



# *Emerald Bay Energy*

**EMERALD BAY ENERGY, INC.**

**MANAGEMENT DISCUSSION AND ANALYSIS**

**FOR THE YEAR ENDED  
DECEMBER 31, 2005**

**MAY 1, 2006**

## MANAGEMENTS' DISCUSSION AND ANALYSIS

*The following discussion and analysis of financial information and related data concerning Emerald Bay Energy, Inc. is reported in Canadian dollars and has been prepared in accordance with Canadian generally accepted accounting principles ("GAAP"), and should be read in conjunction with the audited financial statements for the year ended December 31, 2005.*

*Information which is contained herein contains estimates and assumptions which management is required to make concerning future events, and may constitute forward-looking statements under applicable securities laws. Forward-looking statements include plans, expectations, estimates, forecasts and other comments that are not statements of fact. Although such expectations are viewed as reasonable by the Company, no assurance can be given that such expectations will be realized. Such forward-looking statements are subject to risks and uncertainties and may be based on assumption that may cause actual results to differ materially from those implied herein, and therefore are expressly qualified in their entirety by this cautionary statement*

### OVERVIEW

Emerald Bay Energy, Inc. ("Emerald Bay" or the "Company") is engaged in the business of exploration, development and production of crude oil, natural gas and natural gas liquids.

	For the three months ended		For the twelve months ended	
	Dec 31 2005 (\$)	Dec 31 2004 (\$)	Dec 31 2005 (\$)	Dec 31 2004 (\$)
Revenues (before royalties)	1,202,517	328,906	2,320,876	1,216,492
Research and Development costs	(2,080)	(187,112)	(179,790)	(440,880)
Net income (loss)	(74,308)	(465,359)	(863,310)	(981,108)
Net income (loss) per share (basic and diluted)	(0.01)	(0.04)	(0.05)	(0.08)
Total assets	6,705,341	2,954,212	6,705,341	2,954,212
Secured debt	2,000,000	360,000	2,000,000	360,000

During 2005, the Company completed and tied in 2 gross wells significantly increasing production volumes and revenues. Additionally, the Company completed debt and equity financings totaling \$5,275,000.

The Company continued an active exploration program that included data collection and geophysical analysis during the second half of 2005. The Company is now prepared for an active drilling program in 2006.

At Twining, the Company is in the process of completing an extensive geological and seismic review. This process will be a valuable resource to the Company in identifying drilling targets in the Twining area. The Company is proceeding with well licensing and anticipates drilling to commence in April or May 2006. Additionally, the Company is currently negotiating multiple farm-in opportunities in the Twining/Three Hills area for further exploration this year.

At Edson, the Company is moving forward with a plan to re-complete a Cardium well, drilled with Tom Brown Resources (now part of Encana Corporation) and Devon Energy. Completion options are being reviewed with anticipation of this work to begin after road bans have been lifted sometime in May or June 2006.

At Clive, the Company is working to maximize current production by reducing capacity constraints on transmission lines. Increased activity in the area continues to make operators look for cost effective tie-in options to optimize production. The Company is currently working to route three wells into the pipeline infrastructure. The company expects one well will be flowing by the end of April 2006 with the other two wells anticipated to begin production in the second quarter 2006.

Emerald Bay's geological, engineering and land team continue to evaluate other development and exploration prospects in Alberta, British Columbia and South Texas.

Management expects to increase the Company's reserves, production, and cash flow during the remainder of 2006 and into 2007 as a result of the Company's drilling programs in Alberta. Management also intends to intensify its pursuit of further acquisition, exploitation and exploration prospects with a view to identifying and capturing opportunities that have the potential to provide an additional core area for the Company.

## RESERVES

Emerald Bay engaged Gilbert Lausten Jung Associates Limited (GLJ) to perform an independent reserve evaluation prepared in accordance with NI 51-101 for the Canadian properties. The Company also engaged Paul R. Clevenger Petroleum Engineering Consultants to perform an evaluation of the Company's US oil property.

At the end of 2005 (based on GLJ constant pricing), total proved plus probable reserves in Canada increased 6% over the previous year to 362 thousand boe from 343 thousand boe, and the net present value of proved plus probable reserves (before tax, discounted at 10%) increased 48% to \$5.77 million as at December 31, 2005 from \$3.9 million as at December 31, 2004. The US reserve continuity is shown separately as it was prepared under US evaluation rules and may not be comparable to the Canadian report. The US reserves are not material to the Company's production or reserve value.

	Dec 31 2004	2005 Adds Revisions	2005 Production	Dec 31 2005
Cdn Crude oil & NGL - bbl	42,000	20,700	(5,700)	57,000
Cdn Natural gas – mcf	1,813,000	212,000	(196,000)	1,829,000
Total BOE – Canada	343,000	57,000	(38,000)	362,000
US Crude Oil	11,100	(1,200)	(1,800)	8,100

## DETAILED REVIEW OF FINANCIAL RESULTS

### Net Earnings and Cash Flow

	For the three months ended		For the twelve months ended	
	Dec 31 2005 (\$)	Dec 31 2004 (\$)	Dec 31 2005 (\$)	Dec 31 2004 (\$)
Net earnings (loss)	(74,308)	(465,359)	(863,310)	(981,108)
Per share	(0.01)	(0.04)	(0.05)	(0.08)
Cash flow used from operation	175,292	(367,886)	(335,715)	(898,400)
Per share	0.01	(0.03)	(0.01)	(0.08)

The Company has recorded a net loss of \$863,310 for the twelve months ended December 31, 2005, compared to a net loss of \$981,108 for the period ended December 31, 2004. Increased general and administration relating to substantially increased exploration activities and research and development expenses, accounted for the majority of the net loss in 2005. The company has significantly increased staffing and consulting services for the year to date compared to the prior year.

### Revenue

	For the three months ended		For the twelve months ended	
	Dec 31 2005 (\$)	Dec 31 2004 (\$)	Dec 31 2005 (\$)	Dec 31 2004 (\$)
Oil and NGLs	226,594	73,416	409,984	249,871
Per barrel	60.38	49.24	54.52	42.64
Natural gas	975,923	255,490	1,910,892	966,622
Per mcf	11.45	7.20	9.77	6.98
Total gross revenue	1,202,517	328,906	2,320,876	1,216,493
Per boe	66.94	44.43	57.84	42.35

### Sales Volumes

	For the three months ended		For the twelve months ended	
	Dec 31 2005	Dec 31 2004	Dec 31 2005	Dec 31 2004
Crude oil – barrels per day	13	7	7	6
Natural gas – mcf per day	927	385	536	376
NGLs – barrels per day	27	9	13	10
BOE – barrels per day	195	80	110	79

Gross revenue increased in 2005 as compared to 2004, as sales volumes increased to 110 boed from 79 barrels per day. Revenue from natural gas sales was higher in 2005 due to production from the Twining and Clive wells. Total revenue also increased due to higher prices received in 2005 compared to 2004. Emerald does not currently have any hedges in place.

## **Royalties**

**For the three months ended    For the twelve months ended**

	<b>Dec 31 2005 (\$)</b>	<b>Dec 31 2004 (\$)</b>	<b>Dec 31 2005 (\$)</b>	<b>Dec 31 2004 (\$)</b>
Total royalties	367,420	65,088	618,588	203,977
Per boe	20.45	8.84	15.42	7.07
Percentage of revenue	30.6%	19.8%	26.7%	16.8%

Royalties for the twelve months ended December 31, 2005 increased due to the increase in total revenue as described above. Royalties increased as a percentage of revenue due to the price sensitivity of the Company's royalties. The royalties increased on a BOE basis due to the higher price per BOE in 2005 versus 2004. Higher sales values generally attract a higher royalty rate.

## **Production Expense**

**For the three months ended    For the twelve months ended**

	<b>Dec 31 2005 (\$)</b>	<b>Dec 31 2004 (\$)</b>	<b>Dec 31 2005 (\$)</b>	<b>Dec 31 2004 (\$)</b>
Total production expenses	175,140	448	360,841	240,072
Per boe	9.75	0.06	8.99	8.36
Percentage of revenue	14.6%	0.1%	15.5%	19.7%

Production expenses increased on a per boe basis to \$8.99 from \$8.36 in 2004 but remained fairly consistent.

## **General and administrative expenses**

**For the three months ended    For the twelve months ended**

	<b>Dec 31 2005 (\$)</b>	<b>Dec 31 2004 (\$)</b>	<b>Dec 31 2005 (\$)</b>	<b>Dec 31 2004 (\$)</b>
General and administrative expense	593,269	140,140	1,499,081	938,758

In order to carry out the increased activity levels resulting from the company's five year plan, the company substantially increased staffing levels and consulting services relating to exploration activities and research and development. Additionally, new regulatory requirements have increased administrative expense. Furthermore, certain one time costs relating to research and development expenses, capital raising costs, and prior years services have also added to increased general and administrative expenses for the period. The company does not capitalize any administrative costs.

Stock based compensation increased significantly in 2005 due to the issuance of 650,000 stock options in the second quarter that vested immediately. These options increased stock option expense for the year by \$65,500. Stock option expense for 2005 was \$85,710 as compared to 2004 of \$22,183.

### **Research and development expenses**

	For the three months ended		For the twelve months ended	
	Dec 31 2005 (\$)	Dec 31 2004 (\$)	Dec 31 2005 (\$)	Dec 31 2004 (\$)
Research and development expenditures	2,080	187,112	179,790	440,880

Research and development expenses decreased substantially in the period ended December 31, 2005, compared to the period ended December 31, 2004. The Company has completed the Alpha test phase of the project and is currently seeking development partners through its subsidiary Reach Energy Innovations.

### **Depletion, depreciation and site restoration expense**

	For the three months ended		For the twelve months ended	
	Dec 31 2005 (\$)	Dec 31 2004 (\$)	Dec 31 2005 (\$)	Dec 31 2004 (\$)
Depletion, depreciation and amortization	189,306	87,348	497,047	195,985
Asset Retirement Obligation - Accretion	4,967	2,635	19,677	10,540
Total	194,273	89,983	516,724	206,525

Depletion, depreciation and amortization increased in 2005 as compared to 2004 due to significantly higher capital costs added in the fourth quarter of 2004 and the first quarter of 2005 as well as in increased depletion rate due to higher production volumes in 2005. Accretion increased in 2005 as compared to 2004 due to the ownership of an increased number of oil and natural gas wells and related facilities in 2005.

### **Taxes**

	For the three months ended		For the twelve months ended	
	Dec 31 2005 (\$)	Dec 31 2004 (\$)	Dec 31 2005 (\$)	Dec 31 2004 (\$)
Future income tax expense (recovery)	-	-	-	(146,016)

At December 31, 2005, the Company had a future income tax asset of \$605,000 as compared to the 2004 future income tax asset of \$129,000. A valuation allowance has been set up as there is not virtual certainty that the future income tax asset will be realized in the future. Therefore, no future income tax recovery or expense has been recorded.

## **LIQUIDITY AND CAPITAL RESOURCES**

In order to support Emerald's growth oriented business plan, the Company's strategy is to fund its capital expenditure program by issuing common and flow-through shares, to reinvest its cash flow, and to utilize bank debt.

## **SHAREHOLDERS EQUITY**

As at December 31, 2005, there were 27,637,277 common shares issued and outstanding, and an additional maximum total of 1,179,904 reserved for issuance on the potential exercise of common share purchase options. During 2005 650,000 options were granted and 313,000 options expired. In addition, 9,093,953 common shares may be issued on the exercise of warrants.

## **CONTRACTUAL OBLIGATIONS AND CONTINGENCIES**

The Company operates its office and shop under month to month lease arrangements and has no significant long term contractual obligations or contingencies..

## **OFF-BALANCE SHEET ARRANGEMENTS**

Emerald did not enter into any off-balance sheet arrangements.

## **TRANSACTIONS WITH RELATED PARTIES**

Emerald's initial significant shareholders have continued to support the Company's growth oriented business plan by investing additional funds by way of participating in Emerald's ongoing equity issues. As Emerald executes its growth plan, it is the Company's intention to continue to diversify its shareholder base by attracting new shareholders to participate in future offerings. Note 8 of the audited Financial Statements fully detail Emerald's related party transactions.

## **ACCOUNTING POLICIES**

Emerald's accounting policies are stated in Note 2 to the audited Financial Statements. Emerald follows policies that are in accordance with Canadian generally accepted accounting principles.

## **LEGAL MATTERS**

- a) In 2000, the Company commenced legal action against a joint venturer claiming underpayment of a net profit royalty. The joint venturer has issued a counterclaim for an unspecified amount, claiming an overpayment of this royalty. In the opinion of management, the outcome of these claims is not determinable at this time. On February 24, 2006 the Company's legal counsel discontinued this claim without payment of costs by either party.
- b) In 2003, Alberta Revenue issued Notices of Reassessment to the Company disallowing claims for Alberta Royalty Tax Credits ("ARTC") made in the Alberta Corporate Income tax returns for the years 1998 – 2001. The Company disagrees with these reassessments and the Company has filed a Notice of Objection with Alberta Revenue. The final outcome of this matter is not determinable at this time.

- c) In 2005, an oilfield service provider commenced legal action against the Company relating to the loss of a tool in the well bore of one of the Company's wells. As a result of this incident the Company also incurred losses arising from fishing costs, lost production, and potential well bore damage which the Company considers part of its possible counterclaim in regards to this action. In the opinion of management, the outcome of this action is not determinable at this time. It is also the opinion of management, that the outcome of this action would have minimal effect on the Company