



Q2  
REPORT



*For the six months ended June 30, 2005*



Diaz Resources Ltd.

## Corporate Profile

**Diaz Resources Ltd.** is an oil and gas exploration and development company with land holdings and production in Canada and the United States. The Company's principal business is the exploration for and marketing of natural gas with the majority of the Company's revenue being generated from gas production in Alberta and Texas.

The Company currently focuses its exploration activities on shallow gas reservoirs in southern Alberta, a multi-zone oil and gas prospect at Harmattan in central Alberta and a deep Wilcox gas play in Texas. Southern Alberta combines low cost drilling and low risk exploration opportunities with an excellent natural gas infrastructure while Texas and Harmattan provide significant upside potential for reserves and production.

## Corporate Summary

(Thousands, except per share amounts)

	Six Months Ended June 30	
	2005	2004
<b>Financial</b>		
Total revenue	\$ 7,689	\$ 6,930
Cash flow from operations	\$ 4,560	\$ 4,513
per share, diluted	\$ 0.08	\$ 0.08
Earnings for the period	\$ 1,221	\$ 950
per share, diluted	\$ 0.02	\$ 0.02
Capital additions	\$ 5,122	\$ 5,437
Dispositions	\$ 50	\$ 17
Net debt	\$ 9,604	\$ 7,882
Total assets	\$ 48,563	\$ 43,251
<b>Operations</b>		
<b>Production</b>		
Gas (MMcfd)	6.1	6.3
Oil (Bopd)	153	106
BOEd (6Mcf = 1Bbl)	1,166	1,148
<b>Product Prices</b>		
Gas (\$/Mcf)	\$ 7.21	\$ 6.93
Oil (\$/Bbl)	\$ 56.46	\$ 44.68
Total shares outstanding, at period end	59,802	57,342

## To the Shareholders



I am pleased to report that several recent exploration successes, placed on production during the second quarter, will result in steady increases in production and cash flow for the balance of 2005.

While Diaz's financial and operating results for the second quarter of 2005 were similar to those reported for the second quarter of 2004, the commencement of production from new wells at Harmattan in Alberta and at Allen Ranch in Texas increased the Company's average production significantly, to 1,359 BOEd for the month of June 2005.

In addition, increased production rates from a new well at Hound Dog, Texas, currently producing at 4.5 MMcfd, Diaz interest 22.5%, will markedly improve the Company's financial results for the second half of 2005.

### **Financial**

Revenue for the six months ended June 30, 2005 totaled \$7.7 million compared with \$6.9 million one year earlier.

Cash flow for the period increased to \$4.6 million, or \$0.08 per share compared with \$4.5 million, or \$0.08 per share in 2004. Diaz's cash flow was negatively impacted by \$556,000 of current taxes payable in the United States. The Company will be increasing its capital budget, which will defer current taxes payable. Diaz reported earnings for the six months ended June 30, 2005 of \$1.2 million, or \$0.02 per share compared with \$1.0 million, or \$0.02 per share reported in 2004.

Capital expenditures totaled \$5.1 million compared with \$5.4 million in 2004 and were financed from cash flow and debt. The Company's net debt at the end of the quarter was \$9.6 million and debt repayability, annualized, from cash flow from operations was approximately one time.

## Production

For the second quarter of 2005, natural gas production averaged 6.1 MMcfd compared with 6.3 MMcfd in 2004. Oil production increased to average 153 Bopd compared with 106 Bopd in 2004. Total production increased slightly to average 1,166 BOEd from 1,148 BOEd in 2004.

## Exploration and Development

### CANADA – ALBERTA

#### HARMATTAN – DIAZ WORKING INTEREST 40%

In Q4 2004, Diaz made a significant multi-zone discovery in the Harmattan area of central Alberta. Production facilities and a natural gas pipeline to connect the well to a natural gas plant in the area were constructed in Q1 2005. The well commenced production in April 2005, and for the month of July produced at an average rate of 239 Bopd and 927 Mcfd.

A second well, one mile south of the discovery well, has been drilled and abandoned. A third well on this prospect was drilled in May 2005 and is currently being tested for potential oil production.

#### RETLAW – DIAZ WORKING INTEREST 50%

Diaz participated in the drilling of a gas well at Retlaw 15-29-12-19 W4. The well is anticipated to have an initial production rate of 2.0 MMcfd and Diaz has a 50% working interest in the well, which is scheduled to be on-stream in September 2005. Diaz plans to drill one additional well on this prospect during the last half of 2005.

### UNITED STATES – TEXAS

#### ALLEN RANCH – DIAZ WORKING INTEREST 20%

In Q1 2005, Diaz completed the drilling of the Hancock #1 well on the Allen Ranch prospect. The well encountered four highly prospective Wilcox sands and the two deepest sands have been completed and fracture stimulated. The initial sand flowed gas at 1.6 MMcfd at 4,300 psi. This sand was temporarily suspended and the second sand is producing through temporary facilities at a rate of 4.2 MMcfd at 6,500 psi. Once the second sand has been

evaluated, the two sands will be commingled. A second well on the prospect is planned for the last half of 2005 to test a deeper fault structure.

#### HOUND DOG – DIAZ WORKING INTEREST 22.5%

The R. Dickson #1 well drilled in Q1 2004 encountered nine prospective sands. Most of the deeper Wilcox sands are off-structure and although the well flowed gas from these sands, the rates were not economic. These sands will be tested at a structurally higher point with the drilling of the next well. The well was completed in the Wilcox #8 sand and is currently producing at a rate of 4.5 MMcfd. A second well is planned for the last half of 2005.

## Non-Core Asset Disposition

Subsequent to the end of the quarter, Diaz has sold its 12.5% working interest in a non-core oil property located in southern Alberta. The prospect was providing approximately 21 BOEd before the sale and was sold for \$657,000.

## Share Capital Reorganization

At its shareholders' meeting on June 9, 2005, the Company's shareholders approved an amendment to the Articles of the Company to convert Subordinate Voting Shares and Multiple Voting Shares into one class of Common Shares, on a one-for-one basis. As a result, the Company now has only one class of shares outstanding.

## Business Outlook

The Company is very optimistic regarding the outlook for 2005.

Recent results from the Company's deep Wilcox gas exploration program, especially the multi-zone success of the Allen Ranch prospect, has been most encouraging. As a result, Diaz anticipates significant production and reserve increases in the United States during 2005.

In addition, exploration and development work in southern and central Alberta should provide production and reserve increases in Canada during 2005. Increased production from the Texas Wilcox trend and the development of the new discoveries in the Harmattan and Retlaw areas,

together with high energy prices, should provide the Company with increased cash flow for 2005, which will finance its increased capital budget.

### **Strategic Review Process**

Diaz advises that as part of an ongoing review of business and strategic opportunities available to the Company, the Board of Directors authorized Management to examine strategic and corporate restructuring alternatives that may be beneficial to Diaz shareholders.

No decision on any particular alternative has been reached to-date and there can be no assurance that the Board of Directors will proceed with any alternative once identified.

The strategic alternatives to be considered will include, but will not necessarily be limited to: maintaining the status quo; continuing as an independent oil and gas

company with changes to management; merging with another company or the sale of the Company for cash or shares.

Any strategic or corporate restructuring alternatives identified will be subject to review and approval of the Diaz Board of Directors and to shareholder and regulatory approvals, as required.

On behalf of the Board,

“signed”

R.W. Lamond  
President

August 11, 2005



# Management's Discussion and Analysis

Prepared as of August 8, 2005

*The following discussion and analysis is management's assessment of Diaz's historical, financial and operating results, together with future prospects, and should be read in conjunction with the unaudited consolidated financial statements of the Company for the six months ended June 30, 2005 and the audited financial statements at December 31, 2004. The reader should be aware that historical results are not necessarily indicative of future performance.*

## **Basis of Presentation**

The financial data presented herein has been prepared in accordance with accounting principles generally accepted in Canada. All dollar amounts are in Canadian dollars unless otherwise indicated.

**Non-GAAP Measurements** – The Management's Discussion and Analysis contains the term cash flow from operations, which should not be considered an alternative to, or more meaningful as an indicator of the Company's performance than, cash flow from operating activities, as determined in accordance with accounting principles generally accepted in Canada. Diaz's determination of cash flow from operations may not be particularly comparable to that reported by other companies especially those in other industries. The reconciliation between net earnings and cash flow from operations can be found in the consolidated statements of cash flows in the unaudited interim consolidated financial statements and the audited consolidated financial statements. The Company also presents cash flow from operations per share whereby per share amounts are calculated using weighted average shares outstanding consistent with the calculation of earnings per share.

**BOE Presentation** – The term barrels of oil equivalent (BOE) may be misleading, particularly if used in isolation. A BOE conversion ratio of 6 Mcf : 1 Bbl is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead. All BOE conversions in this report are derived by converting gas to oil in the ratio of six Mcf of gas to one Bbl of oil.

This discussion and the Company's second quarter interim report contain forward-looking statements that involve risk and uncertainties. Such information, although considered reasonable by management at the time of preparation, may prove to be incorrect and actual results may differ materially from those anticipated in the statements made.

## Oil & Gas Production

Diaz is primarily a natural gas producer with 84% of its production in Q2 2005 coming from natural gas wells. Diaz owns interests in producing properties in Canada: Alberta and Saskatchewan, and in the United States, almost exclusively in Texas.

The Company's production averaged 1,166 BOEd for the six months ended June 30, 2005, compared with 1,148 BOEd for the same period in 2004. Oil and NGL production for the period increased to average 153 BOEd, compared with 106 BOEd in 2005. The increase in oil and NGL production is entirely attributed to the Harmattan well, which was placed on-stream at the end of Q1 2005. The initial Harmattan well is currently producing at a rate of approximately 360 BOEd.

Natural gas production for the six months ended June 30, 2005 was relatively unchanged averaging 6.1 MMcfd. Additions to natural gas production in Canada were delayed due to inclement weather in the first half of the year; however, gas wells at Ukalta, Retlaw and Enchant are scheduled to be tied-in during Q3 2005 and these wells, together with new production from the infill drilling program at Enchant and Retlaw should increase Canadian gas production in Q3 2005.

In the U.S., gas production at both Allen Ranch and Hound Dog commenced in Q2 2005 and in July, Diaz's production from the Wilcox trend averaged 3.0 MMcfd.

<b>Oil &amp; Gas Production</b>	Three Months Ended June 30		Six Months Ended June 30	
	2005	2004	2005	2004
<b>Gas – Canada</b>				
Enchant	1,301	2,154	1,529	1,606
Retlaw/Little Bow	808	1,061	854	1,032
Carmangay	510	518	533	419
Therien	224	232	215	239
Provost	139	210	149	213
Jaslan	145	365	159	280
Edwand	75	158	103	174
Iron Springs	97	166	100	158
Harmattan	137	–	69	–
Other	299	354	298	386
<b>Gas – Canada (Mcf)</b>	<b>3,735</b>	<b>5,218</b>	<b>4,009</b>	<b>4,507</b>
<b>Oil &amp; Liquids – Canada</b>				
Harmattan	99	–	57	–
Parkman	28	35	29	35
Neutral Hills	21	20	21	20
Red Earth	12	13	12	13
Other	10	24	17	22
<b>Oil &amp; Liquids – Canada (Bopd)</b>	<b>170</b>	<b>92</b>	<b>136</b>	<b>90</b>
<b>BOEd – Canada (6Mcf = 1Bbl)</b>	<b>793</b>	<b>961</b>	<b>805</b>	<b>841</b>

<b>Oil &amp; Gas Production (continued)</b>	Three Months Ended June 30		Six Months Ended June 30	
	2005	2004	2005	2004
Gas – U.S.				
Provident City	1,619	1,578	1,629	1,620
Mustang Creek	68	81	71	115
Allen Ranch	551	–	277	–
Hound Dog	153	–	77	–
Other	10	12	14	11
Gas – U.S. (Mcf)	2,401	1,671	2,068	1,746
Oil & Liquids – U.S.				
Provident City	17	16	17	16
Oil & Liquids – U.S. (Bopd)	17	16	17	16
BOEd – U.S. (6Mcf = 1Bbl)	417	295	361	307
Gas – Company (Mcf)	6,136	6,889	6,077	6,253
Oil and Liquids – Company (Bopd)	187	108	153	106
BOEd – Company	1,210	1,256	1,166	1,148

<b>Product Prices</b>	Three Months Ended June 30		Six Months Ended June 30	
	2005	2004	2005	2004
Canada				
Gas (\$/Mcf)	\$ 7.17	\$ 6.50	\$ 6.85	\$ 6.58
Oil & Liquids (\$/Bbl)	\$ 58.01	\$ 45.80	\$ 56.13	\$ 43.99
\$/BOE	\$ 46.25	\$ 39.62	\$ 43.65	\$ 39.95
U.S.				
Gas (\$/Mcf)	\$ 8.00	\$ 7.75	\$ 7.90	\$ 7.48
Oil & Liquids (\$/Bbl)	\$ 60.32	\$ 54.01	\$ 58.96	\$ 48.69
\$/BOE	\$ 48.49	\$ 46.91	\$ 47.95	\$ 45.07
\$/BOE – Company	\$ 47.03	\$ 41.33	\$ 44.98	\$ 41.31

Average commodity prices for the six months ended June 30, 2005 were approximately 9% higher than prices for the same period in 2004 and the outlook remains positive for gas prices to remain at these levels. Canadian gas prices averaged \$6.85 per Mcf, 4.1% higher than the \$6.58 reported in 2004. Oil prices were 27.6% higher than the comparable period, at \$56.13 per barrel from \$43.99 in 2004. In the U.S., both gas and oil prices increased by 5.6% and 21.1%, respectively.

Diaz believes oil prices will remain high throughout 2005 due to a strong global demand for oil, with gas prices held up by the trend to follow crude oil pricing. To this end, the Company has sold forward approximately 2 MMcf of natural gas production in Canada, for the period beginning July 1, 2005 to October 31, 2005, with a floor price of \$6.86 per Mcf and a ceiling price of \$7.86 per Mcf.

<b>Revenue from Oil and Gas Production</b> (Thousands)	Three Months Ended June 30		Six Months Ended June 30	
	2005	2004	2005	2004
<b>Canada</b>				
Natural gas	\$ 2,438	\$ 3,084	\$ 4,971	\$ 5,395
Oil and natural gas liquids	898	383	1,383	721
Other	11	8	18	14
<b>Total Revenue</b>	<b>\$ 3,347</b>	<b>\$ 3,475</b>	<b>\$ 6,372</b>	<b>\$ 6,130</b>
<b>U.S.</b>				
Natural gas	\$ 1,747	\$ 1,178	\$ 2,958	\$ 2,376
Oil and natural gas liquids	95	79	179	139
Other	–	1	–	1
<b>Total Revenue</b>	<b>\$ 1,842</b>	<b>\$ 1,258</b>	<b>\$ 3,137</b>	<b>\$ 2,516</b>
<b>Total Revenue – Company</b>	<b>\$ 5,189</b>	<b>\$ 4,733</b>	<b>\$ 9,509</b>	<b>\$ 8,646</b>

Diaz's increasing focus on U.S. exploration is reflected in growing U.S. gas production and revenue from U.S. production accounted for 34% of the Company's revenue during Q2 2005, up from 25% in 2004.

Higher product prices and increased U.S. production increased revenue from U.S. wells to \$3.1 million for the six months ended June 30, 2005 from \$2.5 million reported in 2004. Lower gas production volumes in Canada were offset by higher gas prices and total revenue increased by 4%, to \$6.4 million for the year, to date.

As a result of increased production placed on-stream in April at Harmattan in Canada, and Allen Ranch and Hound Dog in the U.S., and continued high gas prices, Diaz is confident that revenues will continue to grow throughout the year.

<b>Royalties</b> (Thousands, except per BOE and percentage amounts)	Three Months Ended June 30		Six Months Ended June 30	
	2005	2004	2005	2004
<b>Canada</b>				
Crown	\$ 213	\$ 471	\$ 549	\$ 715
Freehold	177	185	392	410
Alberta Royalty Tax Credit (ARTC)	(35)	(104)	(106)	(144)
<b>Royalties, net of ARTC</b>	<b>\$ 355</b>	<b>\$ 552</b>	<b>\$ 835</b>	<b>\$ 981</b>
per BOE	\$ 4.92	\$ 6.31	\$ 5.74	\$ 6.41
<b>Royalty as a percentage of revenue</b>	<b>10.6%</b>	<b>15.9%</b>	<b>13.1%</b>	<b>16.0%</b>
<b>U.S.</b>				
Royalties	\$ 581	\$ 363	\$ 985	\$ 735
per BOE	\$ 15.29	\$ 13.55	\$ 15.06	\$ 13.17
<b>Royalty as a percentage of revenue</b>	<b>31.5%</b>	<b>28.9%</b>	<b>31.4%</b>	<b>29.2%</b>
<b>Total Royalties – Company</b>	<b>\$ 971</b>	<b>\$ 1,019</b>	<b>\$ 1,926</b>	<b>\$ 1,860</b>
per BOE	\$ 8.82	\$ 8.91	\$ 9.13	\$ 8.90

Canadian royalty rates declined to average 10.6%, after ARTC, for Q2 2005. This reflects the royalty free period for the first year of the Harmattan oil production.

U.S. royalty rates increased to 31.5% to reflect higher royalties for new production.

<b>Operating and Transportation Expense</b>	Three Months Ended June 30		Six Months Ended June 30	
	2005	2004	2005	2004
<i>(Thousands, except per BOE amounts)</i>				
Canada	\$ 717	\$ 908	\$ 1,485	\$ 1,613
per BOE	\$ 9.94	\$ 10.37	\$ 10.20	\$ 10.54
U.S.	\$ 37	\$ 22	\$ 87	\$ 51
per BOE	\$ 0.97	\$ 0.83	\$ 1.33	\$ 0.91
Total Expense – Company	\$ 754	\$ 930	\$ 1,572	\$ 1,664
per BOE	\$ 6.85	\$ 8.14	\$ 7.45	\$ 7.97

During the first six months of 2005, operating costs in Canada decreased by 3.3%, to \$10.20 per BOE. In the U.S., operating costs increased by 43%, to \$1.33 per BOE. This increase is due to higher operating costs associated with the first year operations of new Wilcox gas production.

<b>General &amp; Administrative Expense</b>	Three Months Ended June 30		Six Months Ended June 30	
	2005	2004	2005	2004
<i>(Thousands, except per BOE amounts)</i>				
Cash compensation costs	\$ 335	\$ 216	\$ 570	\$ 440
Stock based compensation costs	395	38	425	76
Other overhead costs	199	191	426	421
Recovered from third parties	(83)	(101)	(155)	(189)
Capitalized	(44)	(43)	(81)	(101)
Net General & Administrative Expense	\$ 802	\$ 301	\$ 1,185	\$ 647
per BOE	\$ 7.28	\$ 2.63	\$ 5.62	\$ 3.10

Overhead costs increased to \$1.2 million during the six months ended June 30, 2005 primarily as a result of increased stock based compensation costs, which is a non-cash expense.

<b>Interest Expense</b>	Three Months Ended June 30		Six Months Ended June 30	
	2005	2004	2005	2004
<i>(Thousands, except per BOE and percentage amounts)</i>				
Average bank debt	\$ 9,353	\$ 8,407	\$ 9,060	\$ 7,425
Interest expense	\$ 118	\$ 96	\$ 241	\$ 177
per BOE	\$ 1.07	\$ 0.84	\$ 1.14	\$ 0.85
Average interest rate	5.0%	4.5%	5.0%	4.7%

Total interest expense increased to \$241,000 during the six months ended June 30, 2005 from \$177,000 reported one year earlier. This was due to the larger loan amount during the current period.

The Company's debt levels have increased to over \$9.0 million in 2005 and interest rates are likely to increase in the coming year, in turn increasing Diaz's interest expense.

<b>Depletion, Depreciation &amp; Accretion</b> <i>(Thousands, except per BOE amounts)</i>	Three Months Ended June 30		Six Months Ended June 30	
	2005	2004	2005	2004
<b>Canada</b>				
Depletion and depreciation	\$ 1,291	\$ 1,436	\$ 2,547	\$ 2,439
Asset retirement obligation accretion	51	49	100	76
Net depletion, depreciation & accretion	1,342	1,485	2,647	2,515
per BOE	\$ 18.61	\$ 16.97	\$ 18.18	\$ 16.43
<b>U.S.</b>				
Depletion and depreciation	\$ 341	\$ 182	\$ 582	\$ 366
Asset retirement obligation accretion	1	–	1	1
Amortization of deferred credit	–	–	–	(15)
Net depletion, depreciation & accretion	\$ 342	\$ 182	\$ 583	\$ 352
per BOE	\$ 9.00	\$ 6.79	\$ 8.91	\$ 6.31
<b>Total – Company</b>	<b>\$ 1,684</b>	<b>\$ 1,667</b>	<b>\$ 3,230</b>	<b>\$ 2,867</b>
per BOE	\$ 15.29	\$ 14.58	\$ 15.31	\$ 13.72

Diaz's overall corporate depletion rate has increased to \$15.31 per BOE. This reflects a Canadian depletion rate of \$18.18 per BOE and a U.S. depletion rate of \$8.91 per BOE. Diaz anticipates its depletion rate will be reduced in 2005 as the Company completes wells and increases its proved reserves and as the lower cost U.S. production becomes a larger percentage of the Company's production base.

#### Quarterly Financial Information

<i>(Thousands, except per share amounts)</i>	Three Months Ended							
	2005	2005	2004	2004	2004	2003	2003	2003
	June 30	Mar. 31	Dec. 31	Sept. 30	June 30	Mar. 31	Dec. 31	Sept. 30
				(Restated) <sup>(1)</sup>	(Restated) <sup>(1)</sup>	(Restated) <sup>(1)</sup>	(Restated) <sup>(1)</sup>	(Restated) <sup>(1)</sup>
<b>Total revenue</b>	\$ 4,253	\$ 3,436	\$ 3,730	\$ 3,621	\$ 3,818	\$ 3,112	\$ 2,713	\$ 2,699
<b>Earnings</b>	\$ 831	\$ 390	\$ 568	\$ 26	\$ 360	\$ 590	\$ 191	\$ 660
per share	\$ 0.01	\$ 0.01	\$ 0.01	\$ 0.00	\$ 0.01	\$ 0.01	\$ 0.01	\$ 0.02
<b>Cash flow from operations</b>	\$ 2,496	\$ 2,068	\$ 2,068	\$ 2,204	\$ 2,540	\$ 1,973	\$ 1,395	\$ 1,647
per share	\$ 0.05	\$ 0.03	\$ 0.04	\$ 0.04	\$ 0.04	\$ 0.03	\$ 0.02	\$ 0.04
<b>Fixed asset additions (net)</b>	\$ 2,717	\$ 2,260	\$ 4,562	\$ 2,117	\$ 2,348	\$ 2,912	\$ 3,822	\$ 1,646
<b>Total assets</b>	\$ 48,563	\$ 46,455	\$ 46,675	\$ 43,789	\$ 43,251	\$ 39,805	\$ 39,636	\$ 36,651
<b>Net debt</b>	\$ 9,604	\$ 9,211	\$ 9,095	\$ 7,622	\$ 7,882	\$ 7,992	\$ 7,100	\$ 10,024

<sup>(1)</sup>Transportation costs have been restated as operating expense rather than deducting them from revenue.

#### Liquidity and Capital Resources

Diaz completed the six months ended June 30, 2005 with a net debt of \$9.6 million compared with \$7.9 million in 2004. The Company has a credit facility of \$10.8 million, which is reviewed annually in May.

Diaz has a \$13.4 million capital budget for 2005 with 15% of its budget committed to Harmattan, in Alberta and 40% committed to drilling the Wilcox trend in Texas.

The Company's capital expenditure budget for 2005 will be funded primarily from cash flow.

<b>Income Taxes</b> <i>(Thousands)</i>	Three Months Ended June 30		Six Months Ended June 30	
	2005	2004	2005	2004
<b>Canada</b>				
Current tax	4	\$ (11)	\$ 14	\$ 5
Future tax	(451)	203	(560)	94
<b>Total – Canada</b>	<b>\$ (447)</b>	<b>\$ 192</b>	<b>\$ (546)</b>	<b>\$ 99</b>
<b>U.S.</b>				
Current tax	479	–	542	–
Future tax	23	276	238	544
<b>Total – U.S.</b>	<b>\$ 502</b>	<b>\$ 276</b>	<b>\$ 780</b>	<b>\$ 544</b>
<b>Total – Company</b>	<b>\$ 55</b>	<b>\$ 468</b>	<b>\$ 234</b>	<b>\$ 643</b>

Diaz reports a future tax recovery of \$322,000 and current taxes of \$556,000, being that of capital taxes in Canada and current tax payable in the U.S.

Based on the Company's current forecast of revenues and capital expenditures, Diaz will not be cash taxable in Canada in 2005 and will probably commence paying current income tax in 2006. Diaz will be taxable in the U.S. during 2005 if the Company does not increase its capital budget in the U.S.

### Issuer Bid

During the six months ended June 30, 2005, Diaz repurchased 9,000 Subordinate Voting Shares, no Multiple Voting Shares and 10,000 Common Shares and at an average price of \$0.66 per share.

### Business Risk

The Company is engaged in the exploration, development, production and acquisition of crude oil and natural gas. Diaz's business is inherently risky and there is no assurance that hydrocarbon reserves will be discovered and economically produced.

Financial risks associated with the petroleum industry include fluctuations in commodity prices, interest rates and currency exchange rates. Operational risks include competition, environmental factors, reservoir performance uncertainties, a complex regulatory environment and safety concerns.

The Company minimizes its business risks by focusing on a select group of properties. This enables Diaz to have more control over the timing, direction and costs related to exploration and development opportunities. The geological focus is on areas in which the prospects are well understood by management. Technological tools are regularly used to reduce risk and increase the probability of success. The Company closely follows all government regulations and has an up-to-date emergency response plan that has been communicated to all field operations by management. Diaz also carries insurance coverage to protect itself against potential losses.

Employing a highly motivated and experienced staff of petroleum and natural gas professionals further minimizes the business risk.

The Company is exposed to commodity price and market risk for its principal products of petroleum and natural gas. Commodity prices are influenced by a wide variety of factors of which most are beyond the control of Diaz. To manage this risk, the Company has entered into a number of forward sales contracts in relation to gas prices.

### Outlook

Diaz believes energy prices will remain near current levels throughout 2005. These high prices combined with higher production levels in both Canada and the United States should result in higher cash flow.

Higher cash flow will allow the Company to increase its capital budget and provide continued growth in 2005.

## **Strategic Review Process**

Diaz advises that as part of an ongoing review of business and strategic opportunities available to the Company, the Board of Directors authorized Management to examine strategic and corporate restructuring alternatives that may be beneficial to Diaz shareholders.

No decision on any particular alternative has been reached to-date and there can be no assurance that the Board of Directors will proceed with any alternative once identified.

The strategic alternatives to be considered will include, but will not necessarily be limited to: maintaining the status quo; continuing as an independent oil and gas company with changes to management; merging with another company or the sale of the Company for cash or shares.

Any strategic or corporate restructuring alternatives identified will be subject to review and approval of the Diaz Board of Directors and to shareholder and regulatory approvals, as required.

# Consolidated Balance Sheet

(unaudited)

(Thousands)

As at	June 30 2005	December 31 2004
<b>ASSETS</b>		
Current Assets		
Cash	\$ 1,123	\$ 762
Accounts receivable	4,438	5,006
Prepaid expense	316	213
	<b>5,877</b>	<b>5,981</b>
Property, plant and equipment	67,061	61,939
Accumulated depletion and depreciation	(24,375)	(21,245)
	<b>42,686</b>	<b>40,694</b>
<b>Total Assets</b>	<b>\$ 48,563</b>	<b>\$ 46,675</b>
<b>LIABILITIES</b>		
Current Liabilities		
Accounts payable and accrued liabilities	\$ 6,076	\$ 7,569
Income tax payable	448	–
Bank debt (Note 3)	8,957	7,507
	<b>15,481</b>	<b>15,076</b>
Other Liabilities		
Future income tax liability	5,119	5,432
Asset retirement obligation (Note 6)	2,425	2,338
<b>Total Other Liabilities</b>	<b>7,544</b>	<b>7,770</b>
	<b>23,025</b>	<b>22,846</b>
<b>SHAREHOLDERS' EQUITY</b>		
Share capital (Note 4)	16,229	16,165
Contributed surplus (Note 4)	725	300
Retained earnings	8,584	7,364
	<b>25,538</b>	<b>23,829</b>
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$ 48,563</b>	<b>\$ 46,675</b>

Approved by the Board:

“signed”

R.W. Lamond  
Director

“signed”

C.A. Teare  
Director

# Consolidated Statement of Operations & Retained Earnings

(unaudited)

(Thousands, except per share amounts)

	Three Months Ended June 30		Six Months Ended June 30	
	2005	2004	2005	2004
<b>Revenue</b>				
Production	\$ 5,189	\$ 4,733	\$ 9,509	\$ 8,646
Royalties	(971)	(1,019)	(1,926)	(1,860)
Alberta Royalty Tax Credit	35	104	106	144
	<b>4,253</b>	<b>3,818</b>	<b>7,689</b>	<b>6,930</b>
<b>Expenses</b>				
Operating and transportation	754	930	1,572	1,664
General and administration	802	301	1,185	647
Interest expense	118	96	241	177
Foreign exchange loss (gain)	9	(4)	6	(18)
Depletion, depreciation and accretion	1,684	1,667	3,230	2,867
	<b>3,367</b>	<b>2,990</b>	<b>6,234</b>	<b>5,337</b>
Earnings before income tax	<b>886</b>	<b>828</b>	<b>1,455</b>	<b>1,593</b>
Income tax				
Current	483	(11)	556	5
Future	(428)	479	(322)	638
Total income tax	<b>55</b>	<b>468</b>	<b>234</b>	<b>643</b>
Net earnings for the period	<b>831</b>	<b>360</b>	<b>1,221</b>	<b>950</b>
Excess of cost over paid up capital on share repurchases	(1)	(44)	(1)	(62)
Retained earnings, beginning of period	7,754	6,512	7,364	6,067
Change in accounting policy (Note 2)	—	156	—	29
Retained earnings, end of period	<b>\$ 8,584</b>	<b>\$ 6,984</b>	<b>\$ 8,584</b>	<b>\$ 6,984</b>
Earnings per share, basic and diluted	<b>\$ 0.01</b>	<b>\$ 0.01</b>	<b>\$ 0.02</b>	<b>\$ 0.02</b>

# Consolidated Statement of Cash Flows

(unaudited)

(Thousands)

	Three Months Ended June 30		Six Months Ended June 30	
	2005	2004	2005	2004
Cash provided by (used for):				
Operating Activities				
Earnings for the period	\$ 831	\$ 360	\$ 1,221	\$ 950
Non-cash items:				
Depreciation, depletion and accretion	1,684	1,667	3,230	2,867
Non-cash compensation	396	38	425	76
Future taxes	(428)	479	(322)	638
Foreign exchange loss (gain)	9	(4)	6	(18)
Cash flow from operations	2,492	2,540	4,560	4,513
Abandonments	(101)	(121)	(107)	(131)
Change in non-cash working capital	(343)	(1,226)	(203)	(1,116)
	2,048	1,193	4,250	3,266
Investing Activities				
Property, plant & equipment – additions	(2,824)	(2,227)	(5,078)	(5,146)
Property, plant & equipment – dispositions	50	–	50	17
Change in non-cash working capital	2,665	2,132	(375)	173
	(109)	(95)	(5,403)	(4,956)
Financing Activities				
Increase in bank debt	(1,287)	(352)	1,450	3,237
Class A Subordinate Voting Shares				
Issued for cash on exercise of options	6	2	76	77
Repurchased for cancellation	(12)	(20)	(12)	(20)
Class B Multiple Voting Shares				
Repurchased for cancellation	–	(68)	–	(108)
Offering cost	–	(2)	–	(2)
	(1,293)	(438)	1,514	3,186
Increase (decrease) in cash	646	660	361	1,496
Cash, beginning of period	477	960	762	124
Cash, end of period	\$ 1,123	\$ 1,620	\$ 1,123	\$ 1,620
Supplementary information regarding cash payments:				
Interest paid during the period	\$ 118	\$ 95	\$ 241	\$ 176
Taxes paid during the period	\$ 29	\$ (11)	\$ 102	\$ 5

# Notes to the Interim Consolidated Financial Statements

For the Six Months Ended June 30, 2005

## I. Accounting Policies

The interim consolidated financial statements of Diaz Resources Ltd. ("Diaz") have been prepared in accordance with accounting principles generally accepted in Canada. Management has made the necessary estimates and assumptions regarding certain types of assets, liabilities, revenues and expenses in the preparation of the financial statements. Accordingly, actual results may differ from estimated amounts but management does not believe such differences will materially affect Diaz's financial position or results of operations. Certain information and disclosures normally required to be included in the notes to the annual consolidated financial statements have been condensed or omitted. The reader should refer to the annual consolidated financial statements of Diaz at December 31, 2004.

## 2. Change in Accounting Policies

### ASSET RETIREMENT OBLIGATIONS

As at January 1, 2004, the Company has retroactively adopted the Canadian Institute of Chartered Accountants ("CICA" guideline for accounting for asset retirement obligation – "ARO"). Under this standard, the Company must recognize the fair value of an ARO as a liability in the period in which it is incurred if a reasonable estimate of fair value can be made. The present value of the estimated ARO is capitalized as part of the net capitalized asset base and the depletion of the capitalized asset retirement cost is determined on a basis consistent with depletion of the Company's other assets. With time accretion will increase the carrying amount of the obligation. Accretion will also be expensed.

Previously, the Company provided for estimated future abandonment and site restoration costs for its oil and gas properties using the unit-of-production method. The new policy was adopted with restatement of prior period numbers and resulted in increasing retained earnings at December 31, 2003 by \$68,000. An additional effect of this change is an increase to property, plant and equipment of \$1,517,000 at December 31, 2003 and an increase to liabilities of \$1,361,000 at December 31, 2003.

### STOCK BASED COMPENSATION

At January 1, 2004, the Company adopted the fair value method for accounting of stock based compensation. The change was accounted for retroactively without restatement of prior period numbers. Using the fair value method, compensation costs of stock based compensation are estimated and charged to earnings in the period of the option grant.

Previously, the Company used the intrinsic value method and no compensation expense was recognized.

As a result of this change in accounting policy, retained earnings at January 1, 2004 have been decreased by \$198,000 (2005 – \$300,000), earnings for the six months ended June 30, 2005 have been reduced by \$425,000 and contributed surplus has been increased by \$425,000.

## 3. Bank Debt

All credit facilities that are revolving, in nature, must be disclosed as "current portion of long-term debt." Diaz utilizes a secured revolving production loan that is payable on demand and is subject to an annual review and, therefore, is considered "current," for disclosure purposes and has been disclosed under current liabilities.

## 4. Share Capital

<i>(Thousands)</i>	No. of Shares	Amount
Common Shares		
Balance, December 31, 2004	–	\$ –
Issued on conversion of Subordinate Voting Shares	53,839	14,449
Issued on conversion of Multiple Voting Shares	5,963	1,780
Balance, June 30, 2005	59,802	\$ 16,229

#### 4. Share Capital (continued)

<i>(Thousands)</i>	No. of Shares	Amount
Subordinate Voting Shares		
Balance, December 31, 2004	53,638	\$ 14,385
Purchased for cancellation	(19)	(12)
Issued on exercise of options	220	76
Converted to Common Shares	(53,839)	(14,449)
Balance, June 30, 2005	–	\$ –
Multiple Voting Shares		
Balance, December 31, 2004	5,963	\$ 1,780
Converted to Common Shares	(5,963)	(1,780)
Balance, June 30, 2005	–	\$ –
Total Shares Outstanding, June 30, 2005	59,802	\$ 16,229
Contributed Surplus		\$ 725

#### SHARE CAPITAL REORGANIZATION

On June 9, 2005, the shareholders approved an amendment to the Articles of the Company to convert all of the Subordinate Voting Shares and Multiple Voting Shares into Common Shares on a one-for-one basis.

#### STOCK OPTION PLAN

As at June 30, 2005, there are a total of 3,548,333 options granted and outstanding under the stock option plan with a weighted average exercise price of \$0.46 per share. A total of 2,231,666 options with a weighted average exercise price of \$0.43 are exercisable at the end of the period.

The Company accounts for its stock based compensation plan using the fair value method, whereby compensation costs are charged to earnings in the period in which they are incurred.

The fair value of each option granted is estimated on the date of grant using the Black-Scholes option-pricing model with assumptions as follows:

	Risk Free Interest Rate (%)	Expected Life (Years)	Expected Volatility	Dividends per Share
2004	3.00	4.0	0.90	n/a
2005	3.23	4.0	0.90	n/a

#### 5. Financial Instruments

The Company is exposed to fluctuations in commodity prices, interest rates and Canada/U.S. dollar exchange rates. The Company, when appropriate, utilizes financial instruments to manage its exposure to these risks.

#### NATURAL GAS CONTRACTS

At June 30, 2005, the following contract was in effect:

Costless Collar	Floor Price		Ceiling Price		Time Period for Contract
	(\$/Gj)	(\$/Mcf)	(\$/Gj)	(\$/Mcf)	
2,000 Gj/d (1,900 Mcfd)	\$ 6.50	\$ 6.86	\$ 7.45	\$ 7.86	July 1, 2005 to Oct. 31, 2005

#### 6. Asset Retirement Obligation

The following table presents the reconciliation of the beginning and ending aggregate carrying amount of the obligation associated with the retirement of oil and gas properties:

	2005	2004
Asset Retirement Obligation, beginning of period	\$ 2,338	\$ 2,405
Liabilities incurred	94	160
Liabilities settled	(107)	(150)
Foreign exchange	–	85
Accretion expense	100	(7)
Asset Retirement Obligation, end of period	\$ 2,425	\$ 2,493

The total undiscounted amount of estimated cash flows required to settle the obligation is \$4,667,000, which has been discounted using a credit-adjusted risk free rate of 7 percent. These obligations are expected to be paid between 2005 and 2034.

## 7. Segmented Information

The Company's only industry segment is the exploration for and development and production of oil and natural gas. The following table sets forth the geographical segments of the Company's operations between Canada and the United States.

(Thousands)	Three Months Ended		Six Months Ended	
	June 30		June 30	
	2005	2004	2005	2004
Revenue (net)				
Canada	\$ 2,992	\$ 2,921	\$ 5,537	\$ 5,149
United States	1,261	896	2,152	1,781
	\$ 4,253	\$ 3,817	\$ 7,689	\$ 6,930
Interest Expense				
Canada	\$ 118	\$ 96	\$ 241	\$ 177
United States	–	–	–	–
	\$ 118	\$ 96	\$ 241	\$ 177
Current Taxes				
Canada	\$ 4	\$ (11)	\$ 14	\$ 5
United States	162	–	225	–
	\$ 166	\$ (11)	\$ 239	\$ 5
Cash Flow from Operations				
Canada	\$ 1,747	\$ 1,688	\$ 3,039	\$ 2,807
United States	745	852	1,521	1,706
	\$ 2,492	\$ 2,540	\$ 4,560	\$ 4,513
Depletion, Depreciation & Accretion				
Canada	\$ 1,342	\$ 1,485	\$ 2,647	\$ 2,515
United States	342	182	583	352
	\$ 1,684	\$ 1,667	\$ 3,230	\$ 2,867
Net Earnings (Loss)				
Canada	\$ 460	\$ (37)	\$ 526	\$ 123
United States	371	395	695	825
	\$ 831	\$ 358	\$ 1,221	\$ 948
Additions to Property, Plant & Equipment				
Canada	\$ 2,506	\$ 2,248	\$ 4,134	\$ 4,538
United States	356	260	988	899
	\$ 2,862	\$ 2,508	\$ 5,122	\$ 5,437
Identifiable Assets, Net				
Canada	\$ 42,924	\$ 38,298	\$ 42,924	\$ 38,298
United States	5,639	4,953	5,639	4,953
	\$ 48,563	\$ 43,251	\$ 48,563	\$ 43,251

# Corporate Information

## Directors

Robert W. Lamond  
*Calgary, Alberta*

Charles A. Teare  
*Calgary, Alberta*

Donald K. Clark  
*Calgary, Alberta*

Clive M. Stockdale  
*Vancouver, British Columbia*

Allan R. Twa  
*Calgary, Alberta*

Raj Agrawal <sup>(1)</sup>  
*Calgary, Alberta*

John G.F. McLeod <sup>(1)</sup>  
*Calgary, Alberta*

Robert L. McPherson <sup>(1)</sup>  
*Calgary, Alberta*

<sup>(1)</sup> Member of the Audit Committee

## Legal Counsel

Burnet, Duckworth & Palmer LLP  
*Calgary, Alberta*

## Auditors

Pricewaterhouse Coopers LLP  
*Calgary, Alberta*

## Diaz Resources Ltd.

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info@diazresources.com  
www.diazresources.com

## Officers

R.W. Lamond  
*President, Chairman of the Board & CEO*

C.A. Teare  
*Executive Vice President & CFO*

D.K. Clark  
*Vice President, Operations*

C.S. Cohen  
*Corporate Secretary*

R.D. Arsenault  
*Controller*

## Subsidiaries

Diaz Resources, Inc.

Orbit Oil & Gas Inc.

## Registrar and Transfer Agent

Computershare Trust Company of Canada  
*Calgary, Alberta*  
*Toronto, Ontario*

## Stock Exchange Listing

Toronto Stock Exchange  
Trading Symbols: DZR



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