

ALHAMBRA RESOURCES LTD

Q2

Management's Discussion and Analysis

For the Six Months Ended June 30, 2004



Management's discussion and analysis should be read in conjunction with the unaudited consolidated interim financial statements for the six months ended June 30, 2004 and the audited consolidated financial statements for the year ended December 31, 2003.

The financial data presented has been prepared by management and is in accordance with Canadian generally accepted accounting principles.

During the second quarter of 2004, the Company's focus continued to be on preparing for the leaching of a minimum of 100,000 tonne pilot heap leach test on Alhambra's 100% owned Uzboy gold project located in north central Kazakhstan. Leaching is expected to commence in September, 2004.

Revenues

Alhambra's oil and natural gas sales are derived from a combination of royalty and working interests. During the three months ended June 30, 2004, oil and natural gas sales revenue, net of royalties, were \$159,356, an increase of \$19,349 over the comparable three months ended June 30, 2003 amount of \$140,007. For the six months ended June 30, 2004, oil and natural gas sales revenue, net of royalties, equaled \$298,723, \$4,861 higher than the six months ended June 30, 2003 figure of \$293,862. An increase in oil and natural gas prices accounted for the increase.

Oil and natural gas liquids revenue, net of royalties, remained constant at approximately 35% and natural gas at approximately 65% of total net sales revenue for the three months and six months ended June 30, 2004, compared to the same periods in 2003.

Oil and natural gas liquids sales volumes increased 8% to 13.9 barrels of oil per day ("bopd") for the second quarter of 2004 compared to 12.9 for the second quarter of 2003 but remained virtually unchanged at 14.3 bopd for the six months ended June 30, 2004 and 2003. In addition, the average oil price received increased 28% to \$51.79 CDN per barrel in three months ended June 30, 2004 as compared to \$40.51 CDN during the second quarter of 2003. For the six months ended June 30, 2004, the average oil price increased 18% to 53.80 CDN per barrel compared to \$45.77 CDN for the comparable period in 2003. The increase in price reflects the increase in world oil prices, which rose from an average of \$30.71 US for the six months ended June 30, 2003 to an average of \$38.51 US for the comparable period in 2004. This increase was partially offset by a decline in the value of the United States dollar from 2003 to 2004.

Natural gas sales volumes increased 4% to 144.7 thousand cubic feet per day (mcf/d) for the second quarter of 2004 from 139.2 mcf/d for the comparable period in 2003 and increased 1% to 137.4 mcf/d for the six months ended June 30, 2004 from 136.3 mcf/day for the comparable period in 2003. Prices averaged \$8.32 for the second quarter of 2004 and \$7.46 for the six months ended June 30, 2004, an increase from \$7.35 and \$7.32, respectively for the comparable periods in 2003.

Operating expenses

Alhambra's operating costs are relatively fixed in nature and as a result they do not increase or decrease materially under normal operating conditions. Operating costs increased \$4,894 to \$27,035 during the second quarter of 2004 as compared to \$22,141 in the comparable period of 2003. Increased manpower costs and additional well maintenance were responsible for the increase. On a year to date basis, operating expenses were \$47,095 or \$6.99 per barrel in 2004 compared to \$36,879 or \$5.48 per barrel in 2003.

General and administrative expenses

General and administrative were \$199,499 for the three months ended June 30, 2004, a decrease of 39% over the 2003 comparable period's expenses of \$327,155. For the six months ended June 30, 2004 general and administrative expenses were \$381,581, a decrease of 19% over the comparable six month 2003 figure of \$473,659. The higher costs in 2003 reflected costs incurred relating to convertible debt financing for the Uzboy gold project.

Interest

Interest for the second quarter of 2004 was \$54,908, an increase of \$31,049 over the comparable 2003 amount of \$23,859. The year to date amount of \$107,826 increased \$51,548 over the 2003 year to date amount of \$56,278. These increases are a result of the convertible debt raised in the latter half of 2003, primarily to fund the Uzboy project. This debt is in the form of secured and unsecured notes with an interest rate of 10% per annum.

Stock-based compensation

Stock-based compensation costs relate to the fair value of stock options granted to directors, employees and consultants calculated at the date of grant and expensed over the vesting period of the option. The fair value is determined using the Black-Scholes option pricing model which takes into account the risk free interest rate, the expected life of the option, the expected volatility and the expectation of dividends being paid during the life of the option. Due primarily to the high volatility of the Company's stock price, this calculation gives significant value to the options which must be expensed during their vesting period. The expense for the second quarter of 2004 totaled \$96,184 as compared to \$24,990 for the comparable period in 2003. For the six month period ended June 30, 2004 and 2003, stock-based compensation expenses were \$130,824 and \$31,600, respectively. This increase is a result of a number of options being granted in mid-year 2003 and 2004.

Depletion, depreciation and accretion

Depletion and depreciation of property and equipment and accretion of the asset retirement obligations for the second quarter of 2004 was \$47,288, an increase of \$1,388 over the \$45,900 recorded for the comparable period of 2003. For the six months ended June 30, 2004, depreciation, depletion and accretion expense totaled \$97,256, a decrease of \$21,193 over the comparable 2003 figure of \$118,449. A combination of lower production volumes as noted above and a lower depletion rate were responsible for the decline. Despite the lower production, an 8% increase in year over year proven reserves combined with a lower depletion cost base have resulted in the depletion rate per barrel decreasing to \$12.97 for the six months ended June 30, 2004 as compared to \$15.04 for the comparable 2003 period.

Foreign exchange loss

The Company recorded a \$35,088 foreign exchange loss for the second quarter of 2004 and a \$62,069 loss for the six-month period ended June 30, 2004. The amounts for the three-month and six-month periods ended June 30, 2004 include unrealized portions of \$29,362 and \$48,676, respectively. The unrealized portion arose as a result of the conversion of the US dollar denominated debt carried by the Company. The US dollar strengthened from December 31, 2003 to June 30, 2004 thus requiring Alhambra to record an increase in the Canadian dollar equivalent amount recorded on the balance sheet.

Future income taxes

Alhambra is currently not taxable and has available tax credits to offset future income. Due to the history of operating losses, the Company does not consider it more likely than not that it would be able to realize a future tax benefit and, as a result, no future income tax asset was recorded at June 30, 2004.

Cash flow and earnings

Cash flow utilized in operating activities decreased \$46,376 to \$125,572 for the second quarter of 2004 from \$171,948 recorded in the same period in 2003. The decrease is the result of higher net oil and natural gas operating income of \$14,455 combined with lower general and administration expenses of \$127,656 partially offset by higher interest expense (net of interest income) of \$28,809 and realized foreign exchange loss of \$66,926.

For the six months ended June 30, 2004, cash flow utilized in operating activities increased \$37,062 to \$248,816 in 2004 from the 2003 comparable amount of \$211,754. The increase is the result of lower net oil and natural gas operating income of \$5,355 combined with, higher interest expense (net of interest income) and a realized foreign exchange loss of \$49,192 and \$74,593, respectively, partially offset by lower general and administration expenses of \$92,078.

Net loss for the quarter ended June 30, 2004 increased by \$166,174 to \$298,406 from the \$132,232 recorded for 2003. The decrease in cash flow utilized in operating activities of \$46,376 was more than offset by an unrealized foreign exchange loss of \$29,362, higher stock based compensation of \$71,194, higher depletion, depreciation and accretion of \$1,388 and a 2003 income tax recovery of \$110,606. Based on a weighted average number of shares outstanding in 2004 and 2003 respectively of 29,552,186 and 20,794,500, the loss per share was \$(0.010) and \$(0.006) respectively.

Net loss for the six months ended June 30 2004 increased \$295,655 to \$525,572 from the comparable amount of \$229,917 in 2003. The higher cash flow utilized in operating activities of \$37,062 together with the increase in stock-based compensation of \$99,224, the unrealized foreign exchange loss of \$48,676 and the decrease in future income tax recovery of \$131,886 was only partially offset by the decrease in depletion, depreciation and accretion of \$21,193. Based on a weighted average number of shares outstanding in for the six months ended June 30, 2004 and 2003 respectively, of 27,717,485 and 19,615,273, the loss per share was \$(0.019) and \$(0.011) respectively.

Capital expenditures

The Company's capital expenditure program for the six months ended June 30, 2004 was focused on preparing for a minimum 100,000 tonne pilot heap leach test scheduled to be started in September, 2004. Included in the \$2,105,956 spent on the project during this period was the construction of a 1,200,000 tonne gold recovery plant. Alhambra is also carrying out an exploration program to determine the extent of resources that are contained within the licensed area.

While Alhambra is not carrying out an active exploration and development program on its oil and natural gas assets, it does participate in projects on existing leases should management determine them to be of low risk and offer an economic return. Alhambra participated to a 2.4% working interest in the drilling of a successful natural gas well in the Belly River Formation in the Wood River area of Alberta (100/9-2-3-23W4) that was spudded in 2003 and completed in 2004. Total costs incurred during 2004 were approximately \$4,000.

Liquidity and capital resources

During the six months ended June 30, 2004, Alhambra raised a net \$4,068,977 from the issue of 8,654,140 common shares pursuant to private placement agreements. This cash has been used for funding the Uzboy prospect as well as general working capital requirements. At June 30, 2004 the Company had \$1,774,310 of cash on hand and a deficiency in other working capital of \$1,693,888. Included in this deficiency is \$1,233,625 in unsecured promissory notes due June 30, 2005 of which \$833,625 (US\$625,000) are repayable in US \$. In addition there is \$906,984 in a secured debenture which is denominated in US\$ (US\$680,000) which matures on March 31, 2006. Should the Company produce commercial quantities of gold from the Uzboy prospect, that US dollar based revenue stream will help to mitigate foreign exchange risk. All the notes are

convertible at the option of the holder or depending on the trading price of the Company's stock, at the option of Alhambra.

Changes in accounting policies

In 2003 the CICA issued Accounting Guideline 16 "Oil and Gas Accounting – Full Cost". The guideline is effective for fiscal years commencing after January 1, 2004. The new guideline limits the carrying value of oil and natural gas properties to their fair value. Fair value is defined as being equal to estimated future cash flows from proved plus probable reserves using future prices and costs discounted at zero percent. This differs from the former cost recovery ceiling test that used undiscounted cash flows and constant prices and costs less general and administrative and financing costs. The Company did not have a write-down of its oil assets under the new standard at June 30, 2004.

In 2003, the CICA issued an amendment to Handbook Section 3870 "Stock-based Compensation and other Stock-based Payments". This requires that for fiscal years beginning in 2004 companies calculate the fair value of stock options at the time of the grant and recognize it as an expense over the vesting period of the options. The Company has restated the loss for the six months ended June 30, 2003 resulting in an increase in net loss by \$8,500.

In 2003, the CICA issued Handbook section 3110, "Asset Retirement Obligations". This standard is effective for fiscal years beginning in 2004. Under the new standard, retirement obligations on assets are initially measured at fair value, which is the future value of the liability. The fair value is capitalized as part of the cost of the related assets and depleted to earnings over the assets useful life. The liability accretes until the retirement obligations are settled. An additional liability of \$37,567 was set up on the Company's balance sheet at December 31, 2003.

Outlook

With the completion of the acquisition of Saga Creek Company LLP and Goodwin Golems LLP in 2003, Alhambra is ready to move forward on its objective of becoming a successful gold mining company. The first step planned is to commence a minimum 100,000 tonne pilot heap leach test currently expected to begin in September 2004. As part of this test, the Company is constructing a gold recovery plant with a design capacity of 1.2 million tonnes per year.

Forward looking statements

Certain information regarding the Company set forth in this document, including management's assessment of the Company's future plans and operations, contains forward looking statements that involve substantial known and unknown risks and uncertainties. These forward looking statements are subject to numerous risks and uncertainties, certain of which are beyond the Company's control, including the impact of general economic conditions, industry conditions, volatility of commodity prices, currency fluctuation, imprecision of reserve estimates, environmental risks, taxation policies, competition from other producers, the lack of availability of qualified personnel or management, stock market volatility and the ability to access sufficient capital from internal or external sources. The Company's actual results, performance or achievement could differ materially from those expressed in, or implied by, these forward looking statements and, accordingly, no assurance can be given that any of the events anticipated by the forward looking statements will transpire or occur, or if any of them do so, what benefits that the Company will derive therefrom.