

PETRO-REEF RESOURCES LTD.

MANAGEMENT'S DISCUSSION AND ANALYSIS

This Management's Discussion and Analysis for Petro-Reef Resources Ltd. dated August 27, 2007 is part of the interim report for the three months and six months ended June 30, 2007. It was prepared by management and should be read in conjunction with the unaudited financial statements and notes which are part of the same interim report, as well as the 2005 and 2006 annual audited financial statements and Management's Discussion and Analysis incorporated as part of the company's annual reports for 2005 and 2006, and available for review on the SEDAR website (www.sedar.com).

Petro-Reef has also filed with SEDAR an Annual Information Form (NI Form 51-102F2). It is available on both the SEDAR and Petro-Reef websites.

Petro-Reef Resources Ltd. is a Calgary based crude oil and natural gas exploration and production company with producing properties in Alberta, Canada.

Highlights of Financial and Operations Results for the First Half of 2005, 2006 and 2007

Financial	June 30 2005	June 30 2006	June 30 2007	2006 to 2007 % Change
Crude oil and natural gas revenue net of Royalties and ARTC (\$)	1,322,944	3,505,958	3,819,136	+9
Cash flow from operations (\$)	823,070	2,363,091	2,671,861	+13
Cash flow from operations per share (\$)	0.05	0.11	0.08	-18
Net income (loss) for the period (\$)	(39,093)	78,072	464,210	+495
Net income (loss) per share (\$)	0.00	0.00	0.01	-
Capital expenditures (\$)	856,090	2,715,881	4,618,352	+70
Bank balance	(28,759)	1,348,297	8,089,729	+500
Bank line of credit used	1,000,000	0	0	-
Shareholder's equity (\$)	4,173,767	6,600,111	19,347,503	+180
Common shares outstanding weighted average	17,800,815	22,134,124	33,574,781	+52
Operations				
Daily Average Production				
Crude oil and NGLs (Bbls/day)	1	11	25	-12
Natural gas (Mcf/day)	1,134	3,300	3,274	-1
Total BOE/day	190	563	571	+1
Average Selling Price				
Crude oil (\$per Bbl)	52.38	62.55	55.22	-12
Natural gas (\$per mcf)	7.12	6.74	7.67	+14
NGL (\$per Bbl)	50.78	54.70	53.16	-3

Petro-Reef continued to grow in production and cash flow in the first six months of 2007 compared to the same period in 2006. The average BOE/d increased slightly year over year to 568 BOE/d in the first half of 2007 from 563 BOE/d in the same period 2006. There is additional production behind pipe in wells that have been drilled. The amount of this, which may be crude oil and/or natural gas, will be determined upon completion of production testing.

Note that greater than six million dollars of the bank balance is in bankers Acceptances. None of the balance is invested in asset backed or sub-prime securities.

2007 PRODUCTION & REVENUE SUMMARY (Unaudited)

The next three tables compare production and revenue for the first six months of 2005, 2006 and 2007.

The G & A numbers do not include stock based compensation which is a non cash item.

Alberta Royalty Tax Credits were discontinued beginning January 1, 2007.

Production of natural gas was shut down for two weeks in May 2007 for annual plant turn around by ATCO at the Carbondale plant and for two weeks in June 2007 for the installation of the Petro-Reef plant at 08-01. Consequently the second quarter production represents just over two months of normal production.

2007 PRODUCTION & REVENUE SUMMARY (Unaudited)

MONTHS	BOE	BOE / DAY	REVENUE \$	ROYALTIES \$	EXPENSES \$	G & A \$	CASH FLOW \$
JAN	15,887	512	709,495	145,721	134,942	(31,581)	460,412
FEB	17,340	619	864,763	195,677	126,950	30,121	512,015
MAR	20,413	659	969,438	190,356	151,745	32,328	595,009
APR	17,773	592	862,373	169,375	145,600	45,822	501,577
MAY	16,961	547	785,155	137,097	134,697	209,402	303,958
JUNE	14,780	492	581,062	114,923	124,132	43,116	298,891
Total	102,878	⁽¹⁾ 568	4,772,285	953,149	329,208	329,208	2,671,861

⁽¹⁾ Average

2006 PRODUCTION AND REVENUE SUMMARY (Unaudited)

MONTHS	BOE	BOE / DAY	REVENUE \$	ROYALTIES \$	EXPENSES \$	G & A \$	CASH FLOW \$
JAN	18,750	605	1,025,344	344,847	142,097	21,542	516,857
FEB	16,658	595	778,902	366,807	140,128	103,592	168,373
MAR	18,091	584	885,892	181,121	106,892	31,103	566,777
APR	16,171	539	707,216	82,792	108,919	75,324	440,181
MAY	16,422	530	604,243	114,509	135,131	38,547	316,056
JUNE	15,838	528	750,414	155,976	135,586	104,005	354,847
Total	101,931	⁽¹⁾ 563	4,752,011	1,246,053	768,754	374,112	2,363,092

⁽¹⁾ Average

2005 PRODUCTION & REVENUE SUMMARY (Unaudited)

MONTHS	BOE	BOE / DAY	REVENUE \$	ROYALTIES \$	EXPENSES \$	G & A \$	CASH FLOW \$
JAN	7,368	238	279,841	83,162	48,598	27,234	120,847
FEB	6,769	242	268,507	57,520	53,230	27,602	130,156
MAR	7,144	230	358,322	64,832	47,546	23,205	222,737
APR	5,514	184	244,423	60,164	56,819	15,796	111,645
MAY	4,877	157	321,742	13,232	77,416	24,437	206,817
JUNE	2,831	94	156,590	27,569	78,750	19,402	30,868.73
Total	34,389 ⁽¹⁾	190	1,629,424	306,480	362,357	137,517	823,071

⁽¹⁾ Average

Note:

Petro-Reef calculates netbacks as net dollars per barrel after Crown Royalties, operating expenses and general and administrative expenses and are compared in the following table for the first six months of 2005, 2006 and 2007.

MONTH	2005 NET BACK \$	2006 NET BACK \$	2007 NET BACK \$
JAN	23.36	30.08	28.33
FEB	24.52	25.93	33.48
MAR	29.27	24.42	30.45
APR	29.25	25.80	31.21
MAY	27.61	18.76	29.45
JUNE	17.09	21.40	31.63
Average	26.04	24.55	30.78

The next three tables compare three years of quarterly results.

SUMMARY OF THREE YEARS OF QUARTERLY RESULTS

	Sep. 30 2006	Dec. 31 2006	Mar. 31 2007	Jun. 30 2007
Crude oil and natural gas revenue net of Royalties and ARTC (\$)	1,045,216	1,198,717	2,011,941	1,807,195
Cash Flow from operations (\$)	590,330	604,010	1,567,436	1,104,425
Cash flow from operations per share (\$)	0.03	0.03	0.05	0.08
Net income (loss) for the period (\$)	(67,349)	54,337	436,755	27,455
Net income (loss) per share (\$)	0	0	0	0
Capital expenditures (\$)	2,478,043	2,621,475	2,427,755	2,190,597
Bank balance	846,062	(1,613)	6,759,787	8,089,729
Bank Line of credit used	0	375,000	0	0
Shareholder's equity (\$)	7,003,587	7,919,194	16,168,187	19,347,503
Weighted average common shares outstanding	22,650,791	23,685,291	31,744,781	33,574,781

	Sep. 30 2005	Dec. 31 2005	Mar. 31 2006	Jun. 30 2006
Crude oil and natural gas revenue net of Royalties and ARTC (\$)	582,100	1,319,524	1,797,362	1,708,596
Cash Flow from operations (\$)	244,558	940,085	1,252,007	1,111,085
Cash flow from operations per share (\$)	0.01	0.05	0.06	0.05
Net income (loss) for the period (\$)	(21,890)	309,696	75,453	2,619
Net income (loss) per share (\$)	0	0.02	0	0
Capital expenditures (\$)	244,410	1,280,673	497,869	2,218,013
Bank balance	99,858	397,904	1,031,868	1,348,297
Bank Line of credit used	0	0	0	0
Shareholder's equity (\$)	5,665,500	6,029,968	6,103,921	6,600,111
Weighted average common shares outstanding	18,156,064	18,994,641	21,438,924	22,134,124

	Sep. 30 2004	Dec. 31 2004	Mar. 31 2005	Jun. 30 2005
Crude oil and natural gas revenue net of Royalties and ARTC (\$)	499,139	777,638	701,154	621,790
Cash Flow from operations (\$)	221,913	451,795	473,740	349,330
Cash flow from operations per share (\$)	0.01	0.03	0.03	0.02
Net income (loss) for the period (\$)	34,086	(418,997)	(14,869)	(24,224)
Net income (loss) per share (\$)	0	(0.02)	0	0
Capital expenditures (\$)	114,238	388,971	430,681	425,409
Bank balance	(41,931)	(411,771)	(235,011)	(28,759)
Bank Line of credit used	1,525,000	700,000	650,000	1,000,000
Shareholder's equity (\$)	4,331,539	4,021,268	4,059,186	4,173,767
Weighted average common shares outstanding	17,695,933	17,701,232	17,738,837	17,800,815

ACTIVITY REVIEW AND CORPORATE UPDATE

Petro-Reef's production in the first half of 2007 came mainly from two core properties in Alberta. Alexander/Qui Barre produced about 92%, Peavey/Morinville produced about 7%, and about 1% came from non-operated minor working interest and royalty properties. Approximately 96% of the production was natural gas with about 4% crude oil and natural gas liquids.

During the first six months of 2007 Petro-Reef drilled five wells in the Alexander/Qui Barre prospect area all of which were successful.

In January a well was drilled on Alexander First Nations land at 11-14. Petro-Reef is currently production testing this well.

In February Petro-Reef drilled a successful crude oil well at 10-01. The well is to be tied in to the 08-01 plant, a new prorating oil well battery being built.

Another well was drilled in June at 14-01 and has tested commercial quantities of natural gas. This well was tied in to the plant facility at 08-01.

The well drilled in March was a twin well at 11-27. The first well is producing natural gas. The second well is producing natural gas from a different zone.

Another well was drilled in July at 13-33 and is in the process of being tested for production of crude oil and/or natural gas. A short pipeline will be required to tie in the well and place it on stream.

The well drilled in March 2006 at 13-21 that was announced as a potential abandonment is currently being evaluated for potential production in several coal bed methane zones.

The oil well at 06-01 will also require a short pipeline to tie in to the plant at 08-01, to produce the solution gas associated with the crude oil production.

These wells were preceded by a successful well drilled in December 2006. This twin well at 09-33 encountered the same productive hydrocarbon zones as the original well in the same location. Both wells are now producing from two separate hydrocarbon zones.

Field work in April and May was suspended by the imposition by the County of Sturgeon road bans during spring break-up, after a winter of above normal snowfall.

Current plans to drill 10 more wells before year end 2007 beginning with the well at 13-06 which spudded on August 21. Locations have been prepared for new wells at 11-10, 11-11, and 15-29. Acquisition of surface leases at four additional locations is in progress.

A major central plant facility was constructed at 08-01 and began operation on July 05, 2007. Plant operations include compression, dehydration, separation and water disposal. Smaller existing compressors will be replaced and/or relocated now that the plant is operational. With Petro-Reef's drilling success a new challenge was created as production from each new well was added. This increased the back pressure in the pipeline system significantly and consequently reduced the ability of the lower pressure formations to maintain the same levels of production. The plant is capable of handling low pressure solution gas from the oil wells as well as increased productivity of all the natural gas wells up to a maximum volume of 23 MMcf/d.

The following is a summary of drilling/recompletion activity for 2006 and forecasts for 2007. Petro-Reef's average working interest on the five wells drilled so far in 2007 has been about 59.5%

	2006 Actual	2007 Forecast
Number of wells drilled (gross/net)	14/7.97	16/9.51
Success rate	79%	
Average production/well (BOE/day) (gross/net) (includes dry and abandoned wells)	157.2/93.5	\$155/90
Average cost/well (\$000) (gross/net)	\$934.1/\$518.1	\$950/\$560

The capital budget for 2007 has been projected as follows (\$000)

Land	\$816
Seismic	\$546
Drilling/completions/facilities	\$7,990
Re-completions & facilities	\$1,000
General & administrative	<u>\$1,272</u>
Total	<u>\$11,624</u>

On January 26, 2007 Petro-Reef announced that it had closed its previously announced private-placement financing, raising gross aggregate proceeds of \$6,050,000.50. The offering was fully subscribed. Petro-Reef plans to use the net proceeds of the offering to fund continued exploration and development of its core area in Alexander, Alberta.

The offering consisted of 5,260,870 units of the Corporation ("Units") at a price of \$1.15 per Unit. Each Unit consisted of one common share and one-half of the one common share purchase warrant of the Corporation. Each whole common share purchase warrant ("Warrant") is exercisable to acquire one common share of the Corporation at an exercise price of \$1.75 for a period ending on July 25, 2008. If the closing price of the common shares is higher than \$2.20 for a period of 20 consecutive days at any time after four months and one day after the closing date, the Corporation may accelerate the expiry date of the Warrants by giving notice to the holders. In such case, the Warrants would expire on the 30th day after the date on which notice is given.

Primary Capital Inc. served as the agent for the private-placement offering and received a 7% cash commission out of the gross proceeds and non-transferable broker warrants ("Broker Warrants") exercisable to acquire 368,260 units of the Corporation ("Broker Units") at a price of \$1.15 per Broker Unit until July 25, 2008. Each Broker Unit consists of one common share of the Corporation and one-half of one common share purchase warrant. Each whole common share purchase warrant exercisable to acquire one common share of the Corporation at a price of \$1.75 for a period ending on July 25, 2008.

On February 26, 2007 Petro-Reef announced that 3,499,987 out of a total 3,824,987 purchase warrants issued by the Corporation under financings that closed in August and September 2005 have been exercised. The warrants, which were exercisable at a price of \$0.70 per share, expired on February 20, 2007. As a result the Corporation has received aggregate proceeds of \$2,499,990.90.

Subsequently Petro-Reef issued two news releases regarding a \$3,000,000 Flow Through Share issue as follows, one on April 2, 2007, and one on April 25, 2007.

April 2, 2007

“Petro-Reef Resources Ltd. is pleased to announce that it has entered into an engagement letter with Primary Capital Inc. (“Primary”) pursuant to which Primary has agreed, subject to completion of satisfactory due diligence, to sell on a “best efforts” basis, up to a maximum of 1,500,000 common Shares (“Flow Through Shares”) at a price of \$2.00 per share on a flow through basis for an aggregate purchase price of \$3,000,000 (\$2,805,000 net of commissions). The Closing Date is expected to be on or about April 13, 2007, or as otherwise agreed by Petro-Reef and Primary.

Petro-Reef has agreed to pay Primary a commission equal to 6.5% of the gross proceeds raised, and to issue broker warrants (“Broker Warrants”) to it, entitling Primary to purchase up to that number of common shares of Petro-Reef which is equal to 6.5% of the number of Flow Through Shares issued under the Offering, at an exercise price of \$2.00 per share at any time on or before July 25, 2008. These shares will not carry flow through treatment.

The Flow Through Shares will be issued as a private placement to certain investors identified by Primary. The net proceeds received from the sale of the Flow Through Shares will be used to fund the continued exploration and development of Petro-Reef’s properties. Closing is subject to normal regulatory approvals. The Flow Through Shares will be subject to a four month hold period from the Closing Date.”

April 25, 2007

“Petro-Reef Resources Ltd. has closed its previously announced private-placement financing, raising gross aggregate proceeds of \$3,000,000. The offering, announced on April 2, 2007, was fully subscribed. Petro-Reef plans to use the proceeds of the offering to fund continued exploration and development of its properties.

The offering consisted of 1,500,000 common shares of the Corporation at a price of \$2.00 per share on a flow through basis.

Primary Capital Inc. acted as the agent for the private-placement offering and received a 6.5% cash commission and non-transferable broker warrants (“Broker Warrants”) exercisable to acquire 97,500 common shares of the Corporation at a price of \$2.00 per share until July 25, 2008. The common shares issuable upon the exercise of the Broker Warrants will not carry flow through treatment.

After giving effect to this offering, Petro-Reef has 33,244,781 common shares issued and outstanding.”

The result of the reserves evaluation for 2006 was reported in a news release April 30, 2007 in preparation for inclusion in the annual report for 2006. The complete reserves report for 2006, prepared in accordance with National Instrument 51-101, is available on SEDAR at www.sedar.com and on Petro-Reef’s website at www.petro-reef.ca.

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 \$3.75 million, at prime plus one and 1.25 percent. Credit facility B is for acquisitions and development in the amount of \$1 million at prime plus 1.5 percent. At June 30, 2007 the bank loan was nil, the bank balance was \$8,089,729.

The facilities are secured by \$5,000,000 floating charge debenture over all the company's assets with a negative pledge and undertaking to provide fixed charges on the company's major producing properties at the request of the bank. The facilities are repayable on demand and are reviewed periodically by the bank.

Petro-Reef's Annual General Meeting of the shareholders was held June 13, 2007. Nine directors were elected, six officers were appointed and five committees were formed. PricewaterhouseCoopers LLP was reappointed as auditor for the ensuing year. Refer to page 11 for details and other corporate information.

There were no related party transactions or off balance sheet arrangements in the second quarter of 2007.

The results of the first quarter report and the results of the Annual General Meeting of shareholders were reported in news releases dated May 31, 2007 and June 15, 2007.

Petro-Reef has only one class of share, the common share, each of which carries one vote. There are no convertible securities of Petro-Reef which can be converted, exercised or exchanged for voting common shares.

Petro-Reef has no long term contractual obligations.

The following is an update of Petro-Reef's liquidity and capital resources:

As reported previously, Petro-Reef's short-term requirements for cash are met by cash on hand, cash flow from operations, the exercise of stock options and warrants, 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. 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 following items are set out in detail in the Notes to the Financial Statements which are included as part of this Management's Discussion and Analysis.

1. Accounting policies
2. Property, plant and equipment
3. Demand operating facilities
4. Asset retirement obligation
5. Share capital
 - a) Common shares
 - b) Warrants
 - c) Contributed surplus
 - d) Per share amounts
6. Stock based compensation
7. Cash flow supplemental information

There were no related party transactions in the first half of 2007.

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

- 1) Each exploration prospect must exhibit
 - a) A minimum three hydrocarbon zone potential.
 - b) Each zone must show the potential for:
 - (i) 10:1 profit to capital risk ratio
 - (ii) Minimum of 30% rate of return on capital invested.
 - (iii) Minimum life of 15 years.
- 2) The use of 2-D and 3-D seismic to identify and confirm potential drilling location using state-of-the-art technology.

On behalf of Petro-Reef and the board of directors, management would like to thank the shareholders for their continued support. We will continue to endeavour to meet (and hopefully exceed) your expectations in what has started as an exciting first of fiscal year 2007.

“Joseph Werner”

Joseph Werner
President and Chief Executive Officer

Dated: August 27, 2007

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.

BUSINESS RISKS

Petro-Reef is exposed to risks inherent in the oil and gas business. Operationally, the company faces risks associated with finding, developing and producing oil and gas reserves, such as the availability of rigs and inclement weather. The company continues to follow strict exploration criteria on each prospect to assure high profitability and rate of return on capital investment. Exploration risks are managed by hiring skilled technical staff and by concentrating exploration activity on areas in which Petro-Reef has experience and expertise. Petro-Reef operates most of its production, allowing the company to manage costs, timing and sales of production. Estimates of economically recoverable reserves and the future net cash flow are based on factors such as commodity prices, projected production and future capital and operating costs. These assumptions may differ from actual results. The company has its reserves evaluated annually by an independent engineering firm. Petro-Reef is also exposed to environmental risks and risks associated with the reliance upon relationships with partners. Petro-Reef carries environmental liability, property, drilling and general liability insurance to mitigate its risks. The company is also exposed to financial risks in the form of commodity prices, interest rates, the Canadian to U.S. dollar exchange rate and inflation. Petro-Reef manages commodity prices risks by focusing its capital program on areas that are expected to generate attractive rates of return.

ABBREVIATIONS

ARTC	Alberta Royalty Tax Credit	GJs/d	Gigajoules per day
Bbl	barrel	M ³	cubic meters
Bbls	barrels	Mbbls	thousands of barrels
Bcf	billion cubic feet	Mcf	thousand cubic feet
BOE	barrel of oil equivalent (1 BOE = 6 Mcf)	Mcf/d	thousand cubic feet per day
Bbls/d	Barrels per day	MMbbls	millions of barrels
BOPD	Barrels of oil per day	MMcf	million cubic feet
FNR	Future net revenue	MMcf/d	million cubic feet per day
GJ	Gigajoule	NGLs	natural gas liquids
		NPV	net present value

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 equivalent conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead.

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

In accordance with National Instrument 51-102 released by the Canadian Securities Administrators, Petro-Reef discloses that its auditors have not reviewed the unaudited interim consolidated financial statements for the period ended June 30, 2007

PETRO-REEF RESOURCES LTD.
Balance Sheet
As at June 30, 2007 and December 31, 2006
Unaudited

	June 30, 2007	December 31, 2006
ASSETS		
Current assets		
Bank	\$ 2,022,212	\$ -
Short term investments	6,067,517	-
Accounts receivable	1,979,574	1,864,015
Prepaid expenses and deposits	44,553	21,267
	<u>10,113,856</u>	<u>1,885,282</u>
Property, plant and equipment (note 2)	<u>16,577,189</u>	<u>13,171,164</u>
	<u>\$ 26,691,045</u>	<u>\$ 15,056,446</u>
LIABILITIES		
Current liabilities		
Cheques drawn in excess of bank	\$ -	\$ 1,613
Bank line of credit (note 3)	-	375,000
Accounts payable and accrued charges	5,967,355	5,734,479
	<u>5,967,355</u>	<u>6,111,092</u>
Future income taxes	890,944	634,512
Asset retirement obligation (note 4)	<u>485,243</u>	<u>391,648</u>
	<u>7,343,542</u>	<u>7,137,252</u>
SHAREHOLDERS' EQUITY		
Share capital (note 5)	17,044,191	7,559,760
Warrants (note 5)	1,182,909	606,719
Broker warrants (note 5)	331,828	-
Contributed surplus (note 5)	1,142,259	570,609
Deficit	<u>(353,684)</u>	<u>(817,894)</u>
	<u>19,347,503</u>	<u>7,919,194</u>
	<u>\$ 26,691,045</u>	<u>\$ 15,056,446</u>

See accompanying notes to the financial statements

SIGNED ON BEHALF OF THE BOARD
"Joseph Werner"
 Director

"Robert N. Maertens-Poole"
 Chief Financial Officer

PETRO-REEF RESOURCES LTD.
Statement of Operations, other Comprehensive Income and Deficit
For the three months and six months ended June 30, 2007 and 2006
Unaudited

	3 months Ended June 30/07	3 months Ended June 30/06	6 months Ended June 30/07	6 months Ended June 30/06
Revenue				
Oil and gas sales, net of royalties and ARTC	\$ 1,807,195	\$ 1,708,596	\$3,819,136	\$ 3,505,958
Expenses				
Accretion expense	5,778	3,712	10,928	7,340
Depletion and depreciation	660,518	1,153,263	1,294,993	2,142,275
General and administrative	742,204	347,873	1,034,309	503,038
Interest expense	1,154	552	7,973	1,787
Loss on settlement of asset retirement obligation	-	41	-	86
Production expenses	404,430	379,636	818,067	768,754
	<u>1,814,084</u>	<u>1,885,077</u>	<u>3,166,270</u>	<u>3,423,280</u>
Earnings before the following	(6,889)	(176,481)	652,866	82,678
Interest income	67,776	1,619	67,776	1,781
	<u>60,887</u>	<u>(174,862)</u>	<u>720,642</u>	<u>84,459</u>
Future income tax	33,432	(177,481)	256,432	6,387
	<u>33,432</u>	<u>(177,481)</u>	<u>256,432</u>	<u>6,387</u>
Net income and other comprehensive income for the period	27,455	2,619	464,210	78,072
Deficit – Beginning of period	(381,139)	(807,501)	(817,894)	(882,954)
	<u>(381,139)</u>	<u>(807,501)</u>	<u>(817,894)</u>	<u>(882,954)</u>
Deficit – End of period	\$ (353,684)	\$ (804,882)	\$ (353,684)	\$ (804,882)
	<u>\$ (353,684)</u>	<u>\$ (804,882)</u>	<u>\$ (353,684)</u>	<u>\$ (804,882)</u>
Basic and diluted income per common share	\$ 0.00	\$ 0.00	\$ 0.01	\$ 0.00
	<u>\$ 0.00</u>	<u>\$ 0.00</u>	<u>\$ 0.01</u>	<u>\$ 0.00</u>

See accompanying notes to the financial statements

PETRO-REEF RESOURCES LTD.

Statement of Cash Flow

For the three months and six months ended June 30, 2007 and 2006

Unaudited

	3 months Ended June 30/07	3 months Ended June 30/06	6 months Ended June 30/07	6 months Ended June 30/06
Cash provided by (used in)				
Operating activities				
Net income for the period	\$ 27,455	\$ 2,619	\$ 464,210	\$ 78,072
Items not effecting working capital				
Accretion expense	5,778	3,712	10,928	7,340
Depletion and depreciation	660,518	1,153,263	1,294,993	2,142,275
Loss on settlement of asset retirement obligation	-	41	-	86
Stock based compensation	377,242	128,931	645,298	128,931
Future income taxes	33,432	(177,481)	256,432	6,387
	<u>1,104,425</u>	<u>1,111,085</u>	<u>2,671,861</u>	<u>2,363,091</u>
Asset retirement obligations	-	(61)	-	(489)
Net change in non-cash operating working capital items	<u>(755,181)</u>	<u>1,144,571</u>	<u>(561,259)</u>	<u>820,367</u>
	<u>349,244</u>	<u>2,255,595</u>	<u>2,110,602</u>	<u>3,182,969</u>
Financial activities				
Bank line of credit	-	-	(375,000)	-
Proceeds from share issue	-	364,640	6,050,000	364,640
Proceeds from flow through issue	3,000,000	-	3,000,000	-
Share issue costs	(370,379)	-	(827,233)	-
Proceeds from exercise of stock options and warrants	145,000	-	2,096,034	(1,500)
	<u>2,774,621</u>	<u>364,640</u>	<u>9,943,801</u>	<u>363,140</u>
Investing activities				
Expenditures on property, plant and equipment	(2,190,597)	(2,218,013)	(4,618,352)	(2,715,881)
Net change in non-cash investing working capital items	<u>396,674</u>	<u>(85,793)</u>	<u>655,291</u>	<u>120,165</u>
	<u>(1,793,923)</u>	<u>(2,303,806)</u>	<u>(3,963,061)</u>	<u>(2,595,716)</u>
Change in bank during the period	1,329,942	316,429	8,091,342	950,393
Bank (cheques drawn in excess of bank)				
- Beginning of period	<u>6,759,787</u>	<u>1,031,868</u>	<u>(1,613)</u>	<u>397,904</u>
Bank, End of period	<u>8,089,729</u>	<u>\$ 1,348,297</u>	<u>8,089,729</u>	<u>\$ 1,348,297</u>
Supplemental information				
Bank consists of:				
Bank	\$ 2,022,212	\$ 1,348,297	\$ 2,022,212	\$ 1,348,297
Short term investments	6,067,517	-	6,067,517	-
	<u>\$ 8,089,729</u>	<u>\$ 1,348,297</u>	<u>\$ 8,089,729</u>	<u>\$ 1,348,297</u>
Interest paid	\$ 1,154	\$ 552	\$ 7,973	\$ 1,786
See accompanying notes to the financial statements				

1. Accounting policies

The interim financial statements of Petro-Reef Resources Ltd. (the "Company") have been prepared following the same accounting policies and methods of computation as for the financial statements of the Company as at December 31, 2006. The interim financial statements contain disclosures, which are supplemental to the Company's annual financial statements. Certain disclosures, which are normally required to be included in the notes to the annual financial statements, have been condensed or omitted except as noted below. The year end financial statements should be read in conjunction with the Company's financial statements and notes thereto for the year ended December 31, 2006.

The Company has a working capital surplus of \$4,146,501 as at June 30, 2007 and a working capital deficit of \$4,225,810 as at December 31, 2006. The Company is subject to certain debt covenants pertaining to demand operating facilities (Note 3). At June 30, 2007 the Company was in compliance with all covenants.

2. Property, plant, and equipment

	<u>June 30, 2007</u>		
	Cost	Accumulated depletion and depreciation	Net
Petroleum and natural gas	\$ 26,345,153	\$ 9,816,448	\$ 16,528,705
Furniture and fixtures	95,408	46,924	48,484
	<u>\$26,440,561</u>	<u>\$ 9,863,372</u>	<u>\$ 16,577,189</u>

	<u>December 31, 2006</u>		
	Cost	Accumulated depletion and depreciation	Net
Petroleum and natural gas	\$21,659,267	\$8,528,679	\$13,130,588
Furniture and fixtures	80,275	39,699	40,576
	<u>\$21,739,542</u>	<u>\$8,568,378</u>	<u>\$13,171,164</u>

No interest or general and administrative expenses were capitalized during the period. Unproven property costs of \$1,345,465 (December 31, 2006 -1,249,477) have been excluded from capitalized costs subject to depletion.

3. Demand operating facilities

Facility A is a revolving operating demand loan with a maximum limit of \$3,750,000. Facility B is a non-revolving acquisition/development demand loan that provides an additional \$1,000,000 of financing. Interest is at prime plus 1.25% per annum for Facility A and 1.5% per annum for the Facility B. At June 30, 2007 the balance owing on the current loan was \$Nil (December 31, 2006 - \$375,000).

The facilities are secured by \$5,000,000 floating charge debenture over all the Company's assets with a negative pledge and undertaking to provide fixed charges on the Company's major producing properties at the request of the bank. The facilities are repayable on demand and are reviewed periodically by the bank, the next review being scheduled for August 2007.

4. Asset retirement obligation

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 \$485,243 (December 31, 2006 - \$391,648) as at June 30, 2007 based on a total future liability of \$875,924 (December 31, 2006 - \$711,198) which will be incurred between 2007 and 2025. A credit adjusted risk free rate of 5.36 percent (2006 -5.36 percent) and an inflation rate of 2 percent were used to calculate the fair value of the asset retirement obligation.

A reconciliation of the asset retirement obligation is provided below:

	<u>Six Months Ended</u> <u>June 30, 2007</u>	<u>Year Ended</u> <u>December 31, 2006</u>
Balance, beginning of period	\$ 391,648	\$ 217,915
Liabilities incurred in period	82,667	142,379
Liabilities settled in period	-	(432)
Accretion expense	<u>10,928</u>	<u>31,786</u>
Balance, end of period	<u>\$ 485,243</u>	<u>\$ 391,648</u>

5. Share capital

a) Class A common shares

	<u>Six Months Ended</u> <u>June 30, 2007</u>		<u>Year Ended</u> <u>December 31, 2006</u>	
	<u>Shares</u>	<u>Amount</u>	<u>Shares</u>	<u>Amount</u>
Balance, beginning of period	23,685,291	\$7,559,760	21,438,924	\$5,558,614
Exercise of options (iii)	370,000	280,647	1,180,000	1,042,909
Exercise of warrants (iv)	2,758,620	2,495,758	1,066,367	959,737
Unit private placement (i)	5,260,870	4,867,088	-	-
Flow through shares (ii)	1,500,000	3,000,000	-	-
Share issue costs (i)	-	(788,706)	-	(1,500)
Share issue costs (ii)	-	<u>(370,356)</u>	-	<u>-</u>
Balance, end of period	<u>33,574,781</u>	<u>\$17,044,191</u>	<u>23,685,291</u>	<u>\$7,559,760</u>

- (i) In the first quarter 2007, the Company issued 5,260,870 units priced at \$1.15 per unit. Each unit consisted of one Common Share and one-half of the one common share Purchase Warrant. Each whole common share Purchase Warrant entitles the holder to purchase one additional Common Share at an exercise price of \$1.75 per Common Share until July 25, 2008. The warrants have been ascribed a fair value of \$.45 using the Black-Scholes pricing model assuming a risk-free interest rate of 4.01%; weighted average life of 1.5 years; dividend yield of nil; and expected volatility rate of 106%. Primary Capital Inc., the agent, was paid a cash commission of \$423,500, and was granted non transferable Broker Warrants to acquire 368,260 Common Shares at an exercise price of \$1.15 until July 25, 2008 and to acquire one half of the one common share Purchase Warrant. Each whole common share Purchase Warrant entitles the holder to purchase one additional Common Share at an exercise price of \$1.75 per Common Share until July 25, 2008. These Broker Warrants have been recorded as share issue costs estimated at \$248,407 using the Black-Scholes pricing model assuming a risk-free interest rate of 4.01%; weighted average life of 1.5 years;

PETRO-REEF RESOURCES LTD.
Notes to Financial Statements
As at June 30, 2007 and December 31, 2006

dividend yield of nil; and expected volatility rate of 106%. Legal and other costs incurred, related to this private placement, were \$116,799.

- (ii) In the second quarter 2007, the Company issued 1,500,000 flow - through shares priced at \$2.00. Primary Capital Inc. was paid a cash commission of \$225,000, and was granted non transferable Broker Warrants to acquire 97,500 Common Shares at an exercise price of \$2.00 until July 25, 2008. These Broker Warrants have been recorded as share issue costs estimated at \$83,421 using the Black-Scholes pricing model assuming a risk-free interest rate of 4.047%; weighted average life of 1.25 years; dividend yield of nil; and expected volatility rate of 128%. Legal and other costs incurred, related to the issuance of these flow - through shares, were \$61,935.
- (iii) The increase in share capital as a result of the exercise of stock options is comprised of cash received of \$165,000 and compensation expensed previously of \$115,647.
- (iv) The increase in share capital as a result of the exercise of warrants is comprised of the amount of cash received of \$1,931,039 and the reclassification to share capital of the ascribed value related to the warrants exercised of \$564,719. These warrants were issued by the Corporation under financings that closed in August and September of 2005.

b) Warrants

**Six Months Ended
June 30, 2007**

	<u>Exercise Price</u>	<u>Number</u>	<u>Amount</u>
Balance, beginning of period	\$0.70	2,933,620	\$606,719
Exercise of warrants	<u>0.70</u>	<u>(2,758,620)</u>	<u>(564,719)</u>
Expiry of warrants	0.70	175,000)	(42,000)
Unit private placement ((note 5(a)(i))	<u>1.75</u>	<u>2,630,435</u>	<u>1,182,909</u>
Balance, end of period		<u>2,630,435</u>	<u>\$1,182,909</u>

**Year Ended
December 31, 2006**

	<u>Exercise Price</u>	<u>Number</u>	<u>Amount</u>
Balance, beginning of period	\$0.70	3,999,987	\$820,000
Exercise of warrants	<u>0.70</u>	<u>(1,066,367)</u>	<u>(213,281)</u>
Balance, end of period		<u>2,933,620</u>	<u>\$606,719</u>

PETRO-REEF RESOURCES LTD.
Notes to Financial Statements
As at June 30, 2007 and December 31, 2006

c) Broker warrants

	Six Months Ended June 30, 2007		
	Exercise Price	Number	Amount
Balance, beginning of period	\$ -	-	\$ -
Unit private placement ((note 5(a)(i))	1.15	368,260	248,407
Flow through shares (note 5(a)(ii))	2.00	97,500	83,421
Balance, end of period		<u>465,760</u>	<u>\$ 331,828</u>

d) Contributed surplus

	Six Months Ended June 30, 2007	Year Ended December 31, 2006
Balance beginning of year	\$ 570,609	\$ 534,308
Stock based compensation recognized in the period	645,298	481,709
Adjustment for stock options exercised in the period	(115,648)	(445,408)
Expiry of warrants	<u>42,000</u>	<u>-</u>
Balance, end of period	<u>\$ 1,142,259</u>	<u>\$ 570,609</u>

e) Per share amounts

Earnings per common share are calculated using the weighted average number of common shares outstanding during the period. A reconciliation of the denominators used in the per share calculation is outlined below:

	Six Months Ended June 30, 2007	Year Ended December 31, 2006
Basic weighted average common shares	27,325,192	22,109,165
Effect of dilutive options and warrants	<u>6,408,464</u>	<u>3,304,499</u>
Diluted weighted average common shares	<u>33,733,657</u>	<u>25,413,664</u>

6. Stock based compensation

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 vest after one year and expire after a maximum period of five years from the date of issue.

A summary of the status of the company's stock option plan as of June 30, 2007 and December 31, 2006 and changes during the period are presented below:

	<u>Six Months Ended</u> <u>June 30, 2007</u>		<u>Year Ended</u> <u>December 31, 2006</u>	
	<u>Weighted</u> <u>Number of Average</u> <u>Options</u>	<u>Exercise Price</u>	<u>Weighted</u> <u>Number of Average</u> <u>Options</u>	<u>Exercise Price</u>
<u>Price</u>				
Balance, beginning of year	1,980,000	\$ 0.89	2,120,000	\$ 0.50
Granted	1,215,000	1.64	1,040,000	1.24
Exercised	<u>(370,000)</u>	0.48	<u>(1,180,000)</u>	(0.50)
Balance, end of year	<u>2,825,000</u>	<u>\$ 1.23</u>	<u>1,980,000</u>	<u>\$ 0.89</u>
Exercisable, end of period	<u>1,460,000</u>	<u>\$ 0.80</u>	<u>940,000</u>	<u>\$ 0.50</u>

The outstanding options have a range of exercise prices between \$.42 and \$1.71 per share and a weighted average number of years to expiry of 4.07. The exercisable options have a range of exercise prices between \$.42 and \$1.30 and have a weighted average number of years to expiry of 2.83.

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

DIRECTORS AND OFFICERS

Joseph Werner^{(3) (5)}

Chief Executive Officer
President & Director
Calgary, Alberta

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

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

Robert N. Maertens-Poole⁽⁵⁾

Director
Chief Financial Officer
Calgary, Alberta

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

Director
Calgary, Alberta

Jack P. Donhuysen^{(1) (2) (4)}

Director
Calgary, Alberta

Huba A. Sebo^{(1) (4)}

Director
Calgary, Alberta

Richard W. DeVries⁽¹⁾⁽²⁾

Director
Freeport, The Bahamas

R. Greg Powers^{(3) (6)}

Director, Corporate Secretary
Legal Counsel
Calgary, Alberta

Peter A. Lubey

Director
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Dennis K. Ulrich

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Stock Listing

TSX Venture Exchange
Trading Symbol: **PER**

- (1) Member of the Audit Committee
- (2) Member of the Compensation Committee
- (3) Member of the Governance Committee
- (4) Member of the Reserves Committee
- (5) Member of the Management Committee
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