



Arsenal Energy Inc.

PRESS RELEASE

ARSENAL ANNOUNCES 2006 OPERATING AND FINANCIAL RESULTS AND FILING OF YEAR END DISCLOSURE FORMS

FOR IMMEDIATE RELEASE

CALGARY, April 2, 2007 – Arsenal Energy Inc. (“Arsenal or the Company”) (TSX: “AEI”) (FRANKFURT: A1E) is pleased to announce the results of operations for the three and twelve month periods ended December 31, 2006. In addition the Company filed its Annual Information Form for the year ended December 31, 2006 which includes Arsenal's reserves data and other oil and gas information for the year ended December 31, 2006 together with the report on reserves data by independent qualified reserves evaluator on Form 51-101F2 and the report of the management and directors on oil and gas disclosure on Form 51-101F3 as mandated by National Instrument 51-101 - Standards Disclosure for Oil and Gas Activities of the Canadian Securities Administrators. Arsenal also filed its Audited Consolidated Financial Statements and Management's Discussion and Analysis for the years ended December 31, 2006 and 2005. Copies of Arsenal's Annual Information Form, Audited Consolidated Financial Statements and Management's Discussion and Analysis for the year ended December 31, 2006 may be obtained via SEDAR at www.sedar.com.

2006 CORPORATE HIGHLIGHTS

- Record cashflow of \$7.8 million for the twelve months ended December 31st.
- Fourth quarter production averaged a record 1,983 boe/d.
- Successful testing of deep gas well at Tower Creek.
- Execution of successful 2006 drilling program resulting in 21.0 gross (11.5 net) wells with a 76% success rate.
- Completion of over 4,000 km of seismic in preparation for the drilling program in Egypt

SELECTED FINANCIAL AND OPERATIONAL INFORMATION

FINANCIAL	Three Months Ended December 31		Twelve Months Ended December 31	
	2006	2005	2006	2005
Financial				
Funds from operations ¹	2,685,843	1,048,820	7,817,054	4,242,029
Per unit - basic	0.04	0.03	0.13	0.15
Per unit - diluted	0.04	0.03	0.12	0.14
Bank debt	21,822,985	2,496,195	21,822,985	2,496,195
Operating costs per boe	18.06	17.54	17.26	15.14
Operating netbacks per boe	21.48	16.16	19.99	16.13
Market				
Shares outstanding				
End of period	73,317,173	42,231,244	73,317,173	42,231,244
Weighted average - basic	70,154,281	33,705,825	62,033,289	28,586,521
Weighted average - diluted	71,312,150	34,407,996	63,191,158	29,288,692
Shares trading				
High	1.01	1.98	1.88	1.98
Low	0.72	1.21	0.72	0.88
Close	0.78	1.70	0.78	1.70
Average daily volume	125,500	99,000	137,000	67,000
OPERATIONS				
Daily production (average)				
Crude oil (bbl)	1,618	1,340	1,329	1,140
NGLs (bbl)	43	32	55	35
Natural gas (mcf)	1,930	609	2,255	500
Total (boe) ²	1,983	1,473	1,760	1,257
Realized commodity prices (\$Cdn.)				
Total crude oil (bbl)	47.06	45.19	50.19	51.33
NGLs (bbl)	51.11	68.99	45.91	49.25
Natural gas (mcf)	7.77	8.40	5.97	7.28
Average (boe) ²	47.07	43.98	46.98	44.02
Reference pricing				
WTI (U.S.\$/bbl)	60.21	60.07	66.23	56.57
AECO gas (\$Cdn./mcf)	6.03	11.08	6.64	8.31
Foreign Exchange (\$U.S./\$Cdn.)	1.14	1.17	1.13	1.21

¹ Funds from operations before change in non-cash working capital is not a recognized measure under Canadian generally accepted accounting principles. Management uses funds from operations before change in non-cash working capital to analyze performance and considers it a key measure as it demonstrates the Company's ability to generate the cash necessary to fund future capital investments and to repay debt. Funds from operations before change in non-cash working capital has been defined by the Company as net earnings (loss) plus the addback of non-cash items (depletion, depreciation and accretion, stock-based compensation, future income taxes and unrealized foreign exchange) and excludes the change in non-cash working capital related to operating activities. Arsenal's determination of funds from operations before change in non-cash working capital may not be comparable to that reported by other companies. Arsenal also presents funds from operations before change in non-cash working capital per share whereby amounts per share are calculated using weighted average shares outstanding consistent with the calculation of earnings per share.

² The term barrels of oil equivalent ("boe") may be misleading, particularly if used in isolation. A boe conversion ratio of six thousand cubic feet per barrel (6mcf/bbl) of natural gas to barrels of oil equivalence 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 the report are derived from converting gas to oil in the ratio mix of six thousand cubic feet of gas to one barrel of oil.

LETTER TO SHAREHOLDERS

2006 was a transition year for Arsenal. We looked at where we wanted to go as a company and brought in the right people for the job. With our team in place, we embarked on a detailed review of the domestic asset base and graded the properties based on their ability to meet specific criteria (operatorship, working interest threshold, oil/gas mix, ability to increase land position) and contribute to the achievement of strict operating targets set by the new management team. The result of this process was the largest work program in the company's history as Arsenal successfully met its targets for production rates and cash flow.

We exited the year producing 2,000 barrels of oil equivalent per day with approximately 400 barrels of oil equivalent per day of high net back production waiting to come on stream. We developed several excellent Bakken light oil drilling leads on our existing land base in the state of North Dakota, USA. We also have a drilling project to follow up on our significant success in the Tower Creek area of Alberta which should spud late in the second quarter of 2007. In the first quarter of 2007 we announced a large farmin arrangement in the Evi area of Alberta, which follows up our recent drilling successes.

Internationally, we completed an extensive seismic program on our 5.6 million acre concession in Egypt in order to further define the drilling targets that will make up our drilling program in this highly prolific region. The first exploration well, although dry, provided valuable information, and the company is presently drilling its second exploration well with a third contingent location being prepared to follow later this year.

OPERATIONS OVERVIEW

During the first quarter of 2006, Arsenal completed the corporate acquisition of Tiverton Petroleum Inc. This added the Princess/Alderson and Galahad operating areas to Arsenal's asset mix providing further diversification into lighter oils. These areas have high working interest and operated facilities.

During the second quarter of 2006, Arsenal participated in the successful drilling of a 4,900 meter exploratory Leduc well at Tower Creek, Alberta at 2-21-55-27 W5M in which Arsenal holds a 14% working interest. This well encountered a gas-charged Leduc carbonate reef buildup approximately 190 meters above the lower Leduc platform. Test results of this well exceeded our expectations and an independent reserve evaluation has provided Arsenal with a significant reserve addition. Field work has begun to tie in the well, with targeted on production date of Q2 2007. Raw gas production flow rates are expected to be in the 20 to 25 MMcf/d range. Net sales gas (after shrinkage) to Arsenal is expected to be 2.1 to 2.4 MMcf/d or 350 to 400 boe/d.

In the third quarter of 2006, Arsenal added several senior professionals to bolster its staff. Mr. Tony VanWinkoop became Vice President of Exploration and Mr. Greg Kaidannek joined the company as Senior Exploration Geophysicist. Mr. Rick Howe joined Arsenal as Senior Exploitation Engineer and Mr. Jay LaForge became Senior Operations Technologist.

On November 8, 2006 we closed an \$8.1 million share offering, to strengthen our balance sheet, and fund a portion of our 2007 capital program. We are pleased to note that the original share offering of \$6.0 million was significantly oversubscribed.

TIVERTON ACQUISITION

As outlined in the NI 51-101 disclosures in our Annual Information Form, Arsenal incurred negative reserve revisions on several properties acquired from Tiverton. As a result of these negative revisions, in conjunction with a lower price deck used to evaluate our natural gas reserves, Arsenal incurred a ceiling test impairment of \$13.8 million at December 31, 2006 on these assets. In addition, \$13.5 million of goodwill relating to the Tiverton acquisition was also written off at December 31, 2006. These charges do not affect the current or future cashflow generation of the Company.

OPERATIONS

North Dakota

The Company's North Dakota properties consist of six operated fields, all situated within one hundred and forty miles of the Canada/US border. In 2006 North Dakota production averaged 410 barrels of oil equivalent from reserves characterized by stable, long life production.

During the last few years a large, technology driven oil play has developed in the Williston Basin Bakken formation. Low permeability in the Bakken has limited its development in the past but new fracture stimulation technology for horizontal wells has advanced the play. In 2006 the play expanded into Mountrail County of North Dakota where Arsenal has 4,043 gross acres with an average WI of 98% in the Stanley field. Five horizontal wells, two north and three south of Arsenal's lands, have been drilled by industry with average initial production rates of 800 bbls/d of oil each. The oil is light, sweet and free of water. Arsenal has an existing vertical well on its acreage with log indicated pay superior to these industry wells. Arsenal has recently acquired a 3D survey over its Stanley lands and plans its first horizontal well late in 2007.

Lloydminster

Arsenal has interests in several heavy oil fields, all located within a forty mile radius of the city of Lloydminster. The Company produced during 2006 an average 765 bbls/d of 11° to 14° API crude oil from the Mannville group.

In 2006, Arsenal expanded its position in the Wildmere field with a 25 bbl/d acquisition and the successful drilling of 4 high working interest operated wells adding approximately 60 bbls/d of net production. Wildmere plans for 2007 include the shooting of a 3D survey and drilling 5 wells. In Saskatchewan, Arsenal has interests in 9 fields and has plans to drill 6 operated wells in 2007.

Current oil prices remain high and differentials remain low. Considering recently undertaken operating initiatives, plans to rationalize some of the smaller non operated assets, and the previously described drilling plans, Arsenal expects to see increased netbacks in 2007 at Lloydminster.

Tower Creek

In May 2006 Arsenal earned a 14% WI in the Tower Creek 2-21-55-27 exploration well. The well encountered a Leduc reef identified on 3D seismic and opened up approximately 70 meters of net gas pay at which time drilling was terminated. Testing operations have indicated a wellhead AOF of 27mmcf/d of gas with an H2S content of 15%. Net Proven + Probable Reserves of 752MBoe have been booked to the well. Tie-in operations have commenced and production is anticipated to begin in May or June 2007 at approximately 400 boe/d net to Arsenal.

Arsenal also has elected (17.142% through completion for a 13.1385 % working interest) to participate in a nearby 4,500 meter Wabamun test well identified by the same 3D seismic program. Gross expenditures to drill and complete this well are estimated at \$19 million. Drilling operations are expected to commence in the second quarter of 2007.

Evi/Lubicon

The Evi/Lubicon area is located approximately 200 miles north of Edmonton in the boreal forest. Production in 2006 averaged about 90 bbls/d of high netback light oil from Devonian aged Gilwood and Granite Wash sandstones. During the year Arsenal participated in the drilling of 5 wells resulting in 3 Granite Wash oil wells, 1 Gilwood oil well, and one dry hole. Production grew to approximately 300 bbls/d net by year end.

The Evi area has historically undergone a series of exploration and development phases. Most of the large structures have been drilled and trusts have acquired most of the production. However, across the Granite Wash sub basin a large number of smaller single well structures remain untested and many parts have not been covered by 3D seismic. The Alberta government offers a royalty holiday for discovery of these pools. The holiday combined with low opex and high quality crude yielded netbacks of \$40.46/bbl for Arsenal in 2006.

Arsenal views Evi as an excellent niche exploration program and continues to build a land and seismic inventory and anticipates drilling 4 wells during 2007. One of Arsenal's goals for 2007 is to reach a reserve threshold to support battery construction.

Southern Alberta

This area is constituted by the Princess, Galahad, and Nevis properties and represents most of the production acquired in the Tiverton transaction. Production from these properties averaged about 350 Boe/d over the nine months after the transaction. Nevis and Princess are predominantly gas properties and Galahad is a medium gravity oil property. All three properties are high working interest and contain company operated facilities. Three wells were drilled at Princess during 2006 resulting in two gas wells and one well awaiting completion. Plans for 2007 include initial testing of a 3D seismic delineated oil development opportunity at Princess and a four well program at Galahad.

Other

Arsenal has 150 Boe/d of other mostly non-operated production. Most of this production is good quality, long life sweet gas west of the fifth meridian.

Egypt

In Egypt, Arsenal's property is the 5.6 million acre Nuqra concession located in southeastern Egypt. The lands in the concession are located near the city of Luxor on the east bank of the Nile River and are situated in the heart of the Komombo Basin. The Komombo Basin is a rift basin analogous to the Gulf of Suez Basin in Egypt and the Muglad Basin in Sudan, both of which have major proven oil reserves in excess of 1.0 billion barrels of oil. The Concession Agreement stipulates that an agreed upon work program with a minimum obligation of USD\$11.0 million in capital expenditures over 8 years must be completed by Arsenal.

The Company's predecessor, Quadra Resources Corp., entered into a farmout agreement in 2004 with TransGlobe Petroleum Egypt Inc., a wholly owned subsidiary of TransGlobe Energy Corporation of Calgary, Alberta. Under the terms of the Farmout Agreement, TransGlobe agreed to expend up to \$6.0 million US to earn a working interest. Having since done so, to the maximum available, TransGlobe has earned the right to expend 60% of future costs to earn a 50% working interest, after cost recovery, in the Concession. Arsenal is required to expend 40% of costs to retain, after cost recovery, a 30% working interest in the Concession. TransGlobe has agreed to act as Operator on behalf of Arsenal and the remaining estimated net obligation to Arsenal under the terms of the Concession Agreement is approximately \$2.0 million US.

During 2005, the 3,100 kilometers of acquired 2D seismic was reprocessed to enhance the resolution. During the first quarter of 2006 Transglobe completed an 800 kilometer 2D seismic program. This seismic was combined with the earlier data and resulted in a much more detailed map of the concession. The Rift basin was mapped into three distinct sub-basins.. The central sub-basin has a thick Jurassic sequence that is generally thought to be attractive for oil generation. It has, therefore been selected as the location of the first two wells the group will drill. The first well, Set-1, which was drilled to a depth of approximately 4,500 feet confirmed the existence of an excellent reservoir and seal, however, it was evaluated and subsequently abandoned. The second well, Narmer-1, has spud and is drilling to a target depth of 7800 feet. This well is located approximately 17 miles from Set-1 and will test a separate structure.

The operator estimates that the second well could intersect a structure which could contain 8 to 10 million barrels of oil equivalent in recoverable reserves. The second well site has road access and is located on flat dry land. Drilling of the second well is expected to take approximately 60 days. Arsenal and its' partners have a third contingent location which is in the process of being approved by the Egyptian government. The well, scheduled for the third quarter of 2007, would test another independent structure approximately 4 miles from the Narmer-1 location.

COMMODITY PRICING

Light sweet crude oil declined approximately 20% from highs exceeding USD\$75 per barrel in August, as inventories grew and tensions in the Middle East eased. In January 2007 the price of WTI crude oil dipped to the USD \$50 range and subsequently has increased to approximately USD \$60 per barrel. We expect WTI to trade in the USD \$55-65 range for 2007.

Natural gas prices were significantly depressed during the third and fourth quarters of 2006, as inventories filled storage capacity in Canada and the United States. Recent cold weather in the key eastern states has resulted in natural gas prices recovering from September lows. We expect that the reduction in natural gas drilling in Western Canada, which began in the third quarter 2006, will eventually show up on the supply side of the Canadian natural gas market. Natural gas futures for winter 2008 deliveries have recently been above USD \$9 on the NYMEX exchange. If the demand is high during this year's cooling season, we expect the winter 2007/2008 to be an excellent market for natural gas producers.

Heavy crude oil differentials, however, as expected, widened in the fourth quarter, averaging 35% of WTI and reflected normal seasonality. The differential remained favorable in comparison to the fourth quarter of 2005, due to the addition of heavy oil pipeline capacity to the US Gulf Coast in spring 2006 from the Chicago area. We continue to work with strategic partners to find new markets for our heavy crude oil in order to mitigate the impact of supply and demand shocks on the domestic heavy crude oil market. During first quarter of 2007, we have experienced a narrowing of the differential to under 30% which is below expected differentials for the quarter and this should improve company revenue.

OUTLOOK

In 2007, we expect to build on this momentum and, grow our domestic production in 2007 by 25% and exit the year at 2,500 boe/d pending our ability to put all behind pipe production on line. We will continue to maintain a portfolio of drilling prospects which balances a mixture of lower risk projects such as Evi, Princess, Galahad and Wildmere to maintain stable production, and higher risk higher reward projects such as Tower Creek, our Bakken play in North Dakota and our Nuqra Basin project in Egypt. We believe these assets and this approach creates a stable operational foundation to support high impact projects that have the potential to create significant shareholder value. By focusing on a diversified approach, we expect to outperform other juniors concentrating solely on traditional plays in the Western Canadian basin.

In response to significant industry-wide increases in service and equipment costs, we have turned our attention to reducing and controlling our operating costs. In 2006, Arsenal undertook an active workover program, renegotiated operator agreements and tightly managed day to day costs company-wide. Our efforts began to gain traction in the fourth quarter as average operating costs per barrel dropped by 17%, and we expect further improvement in 2007.

To further control costs and further leverage its asset portfolio, Arsenal initiated an asset rationalization program in January of 2007. Certain non-core assets and facilities have been identified and the company is currently soliciting bids for potential sales and swaps. Additionally, we continue to seek opportunities to increase our working interest in our core areas to reduce administration expenses.

RESULTS OF OPERATIONS

PRODUCTION AND MARKETING

Production volumes for the year ended December 31, 2006 averaged 1,760 boe/d, which represents a 40% increase over 2005. Production volumes for the three month period ended December 31, 2006 averaged 1,983 boe/d, a 20% increase over the same period in 2005. The increase in volumes over comparable periods is attributable to additions through the drill bit at Evi and Wildmere, and the Tiverton corporate acquisition completed in the first quarter of 2006. Arsenal exited the year producing approximately 2,000 boe/d, in-line with revised guidance provided in November 2006.

Crude oil production increased 17% for the year ended December 31, 2006, attributable to drilling activities at Wildmere and Evi and the Tiverton acquisition. Natural gas production increased 351% and related natural gas liquids increased 50% over the prior year due to natural gas and NGL production acquired through the acquisition of Tiverton.

Crude oil is sold under 30-day evergreen contracts while natural gas production is sold in the spot market. Arsenal continues to be an oil weighted producer, with 84% of corporate production during the fourth quarter being oil. The Company has inventoried a number of gas drilling locations, and has chosen to continue with a oil focused drilling program to capitalize on historically high oil prices.

At the date of printing, Arsenal has approximately 500 boe/d behind pipe, the majority relating to the Tower Creek natural gas well. Production from this well is scheduled to begin during June 2007. Based on a flow-test completed in August of 2006 the well is anticipated to produce under choke at 25 mmscf/d, Arsenal's working interest is 14%.

Production for the first quarter is anticipated to average approximately 1,900 boe/d as workover and optimization activities completed during the fourth quarter are expected to offset natural declines. The Company's first quarter drilling program was delayed due to unseasonably warm weather in January, however all scheduled winter access locations were spudded during March and are anticipated to be completed prior to spring break-up.

	Three Months Ended December 31			Twelve Months Ended December 31		
	2006	2005	% Change	2006	2005	% Change
Crude oil (bbl/d)	1,618	1,340	21	1,329	1,140	17
NGL (bbl/d)	43	32	36	55	35	58
Natural gas (mcf/d)	1,930	609	217	2,255	500	351
Total (boe/d)	1,983	1,473	35	1,760	1,257	40
Production split						
Oil & NGLs	84%	93%	(10)	79%	93%	(16)
Natural Gas	16%	7%	135	21%	7%	222

COMMODITY PRICES

Commodity price realizations increased 7% and 7% respectively over comparable periods in 2005. Fourth quarter crude oil prices increased 4% compared to the same quarter in 2005, attributable to the product mix with increased production from Arsenal's light sweet oil production at Evi. Natural gas and NGL price realizations were 8% and 26% lower respectively during the fourth quarter of 2006 reflecting declines in spot market.

Arsenal anticipates continued high oil prices as increasing global demand and tensions in the middle east remain. The Company also anticipates a stronger natural gas market for the remainder of 2007 as the significant decline in North American natural gas drilling during 2006 will impact natural gas injections for the year.

(\$Cdn.)	Three Months Ended December 31			Twelve Months Ended December 31		
Prices - Before Derivatives	2006	2005	% Change	2006	2005	% Change
Total crude oil (bbl)	47.06	45.19	4	50.19	51.33	(2)
NGLs (bbl)	51.11	68.99	(26)	45.91	49.25	(7)
Natural gas (mcf)	7.77	8.40	(8)	5.97	7.28	(18)
Total (boe)	47.07	43.98	7	46.98	44.02	7

Reference Pricing

WTI (\$U.S./bbl)	60.21	60.07	0.2	66.23	56.57	17
AECO gas (\$Cdn./mcf)	6.03	11.08	(46)	6.64	8.31	(20)
NYMEX gas (\$U.S./mmbtu)	6.62	12.85	(48)	6.62	9.06	(27)
Foreign exchange (\$Cdn./\$U.S.)	1.14	1.17	(3)	1.13	1.21	(6)

OIL AND GAS REVENUE

Net oil and gas revenue for the fourth quarter of 2006 was 55% higher than the comparable period in 2005, reflecting increased crude oil production resulting from drilling and the Tiverton acquisition corporate and property acquisitions as well as the termination of the hedge on September 1st. Net oil and gas revenue for the twelve months ended December 31, 2006 was 64% higher in 2006 when compared to the prior period. Other revenue includes processing fees and overriding royalties received.

(\$Cdn.)	Three Months Ended December 31			Twelve Months Ended December 31		
	2006	2005	% Change	2006	2005	% Change
Crude oil sales	6,927,332	5,451,047	27	25,697,802	17,684,874	45
NGL sales	201,806	196,127	3	926,794	614,493	51
Natural gas sales	1,364,167	454,044	200	4,263,966	1,316,093	224
Other	845,513	214,146	295	1,212,883	409,533	196
Loss on forward contracts	(32,684)	(294,188)	(89)	(1,280,711)	(1,287,328)	(1)
Net oil and gas revenue	9,306,134	6,021,176	55	30,820,734	18,737,666	64
Per boe	51.02	44.42	15	47.97	40.71	18

ROYALTIES

During the fourth quarter and for the year ended December 31, 2006, royalties as a percentage of gross oil and gas revenues were consistent at approximately 23%. Arsenal expects the royalty rate to decline as production from Tower Creek is brought on stream as there is one year royalty holiday from that well.

(\$Cdn.)	Three Months Ended December 31			Twelve Months Ended December 31		
	2006	2005	% Change	2006	2005	% Change
Royalties	2,094,647	1,452,733	44	6,885,863	4,344,657	58
% of gross oil and gas revenue	23	24	(6)	22	23	(3)
Per boe	11.48	10.72	7	10.72	9.44	14

OPERATING COSTS

Operating expenses per boe for the three and twelve months ended December 31, 2006 increased 3% and 14%, respectively, over the comparable periods. The increase is due to workover and optimization initiatives completed during the third and fourth quarter of 2006. The workover plan was successful as operating costs have decreased from a peak of \$21.26 per boe during the third quarter. Arsenal plans to continue with field optimization initiatives in Canada and North Dakota, and expects costs to trend lower during 2007. Operating costs continue to be higher than previous management estimates as services costs have increased significantly in 2006, reflecting heightened activity in the industry.

(\$Cdn.)	Three Months Ended December 31			Twelve Months Ended December 31		
	2006	2005	% Change	2006	2005	% Change
Operating expense	3,293,656	2,377,754	39	11,088,038	6,968,397	59
Per boe	18.06	17.54	3	17.26	15.14	14

PRODUCT NETBACKS

Netbacks for the three and twelve month period ended December 31, 2006 increased 33% and 24% respectively over 2005 reflecting the impact of the light sweet production from Evi and increased natural gas production from the Tiverton properties. Arsenal's product mix has lightened significantly over 2005, as heavy oil accounts for approximately 40% of total production compared to 65% during 2005.

(\$Cdn. per boe)	Three Months Ended December 31			Twelve Months Ended December 31		
	2006	2005	% Change	2006	2005	% Change
Net revenue after derivatives	51.02	44.42	15	47.97	40.71	18
Royalties	(11.48)	(10.72)	7	(10.72)	(9.44)	14
Operating expenses	(18.06)	(17.54)	3	(17.26)	(15.14)	14
Operating netback	21.48	16.16	33	19.99	16.13	24

GENERAL AND ADMINISTRATIVE

General and administrative costs per boe decreased 16% during the three month period ended December 31, 2006 over the comparable period in 2005. The decrease is attributable to significantly higher production which offset the additional staff brought on during the year. Arsenal expects general and administrative costs per boe to continue to trend lower as production continues to increase and staffing levels remain consistent. For the twelve month period ended December 31, 2006, general and administrative costs were 9% higher than the prior year, reflecting professional costs incurred during the Tiverton acquisition.

(\$Cdn.)	Three Months Ended December 31			Twelve Months Ended December 31		
	2006	2005	% Change	2006	2005	% Change
General and administrative	607,160	535,310	13	3,283,768	2,153,951	52
General and administrative per boe	3.33	3.95	(16)	5.11	4.70	9

FINANCE CHARGES

Finance charges were 77% and 90% higher over the three and twelve month periods ended December 31, 2006. The increase is attributable to the higher average draw on the Company's credit facility during the current year.

(\$Cdn.)	Three Months Ended December 31			Twelve Months Ended December 31		
	2006	2005	% Change	2006	2005	% Change
Bank line interest	288,066	120,625	139	1,123,465	423,197	165
Per boe	1.58	0.89	77	1.75	0.92	90

INTEREST ON LONG TERM DEBT

Interest on long-term debt relates to the convertible debentures acquired from Tiverton. The debentures bear interest at 8% payable semi-annually on June 30th and December 31st.

(\$Cdn.)	Three Months Ended December 31			Twelve Months Ended December 31		
	2006	2005	% Change	2006	2005	% Change
Interest on long term debt	70,000	-	100	278,256	-	100
Per boe	0.38	-	100	0.43	-	100

DEPLETION, DEPRECIATION, AND ACCRETION

Depletion, depreciation and accretion ("DD&A") per boe increased 104% and 129%, respectively, for the three and twelve months ended December 31, 2006 compared to the same periods in 2005. The increase is attributable to the significantly increased asset base and production levels over the prior year.

(\$Cdn.)	Three Months Ended December 31			Twelve Months Ended December 31		
	2006	2005	% Change	2006	2005	% Change
Depletion, depreciation and accretion	4,730,663	1,723,002	175	13,859,196	4,324,855	220
Per boe	25.93	12.71	104	21.57	9.40	129

CEILING TEST IMPAIRMENT

In accordance with Canadian generally accepted accounting principles, Arsenal completed a ceiling test at December 31, 2006. This test compares the fair value of Arsenal's reserves to its carrying cost. The test is completed on a country by country basis. As a result of the ceiling test, Arsenal wrote down its Canadian cost centre by \$13.8 million at December 31, 2006 to reflect the fair value of the reserves.

(\$Cdn.)	Three Months Ended December 31			Twelve Months Ended December 31		
	2006	2005	% Change	2006	2005	% Change
Ceiling test impairment	13,811,366	-	100	13,811,366	-	100
Per boe	75.71	-	100	21.50	-	100

GOODWILL IMPAIRMENT

At December 31, 2006, Arsenal compared the deemed fair value of goodwill to the carrying value of goodwill. If the fair value of the Company is less than carrying value, the impairment loss is measured by allocating the fair value of the Company to the identifiable assets and liabilities at their fair values. The excess of the Company's fair value over the identifiable net assets is the implied fair value of goodwill. If this amount is less than the book value of goodwill, the difference is the impairment amount. As a result of this test, Arsenal wrote down goodwill by \$13.6 million at December 31, 2006, reflecting the excess of the carrying cost of goodwill to the deemed fair value.

(\$Cdn.)	Three Months Ended December 31			Twelve Months Ended December 31		
	2006	2005	% Change	2006	2005	% Change
Goodwill impairment	13,655,782	-	100	13,655,782	-	100
Per boe	74.86	-	100	21.25	-	100

STOCK BASED COMPENSATION

Compensation expense per boe decreased 10% over the prior year for the twelve month period ended December 31, 2006. For the three month period ended December 31, 2006, compensation expense increased by 12% over the prior year, reflecting options granted to new employees during the period.

(\$Cdn.)	Three Months Ended December 31			Twelve Months Ended December 31		
	2006	2005	% Change	2006	2005	% Change
Compensation expense	519,594	344,322	51	1,398,395	1,119,466	25
Per boe	2.85	2.54	12	2.18	2.43	(10)

TAXES

During the twelve month period ended December 31, 2006, Arsenal accrued \$0.127 million of current taxes on its US streamed income. In Canada, Arsenal does not expect to pay any cash taxes in 2007 based on existing tax pools, planned capital expenditures and the most recent forecast of 2007 taxable income. Although current tax horizons depend on product prices, production levels, and the nature, magnitude and timing of capital spending, the Company currently estimates that no cash income tax will be payable during 2007 on Canadian streamed income.

Future income taxes are recorded to the extent that the carrying value of the assets of Arsenal are different from the tax basis, and if the Company has incurred a net loss during the year. Future income taxes are recorded on corporate acquisitions to the extent the book value of assets acquired exceeds the tax basis.

Future income tax reductions are booked to the extent that the Company satisfies the “more likely than not” test, in that the future tax asset is “more likely than not” to be realized in future periods.

During the fourth quarter of 2006, Arsenal reduced future income taxes by \$4.1 million compared to a future tax reduction of \$0.14 million in 2005. For the year ended December 31, 2006, Arsenal reduced future income taxes by \$7.89 million, compared to future income tax expense of \$0.079 million in 2005. The significant reduction in future income taxes recovery is attributable to a change in the substantively enacted corporate tax rates for Canadian oil and gas producers and to the \$13.8 million ceiling test impairment as discussed in note 7 of the audited financial statements. A future income tax balance of \$8.5 million is recorded as a liability as at December 31, 2006 (2005 – \$7.5 million).

(\$Cdn.)	Three Months Ended December 31			Twelve Months Ended December 31		
	2006	2005	% Change	2006	2005	% Change
Current income taxes	126,758	342,090	100	126,758	342,090	100
Future income taxes (reduction)	(4,188,515)	(148,873)	2,713	(7,889,011)	79,768	100
	(4,061,757)	193,217	(2,202)	(7,762,253)	421,858	(1,940)
Per boe	(22.27)	1.43	(1,662)	(12.08)	0.92	(1,414)

LIQUIDITY

(\$Cdn.)	Twelve Months Ended December 31, 2006
Sources	
Funds from operations	7,817,054
Issue of shares	8,060,963
Exercise of warrants	170,110
Exercise of options	206,501
Change in non-cash working capital - operating items	(3,532,167)
Change in non-cash working capital - investing items	(3,000,618)
Total sources of cash	9,721,843
Uses	
Plant, property and equipment additions	(24,010,422)
Share issue costs	(1,338,209)
Total uses of cash	(25,348,631)
Increase in bank debt	(15,626,788)

Working Capital

At December 31, 2006, the company had a working capital deficit of \$19.2 million, compared to a deficit of \$4.6 million at December 31, 2005. The capital intensive nature of the industry will generally result in the Company having a working capital deficit. The Company has a revolving credit facility for \$23.0 million with a Canadian chartered bank, of which \$21.8 million was drawn at December 31, 2006.

The Company has generated positive funds from operations since 2004, and has a demonstrated ability to raise capital in the equity markets as evidenced by the \$8.1 million raised in November 2006. At December 31, 2006, short term working capital, defined as receivables less payables, was a surplus of \$2.7 million. Funds available for use at December 31, 2006 were \$3.9 million, defined as short term working capital and available room on the Company’s credit facility.

OUTLOOK

STRATEGY

Arsenal's domestic production and cashflow has increased significantly since the inception of the Company through corporate and property acquisition and from the drill bit.

The Company remains committed to utilizing a portion of cashflows earned domestically to fund high impact international opportunities like the Nuqra concession in Egypt. The Company continues to search for other international opportunities with the following profile:

- Experienced and established international operator
- Considerable land acreage
- Pre-existing seismic or geological data establishing existence of source and reservoir rock

Egypt

A two well drilling program on the Nuqra concession began mid February 2007. The total drill program is anticipated to take 90 rig days, ending in May 2007. On March 15, 2007, the Company announced that the first well, Set-1, was dry and subsequently abandoned. The second well, Narmer-1, spudded at the end of March and will take approximately 40 days to reach the target zone.

North America

Arsenal emphasizes a full-cycle approach to its business and plans to continue with internal development opportunities as a means to enhancing its production base and creating value for shareholders. Consistent with its full-cycle approach, Arsenal actively added to its undeveloped land position through crown land sales during 2006 and in early 2007 in order to establish high-quality drilling prospects. The Company also obtained seismic options over considerable acreage in northern Alberta to further expand our core areas there.

The Company will continue to pursue acquisitions that will be accretive on a per share basis to cash flow, production, reserves and net asset value. Arsenal believes that over the long term, outlook for both crude oil and natural gas pricing remains strong.

2007 CAPITAL BUDGET

(\$Cdn.)

Drilling	
Western Alberta	9,500,000
Central Saskatchewan	3,500,000
North Dakota	2,750,000
Egypt	2,500,000
Optimization	
North Dakota	750,000
Central Saskatchewan	1,000,000
Total Capital	20,000,000

The Company has an \$8.1 million flow-through obligation which will be satisfied through exploratory drilling in Western Alberta and Central Saskatchewan during 2007.

CONSOLIDATED BALANCE SHEETS

As at December 31

2006

2005

ASSETS

Current assets

Accounts receivable	7,282,175	4,583,927
Reclamation bonds (note 9)	201,890	203,291
Property, plant and equipment (note 6 and 7)	83,186,918	44,578,604
Goodwill (note 8)	4,791,561	4,791,561
	95,462,544	54,157,383

LIABILITIES

Current liabilities

Accounts payable and accrued liabilities	4,643,907	6,365,577
Revolving demand loan (note 11)	21,822,985	2,496,195
Deferred revenue	-	287,533
	26,466,892	9,149,305
Convertible debentures (note 17)	3,263,473	-
Future income taxes (note 12)	8,548,207	7,509,044
Asset retirement obligations (note 13)	2,638,520	1,295,500
	40,917,092	17,953,849

SHAREHOLDERS' EQUITY

Common shares (note 14)	80,291,169	36,514,809
Warrants (note 15)	303,731	303,731
Contributed surplus (note 16)	2,422,423	1,170,444
Common share conversion rights (note 17)	370,000	-
Deficit	(28,841,871)	(1,785,450)
	54,545,452	36,203,534
	95,462,544	54,157,383

Future operations (note 2)

Segmented information (note 19)

Commitments and contingencies (note 20)

See accompanying notes to the financial statements.

CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT

For the year ended December 31

2006

2005

REVENUE

Oil and gas	30,820,734	18,737,666
Royalties expense, net of Alberta Royalty Tax Credit	(6,885,863)	(4,344,657)
	23,934,871	14,393,009

EXPENSES

Operating	11,088,038	6,968,397
General and administrative	3,283,768	2,153,951
Finance charges	1,123,465	423,197
Interest on long term debt	208,256	-
Foreign exchange	244,280	81,709
Convertible debenture accretion	81,000	-
Depletion, depreciation and accretion	13,859,196	4,324,855
Property, plant and equipment impairment (note 7)	13,811,366	-
Goodwill impairment (note 8)	13,655,782	-
Stock-based compensation (note 16)	1,398,395	1,119,466
	58,753,546	15,071,575

Loss before income taxes (34,818,675) (678,566)

Income taxes (note 12)

Current income taxes	126,758	342,090
Future income taxes (reduction)	(7,889,011)	79,768
	(7,762,253)	421,858

Net loss (27,056,421) (1,100,424)

Deficit - beginning of year (1,785,450) (685,026)

Deficit - end of year (28,841,871) (1,785,450)

Loss per share - basic and diluted (note 13) (0.44) (0.04)

Segmented information (note 19)

See accompanying notes to the financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the year ended December 31

2006

2005

Cash flows from operating activities

Net loss	(27,056,421)	(1,100,424)
Items not affecting cash		
Depletion, depreciation and accretion	13,859,196	4,324,855
Property, plant and equipment impairment	13,811,366	-
Goodwill impairment	13,655,782	-
Future income tax expense (reduction)	(7,889,011)	79,768
Convertible debenture accretion	81,000	-
Stock-based compensation expense	1,398,395	1,119,466
Deferred revenue	(287,533)	(263,346)
Unrealized foreign exchange loss	244,280	81,709
	7,817,054	4,242,028
Net change in non-cash working capital items (note 18)	(3,532,168)	786,775
Net cash from operating activities	4,284,886	5,028,803

Cash flows from investing activities

Corporate acquisitions	-	(5,500,000)
Additions to property, plant and equipment	(24,010,422)	(16,999,809)
Change in non-cash working capital - investing items (note 18)	(3,000,618)	(688,265)
Net cash used in investing activities	(27,011,040)	(23,188,074)

Cash flows from financing activities

Issue of shares for cash	8,060,963	13,573,157
Issue of shares for cash upon exercise of warrants	206,501	6,133,159
Issue of shares for cash upon exercise of stock options	170,110	207,334
Share issue costs	(1,338,209)	(723,785)
Proceeds from revolving demand loan	15,626,790	12,443,478
Repayment of revolving demand loan	-	(13,691,135)
Cash provided by financing activities	22,726,155	17,942,208

Change in cash during the year	-	(217,063)
Cash - beginning of year	-	217,063
Cash - end of year	-	-

Supplemental information (note 18)

Segmented information (note 19)

See accompanying notes to the financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006 and 2005

1. ORGANIZATION AND BASIS OF PRESENTATION

Arsenal Energy Inc. (“Arsenal or the Company”)

Arsenal Energy Inc. is incorporated under the laws of the province of Alberta. The principal business of the Company is the exploration for, exploitation, development and production of oil and natural gas reserves in Canada, the United States and Egypt. Each country in which Arsenal conducts business has been treated as an identifiable reporting segment, refer to note 19 for additional disclosures. All amounts are reported in Canadian dollars unless otherwise noted.

2. FUTURE OPERATIONS

These financial statements have been prepared on a going concern basis, which assumes the Company will continue in operation in the foreseeable future and be able to realize assets and satisfy liabilities in its normal course of business.

For the year ended December 31, 2006, the Company has incurred a loss due to a ceiling test and goodwill impairment test and has experienced recurring losses in prior years. Arsenal believes that current working capital and cash flow from operations will be sufficient to meet its working capital requirements for 2007. Future operations depend upon the Company’s continued ability to generate profitable operations and/or obtain additional financing to fund future operations and to generate positive cash flows from operating activities. If additional sources of financing are not secured, the going concern assumption may not be valid.

3. SIGNIFICANT ACCOUNTING POLICIES

Consolidation

These consolidated financial statements include the accounts of Arsenal and its subsidiaries from the date of acquisition. These accounts are referred to collectively as “Arsenal” or “the Company”. Investments are accounted for using the proportionate consolidation method, whereby the Company’s proportionate share of revenues, expenses, assets and liabilities are included in the accounts.

Revenue recognition

Revenue associated with the sale of crude oil, natural gas, and natural gas liquids owned by the Company are recognized when title passes from the Company to its customers.

Property, plant and equipment

Arsenal uses the full cost accounting method for oil and gas exploration, development and production activities. The cost of acquiring oil and natural gas properties as well as subsequent development costs are capitalized and accumulated in each country. Maintenance and repairs are charged against income, and renewals and enhancements, which extend the economic life of the property, plant and equipment, are capitalized. Gains and losses are not recognized upon disposition of oil and natural gas properties unless such a disposition would alter the rate of depletion by at least 20%. All other equipment is carried at the lesser of depreciated cost and fair value.

Ceiling test

A ceiling test is performed at least annually to assess the carrying value of oil and gas assets. A cost center is defined on a country by country basis, and is tested for recoverability using undiscounted future cash flows from proved reserves and forward indexed commodity prices, adjusted for contractual obligations and product quality differentials. A cost center is written down to its fair value when its carrying value, less the cost of unproved properties, is in excess of the related undiscounted cash flows. Fair value is estimated using accepted present value techniques that incorporate risk and uncertainty when determining expected future cash flows. Unproved properties are excluded from the ceiling test calculation and subject to a separate impairment test.

Depletion, depreciation and accretion

In accordance with the full cost accounting method, all crude oil and natural gas acquisition, exploration, and development costs, including asset retirement costs, are accumulated in a cost center. The aggregate of net capitalized costs and estimated future development costs, less the cost of unproved properties and estimated salvage value, is amortized using the unit-of-production method based on current period production and estimated net proved oil and gas as determined by independent engineers. All other equipment is depreciated over the estimated useful life of the respective assets.

Oil and gas reserves

Oil and gas reserves are based on engineering data, projected future rates of production, estimated commodity prices, and consider the timing of future expenditures. Arsenal expects reserve estimates to be revised based on the results of future drilling activity, testing, production levels, and economics of recovery based on cash flow forecasts.

Income taxes

Arsenal uses the assets and liability method of accounting for income taxes and records future income taxes for the effect of any difference between the accounting and income tax basis of an asset or liability, using the substantively enacted income tax rates. Accumulated future income tax balances are adjusted to reflect changes in income tax rates that are substantively enacted during the period with the adjustment recognized in net income. Future tax assets are recorded only to the extent it is more likely than not that these assets will be realized. The determination of Arsenal's income and other tax liabilities are subject to audit and potential reassessment after the lapse of considerable time. Accordingly, actual income tax liabilities or recoveries may differ from estimates.

Goodwill

Goodwill is the residual amount that results when the purchase price of an acquired business exceeds the fair value of the net identifiable assets and liabilities of the acquired business. Net identifiable liabilities acquired include an estimate of future income taxes. Goodwill is tested at least annually for impairment. Impairment is charged to net income in the period in which it occurs.

The test for impairment is the comparison of the book value of net assets (assets less liabilities) to the fair value of the business unit, being the Company. If the fair value of the Company is less than its book value, the impairment loss is measured by allocating the fair value of the Company to the identifiable assets and liabilities at their fair values. The excess of the Company's fair value over the identifiable net assets is the implied fair value of goodwill. If this amount is less than the book value of goodwill, the difference is the impairment amount. Refer to note 8 for additional information.

Per share calculations

Basic per share amounts are calculated using the weighted average number of shares outstanding during the year. Weighted average number of shares is determined by relating the portion of time within the reporting period that common shares have been outstanding to the total time in that period.

The Company uses the treasury stock method to determine the dilutive effect of stock options and other dilutive instruments. Under the treasury stock method, only dilutive instruments where the market price exceeds the exercise price impact the diluted calculations.

Measurement uncertainty

The timely preparation of financial statements in conformity with Canadian generally accepted accounting principles requires that management make estimates and assumptions and use judgment regarding assets, liabilities, revenues, and expenses. Such estimates primarily relate to unsettled transactions and events as of the date of the financial statements. Accordingly, actual results may differ from estimated amounts as future confirming events occur.

Amounts recorded for depreciation, depletion, and amortization, asset retirement costs and obligations, and amounts used for ceiling test and impairment calculations are based on estimates of oil and natural gas reserves and future costs required to develop those reserves. By their nature, these estimates are subject to measurement uncertainty, and the impact on the financial statements of future periods could be material.

Foreign currency translation

The Company translates foreign currency denominated transactions and the financial statements of integrated foreign operations using the temporal method. Monetary assets and liabilities are translated at year-end rates. Non-monetary assets and liabilities are translated at rates in effect on the dates of the transactions. Income and expenses are translated at average

rates in effect during the year with the exception of amortization, which is translated at historic rates. Exchange gains and losses on translation of monetary assets and liabilities are reflected in income immediately.

Flow-through shares

Flow-through shares are issued at a fixed price and the proceeds are used to fund qualifying exploration and development expenditures within a defined period. The qualifying expenditure deductions funded by flow-through arrangements are renounced to investors in accordance with Canadian tax legislation. To recognize the foregone tax benefits of flow-through shares, share capital is reduced and a future income tax liability is recorded for the estimated future tax cost of the renounced expenditures, when the expenditures are renounced.

Asset retirement obligations

The Company recognizes the fair value of an asset retirement obligation as a liability at the time it incurs a legal obligation for the future abandonment and reclamation costs associated with its petroleum and natural gas operations. Asset retirement obligations are initially measured at their fair value and subsequently adjusted to reflect the passage of time (accretion) and any changes to the estimated cash flows underlying the obligation. The associated asset retirement cost is capitalized as part of property, plant and equipment and amortized to earnings using the unit of production method over estimated proved reserves consistent with the depletion and depreciation of the underlying asset.

Financial instruments

The Company uses financial instruments for non-trading purposes to manage fluctuations in commodity prices. All unrealized derivative financial instruments that either do not qualify as hedges, or are not designated as hedges, are recorded as a derivative asset or a derivative liability on the consolidated balance sheet with any changes in fair value during the period recognized in income.

4. ACQUISITIONS

On March 14, 2006 Arsenal acquired all of the issued and outstanding securities of Tiverton Petroleum Ltd. ("Tiverton"). On August 11, 2005 Arsenal acquired all of the issued and outstanding securities of Quadra Resources Corp. ("Quadra"). On March 31, 2005 Arsenal acquired all of the issued and outstanding of IC Energy Inc. ("IC Energy"). The purchase method of accounting was used for both business combinations and the allocation of the purchase price and consideration for each acquisition is as follows:

	Tiverton 2006	Quadra 2005	IC Energy 2005
Net assets acquired at assigned values:			
Working capital deficiency	(2,112,791)	(145,650)	-
Property, plant and equipment	42,740,000	-	10,243,000
Goodwill	13,572,428	2,126,363	2,665,198
Seismic	-	720,000	-
Undeveloped land	-	4,785,794	-
Bank debt	(3,700,000)	-	-
Convertible debentures	(3,182,473)	-	-
Asset retirement obligation	(1,095,000)	-	(123,713)
Future income taxes	(6,937,798)	-	(2,784,485)
Common share conversion rights	(370,000)	(2,003,493)	-
Net assets acquired	38,914,366	5,483,014	10,000,000
Financed by:			
Shares issued	38,314,366	5,233,014	4,500,000
Cash	-	-	5,500,000
Acquisition costs	600,000	250,000	-
Purchase price	38,914,366	5,483,014	10,000,000

5. RELATED PARTY TRANSACTIONS

Subscription receivable

The Company issued shares to an officer and director on a subscription receivable basis, the proceeds of which will be recognized on a cash basis. At December 31, 2006, \$225,000 is owed by the officer and director.

6. PROPERTY, PLANT AND EQUIPMENT

	2006	2005
Property, plant, and equipment	115,819,143	49,648,267
Accumulated depletion, depreciation, and amortization ⁽¹⁾	(32,632,225)	(5,069,663)
	83,186,918	44,578,604

⁽¹⁾ Includes property, plant and equipment impairment totalling \$13.8 million, refer to note 7.

In Canada and the United States, all costs of unproved properties, net of any associated revenues, have been capitalized and depleted during 2006 and 2005. Future development costs totaling \$2,900,000 (2005 - \$637,600) were included in the depletion calculation. In Egypt, costs of unproved properties totaling \$9,027,478 have been excluded from depletion as drilling and production activities have not commenced. Included in property, plant, and equipment are asset retirement costs of \$2,283,594 (2005 - \$1,020,118). During the year, Arsenal capitalized general and administrative expenses of \$250,000 (2005 - \$167,500).

7. CEILING TEST

On December 31, 2006 Arsenal completed a ceiling test to assess if the property, plant and equipment costs would be recoverable by comparing the fair value of the cost centre to the carrying amount. The prices used in the ceiling test evaluation of Arsenal's natural gas, crude oil, and natural gas liquids reserves at December 31, 2006 were as follows:

Year	WTI Oil (\$U.S./bbl)	Foreign Exchange (\$Cdn./\$U.S.)	12° Hardisty Heavy Oil (\$Cdn./bbl)	NYMEX Gas (\$U.S./mcf)	AECO Gas (\$Cdn./mcf)
2007	65.00	1.14	40.35	7.80	7.40
2008	69.35	1.14	45.25	8.40	8.00
2009	70.75	1.14	50.10	8.30	7.90
2010	69.00	1.14	49.69	8.50	8.00
2011	67.10	1.14	49.15	8.65	8.25
2012 - 2026	76.37	1.14	58.16	10.18	9.68
Remainder (1)	2.00%				

⁽¹⁾ Percentage change represents the annual change each year from 2012 to the end of the reserve life.

As a result of the ceiling test, Arsenal has written down its Canadian cost centre by \$13.8 million to as at December 31, 2006.

8. GOODWILL IMPAIRMENT

As outlined in note 3, at December 31, 2006, Arsenal compared the fair value of goodwill to the carrying value of goodwill. As a result of this test, the Company recorded an impairment to goodwill of \$13.6 million calculated as the excess of the Company's fair value over the identifiable net assets for its Canadian reporting unit.

9. RECLAMATION BONDS

At December 31, 2006 the Company had \$201,890 (2005 - \$203,291) on deposit with the United States Federal and State governments for future site reclamation activities. These funds will be returned when the Company abandons and reclaims well sites in the United States.

10. RISK MANAGEMENT AND FINANCIAL INSTRUMENTS

Commodity price risk management

The Company had one crude oil sales contract fixing the price of future production of 180 barrels per day at CDN\$46.93 per barrel. The Company received a prepayment on the contract equal to an incremental \$5.59 per barrel which was recognized as revenue based on deliveries over the life of the contract. During 2006, \$161,645 was recognized as revenue (2005 - \$263,346). The forward contract expired on August 31, 2006.

Fair value of financial instruments

The Company's exposure under its financial instruments is limited to financial assets and liabilities, all of which are included in these financial statements. The fair values of financial assets, liabilities and convertible debentures that are included in the balance sheet approximate their carrying amounts.

Credit risk

A substantial portion of the Company's accounts receivable are with customers and joint venture partners in the oil and gas industry and are subject to normal industry credit risks. Purchasers of the Company's natural gas, crude oil and natural gas liquids are subject to an internal credit review to minimize the risk of non-payment.

Foreign currency exchange risk

The Company is exposed to foreign currency fluctuations as crude oil and natural gas prices received are referenced to U.S. dollar denominated prices, and revenues earned and costs incurred in the United States and Egypt are denominated in U.S. dollars.

Interest rate risk

The Company is exposed to interest rate risk to the extent that bank debt is at a floating rate of interest.

11. REVOLVING DEMAND LOAN

At December 31, 2006, the Company has available a demand operating loan in the amount of \$23.0 million. The facility can be utilized in either Canadian or US dollars, bears interest on Canadian or US bank prime plus 0.25%, increasing to Canadian or US bank prime plus 0.40% if Net Debt to Annualized Cashflow exceeds 1.25:1. The facility is secured by a fixed and floating charge debenture providing a fixed charge over certain petroleum and natural gas interests and a floating charge over all Canadian and U.S. assets.

12. INCOME TAXES

The tax provision differs from the amount computed by applying the combined Canadian federal and provincial income tax statutory rates to loss before income taxes as follows:

	2006	2005
Loss before income taxes	(34,735,321)	(678,566)
Statutory tax rate	35.39%	38.89%
Expected tax provision (recovery)	(12,292,830)	(263,894)
Adjustments:		
Non-deductible crown royalties	510,371	531,672
Resource allowance	(246,495)	(354,877)
Stock-based compensation	494,892	435,373
Rate reduction	(1,085,012)	85,674
Goodwill impairment	4,834,147	-
Other	22,675	(12,091)
Income taxes (recovery)	(7,762,253)	421,858
Future tax liability comprised of:		
Property, plant and equipment	10,249,310	8,312,970
Share issue costs	(752,087)	(332,753)
Asset retirement obligations	(850,395)	(471,173)
Unrealized foreign exchange loss	(86,451)	-
Other	(12,169)	-
Future income taxes	8,548,207	7,509,044

13. ASSET RETIREMENT OBLIGATIONS

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:

	2006	2005
Asset retirement obligations - beginning of year	1,295,500	780,889
Liabilities acquired (note 4)	1,095,000	334,119
Liabilities incurred	128,100	114,808
Change in estimate	11,920	(14,022)
Accretion expense	108,000	79,706
Asset retirement obligations - end of year	2,638,520	1,295,500

The total undiscounted amount of estimated cash flows required to settle the obligation is \$7.2 million (2005 - \$6.8 million), which has been discounted using a credit-adjusted risk free rate of 8.0% (2005 - 8.0%) and an inflation factor of 1.5%. The majority of these obligations will be incurred between 2014 and 2025, however certain obligations are not anticipated to be incurred until 2035.

14. SHAREHOLDERS' EQUITY

Authorized:

- i) Unlimited number of common shares
- ii) Unlimited number of non-voting preferred shares, issuable in series

Issued:

Common shares	2006		2005	
	Shares	Amount (\$)	Shares	Amount (\$)
Balance - beginning of year	42,881,244	36,839,809	18,989,706	7,783,134
Issued to acquire Tiverton	23,237,671	38,314,366	-	-
Issued to acquire IC Energy	-	-	3,000,000	4,500,000
Issued to acquire Quadra	-	-	4,088,292	5,483,014
Issued for cash	7,328,148	8,060,963	8,760,496	13,573,157
Cost of shares issued	-	(1,131,708)	-	(723,785)
Tax effect of flow-through shares	-	(2,369,913)	-	(1,445,169)
Tax effect of share issue costs	-	379,625	-	247,000
Issued on exercise of options	350,000	206,501	972,025	207,334
Issued on exercise of warrants	170,110	170,110	6,745,725	6,133,159
Allocated from contributed surplus	-	146,416	-	93,205
Allocated from warrants	-	-	-	988,760
Shares issued	73,967,173	80,616,169	42,556,244	36,839,809
Shares held in escrow ^(note 5)	-	(325,000)	-	(325,000)
Balance - end of year	73,967,173	80,291,169	42,556,244	36,514,809

Per share amounts

The per unit calculations for the year ended December 31, 2006 were based on weighted average shares outstanding of 62,033,289 (2005 – 28,586,521). In computing net loss per share – diluted, 1,157,869 (2005 – 702,171) shares were added to the weighted average number of shares outstanding for the year, reflecting the dilutive effect of options and warrants.

Flow through shares

In November of 2006 the Company issued 7,328,148 flow-through shares for gross proceeds of \$8,060,963. In 2005, the Company issued 3,279,544 flow-through shares for gross proceeds of \$5,739,202.

15. WARRANTS

During 2005, Arsenal issued warrants through a private placement equity issue. The fair value of each warrant is estimated on the date of issuance using the Black-Scholes option pricing model with the following weighted average assumptions:

	2006	2005
Risk free rate	4%	4%
Expected life	1 - 2 years	1 - 2 years
Expected volatility	46% - 80%	46% - 80%
Expected dividend	nil	nil

	2006		2005	
	Warrants	Amount (\$)	Warrants	Amount (\$)
Balance - beginning of year	2,031,100	303,731	6,588,664	988,760
Private placement	-	-	2,031,100	303,731
Agents' warrants ⁽¹⁾	170,110	-	157,061	-
Allocated to common equity upon exercise of warrants	(170,110)	-	(6,745,725)	(988,760)
Balance - end of year	2,031,100	303,731	2,031,100	303,731

⁽¹⁾ During 2005 the Company's underwriters and agents exercised their right to an additional 170,110 warrants pursuant to their respective agency agreements. These warrants were exercised during 2006.

16. STOCK OPTIONS

Arsenal has established an Option Plan (the "Plan") for employees, consultants and independent directors. Pursuant to the Plan arrangement, employees, directors and long-term consultants may be granted options to purchase shares. The exercise price for each option granted was not less than the market price of the shares on the grant date and the contractual term of each option is not to exceed five years. Options granted before October 29, 2004 vested immediately; options granted after October 29, 2004 vest over 18 months.

	Options	2006 Weighted Average Price (\$)	Options	2005 Weighted Average Price (\$)
Balance - beginning of period	3,592,252	0.99	2,505,000	0.40
Granted	1,535,000	1.10	2,495,000	1.24
Exercised	(350,000)	0.59	(972,025)	0.23
Forfeited	(250,000)	1.13	(435,723)	0.59
Balance - end of period	4,527,252	1.05	3,592,252	0.99
Exercisable - end of period	3,170,585	1.02	1,977,259	0.90

The following table summarizes information about the stock options outstanding and exercisable at December 31, 2006.

Range (\$)	Options outstanding		Options exercisable		
	Options Outstanding	Weighted average exercise price	Weighted average remaining term	Exercisable	Weighted average exercise price
0.20 - 0.59	747,252	0.46	2.37	747,252	0.46
0.60 - 1.35	3,740,000	1.16	2.95	2,383,333	1.18
1.50 - 2.00	40,000	1.50	3.13	40,000	1.50
Total	4,527,252	1.05	2.86	3,170,585	1.02

Stock-based compensation expense

The fair value of each option granted is estimated at the date of grant using the Black-Scholes option-pricing model with weighted average assumptions for grants as follows:

	2006	2005
Risk free rate	4%	4%
Expected life	5 years	5 years
Expected volatility	57%	80%
Expected dividend	nil	nil
Expected forfeitures	nil	nil

	2006	2005
Balance - beginning of year	1,170,444	144,183
Issuance of stock options	1,398,395	1,119,466
Reclassification to common shares on exercise of options	(146,416)	(93,205)
Balance - end of year	2,422,423	1,170,444

17. CONVERTIBLE DEBENTURES

As outlined in Note 4, Arsenal completed the corporate acquisition of Tiverton on March 14, 2006. A portion of Tiverton's capital structure was comprised of unsecured convertible debentures totalling \$3,480,000. Interest accrues on the debentures at 8%, payable semi-annually on June 30th and December 31st of each year. The debentures will mature on February 15, 2009 unless called for redemption earlier by Arsenal. The debentures are convertible by the holders at any time prior to maturity into 1,539,170 shares of the Company, representing a conversion price of \$2.26 per Arsenal share.

The Company can elect to prepay the debenture providing the Company's shares trade above \$2.60 per share for 22 consecutive days. The convertible debentures are a debt security with an embedded conversion option and were segregated into their debt and equity components based on their respective fair values at the date of acquisition. The \$370,000 equity component represents the holder's conversion right and is included in Shareholders' Equity, the remaining balance has been classified as debt. If the holder exercises the conversion right, they will receive accrued and unpaid interest up to and including the conversion date.

18. SUPPLEMENTAL CASH FLOW INFORMATION

	2006	2005
Change in non-cash working capital items		
Operating accounts receivable	(2,698,248)	(3,312,900)
Operating accounts payable	(833,920)	4,099,675
Amounts relating to operating activities	(3,532,168)	786,775
Amounts relating to investing activities	(3,000,618)	(688,265)
	(6,532,786)	98,510
Taxes paid	213,965	-
Interest paid	1,157,036	392,691

19. SEGMENTED INFORMATION

A portion of the Company's assets and revenues are earned in the United States and a portion of the Company's assets are located in Egypt, and are monitored as an identifiable reporting segment by management. The remaining assets and associated revenues are earned in Canada by Arsenal Energy Inc. Business risks and economic indicators are similar across all geographical regions.

(\$ Cdn.)	2006			
	Canada	U.S	Egypt	Total
Oil and gas revenue	22,887,927	7,932,807	-	30,820,734
Income (loss) before income taxes	(36,805,698)	1,963,968	23,056	(34,818,675)
Operating income	9,933,840	2,912,993	-	12,846,833
Property, plant and equipment (note 6 and 7)	71,895,599	4,473,556	6,817,763	83,186,918
Capital expenditures (including acquisitions)	65,419,000	13,824	1,457,618	66,890,442

(\$ Cdn.)	2005			
	Canada	U.S	Egypt	Total
Oil and gas revenue	11,089,939	7,647,727	-	18,737,666
Income (loss) before income taxes	(1,191,691)	905,996	(145,650)	(431,345)
Operating income	4,465,121	3,132,712	-	7,597,833
Property, plant and equipment (note 6 and 7)	34,522,710	4,695,750	5,360,144	44,578,604
Capital expenditures (including acquisitions)	22,401,656	98,153	-	22,499,809

20. COMMITMENTS AND CONTINGENCIES

Egyptian Concession

The Company's wholly owned subsidiary Quadra Egypt Ltd. entered into a concession agreement with the Egyptian government in 2004. The agreement requires gross expenditures of USD\$11.0 million over an eight year period on seismic evaluation, exploratory drilling and developmental drilling. After completing a farm out agreement with a Canadian public company, Arsenal is responsible for incurring approximately USD\$2.0 million of expenditures to maintain the concession.

Flow-through shares

The Company has an \$8.1 million flow-through obligation which will be satisfied through exploratory drilling and seismic shooting in Western Alberta and Central Saskatchewan during 2007.

Letter of Credit

During the second quarter, Arsenal provided a letter of credit to the Egyptian government for USD\$1.6 million. The letter of credit is to be held until April 10, 2010, or until certain performance measures are achieved by Arsenal and its partners. Arsenal has obtained a Performance Security Guarantee ("PSG") from the Canadian government which guarantees Arsenal against the call of the bond by the Egyptian government. There is no impact to the existing credit facility of Arsenal from providing the letter of credit due to the PSG, however the Company incurred approximately \$50,000 in stamping fees to obtain the PSG.

Office Lease

The Company leases its office premises through an operating lease. for accounting purposes. The estimated operating lease commitments relating to leased office premises are as follows:

(\$Cdn.)	
2007	120,000
2008	120,000
2009	120,000
2010	70,000

Certain statements in this material may be "forward-looking statements" including outlook on oil and gas prices, estimates of future production, estimated completion dates of acquisitions and construction and development projects, business plans for drilling and exploration, estimated amount and timing of capital expenditures and anticipated future debt levels and royalty rates. Information concerning reserves contained in this material may also be deemed forward-looking statements as such estimates involve the implied assessment that the resources described can be profitably produced in the future. These statements are based on current expectations, estimates and projections that involve a number of risks and uncertainties, which could cause actual results to differ from those anticipated by Arsenal. This news release is not for distribution in the United States.

The term barrels of oil equivalent ("boe") may be misleading, particularly if used in isolation. A boe conversion ratio of six thousand cubic feet per barrel (6mcf/bbl) of natural gas to barrels of oil equivalence 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 the report are derived from converting gas to oil in the ratio mix of six thousand cubic feet of gas to one barrel of oil.

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