



2004 Third Quarter Report

To the shareholders,

The third quarter of 2004 exhibited significant growth for Arsenal. Production increased significantly as a result of our acquisition of producing light oil and natural gas properties in North Dakota. Oil and natural gas production increased from approximately 54 boe/day to approximately 460 boe/day. The acquisition closed on August 31, 2004, therefore the third quarter only includes one month of revenue from this property.

Arsenal plans to further develop the potential of this operated property in North Dakota through drilling, water flooding and other optimization processes. A horizontally drilled Bakken light oil play has been noted in the immediate vicinity of our lands in North Dakota. The said Bakken zone is below the existing producing formations of our wells in North Dakota. Industry interest in our lands has been growing due to the success in this geological play. We are evaluating options at this time. We also plan to further pursue exploration opportunities on our properties located in Saskatchewan. Saskatchewan continues to be a focal point for our company. Arsenal has been assembling land in certain areas in Saskatchewan. The company also was engaged in pursuing deeper natural gas drilling opportunities in western Alberta. We have entered into agreements to drill two of these opportunities; one well will commence during the fourth quarter of 2004 and the second well will be drilled during the first quarter of 2005.

Our shallow gas exploration play in southern Saskatchewan has been halted due to the litigation between two partners. Arsenal is not involved in the said litigation but further work in the area has stopped until certain issues have been resolved.

We were pleased to announce several additions to our management team and our board. In October Trevor Mitzel, CA, CFA joined Arsenal as Chief Financial Officer. Lyle Skaien, P.Eng., became a director during the same month. Bernie Dumanowski, P. Eng., was added as V.P. Operations in November. Jock Graham, B. Sc. P. Geol. decided to devote the majority of his time to Arsenal as a consulting geologist. The additions to the management team brings Arsenal to a new exciting stage. Arsenal welcomes our new employees and our new director.

On behalf of the Board of Directors,

signed

Michael S. Vandale
President and Chief Executive Officer

Management's Discussion and Analysis

September 30, 2004 - The following Management's Discussion and Analysis of financial results as provided by the management of Arsenal Energy Inc. ("Arsenal" or "The Company") should be read in conjunction with the unaudited interim financial statements and selected notes for the nine months ended September 30, 2004 and 2003. This commentary is based on information available to October 30, 2004.

BOE's 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.

"Cash flow from operations" should not be considered an alternative to, or more meaningful than cash flow from operating activities as determined in accordance with Canadian generally accepted accounting principles ("GAAP") as an indicator of the Company's performance. "Cash flow from operations" represents cash flow from operating activities prior to changes in non-cash working capital. Arsenal's determination of cash flow from operations may not be comparable to that found in the consolidated statements of cash flows in the unaudited interim 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.

NET EARNINGS AND CASH FLOW FROM OPERATIONS

Arsenal generated cash flow from operations of \$126,247 for the nine months ended September 30, 2004, down from \$180,302 produced in the same period of 2003. The decrease is attributed to an increase in general and administrative costs primarily related to expenses incurred in the acquisition of the North Dakota properties.

For the nine months ended September 30, 2004, the net loss was \$172,355, compared to net earnings of \$47,966 for the same period in 2003. Net earnings for 2003 were restated to reflect the adoption of CICA Handbook Section 3110 "Asset Retirement Obligations" (resulting in a net earnings decrease of \$11,474).

Production Volumes

Production volumes for the first nine months of 2004 from Canadian properties averaged 54 boe/d, down from the 57 boe/d for the same period in 2003 and the average from the North Dakota properties for the first month of operating was 410 boe/d. Total production in September equated to 466 boe/d.

Commodity Prices

For the nine months ending September 30, 2004, Arsenal received an average price for crude oil and liquids of \$53.53/bbl, compared to \$41.83/bbl received during the same period in 2003.

Revenue

Revenue for the nine months ended September 30, 2004 was \$1,261,940, an increase of \$610,988 compared to the same period in 2003 (\$650,952). The increase in revenue is directly attributable to the additional production in September from the North Dakota properties and increased commodity prices in Canada.

Royalties

For the nine months ending September 30, 2004, total royalties were \$246,670 compared with \$107,585 in the same period in 2003, reflecting the increase in revenue from the North Dakota properties.

Operating Expenses

For the nine months ended September 30, 2004, operating costs totaled \$356,291, compared to \$171,426 in the same period of 2003. Operating expenses averaged \$13.47/boe for the third quarter of 2004, up \$4.09/boe, compared to the same period in 2003. Increases in operating costs reflect the higher average production costs of the North Dakota properties and the reduced oil production per well in Western Saskatchewan as each well reduced from higher flush production to lower stable production.

Operating Netbacks

Operating netbacks for Arsenal in the third quarter of 2004 were \$29.43/boe and \$29.93/boe in the third quarter of 2003.

General and Administrative

Gross general and administrative costs during the third quarter of 2004 were \$480,559 compared to \$238,538 in 2003. This increase in the amount of general and administrative costs represents an increase in administrative focus on exploration projects, financing and the acquisition of the North Dakota properties.

Capital Expenditures

Capital expenditures during the third quarter of 2004 were \$6,020,615, compared to \$1,096,546 in 2003. Arsenal drilled 4 (1.0 net) wells and acquired assets of \$5,420,162 in North Dakota during the first nine months of 2004. In the third quarter of 2003 capital expenditures related to the completion and equipping of 10 (3.75 net) wells drilled in the fourth quarter of 2002.

At September 30, 2004, the Company had approximately 54,640 gross (13,660 net) undeveloped acres of land in Saskatchewan. During the first quarter of 2004, the Company completed the first phase of a large area farm-in arrangement in the Bengough, Saskatchewan area with the drilling of five wells.

Depletion, Depreciation and Accretion Costs

Depletion, depreciation and accretion (site restoration) expense for the nine months ended September 30, 2004 totaled \$278,548 compared to \$132,336 expensed in the third quarter of 2003. The depletion and depreciation rate for the third quarter of 2004 averaged \$11.59/boe, compared to \$9.87/boe in the third quarter of 2003. Depletion, depreciation and accretion (site restoration) for the third quarter of 2003 was restated to reflect the adoption of CICA Handbook Section 3110 "Asset Retirement Obligations" (resulting in a net expense increase of \$11,474).

Income Taxes

The combined provincial, federal and state effective tax rate for the period was 38%. Future income tax expense for the second quarter of 2003 was restated to reflect the adoption of CICA Handbook Section 3110 "Asset Retirement Obligations" (resulting in no material change in the original income tax position).

Liquidity and Capital Resources

Arsenal had a working capital deficit of \$3,768,283 as at September 30, 2004. This working capital deficit includes the revolving demand loan of \$3,700,000 which is classified as a current liability. Excluding this loan Arsenal had working capital deficit of \$68,283. At September 30, 2004 Arsenal had \$300,000 available on its revolving credit facility.

Arsenal is committed to incur income tax attributes associated with oil and gas exploration and development activities pursuant to a \$1,400,000 flow-through common share financing in December 2003. By September 30, 2004 the Company had incurred \$502,000 of qualifying expenditures, with \$898,000 to be incurred by December 31, 2004. Subsequent to September 30, 2004 Arsenal advanced \$326,000 towards a prospect expected to begin drilling during the last week of November, 2004.

In May 2004, Arsenal finalized a second flow-through share private placement and incurred a further commitment for \$1,000,000 of qualifying expenditures in 2005.

Business Prospects and 2004 Outlook

Arsenal Energy Inc. is optimistic about its future prospects. The Company has been successful in growing its production and land base since its formation in 2001 and is expected to continue with future growth through development of its core assets, new exploration on the Company's inventory of geological prospects and acquisitions of producing properties. Currently, the Company's producing properties are located in North Dakota and west central Saskatchewan. During the remainder of 2004, the Company will continue to focus its exploration efforts for natural gas and economically viable crude oil.

On November 25, 2004 the Company completed the first close of a private placement financing with Wellington West Capital Inc. acting as agent for gross proceeds of \$1,090,250. The Company issued 1,453,666 units at subscription price of \$0.75 per unit. The Company has committed to a second and final closing of up to an additional 2,546,334 units equaling gross proceeds of up to \$1,909,751. Each unit issued consists of a common flow through share and a full warrant with an exercise price of \$1.00 expiring 12 months from the date of issuance. The Company will renounce 100% of the tax pools related to the flow through funds.

On November 25th the Company entered into an Offer to Purchase Agreement to acquire 100% of the issued and outstanding shares of Nahanni Oil and Gas Ltd. for total consideration of \$3,000,000. The consideration will be satisfied through the issuance of 1,000,000 common shares of Arsenal Energy Inc. at a deemed price of \$0.75 per share and a cash payment of \$2,250,000. The acquisition is subject to due diligence and regulatory approval.

The Transaction is anticipated to close no later than December 15, 2004. Nahanni is an oil and gas exploration and production company with current production of approximately 190 boe per day. The majority of the Nahanni's production is located in Western Saskatchewan. In addition to acquiring producing properties, Arsenal will also benefit from Nahanni's inventory of land and drilling opportunities. Upon completion of the transaction Arsenal will have daily production of approximately 650 boe per day.

Forward Looking Information

This document contains forward looking statements relating to financial condition, results, reserves, development, cash flows among other matters. These forward looking statements are estimates in the best judgment of Arsenal Energy Inc. They involve a number of known and unknown risks and uncertainties including but not limited to commodity prices, drilling costs, exploration success rate, interest rate changes and environmental items that could cause actual results to differ materially from those suggested in the statements. Reader is cautioned not to place undue reliance on these forward looking statements which speak only as of the date they were made. Additionally, we do not undertake to any obligation to publicly release any revisions to these forward looking statements.

The accompanying unaudited interim financial statements of Arsenal Energy Inc. have been prepared by management and approved by the audit committee and Board of Directors of the Corporation. These statements have been reviewed by the Corporations external auditors.

Dated September 30, 2004

signed

President and Chief Executive Officer
Michael Vandale

ARSENAL ENERGY INC.

Consolidated Balance Sheet

	September 30 2004 (unaudited)	December 31 2003 (restated)
Assets		
Current Assets		
Cash and short-term deposits	\$ 292,054	\$ 743,580
Accounts receivable	<u>644,963</u>	<u>93,439</u>
	937,017	837,019
Property Plant and Equipment (note 3)	8,617,587	2,052,837
Reclamation Bonds (note 4)	223,340	-
	<u>\$ 9,777,944</u>	<u>\$ 2,889,856</u>
Liabilities and Shareholders Equity		
Current Liabilities		
Accounts payable	\$ 652,650	\$ 535,514
Revolving demand loan (note 5)	3,700,000	-
Current portion of deferred revenue	<u>352,650</u>	<u>-</u>
	4,705,300	535,514
Other Liabilities		
Deferred revenue (note 6)	352,650	-
Asset retirement obligation (note 7)	684,345	106,582
Future income tax	<u>133,509</u>	<u>183,760</u>
	1,170,504	290,342
Shareholders Equity		
Share capital (note 8)	4,403,216	2,163,533
Warrants (note 8)	131,442	
Contributed surplus (note 8)	98,354	59,990
Retained earnings (deficit)	<u>(730,872)</u>	<u>(159,523)</u>
Subsequent Events (note 13)	3,902,140	2,064,000
	<u>\$ 9,777,944</u>	<u>\$ 2,889,856</u>

ARSENAL ENERGY INC.

Consolidated Statement of Operations and Deficit

	Nine Months Ended		Three Months Ended	
	Sept. 30	Sept. 30	Sept. 30	Sept. 30
	2004	2003	2004	2003
	(unaudited)	(restated) (unaudited)	(unaudited)	(restated) (unaudited)
Revenue				
Oil and gas sales	\$ 1,261,940	\$ 650,952	\$ 894,574	\$ 181,523
Royalty income	34,667	46,899	3,992	24,424
Royalties and production taxes	<u>(246,670)</u>	<u>(107,585)</u>	<u>(182,380)</u>	<u>(31,767)</u>
	1,049,937	590,266	716,186	174,180
Expenses				
Oil and gas production	356,291	171,426	268,595	85,940
Depreciation, depletion and accretion	278,548	132,336	163,105	40,136
Bank financing charges	56,611	-	56,611	-
Stock based compensation (note 8(f))	38,364	-	25,645	-
General and administrative	<u>480,559</u>	<u>238,538</u>	<u>241,143</u>	<u>50,250</u>
	1,210,373	542,300	755,099	176,326
Net (loss) earnings before tax	(160,436)	47,966	(38,913)	(2,146)
Future income tax provision (note 9)	<u>11,919</u>	-	-	-
Earnings (loss) for the period	(172,355)	47,966	(38,913)	(2,146)
Deficit beginning of period	(159,523)	(200,098)	(281,046)	(154,219)
Reduction on acquisition of Orange Exploration	(398,994)			
Deficit end of period	<u>\$ (730,872)</u>	<u>\$ (152,132)</u>	<u>\$ (319,959)</u>	<u>\$ (156,365)</u>
<u>Earnings per share</u>				
Basic	\$ (0.02)	\$ 0.01	\$ -	\$ -

ARSENAL ENERGY INC.

Consolidated Statement of Cash Flows

	Nine Months Ended		Three Months Ended	
	Sept. 30	Sept. 30	Sept. 30	Sept. 30
	2004	2003	2004	2003
	(unaudited)	(restated) (unaudited)	(unaudited)	(restated) (unaudited)
Cash provided by (used in):				
Operations:				
Earnings (loss) for the period	(172,355)	47,966	(38,913)	(2,146)
Items not involving cash:				
Decrease in deferred Revenue	(30,229)	-	(30,229)	-
Stock based compensation	38,364	-	38,364	-
Future income tax provision	11,919	-	-	-
Depreciation, depletion and accretion	278,548	132,336	163,105	40,136
Cash flow from operations	126,247	180,302	119,608	37,990
Changes in non-cash working capital	(434,388)	45,051	20,572	207,618
	(308,141)	225,353	140,180	245,608
Financing:				
Increase in bank debt	3,700,000	360,000	3,700,000	(10,000)
Deferred revenue	735,529	-	735,529	-
Cash acquired on Legend amalgamation	-	253,262	-	-
Amalgamation costs	-	(42,139)	-	(1,886)
Shareholder loans	-	303,733	-	303,733
Issuance of shares	1,665,041	-	1,026,380	-
	6,100,570	874,856	5,461,909	291,847
Investing:				
Reclamation bonds	223,340	-	223,340	-
Property, plant and equipment	6,020,615	1,096,546	5,239,622	535,381
	6,243,955	1,096,546	5,462,962	535,381
Increase in cash and short-term deposits	(451,526)	3,663	139,127	2,074
Cash and short-term deposits, opening	743,580	2,991	152,928	4,580
Cash and short-term deposits, closing	292,055	6,654	292,055	6,654

ARSENAL ENERGY INC.

Notes to the Consolidated Financial Statements

Nine months ended September 30, 2004

1. Incorporation and organization of the Company:

Arsenal Capital Inc. was incorporated under the *Business Corporations Act* (Alberta). During 2002, the Company completed its qualifying transaction and changed its name to Arsenal Energy Inc.

2. Significant accounting policies:

The consolidated statements have been prepared in accordance with accounting principles generally accepted in Canada. In management's opinion, all adjustments necessary for fair presentation have been reflected in the financial statements. All adjustments made are normal and recurring in nature. The Company has followed the same accounting policies and methods of application as the most recent audited financial statements, except as stated here within. These statements should be read in conjunction with the December 31, 2003 audited statements.

(a) Asset retirement obligations:

Effective January 1, 2004, the Company adopted the new Canadian accounting standard for asset retirement obligations. The new standard requires the Company to record the fair value of an asset retirement obligation as a liability in the period in which it incurs a legal obligation associated with the retirement of tangible long-lived assets that result from the acquisition, construction, development, and/or normal use of the assets. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset and depleted and depreciated using a unit of production method over estimated gross proved reserves. Subsequent to the initial measurement of the asset retirement obligations, the obligations are adjusted at the end of each period to reflect the passage of time and changes in the estimated future cash flows underlying the obligation. The effect of adoption of the new standard on the financial statements is disclosed in note 7.

ARSENAL ENERGY INC.

Notes to the Consolidated Financial Statements, Page 2

Nine months ended September 30, 2004

(b) Full cost ceiling test:

Effective January 1, 2004, the Company adopted the new Canadian accounting guideline for the full cost method of accounting for oil and gas activities. The new guideline requires a detailed impairment calculation be prepared annually, or when events or circumstances indicate a potential impairment of the carrying amount of oil and gas assets may have occurred.

An impairment loss is recognized when the carrying amount of a cost centre is not recoverable and exceeds its fair value. The carrying amount is assessed to be recoverable when the sum of the undiscounted cash flows expected from proved reserves plus the cost of unproved interests, net of impairments, exceeds the carrying amount of the cost centre. When the carrying amount is assessed not to be recoverable, an impairment loss is recognized to the extent that the carrying amount of the cost centre exceeds the sum of the discounted cash flows from proved and probable reserves plus the cost of unproved interests, net of impairments, of the cost centre. The cash flows are estimated using expected future product prices and costs and are discounted using a risk-free interest rate. Adoption of the new guideline had no effect on the Company's financial statements. The future prices used in the initial adoption ceiling test are disclosed in note 3.

Prior to January 1, 2004, an impairment loss was recognized when the carrying amount of a cost centre exceeded its recoverable amount. The recoverable amount was the sum of the undiscounted cash flows expected from the production of proved reserves plus the lower of cost or market of unproved interests less estimated future costs for administration, financing and site restoration. The cash flows were estimated using period prices and costs.

ARSENAL ENERGY INC.

Notes to the Consolidated Financial Statements, Page 3

Nine months ended September 30, 2004

2. Significant accounting policies:

(c) Hedging relationships:

Effective January 1, 2004, the Company adopted the new Canadian accounting guideline relating to hedging relationships which require the identification, designation and documentation of each hedging relationship as well as an assessment of the effectiveness of the hedging relationship. The guideline does not specify how hedge accounting is applied, and accordingly, the Company's derivative financial instrument accounting policy in the 2003 annual consolidated financial statements remains unchanged. Adoption of the new guideline had no effect on the Company's financial statements. The Company has not entered into any hedging arrangements as of September 30, 2004.

(d) Stock-based compensation:

Effective January 1, 2004, the Company retroactively adopted the revised Canadian accounting standard for stock-based compensation and other stock-based payments without restatement of prior periods. Under the fair value method, compensation cost attributable to all stock options granted to employees and directors is measured at fair value at the grant date and expensed over the vesting period with a corresponding increase to contributed surplus. Upon the exercise of the option, consideration received together with the amount previously recognized in the contributed surplus is recorded as an increase to share capital. The effect of adoption of the revised standard on the financial statements is disclosed in note 8(f).

Prior to January 1, 2004, no compensation cost was recorded for stock options granted to employees and directors. The Company previously disclosed the pro forma effect of accounting for these awards under the fair value based method.

(e) 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.

ARSENAL ENERGY INC.

Notes to the Consolidated Financial Statements, Page 4

Nine months ended September 30, 2004

3. Property, plant and equipment:

September 30, 2004	Cost	Accumulated depreciation	Net book value
Petroleum and natural gas properties and equipment	\$ 8,480,587	\$ 601,125	\$ 7,879,462
Asset retirement obligation	684,345	-	-
684,345 Other equipment	66,245	12,465	53,780
	\$ 9,231,177	\$ 613,590	\$ 8,617,587
December 31, 2003 (restated)	Cost	Accumulated depreciation	Net book value
Petroleum and natural gas properties and equipment	\$ 2,235,519	\$ 316,310	\$ 1,919,209
Asset retirement obligation	106,582	-	-
106,582 Other equipment	33,908	6,862	27,046
	\$ 2,376,009	\$ 323,172	\$ 2,052,837

On August 31, 2004 the Company completed the acquisition of certain oil and gas properties in North Dakota for total cash consideration of \$5,418,162.

ARSENAL ENERGY INC.

Notes to the Consolidated Financial Statements, Page 5

Nine months ended September 30, 2004

3. Property and equipment (continued):

Adoption of the new accounting guideline on full cost accounting, as outlined in note 2(b), had no effect on the Company's financial statements. The future commodity prices used in the ceiling test prepared on initial adoption were based on September 30, 2004 commodity price forecasts of our independent reserve engineers adjusted for differential specific to the Company reserves. The following table summarizes the future benchmark prices the Company used in the ceiling test:

\$CDN.	Oil Price	Oil Price	Gas Price	Gas Price
	\$Cdn/bbl	\$Cdn/bbl	\$Cdn/mcf	\$Cdn/mcf
	Cdn.	U.S.	Cdn.	U.S.
	Properties	Properties	Properties	Properties
2004	\$56.90	\$54.35	\$6.66	\$7.39
2005	\$51.55	\$49.03	\$6.66	\$7.38
2006	\$47.20	\$44.71	\$6.52	\$7.23
2007	\$45.40	\$42.92	\$5.93	\$6.66
2008	\$43.50	\$41.00	\$5.73	\$6.46
Annual escalation thereafter	1.50%	1.50%	1.50%	1.50%

4. Reclamation bonds:

As at September 30, 2004 the Company had \$223,340 on deposit with the U.S. Federal and State governments for future site reclamation activities. These funds will be returned when the Company abandons and reclaims well sites in the U.S.

5. Bank loan and promissory notes:

The Company has available a demand operating loan in the amount of \$4,000,000 bearing interest at the bank prime rate plus 1.0% per annum and 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 US assets.

6. Deferred revenue:

The Company entered into a crude oil sale contract during the period fixing the price of future production of 180 barrels per day for two years at \$46.93CDN. The Company received a prepayment on the contract equal to an incremental \$5.59CDN per barrel which will applied based on deliveries over the life of the contract. This sale contract is not considered a hedge for accounting purposes.

ARSENAL ENERGY INC.

Notes to the Consolidated Financial Statements, Page 6

Nine months ended September 30, 2004

7. Asset retirement obligations:

The Company's asset retirement obligations result from net ownership interests in petroleum and natural gas assets including well sites, gathering systems and processing facilities. The company estimates the total undiscounted amount of cash flows required to settle its asset retirement obligations is approximately \$1,144,957 which will be incurred between 2005 and 2033. A credit-adjusted risk free rate of 6.5 percent was used to calculate the fair value of the asset retirement obligations.

A reconciliation of the asset retirement obligations is provided below:

	Nine month period ended September 30 2004	Year ended 31-Dec 2003
		(restated)
Balance, beginning of period	\$106,582	\$68,840
Accretion expense	-	14,708
Adjustment for Acquisitions	577,763	-
Liabilities incurred	-	23,034
Balance, end of period	\$684,345	\$106,582

ARSENAL ENERGY INC.

Notes to the Consolidated Financial Statements, Page 7

Nine months ended September 30, 2004

8. Share capital:

(a) Authorized:

Unlimited number of common shares; and

Unlimited number of preferred shares, issuable in series (of which none have been issued).

(b) Issued common shares, warrants and contributed surplus:

Common shares	Number of shares	Consideration
Balance, December 31, 2003	8,740,836	\$2,163,533
Issued on acquisition of Orange Exploration Inc. (note 10)	1,850,000	550,375
Stock Options exercised	100,000	20,000
Private placement of common share	2,897,831	1,769,903
Share issue costs (net of tax effect of 62,170)	–	(100,595)
Balance, September 30, 2004	13,588,667	\$ 4,403,216

Warrants

	Amount
Balance, December 31, 2003	\$ -
Warrants issued on acquisition of Orange Exploration (note 10)	80,820
Private placement of warrants	50,622
Balance, September 30, 2004	\$ 131,442

Contributed Surplus

	Amount
Balance, December 31, 2003	\$ 59,990
Issuance of stock options	38,364
Balance, September 30, 2004	\$ 98,354

The fair value of each warrant and agents option granted is estimated on the date of issuance using the Black-Scholes option pricing model with the following weighted average assumptions used for grants during the nine months period ended September 30, 2004: zero dividend yield; expected volatility of 80%; risk free rate of 4%; and an expected life of 2 to 5 years. This resulted in fair values of agents options and warrants issued ranging from \$0.06 to \$0.32 per option or warrant.

ARSENAL ENERGY INC.

Notes to the Consolidated Financial Statements, Page 8

Nine months ended September 30, 2004

8. Share capital (continued):

(c) 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 September 30, 2004 \$325,000 is owed by the officer and director. The shares have not been recognized as issued for accounting purposes.

(d) Flow through shares:

In the nine months ending September 30, 2004 the Company executed subscriptions for 1,000,000 flow-through shares for proceeds of \$1,000,000.

Arsenal is committed to incur income tax attributes associated with oil and gas exploration and development activities pursuant to a \$1,400,000 flow-through common share financing in December 2003. By September 30, 2004 the Company had incurred \$502,000 of qualifying expenditures, with \$898,000 to be incurred by December 31, 2004. Subsequent to September 30, 2004 Arsenal advanced \$326,000 towards a prospect expected to begin drilling during the last week of November, 2004.

(e) Stock options:

The Corporation has a stock option plan in which the Company may grant options to employees, directors and officers of the company. As at September 30, 2004 the Company has granted a total of 1,490,000 options ranging in exercise price from \$0.20 to \$0.50. The options expire five years from their grant date and vest evenly over an 18 month period. The weighted average contractual life in years of the options outstanding at September 30, 2004 was 4 years.

<u>No. of Stock Options</u>	<u>Date Granted</u>	<u>Price per Common Share</u>	<u>Expiry Date</u>
175,568	21-Dec-00	\$0.20	21-Dec-05
40,000	4-May-04	\$0.23	4-May-09
974,432	29-May-03	\$0.20	29-May-08
<u>300,000</u>	19-Jul-04	\$0.50	19-Jul-09
1,490,000			

ARSENAL ENERGY INC.

Notes to the Consolidated Financial Statements, Page 9

Nine months ended September 30, 2004

(f) Stock-based compensation:

The fair value of each option grant is estimated on the date of issuance using the Black-Scholes option pricing model with the following weighted average assumptions used for grants during the nine months period ended September 30, 2004: zero dividend yield; expected volatility of 80%; risk free rate of 4%; and an expected life of 5 years. This resulted in fair values of options issued ranging from \$0.37 to \$0.53 per option.

The effect of the change in accounting policy as outlined in note 2(d) has been recorded retroactively without restatement of prior periods. At January 1, 2004, the effect of the change resulted in an increase to contributed surplus and an offsetting decrease to retained earnings of \$43,290.

9. Income taxes:

The combined provincial, federal and state effective tax rate for the period was 38%.

10. Business acquisition:

On March 24, 2004 the Company acquired 100% of the issued and outstanding shares of Orange Exploration Inc. As a result of the acquisition, Arsenal issued 1,850,000 common shares of Arsenal and an aggregate of 1,200,000 share purchase warrants. Each warrant is exercisable into one (1) common share of Arsenal at an exercise price of \$0.53 per share on or before March 24, 2005. This transaction was a related party transaction in that both companies had common ownership and control. The acquisition was accounted for as a purchase based on the fair value of the consideration paid which was equal to \$631,194. The asset was recorded in property, plant and equipment at the carrying value of Orange Exploration of \$232,200, the difference between the fair value of the consideration given and the carrying value, \$398,994 was booked as a reduction of retained earnings. The fair value of the share purchase warrants granted was calculated using the following assumptions: zero dividend yield; expected volatility of 80%; risk free rate of 4%; and an expected life of 1 year. This resulted in fair a value \$0.07 per option.

ARSENAL ENERGY INC.

Notes to the Consolidated Financial Statements, Page 10

Nine months ended September 30, 2004

11. Fair Value of Financial Instruments:

The Company's financial instruments recognized in the balance sheet consist of accounts receivable, accounts payable, reclamation bonds and accrued liabilities. The fair value of these financial instruments approximate their carrying amounts due to their short terms to maturity.

At September 30, 2004 the estimated fair value of financial instrument transactions consisting of a crude oil sale contract was negative \$380,000. This amount represents the estimated fair value based on market values at September 30, 2004 and represents an estimate of what the Company would pay to terminate the contract.

12. Related party transactions:

As at September 30, 2004 the Company was owed \$8,186 from a Director and an Officer of the Company. The amount owing relates to advances against consulting fees.

13. Subsequent events:

Subsequent to September 30, 2004 the Company completed first close of a private placement financing for gross proceeds of \$1,090,250. The Company issued 1,453,666 units at subscription price of \$0.75 per unit. The Company has committed to a second and final closing of up to an additional 2,546,334 units. Each unit consisted of a common flow through share and a full warrant with an exercise price of \$1.00 expiring 12 months from the date of issuance. The Company will renounce 100% of the tax pools related to the flow through funds.

On November 25th the Company entered into an Offer to Purchase Agreement to acquire 100% of the issued and outstanding shares of Nahanni Oil and Gas Ltd. for total consideration of \$3,000,000. The consideration will be satisfied through the issuance of 1,000,000 common shares of Arsenal Energy Inc. at a deemed price of \$0.75 per share and a cash payment of \$2,250,000. The acquisition is subject to due diligence and regulatory approval.

Subsequent to September 30, 2004 the Company issued 865,000 stock options to directors, officers and employees of the Company. The options vest evenly over an 18 month period, have an exercise price of \$0.59 and expire in October of 2009.