TERRACE ENERGY CORP
(Formerly Terrace Resources Inc.)
(the "Company")
MANAGEMENT'S DISCUSSION AND ANALYSIS
OF THE COMPANY'S FINANCIAL CONDITION AND RESULTS OF OPERATIONS
FOR THE NINE AND THREE MONTHS ENDED OCTOBER 31, 2011

Date and Subject of this Discussion and Analysis

This discussion and analysis, made as of December 29, 2011, is integral to, and should be read in conjunction with, the Company's unaudited condensed interim consolidated financial statements for the nine and three months ended October 31, 2011, the audited financial statements for year ended January 31, 2011 and the Company's Filing Statement dated June 1, 2011. These financial statements, and additional information relating to the Company, are available for viewing at www.sedar.com. All information in this MD&A related to 2011 and 2010 has been prepared in accordance with IFRS and all dollar amounts are quoted in Canadian dollars, the reporting currency and functional currency of the Company, unless otherwise noted.

Cautionary Statement Regarding Forward Looking Statements

This discussion and analysis and the documents referenced in this discussion and analysis contain forward-looking information which may include, but is not limited to, statements with respect to future activities of the Company, the Company's plans for its oil and gas properties, the future financial or operating performance of the Company, its subsidiaries and its projects, the timing and amount of estimated future capital, operating and exploration expenditures, costs and timing of future exploration, requirements for additional capital, government regulation of mining operations, environmental risks, reclamation expenses, title disputes or claims, limitations of insurance coverage, the timing and possible outcome of pending litigation and regulatory matters and other matters. These statements relate to analyses and other information that are based on forecasts of future results, estimates of amounts not yet determinable and assumptions of management. Readers are cautioned not to place undue reliance upon these forward looking statements.

Description of Business

Terrace Energy Corp. (the "Company") was incorporated on July 6, 2006 under the Business Corporations Act (British Columbia) and previously named Terrace Resources Inc.

The Company was classified as a capital pool corporation ("CPC") as defined in TSX Venture Exchange (the "Exchange") Policy 2.4. In June 2009, the Company completed a transaction whereby four other CPCs purchased common shares of the Company and distributed them to their respective shareholders upon dissolution. At the particular time, the Company was required to place $2,500,000 into a segregated account, which could not be accessed without Exchange approval. These funds, together with accrued interest, were made available for general working capital purposes upon completion of the Company's qualifying transaction in June 2011.

The Company is now classified as a Tier 2 Oil and Gas issuer. Its common shares trade on the Exchange under the symbol "TZR".

Oil & Gas Properties

Los Patos Gas Unit

During the current year, the Company's wholly-owned subsidiary, Terrace Operating, LLC, and Eagle Energy Development Company entered into a farm-out agreement which entitled the Company to earn up to an 87.5%

Description of Business (continued)

working interest and 65.1875% net revenue interest in certain oil gas leases covering 320 acres referred to as the "Los Patos Gas Unit" in the Tailfeathers Yegua field in Wharton County Texas, by successfully fracture-stimulating an existing well. The agreement constituted the Company's qualifying transaction.

Work over operations on the Patos Gas Unit #1 well were completed in October 2011. The Company incurred total expenditures of $366,668, which were approximately $35,000 more than the amount estimated in the Company's filing statement dated June 1, 2011. The fracture stimulation was successful but the Company failed to connect the well in a manner that would allow it to drain the primary reservoir and, as a consequence, revenue earned to date from the sale of gas has been incidental and recorded as an offset to costs incurred. The expenditures did allow the Company to earn its interests in all of the acreage under the farm-out agreement and is no longer obligated to incur additional costs.

The Company is currently evaluating alternative drilling locations to better access the reservoir and methods to increase sustainable production from the Patos Gas Unit #1 well. However, the Company does not expect to incur additional material expenditures until such time the market for natural gas in the United States improves.

A more complete description of the Los Patos Gas Unit is contained in the Company's Filing Statement dated June 1, 2011 and the report on reserve data, prepared by H.J. Gruy and Associates, Inc. attached thereto, which is available for viewing at www.sedar.com.

Cutlass Project

Subsequent to October 31, 2011, the Company's wholly owned subsidiary, Terrace Cutlass LLC entered into an agreement with Lightning Oil Company, of San Antonio Texas ("Lightning"), under which the Company was granted the right to earn an 18.75% net revenue interest ("NRI") in certain oil, gas and mineral leases covering 3,395 net acres in the Dimmit and LaSalle Counties, Texas.

In order to earn the NRI, the Company agreed to pay 27.78% of all costs, including acreage leases, prospect fees, site preparation and drilling, until the completion of three wells and thereafter 25% of all costs. The Company estimates its initial financial commitment under the agreement to be approximately US$2.2 million relating to the lease payments, prospect fees and infrastructure costs covering 1,342 net acres (the "Dimmit County Acreage") plus its share of the drilling costs for the first well on the Dimmit County Acreage payable when Lighting gives notice that it has made a commitment to commence drilling. Terrace expects that drilling of the first well will commence in March 2012.

Upon completion of the drilling of the first well, the Company may, following a technical evaluation of the first well, choose not to participate in any further well development on the Dimmit County Acreage, in which case it will forfeit all its right, title and interest in and to the entire project and the agreement will terminate.

If the Company concludes that completion of the first well is warranted, its share of the costs to complete and place the first well into production are estimated to be approximately US$700,000. The Company is also required to pay its share of the drilling and completion costs of the second well on the Dimmit County Acreage, at an estimated cost to Cutlass of US$1.9 million, in order to earn its interest in that acreage.

In addition, after the drilling and technical evaluation of the first well on the Dimmit County Acreage, Terrace will have the right to exercise its option to earn an 18.75% NRI in the remaining 2,053 acres (the "LaSalle County Acreage") at a cost of approximately US$3,750,000, representing its share of lease payments, site

Description of Business (continued)

preparation and drilling costs of two wells on the LaSalle County Acreage, in order to earn its interest in that acreage.

Lightning will be the operator of the project with technical and operational input from the Company's technical personnel.

The Company incurred expenses, as required under the terms of the agreement, of US$536,416 subsequent to October 31, 2011.

STS Project

Subsequent to October 31, 2011, the Company's wholly-owned subsidiary, Terrace STS LLC, entered into an agreement with Whittier Energy Company of Houston, Texas ("Whittier") to purchase all of Whittier's leasehold interest in approximately 14,400 gross acres (3875 net acres) in LaSalle and McMullen Counties, Texas. Whittier's interests to be acquired by the Company vary slightly across the acreage, averaging a 26.88% Working Interest and a 20.16% NRI.

The purchase price was US$1.0 million, which was paid subsequent to October 31, 2011. The operator of the project proposed an initial test well of the Olmos formation at an estimated net cost to the Company of US$1.2 million of which US$1.06 million was also advanced to the operator subsequent to October 31, 2011 as required under the joint operating agreement. It is expected that the well will be completed and tested in January 2012.

Results of Operations

The loss for the nine months ended October 31, 2011 was $643,408, net of interest income and foreign exchange of $14,283, compared to a loss of $46,780, net of interest income and foreign exchange of $15,914, for the nine months ended October 31, 2010.

The Company completed its qualifying transaction in June 2011 and thereafter incurred expenses typical of an oil and gas issuer and not a capital pool company. As a result, expenses for the comparable period are significantly less and not relevant to the Company's current operations.

A breakdown of expenses for the nine month periods are as follows:

	Nine months ended October 31, 2011	Nine months ended October 31, 2010
Business investigation costs	$ 93,557	$ 5,983
Property investigation costs	77,949	-
Geological consulting	75,031	-
Professional fees	121,179	28,574
Transfer agent and filing fees	42,929	16,640
Administration	56,429	1,497
Stock-based compensation (associated with stock option grants)	181,794	-
Travel	8,823	-
	$ 657,691	$ 62,694

Results of Operations (continued)

The increase in expenses for the nine months ended October 31, 2011 compared to the nine months ended October 31, 2010 is primarily attributable to: stock-based compensation of $181,794; an increase in professional expenses of $92,605, transfer and filing fees of $26,289 and business investigation costs of $87,574 associated with the completion of the Company's qualifying transaction; and other expenses, such as geological consulting and property investigation costs, associated with the Company's current business of investigating, acquiring and managing oil and gas assets.

The increase in expenses for the three months ended October 31, 2011 compared to the three months ended October 31, 2010 is primarily the result of expenses, such as geological consulting and property investigation costs, associated with the Company's current business of investigating, acquiring and managing oil and gas assets and stock-based compensation.

Summary of Quarterly Results

The results of the Company's most recent eight quarters are set out below:

	October 31 2011 (IFRS)	July 31 2011 (IFRS)[a]	April 30 2011 (IFRS)[a]	January 31 2011 (IFRS)[a]	October 31 2010 (IFRS)[a]	July 31 2010 (IFRS)[a]	April 30 2010 (IFRS)[a]	January 31 2010 (GAAP)[b]
Net income (loss) for the Period	$(251,308)[1]	$(250,869)[2]	$(145,087)	$ (14,429)	$ 4,026	$ (26,046)	$(24,760)	$(6,140)
Loss per share	$ (0.01)	$ (0.01)	$ (0.00)	$ (0.00)	$ 0.00	$ (0.01)	$ (0.00)	$ (0.00)

Notes:

a – prepared under IFRS
b – prepared under Canadian Generally Accepted Accounting principles ("GAAP")

1) The Company's loss includes expense incurred in connection with the Company's new business after the completion of its qualifying transaction in June 2011.
2) The Company's loss during this period includes non-cash deductions of $173,699 for stock-based compensation

Fluctuations in reported earnings during the quarters are primarily due to changes in stock-based compensation, professional fees, business investigation costs and costs associated with its new business after completion of the Company's qualifying transaction in June 2011. There was no impact on quarterly results transitioning from Canadian Generally Accepted Accounting Principles to International Financial Reporting Standards ("IFRS").

Financial Condition, Liquidity and Capital Resources

As at October 31, 2011, the Company had cash of $2,953,592 and accrued liabilities of $182,806 due within three months of the period-end.

In June 2011, the Company completed a private placement of 10 million units at $0.09 per unit for gross proceeds of $900,000, which is included in the above cash balance.

Subsequent to October 31, 2011, the Company completed a private placement of 9 million common shares at $0.25 for gross proceeds of $2,250,000.

Financial Condition, Liquidity and Capital Resources (continued)

The Company also received $63,000 subsequent to October 31, 2011 from the issuance of 350,000 common shares on the exercise of share purchase warrants.

The proceeds from these placements will be used together with the Company's existing working capital and previously restricted cash to fund the development of the Company's oil and gas properties and for general working capital purposes.

As of the date of this report, the Company has no significant commitments or restrictions on its cash except as described herein (see "Description of Business – Oil & Gas Properties"). The Company has not pledged any of its assets as security for loans, or otherwise, and is not subject to any debt or other covenants. Management of the Company believes it has sufficient capital to meet its financial obligations over the next twelve months. However, additional financing may be required to fund the future development of its oil and gas properties. Although the Company has been successful with securing capital in the past, there is no assurance that it will secure necessary capital in the future.

Off Balance Sheet Arrangements

There are no off-balance sheet arrangements to which the Company is committed.

Transaction with Related Parties

During the current period, the Company paid $75,031 (2010 - $nil) for geological consulting services provided by a director of the Company.

These transactions are in the normal course of operations and are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

Critical Risk Factors

The exploration and development of oil and gas involves certain significant risks not within the control of management. Critical risks factors affecting the prospects of the Company include, but not limited to, the following:

Finance Risk

The Company is an exploration stage company now engaged in the exploration of oil and gas, and is not in production. As a consequence, the Company does not generate cash flow from operations and it is not assured that it will generate cash flow from operations in the near future. Continuing operations are, therefore, dependent upon the Company's ability to secure additional capital as required, which is also not assured.

Property Title Risk

Title to oil and gas lease properties involve certain inherent risks due to the difficulties of determining the validity of certain claims, as well as the potential for problems arising from the ambiguous conveyancing history that is characteristic of many oil and gas properties. The Company has investigated title to all of its properties, and, to the best of its knowledge these titles are properly registered and in good standing.

Critical Risk Factors (continued)

Economic Risk

The commercial viability of any oil and gas resource depends on many factors, including its size, existence of economically recoverable reserves and proximity to infrastructure. Government regulation, taxes, royalties, land tenure, land use, environmental protection and reclamation and closure obligations also affect the economic viability of a particular oil and gas resource.

Currency Risk

The Company's principal asset is located in the United States. As at the date of this report, the majority of the Company's cash was held in Canadian dollars and was therefore subject to fluctuation against the United States dollar. Based on the balances as at the date of this report, if the U.S. dollar had weakened (strengthened) against the Canadian dollar, with all other variables held constant, by 1%, net loss would be approximately $1,000. There would be no effect on other comprehensive loss. The Company does not use derivatives or similar instruments to manage currency risk.

Financial Instruments

The Company's financial instruments consist primarily of cash and accounts payables and accrued liabilities. Unless otherwise noted, it is management's opinion that the Company is not exposed to significant interest, currency, or credit risks arising from these financial instruments. The fair value of these financial instruments approximates their carrying value, unless otherwise noted.

Accounting Changes

Basis of presentation

These consolidated financial statements have been prepared in accordance with International Accounting Standard 34 Interim Financial Reporting ("IAS 34") as issued by the International Accounting Standards Board ("IASB"). The policies applied in these interim financial statements are based on International Financial Reporting Standards ("IFRS") issued and outstanding as at December 29, 2011, the date the Board of Directors approved these interim financial statements for issue. Any subsequent changes to IFRS that are issued and effective as at January 31, 2012, could result in a restatement of these interim financial statements.

These condensed interim financial statements have been prepared on a historical cost basis using the accrual basis of accounting, except for cash flow information.

These condensed interim consolidated financial statements were prepared in accordance with International Accounting Standard *34 Interim Financial Reporting*. They do not include all of the information required for full annual financial statements.

The accounting policies set out below have been applied consistently to all the periods presented in preparing the opening balance sheet at February 1, 2010 for purposes of transition to IFRS.

Transition to IFRS

As stated in Note 7, these are the Company's third condensed interim consolidated financial statements for the period covered by the first annual financial statements prepared in accordance with IFRS. There are no

Accounting Changes (continued)

differences between Canadian GAAP and IFRS that are applicable to the measurement of the Company's assets and liabilities (i) at the transition date of February 1, 2010; (ii) at January 31, 2011; and (iii) at October 31, 2011. There is no impact on net loss and comprehensive loss for any period presented. Further, there has been no application of any of the exceptions available under IFRS 1 - First Time Adoption of IFRS.

The accounting policies set out in Note 2 have been applied in preparing the consolidated financial statements for the period ended October 31, 2011, the comparative information presented in these financial statements for the period ended October 31, 2010, and in the preparation of an opening IFRS balance sheet as February 1, 2010.

Use of judgments and estimates

The preparation of financial statements requires management to make estimates that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the condensed financial statements and the reported amounts of revenues and expenses during the reported period.

Additional Information

Securities issued during the period
10,000,000 common shares for proceeds of $900,000
10,000,000 share purchase warrants exercisable at $0.18 each, expiring June 21, 2016
1,950,000 incentive stock options exercisable at $0.12 each, expiring June 21, 2016
250,000 incentive stock options exercisable at $0.19 each, expiring July 15, 2016
250,000 incentive stock options exercisable at $0.21 each, expiring September 6, 2016
250,000 incentive stock options exercisable at $0.19 each, expiring October 18, 2016

Securities issued at the end of the period
The Company had 40,881,821common shares issued and outstanding as at October 31, 2011 and 50,231,821 as at the date of this report.

The Company had the following stock options and warrants outstanding as at October 31, 2011

10,000,000 share purchase warrants exercisable at $0.18 each, expiring June 21, 2016
1,950,000 incentive stock options exercisable at $0.12 each, expiring June 21, 2016
250,000 incentive stock options exercisable at $0.19 each, expiring July 15, 2016
250,000 incentive stock options exercisable at $0.21 each, expiring September 6, 2016
250,000 incentive stock options exercisable at $0.19 each, expiring October 18, 2016

Securities issued subsequent to the end of the period
Subsequent to this October 31, 2011 the Company issued:

9,000,000 common shares for gross proceeds of $2,250,000
350,000 common shares on the exercise of share purchase warrants for gross proceeds of $63,000
100,000 incentive stock options exercisable at $0.53 each, expiring November 25, 2016

Additional Information (continued)

Directors and Officers

Eric Boehnke	Director and C.E.O.
David Gibbs	Director
Dan Carriere	Director
Murray Oliver	Director
William McCartney	Director
Scott Davis	CFO
Paul Visosky	Secretary
Ken Shannon	Assistant Secretary

Contact Person

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