TERRACE ENERGY CORP.
(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, 2012 AND 2011

Introduction

The following Management Discussion and Analysis ("MD&A") of Terrace Energy Corp. (the "Company" or "Terrace") has been prepared by management, in accordance with the requirements of National Instrument of 51-102 as of December 28, 2012 and should be read in conjunction with the unaudited condensed consolidated interim financial statements for the nine and three months ended October 31, 2012 and 2011 and the related notes contained therein which have been prepared under International Financial Reporting Standards ("IFRS"), the audited consolidated financial statements and the related MD&A for the year ended January 31, 2012, and all other disclosure documents of the Company. The information contained herein is not a substitute for detailed investigation or analysis on any particular issue. The information provided in this document is not intended to be a comprehensive review of all matters and developments concerning the Company. Additional information relevant to the Company's activities can be found on SEDAR at www.sedar.com and the Company's website at www.terraceenergy.net.

All financial information in this MD&A related to 2012 and 2011 have been prepared in accordance with IFRS and all dollar amounts are quoted in Canadian dollars, the reporting and functional currency of the Company, unless specifically 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 required, operating and capital expenditures, costs and timing of future exploration, government regulation of oil and gas operations, environmental risks, reclamation expenses, title disputes or claims, limitations of insurance coverage, the timing and possible outcome of pending litigation and regulatory 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.

Cautionary Note to United States Investors

This discussion and analysis and the Company's financial statements are prepared and presented in accordance with the rules and regulations that govern Canadian reporting issuers, as required by the TSXV and applicable securities laws in Canada. The Company does not report to the United States Securities and Exchange Commission, and, in its public disclosure, it may use terms which are not permitted terminology in the United States. In addition, United States investors are cautioned that the Company's financial statements do not conform with, nor are they reconciled to, accounting principles generally accepted in the United States.

Overview

Background

Terrace Energy Corp. 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".

The Company is in the business of acquiring, exploring and developing oil and gas properties. The Company has a limited history of revenues or operating cash flows. The continuing operations of the Company are therefore dependent upon its ability to raise additional capital as required and future profitable operations, neither of which is assured.

The Company's head and principal office is located at Suite 270, 666 Burrard Street, Vancouver, British Columbia V6C 2X8. Its registered and records office is located at 10th Floor, 595 Howe Street, Vancouver, British Columbia V6C 2T5. The Company also maintains an office in Houston, Texas.

The following table lists the Company's principal operating subsidiaries, their jurisdiction of incorporation and its percentage ownership of their voting securities:

Name of subsidiary	Place of Incorporation	Percentage ownership
Terrace US Holdings LLC	USA	100%
Terrace Operating LLC	USA	100%
Terrace Cutlass LLC	USA	100%
Terrace STS LLC	USA	100%

Exploration and Evaluation Assets

The following is a brief description of the Company's principal exploration and evaluation properties:

Los Patos Gas Unit

In June, 2011, 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% 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. The Company fulfilled its obligations under the agreement in 2011 and earned its interests in all of the project acreage. The well was deemed not successful and the Company made the decision to abandon the well and allow the mineral leases to terminate. As a result the Company incurred an impairment charge of $140,000 during the period.

STS Olmos

In November 2011, the Company entered into an agreement, through a wholly-owned subsidiary, to acquire varying working and net revenue interests, which average 26.88% and 20.16%, respectively, in approximately 14,400 gross acres (3,875 net acres) in LaSalle and McMullen Counties, Texas and an evaluation well. The purchase price was $1,014,100.

The Company's share of the aggregate costs, during the period, to drill, complete and place into production three wells was $7,065,374, which is set out in more detail below. These costs and $60,846 of the acreage lease acquisition cost were transferred from Exploration and Evaluation assets to Property and Equipment.

Well	Working Interest	Net Revenue Interest	Production Date	Number of Days in Production to October 31, 2012	Cost	Sales
STS 1-667	16.87%	12.65%	February 10, 2012	265	$ 1,674,929	$ 848,168
SP5 #1-47H	33.00%	25.00%	October 18, 2012	14	2,777,426	126,494
SP5 #2-47H	33.00%	25.00%	October 20, 2012	12	2,613,019	99,241
Test wells					-	16,254
					$ 7,065,374	$ 1,090,157

The Company has secured its working and net revenue interests in all of the project acreage subject to participation in the development of additional wells proposed from time to time by the project's operator. The Company is presently reviewing the 2013 project development plan with the operator.

Cutlass

In November 2011, the Company entered into an agreement, through a wholly-owned subsidiary, to earn a 25% working interest and an 18.75% net revenue interest in certain leases covering 3,395 net acres in Dimmit and LaSalle counties, Texas for $376,508 and a commitment to participate in a two well drilling program. In February 2012, the Company acquired an additional 5% working interest and 3.75% net revenue interest for an additional $233,254.

In order to earn the net revenue interests (22.5% in aggregate), the Company agreed to pay 33.33% of all costs, including acreage leases, prospect fees, site preparation and drilling, until the completion of two wells, and thereafter 30% of all costs relating to the lease payments, prospect fees and infrastructure costs covering 1,342 net acres (the "Dimmit County Acreage").

Drilling of the first well on the Dimmit County acreage was substantially completed in June, 2012. The results were subsequently analyzed and a plan to fracture stimulate the well has been developed. The Company's share of well and infrastructure costs to October 31, 2012 was $2,537,568. The Company expects the well to be fracture stimulated and, if successful, placed into production in the first quarter of 2013 at an estimated cost to the Company of $1,200,000.

The Company must participate in the development of a second well on the Dimmit County Acreage at an estimated cost of $2.7 million. Work on this well is currently scheduled for the second quarter of 2013.

After the drilling and technical evaluation of the first well on the Dimmit County Acreage, the Company exercised its option to earn a 22.5% net revenue interest in the remaining 2,053 acres (the "LaSalle County Acreage") at a cost of $580,206. The Company was obligated to fund 33.33% of the cost of an initial well on the

La Salle County acreage.

Drilling of the initial well commenced in late June 2012. A vertical hole was completed and results are under analysis. Completion plans for this well and plans for additional development wells will be formulated during the first quarter of 2013 based on analysis of petrophysical and geological information gathered from the well. The Company's share of well and infrastructure costs October 31, 2012 was $1,675,352.

Results of Operations

For the nine months ended October 31, 2012 and 2011

The Company began the business of acquiring, exploring and developing oil and gas property interests in June 2011. The Company's first revenues derived from operations were earned during the nine months ended October 31, 2012.

Net loss for the nine months ended October 31, 2012 was $239,815 compared to $181,794 for the nine months ended October 31, 2011. The results are summarized as follows:

	2012	2011
Oil & Gas revenues	$ 1,090,157	$ -
Direct operating expenses	206,648	-
General and administrative expenses (excluding items set out below)	830,967	475,897
	52,542	(475,897)
Foreign exchange	(79,113)	(3,538)
Interest income	(18,987)	(10,745)
Share based payments	250,457	181,794
Impairment charges	140,000	-
	292,357	167,511
Net loss for the period	$ (239,815)	$ (643,408)

Oil and gas sales for the nine months ended October 31, 2012 were $1,090,157 compared to $nil for the nine months ended October 31, 2011.

The Company's first well was completed and placed into production in February, 2012. Its second and third wells were placed into production in late October 2012. The Company's aggregate share of production from these wells for the nine months ended October 31, 2012 was approximately 10,492 barrels of oil and liquids at an average price of USD $96.59 per barrel and 9.7 million cubic feet of natural gas at an average price USD $2.64 per million cubic feet.

*Direct operating expense*s for the nine months ended October 31, 2012 was $116,514, compared to $nil for the nine months ended October 31, 2011. Total depletion and accretion expense for the nine months ended October 31, 2012 was $43,379 compared to $nil for the nine months ended October 31, 2011. Royalties were $46,755 for the nine months ended October 31, 2012 compared to $nil for the nine months ended October 31, 2011.

Administrative expenses for the nine months ended October 31, 2012 were $384,186 compared to $56,429 for the nine months ended October 31, 2011. The increase in administrative expenses is primarily attributable to office expenses, executive and other salaries and rent relating to the establishment of offices in Texas. The amount is net of a recovery of previously disputed sales tax in the amount of $41,680.

Business investigation costs for the nine months ended October 31, 2012 were $nil compared to $93,557 for the nine months ended October 31, 2011. These expenses were incurred prior to the Company being classifies as a Tier 2 Oil & Gas Issuer, as defined by the Exchange, and relate to its search for a qualifying transaction, which was completed in June 2011.

Consulting expenses for the nine months ended October 31, 2012 were $99,370 compared to $75,031 for the nine months ended October 31, 2011. Upon completing its qualifying transaction in June 2011, the Company engaged David Gibbs to manage its operations, on a fee for services basis. In April 2012, Mr. Gibbs was appointed president of the Company and thereafter he has been paid a salary, which has been charged to administrative expenses.

Professional expenses for the nine months ended October 31, 2012, including legal and audit were $146,826 compared to $121,179 for the nine months ended October 31, 2011.

Investor relations expenses for the nine months ended October 31, 2012 were $92,553 compared to $nil for the nine months ended October 31, 2011. Investor relations expenses include public relations, certain specified travel and entertainment costs and communication expenses.

Project investigation costs for the nine months ended October 31, 2012 were $5,082 compared to $77,949 for the nine months ended October 31, 2011. These expenses relate to the Company's ongoing assessment of prospective projects. When a project is determined not to be suitable all costs associated with the investigations are expensed.

Travel expenses for the nine months ended October 31, 2012 were $68,651 compared to $8,823 for the nine months ended October 31, 2011. These expenses increased due to the commencement of operations in Texas.

Transfer agent and filing fees for the nine months ended October 31, 2012 were $34,299 compared to $42,929 for the nine months ended October 31, 2011.

For the three months ended October 31, 2012 and 2011

Net loss for the three months ended October 31, 2012 was $211,879 compared $251,308 for the three months ended October 31, 2011. The results are summarized as follows:

		2012		2011
Oil & Gas revenues	$	332,019	$	-
Direct operating expenses		67,690		-
General and administrative expenses (excluding items set out below)		224,488		241,559
		39,841		(241,559)
Foreign exchange		13,352		1,654
Interest income		(6,419)		-
Share based payments		104,787		8,095
Impairment charges		140,000		-
		251,720		9,749
Net loss for the period	$	(211,879)	$	(251,308)

Oil and gas sales for the three months ended October 31, 2012 were $332,019 compared to $nil for the three months ended October 31, 2011.

The Company's first well was completed and placed into production in February, 2012. Its second and third wells were placed into production in late October 2012. The Company's aggregate share of production from these wells for the three months ended October 31, 2012 was approximately 3,537 barrels of oil and liquids at an average price of USD $95.57 per barrel and 1.16 million cubic feet of natural gas at an average price USD $2.64 per million cubic feet.

Direct operating expenses for the three months ended October 31, 2012 was $37,166, compared to $nil for the three months ended October 31, 2011. Total depletion and accretion expense for the three months ended October 31, 2012 was $24,955 compared to $nil for the three months ended October 31, 2011. Royalties were $5,569 for the three months ended October 31, 2012 compared to $nil for the three months ended October 31, 2011.

Administrative expenses for the three months ended October 31, 2012 were $139,463 compared to $51,582 for the three months ended October 31, 2011. The increase in administrative expenses is primarily attributable to office expenses, executive and other salaries and rent relating to the establishment of offices in Texas. The amount is net of a recovery of previously disputed sales tax in the amount of $41,680.

Business investigation costs for the three months ended October 31, 2012 were $nil compared to $17,875 for the three months ended October 31, 2011. These expenses were incurred prior to the Company being classifies as a Tier 2 Oil & Gas Issuer, as defined by the Exchange, and relate to its search for a qualifying transaction, which was completed in June 2011.

Consulting expenses for the three months ended October 31, 2012 were $18,791 compared to $75,031 for the three months ended October 31, 2011. Upon completing its qualifying transaction in June 2011, the Company engaged David Gibbs to manage its operations, on a fee for services basis. In April 2012, Mr. Gibbs was appointed president of the Company and thereafter he was paid a salary, which has been charged to administrative expenses.

Professional expenses for the three months ended October 31, 2012, including legal and audit, were $24,551 compared to $6,458 for the three months ended October 31, 2011.

Investor relations expenses for the three months ended October 31, 2012 were $23,072 compared to $nil for the three months ended October 31, 2011. Investor relations expenses include public relations, certain specified travel and entertainment costs and communication expenses.

Travel expenses for the three months ended October 31, 2012 were $15,156 compared to $8,823 for the three months ended October 31, 2011. These expenses increased due to the commencement of operations in Texas.

Summary of Quarterly Results

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

	October 31, 2012	July 31, 2012	April 30, 2012	January 31, 2012
Revenue	$ 332,019	$ 202,382	$ 555,756	$ -
Net income (loss)	(211,879) [1]	(240,180) [2]	212,244 [3]	(561,886) [4]
Exploration and evaluation	6,355,442	7,955,545	3,217,255	2,973,526
Property and equipment	7,138,716	1,467,743	1,313,608	-
Total assets	15,697,145	15,793,285	9,449,160	5,592,676
Income (loss) per share – basic and diluted	(0.00)	(0.00)	0.00	(0.01)

	October 31, 2012	July 31, 2012	April 30, 2012	January 31, 2012
Revenue	$ -	$ -	$ -	$ -
Net income (loss)	(251,308) [5]	(251,065) [6]	(145,087)	(14,429)
Exploration and evaluation	360,959	-	-	-
Property and equipment	-	-	-	-
Total assets	3,332,630	3,425,756	2,636,833	2,744,704
Income (loss) per share – basic and diluted	(0.01)	(0.01)	(0.00)	(0.01)

Notes:

1) Net income during this period includes non-cash deductions of $104,787 for share–based payments, $24,955 for depletion and accretion expenses and $140,000 impairment charge
2) Net income during this period includes non-cash deductions of $70,121 for share–based payments and $12,918 for depletion and accretion expenses.
3) Net income during this period includes non-cash deductions of $75,549 for share–based payments and $5,506 for depletion and accretion expenses.

4) The Company's loss during this period includes non-cash deductions of $95,878 for share-based payments and $234,564 for impairment of oil and gas properties.
5) The Company's loss includes expenses incurred in connection with the Company's new business after the completion of its qualifying transaction in June 2011.
6) The Company's loss during this period includes non-cash deductions of $173,699 for share-based payments.

Fluctuations in reported earnings during the prior quarters are primarily due to changes in share-based payments, 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, 2012, the Company had cash of $1,511,632, accounts receivable of $339,980 and accounts payable and accrued liabilities of $283,759 due within three months of the three months ended October 31, 2012.

In May 2012, the Company closed a private placement of 10,000,000 common shares at a purchase price of $1.00 per share for gross proceeds of $10,000,000. Share issue costs of $48,670 were paid in relation to the private placement.

In July 2012, the Company issued 150,000 common shares on the exercise of stock options at a purchase price of $0.12 per share for gross proceeds of $18,000.

It is expected that the balance of the Company's existing working capital will be used to fund the development of the Company's oil and gas properties (see commitments described under "Exploration and Evaluation") 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 "Exploration and Evaluation"). 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 or will generate from operations sufficient capital to meet its financial obligations over the next twelve months. However, there is no assurance the Company will generate sufficient sustainable cash flows to fund the future development of its oil and gas properties and therefore may have to seek additional financing (see commitments described under "Exploration and Evaluation Assets"). 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.

Key Management Personnel Compensation

During the nine months ended October 31, 2012, the Company:

a) Paid or accrued $76,532 (2011 - $nil) for consulting services to Dave Gibbs who since became an officer of the Company of which $7,007 were capitalized, $1,345 (2011 - $nil) for project investigation costs, $nil (2011 - $2,931) for business investigation costs to Dave Gibbs;

b) Paid or accrued $31,498 (2011 - $nil) for administrative services to a firm where Deborah Cotter, an officer of the Company is a principal;

c) Paid or accrued $27,125 (2011 - $nil) for accounting services to a firm where Scott Davis, an officer of the Company is a principal;

d) Paid or accrued $67,284 for legal services to a law firm in which Paul Visosky, the former corporate secretary of the Company is a principal; and

e) Paid or accrued $nil (2011 - $8,000) for accounting services to Jennie Choboter, a former officer of the Company.

The compensation paid to key management personnel was $253,657 (2011 - $83,031), which is being expensed over the vesting periods of the options.

New accounting policy

Revenue recognition

Revenue from the sale of oil and gas is recorded when title passes to an external party and is based on volumes delivered to customers at contractual delivery points, and rates and collectability are reasonably assured.

Delivery is generally at the time the product enters the pipeline. The cost associated with the delivery, including operating and maintenance costs, transportation and production based royalty expenses, are recognized during the same period in which the related revenue is earned and recorded.

New accounting standards and interpretation

A number of new standards, amendments to standards and interpretations are effective for annual periods beginning after January 1, 2013, including IAS 1 *Presentation of Financial Statements,* IAS 19 *Employee Benefits,* IFRS 9 *Financial Instruments,* IFRS *10 Consolidated Financial Statements,* IFRS 11 *Joint Arrangements,* IFRS 12 *Disclosure of Interest of Other Entities, and* IFRS 13 *Fair Value Measurement,* and have not been applied in preparing these consolidated financial statements. None of these are expected to have a significant effect on the consolidated financial statements of the Company, except for IFRS 9 *Financial Instruments* ("IFRS 9"), which becomes mandatory for the Company's 2015 consolidated financial statements and could change the classification and measurement of financial assets. The extent of the effects of the new accounting standards on the condensed interim consolidated financial statements has not been determined.

Risk Factors

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

Exploration, Development and Production Risks

Oil and natural gas exploration involves a high degree of risk and there is no assurance that expenditures made on future exploration by the Company will result in new discoveries of oil or natural gas in commercial quantities. The Company, through its subsidiaries, has the right to earn working interests in various oil & gas properties described herein. To earn such interests the Company must incur certain specified expenditures to evaluate and complete a number of prospective wells capable of producing oil and gas in paying quantities. No assurance can be given that the Company will be successful in completing a well capable of producing oil and gas. The long-term commercial success of the Company depends on its ability to find, acquire, develop and commercially produce oil and natural gas reserves. Without the continual addition of new reserves, any existing reserves the Company may have at any particular time and the associated production if any therefrom will decline over time

as the reserves are exploited. A future increase in the Company's reserves will depend not only on its ability to explore and develop any properties it may have from time to time, but also on its ability to select and acquire suitable producing properties or prospects. No assurance can be given that the Company will be able to continue to locate satisfactory properties for acquisition or participation. Exploration and development activities may be delayed or adversely affected by factors outside the control of the Company including adverse climatic and geographic conditions, labour disputes, compliance with governmental requirements, shortage or delays in installing and commissioning plant and equipment or import or customs delays. Drilling may involve unprofitable efforts, not only with respect to dry wells, but also with respect to wells, though yielding some oil or gas, are not sufficiently productive to justify commercial development or cover operating and other costs. Oil and natural gas exploration, development and production operations are subject to all the risks and hazards typically associated with such operations, including hazards such as fire, explosion, blowouts, cratering, sour gas releases and spills, each of which could result in substantial damage to oil and natural gas wells, production facilities, other property and the environment or in personal injury.

<u>Additional Funding Requirements</u>
Terrace has limited history of production or profitability and its financial resources may not be sufficient to fund its ongoing activities at all times (see commitments described under "Exploration and Evaluation"). From time to time, the Company will require additional financing to carry out its oil and gas acquisition, exploration and development activities. Failure to obtain such financing on a timely basis could cause the Company to forfeit its interest in certain properties, miss certain acquisition opportunities and reduce or terminate its operations. Any additional financing is likely to involve the issuance of securities which could be substantially dilutive.

<u>No Assurance of Title</u>
Title to oil and gas interests is often not capable of conclusive determination without incurring substantial expense. The nature of the oil and gas leasing and title regime in the U.S. is such that interests in tracts of acreage may be represented by many leases and other agreements affecting oil and gas rights and access and obtaining absolute confirmation of chain of title would be time consuming and expensive. While the Company will conduct a title review of a particular area prior to commencement of drilling there can be no assurance of title. Title may be subject to unregistered liens and other defects which, if affecting a core area, could have a material adverse effect on the Company, its financial condition, results of operations and prospects.

<u>Permits and Licenses</u>
The activities of the Company are subject to government approvals, various laws governing prospecting, development, land resumptions, production taxes, labour standards and occupational health, safety, toxic substances and other matters, including issues affecting local native populations. Although the Company believes its planned development work is in accordance with all applicable rules and regulations, no assurance can be given that new rules and regulations will not be enacted or that existing rules and regulations will not be applied in a manner which could limit or curtail production or development. Amendments to current laws and regulations governing operations and activities of exploration and quarrying, or more stringent implementation thereof, could have a material adverse impact on the business, operations and financial performance of the Company. Further, the exploration and development permits and licenses that have and may be issued in respect of each project may be subject to conditions which, if not satisfied, may lead to the revocation of such permits and licenses. In the event of revocation, the value of the Company's investments in such projects may decline.

<u>Reserve Estimates</u>
No current reserves have been estimated in respect of the Company's oil & gas properties. There are numerous uncertainties inherent in estimating quantities of oil, natural gas and natural gas liquids reserves and resources and associated cash flows, including many factors beyond the Company's control. In general, estimates of economically recoverable oil and natural gas reserves and the future net cash flows from them are based upon a number of variable factors and assumptions, such as historical production from the properties, production rates, ultimate reserve recovery, timing and amount of capital expenditures, marketability of oil and natural gas, royalty

rates, the assumed effects of regulation by governmental agencies and future operating costs, all of which may vary from actual results. The Company's actual production, revenues, taxes and development and operating expenditures with respect to its reserves will vary from estimates thereof and such variations could be material.

Prices and Markets for Oil and Natural Gas

Oil and natural gas are commodities whose prices are determined based on world demand, supply and other factors, all of which will be beyond the control of the Company. World prices for oil and natural gas have fluctuated widely in recent years. Any material decline in prices could result in a reduction of net production revenue. Certain wells or other projects may become uneconomic as a result of a decline in world oil prices or natural gas prices, leading to a reduction in the volume of the Company's oil and gas reserves. The Company might also elect not to produce from certain wells at lower prices. All of these factors could result in a material decrease in the Company's future net production revenue, causing a reduction in its oil and gas acquisition and development activities. Prices for oil and gas are subject to large fluctuations in response to relatively minor changes in the supply of and demand for oil and gas, market uncertainty and a variety of additional factors beyond the control of the Company. These factors include economic conditions, in the United States and Canada, the actions of OPEC, governmental regulation, political stability in the Middle East and elsewhere, the foreign supply of oil and gas, risks of supply disruption, the price of foreign imports and the availability of alternative fuel sources. Any substantial and extended decline in the price of oil and gas would have an adverse effect on the Company's carrying value of its reserves, borrowing capacity, revenues, profitability and cash flows from operations and may have a material adverse effect on the Company's business, financial condition, results of operations and prospects.

Lack of Adequate Insurance

In the course of exploration, development and production of mineral properties, certain risks, and in particular, unexpected or unusual geological operating conditions including rock bursts, cave-ins, fires, flooding and earthquakes may occur. It is not always possible to fully insure against such risks and the Company may decide not to take out insurance against such risks as a result of high premiums or other reasons. Should such liabilities arise, they could reduce or eliminate any future profitability and result in increasing costs and a decline in the value of the securities of the Company.

Competition

The oil and gas industry is highly competitive. The Company's competitors for the acquisition, exploration, production and development of oil and natural gas properties, and for capital to finance such activities will include companies that have greater financial and personal resources available to them than the Company.

Risks Associated with Joint Operating Agreements

The development of the Company's oil & gas properties is governed by a various joint operating agreements. The existence or occurrence of a disagreement or dispute with or among the other parties to such agreement could have a material adverse impact on the Company's profitability or the viability of its interests, which could have a material adverse impact on the Company's business prospects, results of operations and financial condition.

Environmental Risks

All phases of the oil and natural gas business present environmental risks and hazards and are subject to environmental regulation pursuant to a variety of international conventions and provincial and municipal laws and regulations. Environmental legislation provides for, among other things, restrictions and prohibitions on spills, releases or emissions of various substances produced in association with oil and gas operations. The legislation also requires that wells and facility sites be operated, maintained, abandoned and reclaimed to the satisfaction of applicable regulatory authorities. Compliance with such legislation can require significant expenditures and a breach may result in the imposition of fines and penalties, some of which may be material. Environmental legislation is evolving in a manner expected to result in stricter standards and enforcement, larger fines and liability and potentially increased capital expenditures and operating costs. There is no assurance that

future changes in environmental regulation, if any, will not adversely affect the Company's operations or prevent operations all together. Government approvals and permits are currently, and may in the future be, required in connection with the Company's operations, which could potentially make operations expensive or prohibit them altogether. To the extent such future approvals are required and not obtained, the Company may be curtailed or prohibited from proceeding with planned exploration or development of the Properties or from commencing production.

Availability of Drilling Equipment and Access Restrictions

Oil and natural gas exploration and development activities are dependent on the availability of drilling and related equipment in the particular areas where such activities will be conducted. Demand for such limited equipment or access restrictions may affect the availability of such equipment to the Company and may delay exploration and development activities.

Current Global Financial Conditions

Current global financial conditions have been subject to increased volatility and numerous financial institutions have either gone into bankruptcy or have had to be rescued by governmental authorities. Access to public financing has been negatively impacted by both sub-prime mortgages and the liquidity crisis affecting the asset-backed commercial paper market. These factors may impact the ability of the Company to obtain equity or debt financing in the future and, if obtained, on terms favourable to the Company. If these increased levels of volatility and market turmoil continue, the Company's operations could be adversely impacted and the value and the price of the Company's shares could continue to be adversely affected.

Geo Political Risks

The marketability and price of oil and natural gas that may be acquired or discovered by the Company is and will continue to be affected by political events throughout the world that cause disruptions in the supply of oil. Conflicts, or conversely peaceful developments, arising in the Middle East, and other areas of the world, have a significant impact on the price of oil and natural gas. Any particular event could result in a material decline in prices and therefore result in a reduction of the Company's net production revenue.

Transportation Costs

Disruption in or increased costs of transportation services could make oil and natural gas a less competitive source of energy or could make the Company's oil and natural gas less competitive than other sources. The industry depends on rail, trucking, ocean-going vessels, pipeline facilities, and barge transportation to deliver shipments, and transportation costs are a significant component of the total cost of supplying oil and natural gas. Disruptions of these transportation services because of weather related problems, strikes, lockouts, delays or other events could temporarily impair the ability to supply oil and natural gas to customers and may result in lost sales. In addition, increases in transportation costs, or changes in transportation costs for oil and natural gas produced by competitors, could adversely affect profitability. To the extent such increases are sustained, the Company could experience losses and may decide to discontinue certain operations forcing the Company to incur closure and/or care and maintenance costs, as the case may be. Additionally, lack of access to transportation may hinder the expansion of production at some of the Company's properties and the Company may be required to use more expensive transportation alternatives.

Capacity of Pipelines, Refineries and Natural Gas Processing Facilities

Although expansion projects are ongoing, the availability of sufficient marketing capacity continues to affect the oil and natural gas industry and limit the ability to produce and to market natural gas production. The rapid expansion of production in the Company's core area may create temporary disruptions in the capacity of marketing infrastructure. In addition, the pro-rationing of capacity on the inter-state pipeline systems also continues to affect the ability to export oil and natural gas.

Reliance on Key Individuals

The Company's success depends to a certain degree upon certain key members of the management. It is expected that these individuals will be a significant factor in the Company's growth and success. The loss of the service of members of the management and certain key employees could have a material adverse effect on the Company.

Conflicts of Interest

Certain of the Company's directors are also directors, officers or shareholders of other companies that are engaged in the business of acquiring, developing and exploiting natural resource properties. Such associations may give rise to conflicts of interest from time to time. Such a conflict poses the risk that the Company may enter into a transaction on terms which place the Company in a worse position than if no conflict existed. The directors are required by law to act honestly and in good faith with a view to the best interest of the Company and to disclose any interest which they may have in any project or opportunity of the Company. However, each director has similar obligations to other companies for which such director serves as an officer or director. If a conflict of interest arises at a meeting of the board of directors, any director in a conflict is required disclose his interest and abstain from voting on such matter. In determining whether or not the Company will participate in any project or opportunity, the board of directors will primarily consider the degree of risk to which the Company may be exposed and its financial position at that time.

Financial Instruments

The Company has classified its financial instruments as follows:

- Cash - as FVTPL;
- Accounts receivable – as loans and receivables; and
- Accounts payable and accrued liabilities - as other financial liabilities.

The Company’s risk exposure and the impact on the Company’s financial instruments are summarized below:

Fair value

The carrying values of cash, restricted cash, accounts receivable, and accounts payable and accrued liabilities approximate their fair values due to the short-term maturity of these financial instruments.

Credit risk

Credit risk is the risk of potential loss to the Company if the counterparty to a financial instrument fails to meet its contractual obligations.

The Company's credit risk is primarily attributable to its cash and accounts receivables. The Company manages exposure to credit risk on liquid financial assets through maintaining its cash with major Canadian financial institutions, for which management believes the risk of loss to be minimal. Accounts receivable is comprised from the sale of oil and gas.

Market risk

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate due to changes in the market prices. Market risk is comprised of three types of risk: interest rate risk, foreign currency risk and other price risk.

(i) Interest rate risk

To the extent that payments made or received on the Company’s monetary assets and liabilities are affected by changes in prevailing market interest rates, the Company is exposed to interest rate cash flow risk.

To the extent that changes in prevailing market interest rates differ from the interest rates in the Company's monetary assets and liabilities, the Company is exposed to interest rate price risk.

The Company's exposure to interest rate risk is minimal.

(ii) Foreign 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 October 31, 2012, if the US dollar had weakened (strengthened) against the Canadian dollar, with all other variables held constant, by 1%, net loss would be approximately $11,762. There would be no effect on other comprehensive loss. The Company does not use derivatives or similar instruments to manage currency risk.

(iii) Other price risk

Other price risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate due to changes in the market prices, other than those arising from interest rate risk or foreign currency risk. The Company is not exposed to significant other price risk.

Liquidity risk

Liquidity risk is the risk that the Company will encounter difficulty in satisfying financial obligations as they become due. The Company manages liquidity risk through maintaining sufficient cash on hand to meet its obligations as they become due. As at October 31, 2012, the Company had cash of $1,511,632, accounts receivable from the sale of oil and gas of $277,128 and $62,852 from harmonized sales tax ("HST") receivable from the Canadian tax authorities and accounts payable and accrued liabilities of $283,759 due within three months of the period-end.

The Company owns varying interests in oil and gas properties subject to joint operating agreements, which provide, among other things, that the Company make advance payments, from time to time, to fund its share of estimated exploration and evaluation costs. The Company may not have sufficient working capital and future cash flow from operations to fund its share of the agreed upon estimated costs of proposed development activities. As a consequence, the Company may have to secure new sources of capital, which is not assured, to maintain its interests in such proposed development.

Shareholder's Equity and Outstanding Share Data

The authorized share capital of the Company consists of an unlimited number of common shares. As of October 31, 2012 and December 28, 2012, the Company had 63,069,321 common shares outstanding.

As of December 28, 2012, the Company had the following stock options and warrants outstanding:

- Stock options

Number of options	Number of options exercisable	Exercise price	Expiry Date
1,650,000	1,650,000	$ 0.12	June 22, 2016
250,000	100,000	$ 0.19	July 15, 2016
250,000	100,000	$ 0.21	September 16, 2016
250,000	100,000	$ 0.19	October 18, 2016
100,000	40,000	$ 0.53	November 25, 2016
250,000	62,500	$ 0.67	December 16, 2016
150,000	37,500	$ 1.35	July 8, 2017
2,900,000	2,090,000		

- Warrants

Number of warrants	Exercise price	Expiry date
7,112,500	$ 0.18	June 21, 2016

Internal Controls Over Financial Reporting

Changes in Internal Control over Financial Reporting ("ICFR")
In connection with National Instrument 52-109, Certification of Disclosure in Issuer's Annual and Interim Filings ("NI 52-109") adopted in December 2008 by each of the securities commissions across Canada, the Chief Executive Officer and Chief Financial Officer of the Company will file a Venture Issuer Basic Certificate with respect to financial information contained in the unaudited interim financial statements and the audited annual financial statements and respective accompanying Management's Discussion and Analysis. The Venture Issue Basic Certification does not include representations relating to the establishment and maintenance of disclosure controls and procedures and internal control over financial reporting, as defined in NI52-109.

Proposed Transactions

On December 21, 2012, the Company announced that its wholly owned subsidiary, Terrace US Holdings, LLC ("Terrace US" and, together with Terrace Energy, "Terrace") has entered into an agreement with Redhawk Resources, LLC ("Redhawk") wherein Redhawk has granted Terrace US an option to acquire interests in certain mineral leases in Finney County, Kansas (the "Option"). Such leases include the right to explore and exploit the coveted Mississippi Lime formation.

Under the terms of the Option, Terrace US may acquire, at any time up to the close of business on April 30, 2013, an 82% working interest and a 65.6% net revenue interest in approximately 15,000 net mineral acres in Finney County, Kansas for approximately US$2.3 million on closing and a commitment to fund 100% of the drilling, development, marketing, leasehold maintenance, and other related costs of the project to a maximum of US$5,365,500. Terrace US would be designated the project's operator upon closing. To secure the Option, Terrace paid Redhawk a US$225,150 non-refundable deposit against the purchase price. Terrace intends to complete its due diligence and capital requirements review in the first quarter of 2013.

Contingencies

There are no contingent liabilities.

Management's Responsibility For Financial Statements

The information provided in this report, including the financial statements, is the responsibility of management. In the preparation of these statements, estimates are sometimes necessary to make a determination of future values for certain assets or liabilities. Management believes such estimates have been based on careful judgments and have been properly reflected in the financial statements.

Other MD&A Requirements

Additional disclosure of the Company's technical reports, material change reports, news releases and other information can be obtained on SEDAR at www.sedar.com.

Directors and Officers

Eric Boehnke	Director and CEO
David Gibbs	Director and President
Dan Carriere	Director
Murray Oliver	Director
William McCartney	Director
Ken Shannon	Director
Scott Davis	CFO
Deborah Cotter	Secretary

Contact Person

Murray Oliver
Telephone: (604) 687-0888
email: mjo@pemcorp.com