	+28
Natural Gas (\$per mcf)	9.57	6.51	+47
NGL (\$per Bbl)	55.50	48.25	+15
Operations	December 2005	December 2004	<u>% Change</u>
Daily Average Production			
Crude Oil and NGLs (Bbls/day)	1	0	-
Natural Gas (mcf/day)	2,731	1,437	+90
Total BOE/day	456	240	+90
Average Selling Price			
Crude Oil (\$/Bbl)	44.70	-	-
NGL (\$/Bbl)	-	-	-
Natural Gas (\$/mcf)	12.86	6.38	+102

THREE-YEAR REVIEW

	2005	2004	2003
FINANCIAL			(Restated)
Crude Oil and Natural Gas Revenue Net of royalties and ARTC	\$3,224,567	\$2,162,656	\$894,261
Net (Loss) Earnings from Operations	\$248,714	(\$542,087)	(\$156,741)
Net (Loss) Earnings per Share	\$0.01	(\$0.03)	(\$0.01)
Capital Expenditures	\$2,374,843	\$1,148,725	\$1,557,439
Total Assets	\$10,462,289	\$8,691,850	\$8,174,724
Bank Balance (Loan)	\$397,904	(\$700,000)	(\$1,150,000)
Shareholder's Equity	\$6,029,968	\$4,021,268	\$4,247,706
Common Shares Outstanding			
End of Period	21,438,924	17,738,937	17,688,937
Weighted Average	18,994,641	17,701,232	17,688,937
OPERATIONS			
Average Production			
Crude Oil and NGLs (Bbls/day)	2	13	6
Natural Gas (Mcf/day)	1,080	954	409
Total BOE per day 6:1	182	172	74
Finding & Development Cost per BOE ⁽¹⁾	\$5.27	\$9.61	\$18.00
Netbacks (\$ per BOE) ⁽³⁾	\$34.90	\$23.70	\$23.95
Reserve Replacement Ratio	2.41	0.66	3.2
Average Selling Price			
Crude Oil (\$ per BOE)	59.97	\$45.25	\$43.21
Natural Gas (\$ per BOE)	57.43	\$37.02	\$39.96
NGL (\$ per BOE)	55.50	\$48.25	\$44.14
Reserves (Proved plus Probable)			
Crude Oil and NGLs (Bbls)	1,000	16,300	40,400
Natural Gas (MMcf)	3,754	2,569	2,527
Total BOE	503,500	444,467	461,600
Present Value of Reserves (M\$) ⁽²⁾			
Undiscounted before Taxes	\$26,119	\$12,848	\$13,277
Discounted before Taxes at 10%	\$18,639	\$9,294	\$9,490
Established Reserve Life Index (P+P)	22.5 yrs	32.6 yrs	24.4 yrs
Proved Reserve Life Index	19.3 yrs	18.3 yrs	15.4 yrs

(1) After revisions due to NI51-101.

(2) Using constant prices and costs.

(3) Using a conversion of 6,000 cubic feet of natural gas for one barrel of oil equivalent.

(4) Crude oil sales were non-operated and reported with total oil and gas sales combined.

Netbacks are calculated by subtracting royalty expenses and operating expenses from revenue per barrel of oil equivalent. These calculations are before Alberta Royalty Tax Credits.

Petro-Reef's reserve replacement ratio for 2005 using proved reserves only was 2.41 to 1. Reserve replacement ratio for a given year is calculated by dividing total reserves at the end of the year by the total reserves at the beginning of the year.

Operating costs for 2005 averaged about \$63,000 per month, an increase from an average of about \$51,000 per month for 2004. The increased costs were a result of costs of fieldwork required to produce the one new well drilled in June 2005 and the re-completion, and reworking of more wells than in 2004. In December 2005 operating costs almost doubled the average for the year with the onset of production of the latest natural gas well at a rate in excess of four million cubic feet per day (MMcf/d), for a 90 percent increase in production.

Net general and administration costs had a modest increase to approximately \$34,500 per month in 2005 from approximately \$33,000 per month in 2004 and approximately \$28,600 per month in 2003. Except for some minor increases, the highest costs since 2003 were due to additional reporting requirements, legal, accounting, engineering and related third party charges.

Capital expenditures for 2005 were \$2,378,843 compared with \$1,148,725 in 2004, an increase of 107 percent.

The net present value of proved plus probable reserves at constant prices and costs (undiscounted), before income tax, for 2005 is \$26,119,000. This is a 107 percent increase from \$12,634,000 in 2004. The comparable numbers at a 10 percent discount of future net revenues are \$18,639,000 for 2005, and \$9,094,000 for 2004, a 105 percent increase.

There are no long-term financial liabilities and there have been no dividends declared.

At year end there was no bank loan.

Revenues fluctuated during 2005 because of changes in volumes of product produced and with changes in product price. Because Petro-Reef produces more than 99 percent natural gas, natural gas prices fluctuations had more impact than prices for crude oil. The following table shows natural gas prices received by Petro-Reef for 2005, 2004 and 2003 by month and by quarter.

Product Price for Natural Gas (\$ per Gigajoule)

Years: 2005-2004-2003

Month of:	\$ Price Per GJ Year 2005	\$ Price Per GJ Year 2004	\$ Price Per GJ Year 2003
January	6.233800	6.659749	6.643443
February	6.260490	5.757239	8.516847
March	7.000700	5.881507	8.081131
Average Price per Quarter:	6.498330	6.099498	7.747140

April	7.347800	6.274938	6.432713
May	6.562240	6.950898	6.497444
June	7.052828	6.564088	6.272281
Average Price per Quarter:	6.987623	6.596645	6.400812

July	7.058280	6.479279	5.478141
August	8.727350	5.724071	5.700614
September	10.478270	5.326431	5.328396
Average Price per Quarter:	8.754633	5.843260	5.502383

October	11.725960	6.170750	5.245812
November	8.837250	5.878970	4.989099
December	11.414247	6.382450	6.178671
Average Price per Quarter:	10.659152	6.1440570	5.471194

Average Price for Year	8.22	6.17	6.28
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Note: 1 gigajoule = 1.054615 thousand cubic feet

SELECTED FINANCIAL INFORMATION

FINANCIAL (year-ended December 31)	2005	2004	2003
Crude Oil and Natural Gas Revenue net of royalties and ARTC	\$3,224,567	\$2,162,656	\$894,261
Cash Flow from Operations	\$2,187,030	\$1,514,596	\$17,029
Net (Loss) Earnings from Operations	\$248,714	(\$542,087)	(\$156,741)
Net (Loss) Earnings per Share, Basic and Diluted	\$0.01	(\$0.03)	(\$0.01)
Capital Expenditures	\$2,374,843	\$1,148,725	\$1,557,439
Total Assets	\$10,462,289	\$8,691,850	\$8,174,724
Bank Balance (Loan)	\$397,904	(\$700,000)	(\$1,150,000)
Shareholders' Equity	\$6,029,968	\$4,021,269	\$4,247,706

The following table summarizes the results of the 12 most recently completed quarters.

Summary of Quarterly Results For The Last Twelve Quarters				
		Oil & Gas Sales Net of Royalties And ARTC	Net Earnings (Loss)	Basic and Diluted Earnings per share
2003			(Restated)	
	Q1	\$211,493	(\$609)	\$0.00
	Q2	\$176,756	\$14,964	\$0.00
	Q3	\$119,614	(\$113,592)	\$0.00
	Q4	<u>\$386,398</u>	<u>(\$57,504)</u>	(\$0.01)
Total		<u>\$894,261</u>	<u>(\$156,741)</u>	
2004				
	Q1	\$354,288	(\$81,806)	\$0.00
	Q2	\$531,591	(\$75,371)	\$0.00
	Q3	\$499,139	\$34,086	\$0.00
	Q4	<u>\$777,638</u>	<u>(\$418,996)</u>	(\$0.03)
Total		<u>\$2,162,656</u>	<u>(\$542,087)</u>	
2005				
	Q1	\$743,193.70	(\$14,869)	\$0.00
	Q2	\$522,696.91	(\$24,224)	\$0.00
	Q3	\$560,987.35	(\$21,890)	\$0.00
	Q4	<u>\$1,201,738.84</u>	<u>\$309,697</u>	\$0.01
Total		<u>\$3,224,577.67</u>	<u>\$248,714</u>	

The following tables summarize the production and revenues for 2003-2004-2005.

2003 PRODUCTION AND REVENUE SUMMARY BY PRODUCTION DATE

	(1) <u>BOE</u>	(2) <u>BOE / Day</u>	(3) <u>REVENUE</u> \$	(4) <u>ROYALTIES</u> \$	(5) <u>EXPENSES</u> \$	(6) <u>(3)-(4)-(5)</u> \$	(7) <u>NET BACK</u> \$/ BOE	(8) <u>NET G + A</u> \$	(9) <u>(6) – (8)</u> \$
JAN	1,446.67	46.67	61,120.33	8,415.35	14,010.20	38,694.78	26.75	25,181.45	13,513.33
FEB	1,628.14	58.15	86,808.34	12,609.41	16,382.34	57,816.59	35.51	15,181.43	42,635.16
MAR	1,965.54	63.40	97,834.87	13,850.14	17,076.10	66,908.63	34.04	41,641.91	25,266.72
APR	1,582.68	52.76	64,149.81	9,153.37	19,390.41	35,606.03	22.50	34,567.39	1,038.64
MAY	1,353.92	43.67	54,501.52	6,135.92	18,498.43	29,867.17	22.06	37,283.69	(7,416.52)
JUN	1,325.16	44.17	52,885.88	7,056.38	26,555.96	19,273.54	14.54	32,785.47	(13,511.93)
JUL	1,394.02	44.97	49,595.53	6,214.66	18,414.23	24,966.64	17.91	29,866.18	(4,899.54)
AUG	2,080.81	67.12	74,596.15	8,995.62	17,078.82	48,521.71	23.32	28,189.32	20,332.39
SEP	1,961.11	65.37	65,408.29	8,414.63	21,944.48	35,049.18	17.87	23,415.38	11,633.80
OCT	2,316.69	74.73	76,024.03	10,194.01	15,562.02	50,268.00	21.70	12,933.00	37,335.00
NOV	4,110.79	137.03	130,065.50	12,442.85	36,976.18	80,646.47	19.62	19,667.21	60,979.26
DEC	6,055.15	195.33	236,099.75	35,432.90	36,971.05	163,695.80	27.03	42,943.81	120,751.99
ARTC			1,049,090.00 7,155.00			651,314.54 7,155.00			307,658.30 7,155.00
Total	27,220.66	893.37	1,056,245.00	138,915.24	258,860.22	658,469.54	282.85	343,656.24	314,813.30
Average	2,268.39	74.45	88,020.42	11,576.27	21,571.69	54,872.46	23.93	28,638.02	26,234.44

NOTES:

- (3) Product sales and royalty income
 - (6) Net revenue after royalties and operating expenses
 - (9) Net profit before bank debt
- ARTC – Alberta Royalty Tax Credit

2004 PRODUCTION AND REVENUE SUMMARY BY PRODUCTION DATE

	(1) BOE	(2) BOE / Day	(3) REVENUE \$	(4) ROYALTIES \$	(5) EXPENSES \$	(6) (3)-(4)-(5) \$	(7) NET BACK \$/ BOE	(8) NET G + A \$	(9) (6) – (8) \$
JAN	2,825.17	91.13	137,355.77	12,709.29	43,284.05	81,362.43	28.80	18,837.22	62,525.21
FEB	3,641.01	125.55	133,496.03	13,771.13	42,704.64	77,020.29	21.15	29,074.94	47,945.35
MAR	3,417.61	110.25	127,525.48	14,289.24	48,280.94	64,955.30	19.01	15,259.65	49,695.65
APR	5,770.79	192.36	233,092.98	15,498.94	61,999.80	155,594.24	29.96	45,816.05	109,778.19
MAY	3,992.75	128.80	180,722.54	15,395.47	43,759.92	121,567.15	30.45	16,384.28	105,182.87
JUN	3,466.69	115.56	145,289.96	13,848.70	48,927.05	82,514.21	23.80	39,837.73	42,676.48
JUL	3,715.14	119.84	152,414.21	13,674.49	37,332.76	101,406.96	27.30	35,132.52	66,274.44
AUG	3,905.77	125.99	149,652.72	23,671.87	80,493.17	45,487.68	11.65	12,289.45	33,198.23
SEP	8,257.77	275.26	281,082.07	62,951.32	58,432.77	159,647.98	19.33	25,906.62	133,741.36
OCT	8,447.87	272.51	342,544.17	71,917.97	55,010.69	215,615.51	25.52	25,410.16	190,205.35
NOV	8,070.05	269.00	320,631.26	85,299.54	52,887.68	182,444.04	22.61	24,348.22	158,095.82
DEC	7,425.08	239.52	318,982.17	91,470.06	43,000.63	184,511.48	24.85	108,273.16	76,238.32
ARTC			2,523,789.39 76,388.00			1,472,127.27 76,388.00			1,075,557.27 76,388.00
Total	62,935.71	2,065.77	2,600,177.39	434,498.02	616,164.70	1,548,515.27	284.43	396,570.00	1,151,945.27
Average	5,244.64	172.15	216,681.45	36,208.17	51,347.06	129,042.94	23.70	33,047.50	95,995.44

NOTES:

- (3) Product sales and royalty income
 - (6) Net revenue after royalties and operating expenses
 - (9) Net profit before bank debt
- ARTC – Alberta Royalty Tax Credit

2005 PRODUCTION AND REVENUE SUMMARY BY PRODUCTION DATE WITHIN ACCOUNTING

	(1) BOE	BOE / Day	(3) REVENUE \$	(4) ROYALTIES \$	(5) EXPENSES \$	(6) (3)-(4)-(5) \$	(7) NET BACK \$ / BOE	(8) NET G + A \$	(9) (6) - (8) \$
JAN	7,367.51	237.66	310,711.42	70,680.79	64,643.59	175,387.04	23.81	22,325.27	153,061.77
FEB	6,773.74	241.92	288,734.03	60,640.03	59,529.17	168,564.83	24.89	22,844.63	145,720.20
MAR	7,191.67	231.99	343,926.08	68,857.01	60,307.95	214,761.12	29.86	19,485.05	195,276.07
APR	5,609.23	186.97	283,212.95	59,962.41	54,385.15	168,865.39	30.10	10,822.37	158,043.02
MAY	4,970.16	160.33	222,242.41	44,181.74	38,870.44	139,190.23	28.01	20,272.25	118,917.98
JUNE	2,986.45	99.55	140,777.82	19,392.12	75,196.28	46,189.42	15.47	15,554.30	30,635.12
JUL	3,095.79	99.86	179,998.70	31,696.59	62,789.33	85,512.78	27.62	87,883.82	(2,371.04)
AUG	3,901.35	125.85	229,811.06	37,950.26	59,278.69	132,582.11	33.98	32,723.56	99,858.55
SEP	3,825.79	127.53	266,590.43	45,765.99	63,607.76	157,216.68	41.09	31,017.72	126,198.96
OCT	3,107.61	100.25	245,614.59	40,079.51	49,190.15	156,344.93	50.31	10,397.90	145,947.03
NOV	3,418.72	113.96	202,850.89	39,535.41	46,393.77	116,921.71	34.20	28,003.25	88,918.46
DEC	14,141.01	456.16	1,086,446.35	253,558.07	119,574.69	713,313.59	50.44	112,837.66	600,475.93
Total	66,389.03	181.84 ⁽¹⁾	3,800,916.73	772,299.93	753,766.97	2,274,849.83	34.27 ⁽³⁾	414,167.78	1,860,682.05
Other Months	(84.00)	(0.23) ⁽¹⁾	(2,644.73)	(45,699.28)	3,936.03	39,118.52	0.63	-	-
Total	66,305.03	-	3,798,272.00	726,600.65	757,703.00	2,313,968.35	-	-	-
ARTC	-	-	152,896.00	-	-	152,896.00	-	-	152,896.00
Total	-	-	3,951,168.00	-	-	2,466,864.35	-	-	2,013,578.05
Average	5,525.42	181.61	329,264.00	60,550.05	63,141.92	205,572.03	34.90	34,513.98	167,798.17

Column (3) Product sales and royalty income
Column (6) Net revenue after royalties and operating expenses
Column (9) Net profit before bank debt
⁽¹⁾ Average

PROPERTY REVIEW

Petro-Reef operated the drilling of two wells in the Alexander/Qui Barre, Alberta area in 2005. The company drilled the first well in May 2005. This well was drilled directionally in order to penetrate Lower Cretaceous zones at the desired location. Natural gas was encountered in several up-hole formations which required the use of progressively heavier drilling fluid to control the natural gas and prevent a potentially dangerous blow-out situation. The well was drilled to total depth and was being prepared to run logs when the drill pipe became permanently stuck, even after several days of attempting to break it free. The drill pipe was cut off above the portion that was stuck and cemented in place. It was still possible to complete a drill stem test in the Belly River formation up-hole. The test produced natural gas with inconclusive results. Petro-Reef plans to drill a new well from the same surface location. From the information obtained from the directional hole it has been concluded that a vertical hole should encounter the prospective lower zones in a more favorable position. This decision is based on further geological and geophysical evaluation of all available data.

Petro-Reef drilled its second well of 2005 in October and reported the results in a news release on October 27, 2005 as follows:

Petro-Reef Resources Ltd. (“the company”) drilled a well in its core area at Alexander, Alberta in October 2005. The well was completed with production casing run and absolute open flow tested at 335.549 e³m³/day (11.910 MMcf/d) or 1,985 barrels of oil equivalent per day.

The well will be placed on stream at approximately 3.25 MMcf/d (542 BOE/d – 461 BOE/d net to Petro-Reef before BTU adjustment). The company has an 85 percent working interest in the well until 500 percent of the drilling and completion cost and 200 percent of the equipping and tie-in cost have been recovered at which time Petro-Reef’s working interest will revert to 34 percent.

This well was put into production at a rate in excess of 4 MMcf/d and has maintained this level to date.

On November 9, 2005 Petro-Reef issued another news release regarding activities in the area as follows:

Petro-Reef Resources Ltd. announces that it has successfully recompleted a well in its core area at Alexander, Alberta. The well based on a one-day production test, tested at a rate of 300 barrels of 24° API crude oil per day. The company has a 44 percent working interest in the well and is the operator. The well will be placed on stream at an anticipated production rate of 150 barrels of crude oil per day (66 barrels of crude oil per day net to Petro-Reef).

The company has three other wells structurally higher with the same oil zone defined on well logs. The company owned 3-D seismic indicates the oil reservoir to be potentially 3.5 miles long and 1.0 to 1.5 miles wide with pay thickness ranging from 30 to 60 feet.

An attempted completion of this well was unsuccessful. Further evaluation continues for this well for eventual recompletion in another zone.

Plans for the Alexander/Qui Barre area are to drill additional wells, both development and exploration. The approximately eight square miles of 3-D seismic acquired in 2003 and the 3-D seismic of approximately six square miles acquired in 2005 have been interpreted and indicate at least 25 potential drilling locations for oil and or natural gas. These locations will be used to validate much of the acreage in the area. With success these wells will lead to further development and other exploration drilling.

In the Peavey/Morinville, Alberta prospect area no new wells were drilled in 2005. The emphasis in 2004 and 2005 was to develop production from several capped natural gas wells that either had not been tied-in for production or were candidates for re-completion in up-hole horizons because they had previously tested or indicated by log analysis that they were capable of commercial production.

Spring break-up 2005 took an unusually long time followed by extended rain. The combination caused serious shutdown periods during which it was not possible to service the wells when there were problems. Mother Nature dealt Petro-Reef another challenge when lightning struck an oil tank, blew off the top and burned the contents. The area was promptly cleaned up, the tank was replaced, and production resumed in short order.

SUBSEQUENT EVENTS

On January 9, 2006 Petro-Reef updated shareholders on the corporation's progress as follows:

Petro-Reef exited 2005 producing in excess of 1,050 BOE/d gross, 700 BOE/d, net to Petro-Reef up from its forecast of 650 BOE/d. The increase in production is primarily due to its position in the recently announced successful gas well going on stream in its core area at Alexander, Alberta. The company has an 85 percent working interest in the well until 400 percent of the drilling and completion cost and 200 percent of the equipping and tie-in cost have been recovered at which time Petro-Reef's working interest will revert to 34 percent.

Petro Reef reports also, that it will be participating in drilling four new offsetting wells and recompleting three wells. This is expected to take place in the first quarter of 2006. These seven wells will be drilled and recompleted in the core area of Alexander, Alberta. The industry demand for drilling rigs and service rigs is very strong. Timely availability of rigs may become a problem. Petro-Reef has working interest in these wells ranging from thirty-four percent to forty-four percent.

For 2006 Petro-Reef plans to drill/recomplete up to 30 wells using cash flow and the existing line of bank credit.

This was followed on March 20, 2006 by the following news release:

Petro-Reef Resources Ltd., a junior oil and gas company operating in Alberta, is pleased to announce that it has secured two drilling rigs to resume its drilling program in its core area of Alexander, Alberta. Petro-Reef has been unable to pursue its program since November 2005 due to industry-wide challenges with rig availability. Because the Company anticipated rig availability issues, the resumed drilling program puts Petro-Reef back on track to achieve its production targets.

As part of the renewed program, Petro-Reef plans to drill five more wells offsetting a successful natural gas discovery in October 2005. In October, the Company announced that it had completed a new natural gas well at 12-28 in its core area of Alexander/Qui Barre. The well tested at 11.91 million cubic feet per day (MMcf/d), equivalent to 1,958 barrels of oil equivalent per day (BOE/d). The well was placed on production in December 2005 and has been producing at a stabilized rate of 4.18 MMcf/d (697 BOE/d). Petro-Reef's interest in the well is 84 percent before payout of a 400 percent penalty.

As a result of the success of the 12-28 well drilled in October 2005, Petro-Reef has increased its interest in the Alexander/Qui Barre area by 20 percent, taking its interest in an additional fifteen (15) wells to a range of between 54 percent and 64 percent on 9,271 gross acres (4,966 net acres) for an average of 51 percent.

A second well drilled as part of the program in November 2005 was anticipated to produce at 66 Bop/d net. This well has since been suspended due to water production. Petro-Reef has a 44 percent interest in the well. Early production from the well was not included in Petro-Reef's 2005 forecasts.

As previously announced, Petro-Reef expects to drill or recomplete up to 25 wells in 2006 rig availability permitting. The Company is currently producing between 600 and 700 BOE/d. Petro-Reef is on track to exit 2006 producing between 1,100 BOE/d and 1,500 BOE/d.

The results of operations in 2005, 2004 and 2003 are set out in the following tables under three categories:

- 1) Land acquisitions
- 2) Petro-Reef operated wells
- 3) Wells where Petro-Reef is not the operator

Joint-venture partnerships are involved in both the operated and non-operated drilling and accounts for the varying interests held by Petro-Reef.

**LAND COSTS FOR THE ACQUISITION OF MINERAL LEASES
(NET OF DISPOSITIONS, RENTALS OR SURFACE LEASES)**

<u>YEAR</u>	<u>PERIOD</u>	<u>GROSS ACRES</u>	<u>NET ACRES</u>	<u>COST (NET)</u>	<u>COMMENTS</u>
2003	Q1	0	0	\$ 287	Lease Service Only
	Q2	160	70	\$ 4,677	
	Q3	480	212	\$26,593	
	Q4	640	282	\$26,594	
TOTAL		<u>1280</u>	<u>564</u>	<u>\$58,151</u>	\$103 average per net acre
2004	Q1	6	3	\$ 480	Lease Service Only
	Q2	-	-	\$ 466	
	Q3	1,189	404	\$16,140	
	Q4	1,829	724	\$61,506	
TOTAL		<u>3,024</u>	<u>1,113</u>	<u>\$78,592</u>	\$71 average per net acre
2005	Q1	1,920	653	\$103,316	
	Q2	480	206	\$ 32,500	
	Q3	1,920	960	\$ 51,837	
	Q4	968	752	\$ 35,232	
TOTAL		<u>5,288</u>	<u>2,571</u>	<u>\$222,885.58</u>	\$87 average per net acre

Lease Service Only cost refers to third party land company expenses.

The increases for 2004 and 2005 are 97 percent and one 103 percent for acreage, and 35 percent and 183 percent for costs respectively.

PETRO-REEF RESOURCES LTD. OPERATED WELLS

DRILLING, COMPLETION & WORKOVERS			
YEAR	LOCATION	COST	PER % W.I.
2003			
Q1			
Q2			
Q3	05-31-55-26W4	\$460,710	44.00
Q4			
Q1	14-30-55-26W4	\$722	24.00
2004			
Q2	14-30-55-26W4	\$147,450	24.00
	05-31-55-26W4	\$21,093	44.00
Q3	14-30-55-26W4	\$23,319	24.00
	05-31-55-26W4	\$17,741	44.00
	09-30-56-24W4	\$4,755	71.50
	05-25-56-25W4	\$192	39.00
Q4	14-30-55-26W4	\$1,757	24.00
	05-31-55-26W4	\$219	44.00
	05-25-56-25W4	\$18,612	39.00
2005			
Q1	10-30-56-27W4	\$17,284	35.13
	13-29-55-26W4	\$2,746	44.00
	05-31-55-26W4	\$1,641	44.00
	06-15-56-27W4	\$152	50.00
	14-25-55-25W4	\$13	15.96
	16-26-55-25W4	\$274	50.00
	16-26-56-25W4	\$332	25.88
	04-19-56-24W4	\$26,689	36.50
	06-35-56-25W4	\$639	61.28
	07-32-56-25W4	\$2,083	72.50
	07-35-56-25W4	\$440	62.27
	05-25-56-25W4	\$166	39.00
Q2	10-30-56-27W4	\$1,253	35.13
	13-29-55-26W4	\$193,660	44.00
	14-30-55-26W4	\$5,411	24.00
	05-31-55-26W4	\$31,294	44.00
	14-25-55-25W4	\$431	15.96
	16-26-55-25W4	\$329	50.00
	05-36-55-25W4	\$308	20.00
	06-35-56-24W4	\$3,333	61.28
	07-32-56-25W4	\$144	72.50
	07-35-56-25W4	\$63	62.27

DRILLING, COMPLETION & WORKOVERS cont.			
YEAR	LOCATION	COST	PER % W.I.

2005

Q3	12-28-55-26W4	\$68,506	54.00
	13-29-55-26W4	\$34,348	44.00
	05-31-55-26W4	\$61,285	44.00
	06-01-56-27W4	\$7,297	44.00
	06-15-56-27W4	\$1,136	50.00
	14-25-55-25W4	\$59	15.96
	16-26-55-25W4	\$53	50.00
	04-19-56-24W4	\$383	36.50
	05-36-55-25W4	\$965	20.00
	06-35-56-25W4	\$2,183	62.27
	07-32-56-25W4	\$429	72.50
07-35-56-25W4	\$501	62.27	
Q4	10-33-55-26W4	\$13,025	54.00
	11-27-55-26W4	\$3,918	54.00
	12-28-55-26W4	\$488,346	54.00
	12-33-55-26W4	\$5,693	54.00
	13-21-55-26W4	\$4,271	54.00
	13-29-55-26W4	\$927	44.00
	05-31-55-26W4	\$6,362	44.00
	06-01-56-27W4	\$4,303	44.00
	08-01-56-27W4	\$128,790	44.00
	05-36-55-25W4	\$557	20.00
	06-35-56-25W4	\$1,105	61.28
	07-35-56-25W4	\$558	62.27
	05-25-56-25W4	\$25,852	39.00

Note (1) Reserves as determined by independent engineering appraisal at the end of each year that the well is drilled in (proved reserves only)

PETRO-REEF RESOURCES LTD. OPERATED WELLS

EQUIPPING & TIE-IN								
YEAR	LOCATION	COST	PER % W.I.	PER % GORR	First Month Production BOE/D	First Month Revenue (Net PER)	Revenue December (Net PER)	Reserves (1) (Net PER)
2003								
Q1								
Q2								
Q3								
Q4	05-31-55-26W4	\$176,761	44.00		134.00	\$131,109	\$131,109	Being Evaluated
2004								
Q1	10-30-56-27W4	\$22,260	35.13					
	05-31-55-26W4	\$93,669	44.00					
	09-30-56-24W4	\$39,216	71.50	0.855	424.74	\$16,982	\$161,110	575
Q2	05-31-55-26W4	\$34,438	44.00					
	09-30-56-24W4	\$35,710	71.50	0.855				
Q3	14-30-55-26W4	\$57,570	34.00		1,660.22	\$36,725	\$659,674	229
	05-31-55-26W4	\$4,444	44.00					
	09-30-56-24W4	\$231	71.50	0.855				
Q4	14-30-55-26W4	\$278	34.00					
	05-31-55-26W4	(\$61)	44.00	0.33				
2005								
Q1	14-30-55-26W4	\$3,333	24.00					
	05-31-55-26W4	\$35,216	44.00					
	04-19-56-24W4	\$68,343	36.50					
	05-25-56-25W4	\$63,341	39.00					
	09-30-56-24W4	\$7,299	71.50					
Q2	10-30-56-27W4	\$5,109	35.13					
	13-29-55-26W4	\$3,105	34.00					
	14-30-55-26W4	\$278	24.00					
	04-19-56-24W4	\$221	36.50					
	09-30-56-24W4	\$11,895	71.50					
Q3	13-29-55-26W4	\$2,112	44.00					
	14-30-55-26W4	\$88	44.00					
Q4	12-28-55-26W4	\$345,486	54.00					
	14-30-55-26W4	\$22,355	24.00					
	05-31-55-26W4	\$5,333	64.00					
	06-01-56-27W4	\$134	44.00					
	08-01-56-27W4	\$97,678	44.00					
	05-25-56-25W4	(\$11,032)	39.00					
	09-30-56-24W4	\$18,389	71.50					

Note (1) Reserves as determined by independent engineering appraisal at the end of each year in which the well was drilled (proved reserves only).

PETRO-REEF RESOURCES LTD. NON-OPERATED WELLS

DRILLING, COMPLETION & WORKOVERS									
Year	Location	Cost	Status	PER % W.I.	PER % GORR	First Month Production BOE/D	First Month Revenue (Net PER)	Revenue December (Net PER)	Reserves (1) (Net PER)
2003	Note: There were no wells drilled in 2003 where Petro-Reef was not the operator								
2004									
Q4	06-07-56-25W4	\$7,581	Producing Gas Well	12.50					
Q4	01-20-56-27W4	\$3,895	Producing Gas Well	1.04					
2005									
Q1	15-36-55-27W4	\$2,056.67	Producing Gas Well	2.09375					
Q2	06-07-55-25W4	\$23,092.89	Producing Gas Well	12.50					

EQUIPPING & TIE-IN									
Year	Location	Cost	Status	PER % W.I.	PER % GORR	First Month Production BOE/D	First Month Revenue (Net PER)	Revenue December (Net PER)	Reserves (1) (Net PER)
2003	Note: There were no wells drilled in 2003 where Petro-Reef was not the operator								
2004									
Q4	06-07-56-25W4	\$9,397	Producing Gas Well	60.9375		147.30	\$3,795	\$3,683	
Q4	01-20-56-27W4	\$4,236	Producing Gas Well	1.04		9.35	\$226	\$227	2
Q4	15-25-56-25W4	\$2,756	Producing Gas Well	1.2750257	9.00	98.20	\$3,610	\$8,311	31
2005	Note: There were no wells equipped or tied-in where Petro-Reef was not the operator								

Note (1) Reserves as determined by independent engineering appraisal at the end of each year that the well is drilled in (proved reserves only).

The following table represents the pro-forma budget and cash flow for 2006 as prepared by management in respect of revenues expected, less expenses (royalties, operating, interest, general and administrative and professional fees), cash flow, capital expenditures, and net cash flow for the periods indicated.

**PETRO-REEF CASH FLOW AND PRO-FORMA BUDGET FOR 2006
QUARTER ENDED (000s)**

	<u>March 31</u>	<u>June 30</u>	<u>Sept. 30</u>	<u>Dec. 31</u>	<u>Total</u>
Gross Crude Oil & Natural Gas Revenue	\$2,567	\$2,900	\$3,500	\$4,000	\$12,967
Expenses					
Royalties & Operating	1,021	1,160	1,400	1,600	5,181
Interest	-	20	42	42	104
General and Administrative	<u>140</u>	<u>196</u>	<u>332</u>	<u>192</u>	<u>860</u>
Total Expenses	<u>1,161</u>	<u>1,376</u>	<u>1,774</u>	<u>1,834</u>	<u>6,145</u>
Cash Flow (before Capital)	<u>1,406</u>	<u>1,524</u>	<u>1,726</u>	<u>2,166</u>	<u>6,822</u>
Capital Cost					
-Drilling, Completion & Tie-In	190	-	3,145	2,487	5,822
-Seismic & Land	<u>182</u>			<u>318</u>	<u>500</u>
Net Cash Flow (After Capital)	<u>\$1,034</u>	<u>\$1,524</u>	<u>(\$1,419)</u>	<u>(\$639)</u>	<u>\$500</u>

Petro-Reef's short-term requirements for cash are met by cash on hand, current cash flow from operations and bank financing. Management has determined that Petro-Reef's cash flow estimates can be attained through a combination of these sources. Long-term cash requirements will depend on the success of the drilling program. Currently, long-term financing is done with bank financing and current cash flow from operations. Consideration for future financing will include increase in bank financing, and issuance of shares from treasury. The company is not nor does it expect to be in default of any of its obligations.

The National Bank of Canada has made available to Petro-Reef two sources of financing. Credit Facility A is a revolving line of credit for \$2 million, at prime plus one and 1.5 percent. Credit Facility B is for acquisitions and development in the amount of \$500,000 at prime plus 1.5 percent.

On September 16, 2005, the Corporation raised \$1,575,000 by private placement of 3.5 million units. The units were priced at \$0.45 and consist of one Common Share and one Purchase Warrant. Each Purchase Warrant entitles the holder to purchase one additional Common Share at an exercise price of \$0.70 per Common Share, for a period of 18 months from closing of the private placement (i.e. up to March 16, 2007).

The first financing closed on August 18, 2005 for 1,277,776 Units for an aggregate consideration of \$575,000. The balance of the offering closed on September 15, 2005.

Petro-Reef has no off-balance sheet arrangements.

As the time of writing this report Petro-Reef is not considering any proposed acquisitions or dispositions outside the normal course of business. If, as and when a transaction is proposed, and finalized it shall be reported as required.

The present office lease agreement expires on September 30, 2006. Future lease payments to the end of the lease term under the company's office lease will total \$31, 531.

The financial statements of Petro-Reef have been prepared in accordance with accounting principles generally accepted in Canada. Management has made the necessary estimates and assumptions regarding certain types of assets, liabilities, revenues and expenses in the preparation of the financial statements. Accordingly, actual results may differ from estimated amounts but management does not believe such differences will materially affect the company's financial position or results of operations.

Effective January 1, 2004, the Company adopted the new Canadian accounting standard for asset retirement obligations. The new standard requires the Company to record the present value of future asset retirement obligations as a liability in the period in which it incurs a legal obligation associated with the retirement of tangible long-lived assets that result from the acquisition, construction, development, and/or normal use of the assets. The associated asset retirement costs are capitalized as part of the carrying amount of the property, plant and equipment and depleted and depreciated using a unit of production method over estimated gross proved reserves. Subsequent to the initial measurement of the asset retirement obligation, the obligation is adjusted at the end of each period to reflect the passage of time (accretion), and changes in the estimated future cash flows underlying the obligation. The effect of adoption of the new standard on the financial statements is disclosed below.

The total future asset retirement obligation was estimated based on the Company's net ownership in all wells and facilities, estimated costs to reclaim and abandon the wells and the estimated timing of costs to be incurred in future periods. The Company has estimated the net present value of its asset retirement obligation to be \$217,915 (2004 – \$155,456) as at December 31, 2005 based on a total future liability of \$389,677 (2004 – 279,714), which will be incurred between 2005 and 2025. A credit adjusted risk free rate of 6.08 percent (2004 – 7.5 percent) and an inflation rate of two percent were used to calculate the fair value of the asset retirement obligation.

A reconciliation of the asset retirement obligation is provided below:

	<u>2005</u>	<u>2004</u>
Balance, beginning of year	\$ 155,456	\$ 190,436
Liabilities incurred in year	64,423	4,638
Liabilities settled in year	(15,229)	(48,583)
Revisions to estimate	--	(4,638)
Accretion expense	13,265	13,603
Balance, end of year	<u>\$ 217,915</u>	<u>\$ 155,456</u>

STOCK OPTIONS

The authorized share capital of the company is comprised of an unlimited number of preferred shares and an unlimited number of common shares. Details of the changes in the company's issued share capital during 2005 and 2004 are as follows:

	2005		2004	
	Number of shares	Amount \$	Number of shares	Amount \$
Common Shares				
Balance – Beginning of year	17,738,937	4,772,876	17,688,937	4,743,176
Issued for the exercise of:				
Stock options	200,000	101,060	50,000	29,700
Unit private placement	3,499,987	874,995	3,499,987	--
Share issue costs (net of \$86,500 of tax)	--	190,317	--	--
Balance – End of year	21,438,924	5,558,614	17,738,937	4,772,876

Basic and diluted earnings (loss) per common share are calculated using the weighted average number of common shares outstanding during the year of 18,994,641 (2004 – 17,701,232).

The increase in share capital as a result of the exercise of stock options is comprised of the amount of cash received of \$15,000 and the compensation expense previously recognized of \$14,700.

The company has a stock option plan for directors, officers and key employees. The exercise price of each option equals the market price of the company's stock on the date of grant. Options are vested over three years and expire after a maximum exercise period of five years from the date of issuance. A summary of the status of the company's stock option plan as of December 31, 2004 and 2003 and changes during the year is presented below:

	2005		2004	
	Number of Options	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price
Balance beginning of year	1,510,000	\$ 0.49	1,310,000	\$ 0.42
Granted	810,000	0.50	350,000	0.70
Exercised	(200,000)	(0.40)	(50,000)	(0.30)
Expired	-	-	(100,000)	(0.42)
Balance end of year	<u>2,120,000</u>	<u>\$ 0.50</u>	<u>1,510,000</u>	<u>\$ 0.49</u>
Exercisable end of year	<u>1,310,000</u>	<u>\$ 0.50</u>	<u>1,160,000</u>	<u>\$ 0.43</u>

The following table summarizes information about stock options outstanding at December 31, 2005:

Exercise Price	Options outstanding		Options exercisable	
	Number Outstanding	Weighted Average Remaining Contractual Life	Number Exercisable	Weighted Average Remaining Contractual Life
\$0.30	10,000	2.04	10,000	2.04
0.42	700,000	2.52	700,000	2.52
0.49	250,000	0.60	250,000	0.60
0.50	800,000	4.54	-	-
0.52	10,000	4.65	-	-
0.70	300,000	3.46	300,000	3.46
0.71	<u>50,000</u>	3.22	<u>50,000</u>	3.22
	<u>2,120,000</u>	3.19	<u>1,310,000</u>	2.40

Compensation cost of \$176,308 (2004 - \$300,649) has been recognized for stock options granted during the year.

The weighted average fair value of each option granted during the year ended December 31, 2005 is estimated on the date of grant using the Black-Scholes options pricing model with the following weighted average assumptions:

	2005	2004
Fair value of options granted (\$/share)	\$ 0.33	\$ 0.60
Risk-free interest rate (%)	3.40	4.24
Expected life (years)	3	3
Expected volatility (%)	102	133
Expected dividend yield (%)	-	-

CONTRIBUTED SURPLUS

	2005	2004
Balance – Beginning of year	<u>\$380,060</u>	<u>\$94,111</u>
Stock based compensation expense	\$176,308	\$300,649
Adjustment for options exercised in the year	(\$22,060)	(\$14,700)
Balance – End of year	<u>\$120,000</u>	<u>\$380,060</u>