

## 04: DEFINING MOMENTS



ARSENAL ENERGY INC.  
Annual Report

# ARSENAL ENERGY INC.

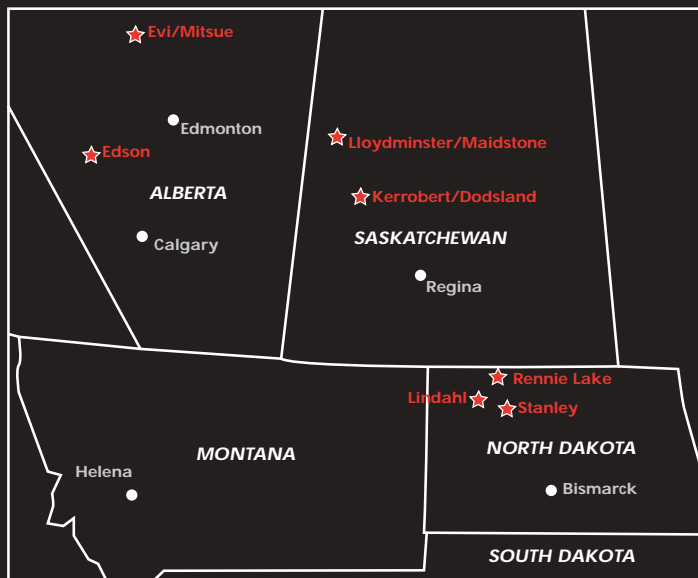


## CORPORATE PROFILE

Arsenal Energy Inc. is an oil and gas exploration company located in Calgary, Alberta, Canada. The mandate of the Company is to explore for oil and natural gas both domestically and internationally.

As we enter 2005, we strive to keep the momentum that we generated in 2004. We are confident that 2005 will be a terrific year for our company. We will continue to seek acquisitions that are accretive, while also enhancing value through the drill bit. We look forward to continued value creation and growth in 2005 and beyond.

## MAIN AREAS



## 04: HIGHLIGHTS

### SUMMARY OF OPERATING & FINANCIAL RESULTS

	Three Months Ended December 31		Twelve Months Ended December 31	
	2004	2003	2004	2003
		Restated <sup>1</sup>		Restated <sup>1</sup>
<b>FINANCIAL</b>				
Cash flow from operations <sup>2</sup> (\$)	92,492	(77,159)	287,764	103,143
Per unit - basic and diluted (\$)	0.01	(0.01)	0.02	0.02
Bank debt (\$)	3,743,852	-	3,743,852	-
Operating costs per boe (\$)	19.31	12.19	17.60	11.52
Operating netbacks per boe (\$)	15.05	21.70	18.26	26.40
<b>Market</b>				
Shares outstanding				
End of period	18,989,706	8,740,836	18,989,706	8,740,836
Weighted average - basic	14,759,445	5,965,439	11,837,622	5,965,439
Weighted average - diluted	15,603,505	6,241,151	12,681,693	6,241,151
Shares trading				
High (\$)	1.00	0.70	1.00	0.70
Low (\$)	0.59	0.41	0.59	0.12
Close (\$)	0.85	0.60	0.85	0.60
Average daily volume	19,000	5,000	13,200	5,000
<b>OPERATIONS</b>				
<b>Daily production (average)</b>				
Crude oil (bbl)	369	70	152	58
NGLs (bbl)	32	1	11	1
Natural gas (mcf)	245	6	82	6
Total (boe) <sup>3</sup>	442	72	177	60
<b>Realized commodity prices (\$Cdn.)</b>				
Total crude oil (bbl)	49.62	43.12	49.83	42.84
NGLs (bbl)	49.54	31.37	47.01	32.55
Natural gas (mcf)	7.77	6.61	7.52	6.49
Average (boe) <sup>3</sup>	45.68	42.24	46.36	41.94
<b>Reference pricing</b>				
WTI (\$U.S./bbl)	48.28	31.18	41.40	31.04
AECO gas (\$Cdn./mcf)	7.08	5.59	6.79	6.70
Foreign Exchange (\$U.S./\$Cdn.)	1.22	1.32	1.33	1.40

<sup>1</sup> Various 2003 amounts have been restated to reflect changes in accounting policies.

<sup>2</sup> Management's Discussion and Analysis contains the term cash flow from operations, which should not be considered to be an alternative to, or more meaningful than net income as determined in accordance with Canadian generally accepted accounting principles as an indicator of the Company's performance. The company presents cash flow from operations per share whereby per share amounts are calculated consistent with the calculation of earnings per share.

<sup>3</sup> 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.



*There is no question that the company that exited 2004 was fundamentally different than the one that entered it. Production increased from 60 barrels of oil equivalent per day to 912 barrels of oil equivalent per day, with commensurate increases in both commodity revenues and aggregate cash flows.*

### OPERATIONS IN REVIEW

2004 was a strong year for oil and gas producers in the western Canadian sedimentary basin. Record commodity prices, new drilling and optimization technologies combined to generate above average returns for most producers. For Arsenal it was the year in which the foundation was laid for future growth and the generation of shareholder value. Starting with the acquisition of properties in North Dakota, we were able to create momentum that continued with the acquisition of Nahanni Oil and Gas Ltd. and IC Energy Ltd. in the first quarter of 2005.

#### **North Dakota**

These light sweet crude properties were acquired on August 31, 2004. Production has remained stable throughout the year at 400 barrels of oil equivalent per day. These properties are notable for their stable long life production.

#### **Lloydminster**

These properties were initially acquired through the Nahanni acquisition in December 2004. After a six well drilling program during December 2004 and January 2005, production from the Lloydminster area was approximately 600 barrels of oil equivalent per day. We have identified an additional six locations on our existing lands, which will be undertaken during 2005.

#### **Maidstone**

These properties were acquired on March 31, 2005 through acquisition of IC Energy Ltd. At the date of acquisition production from these properties was approximately 775 barrels of oil equivalent. These properties are in close proximity to the Lloydminster lands, enabling us to exploit certain operating efficiencies between both areas.



## 04: DEFINING MOMENTS



### **Northwest Alberta**

We continued to acquire land and enter into farm-in agreements on lands in northwest Alberta. One well was drilled at Edson during December 2004 and January 2005 which continued to be evaluated and tested by the operator during the first quarter of 2005. One additional well is anticipated to be drilled at Edson this summer, and with the operator Arsenal acquired an additional 5 sections of land in the area.

We signed farm-in agreements for a three well program at Evi (south) and Mitsue, with an option for additional locations at Kaybob and Evi.

### **Reserves**

Reserves increased significantly over 2003, reflecting the acquisitions and drilling completed during the year. We completed an additional evaluation of our properties at March 31, 2005 after the acquisition of IC Energy Ltd. Proved, probable, and possible reserves totaled 5 million barrels of oil equivalent, while proved plus probable reserves totaled 3.2 million barrels of oil equivalent, compared to 0.136 million proved barrels of oil equivalent at December 31, 2003.

At March 31, 2005 the 10 percent discounted value at a forecast price of proved, probable, and possible reserves was \$49.5 million, compared to \$1.3 million at December 31, 2003.

The constant price evaluation of the proven, probable, and possible oil and gas reserves of Arsenal was \$73 million.

### **Commodity Pricing**

Heavy oil pricing was significantly impacted by disruptions in the western Canadian synthetic crude oil and heavy crude markets. Due to maintenance and equipment failures industry bitumen upgraders were off production in December and bitumen streams normally moved into the synthetic market were diverted into the heavy crude oil market. This reduced the amount of upgrading capacity and increased the amount of heavy crude oil on the markets, significantly increasing the price differentials for heavy oil. Diluent costs increased to reflect the great demand requirements. At the time of printing these issues have largely been resolved. The heavy oil price differential has reduced to near historical averages, however diluent costs remain high. As the summer season approaches and heavy oil demand peaks, we expect to see a full recovery of the heavy oil market, as differentials return to the historical average of 30 percent of WTI.



Light sweet crude oil continues to test historical highs with increasing demand from Asia and stagnant global production. It is anticipated in the market that WTI will remain above \$45 U.S for the remainder of the year, and potentially could increase to record highs if Asian demand increases or there is a supply shock.

Natural gas has remained well above historical averages for the past year, and is expected to continue to remain above those averages in the short term, as infrastructure constraints continue to restrict supply.

### **Outlook**

As we enter 2005, we strive to keep the momentum that we generated in 2004. We will continue to seek acquisitions that are accretive, while also generating value through the drill bit. The Nahanni and IC Energy Ltd. acquisitions were completed based on attractive flowing metrics of under \$15,000 per barrel of oil equivalent. We also enjoyed a successful drilling program in December which resulted in an incremental 300 barrels of oil equivalent per day of production.

We are confident that 2005 will be a terrific year for our company. We are currently producing 1,800 barrels of oil equivalent per day, we have an excellent inventory of drilling locations of low risk, and we have a strong team of people with the ability to execute on our initiatives. We look forward to continued value creation and growth in 2005 and beyond.

On behalf of the Board of Directors,



**Michael S. Vandale**  
*President*



## CORPORATE HIGHLIGHTS

- Generation of exceptional shareholder returns. At December 31, 2004 we achieved a 45% growth in share price during 2004. At the time of printing our share price was 150% greater than at the beginning of January 2004.
- Proved reserves increased 2100 percent to 3.02 mmbœ from 0.136 mmbœ in 2003.
- The acquisition of 400 barrels of light oil equivalent in North Dakota closing on August 31, 2004.
- The acquisition of Nahanni Oil and Gas Ltd. on December 15, 2004. At the date of acquisition Nahanni was producing 190 barrels of oil equivalent per day, after a successful drilling program in December 2004 and January 2005 production increased to over 500 barrels of oil equivalent per day.
- Assembling of a land inventory in Alberta and Saskatchewan. In Alberta our targets include natural gas and light sweet crude. In Saskatchewan our targets are low risk developmental heavy crude.
- On March 31, 2005 we acquired IC Energy Ltd., a privately held oil and gas producer in southwest Saskatchewan. After the close of this acquisition the company was producing 1,800 barrels of oil equivalent per day.

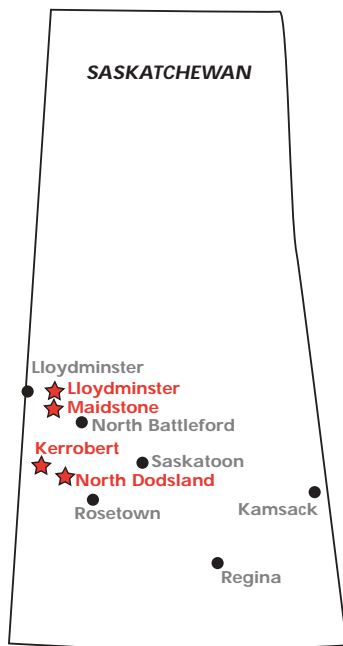
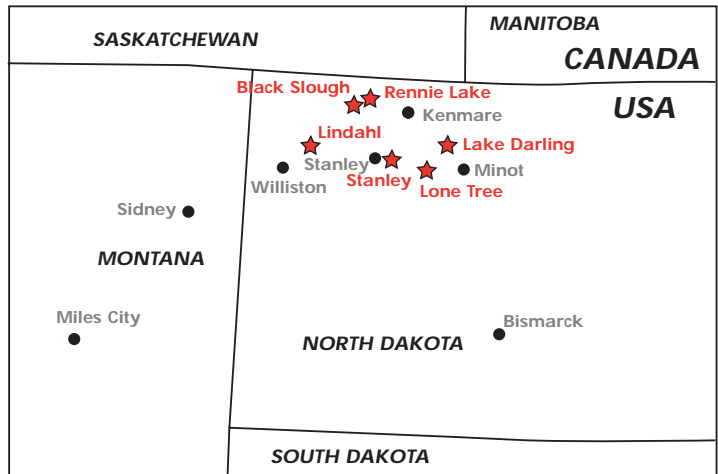
*For 2005 we have initiated a plan to further grow the company based on the following principles:*

- Maintain a strong balance sheet and practice financial discipline.
- Pursue accretive acquisitions in our core areas where operating efficiencies and synergies can be exploited.
- Grow production and reserves organically through the drill bit. Management has developed a drilling program for 2005 and beyond that is a combination of developmental and exploratory drilling with an aggregate risk profile befitting a company of our size.
- Continue to attract top talent to our company. During 2004 and 2005 we added key members to our management team and board of directors. In November Bernie Dumanowski, P. Eng., was added as VP of Operations, and Lyle Skaien, P. Eng was added to our board. In January 2005 Jesse Meidl, CA joined as Chief Financial Officer. In the field we retained the operators from both Nahanni and IC who will ensure that those properties continue to be operated as cost effectively as possible.

## AREAS OF OPERATIONS

### North Dakota, USA

The six operating properties (fields) in North Dakota are Black Slough, Rennie Lake, Lindahl, Lake Darling, Stanley and Lone Tree, acquired from Nexen on August 31, 2004. The production of approximately 400 barrels of oil equivalent per day from these light sweet oil properties is characterized by their stable long life production. Future production optimization and select workovers are anticipated in 2005. No wells were drilled in 2004.



### Lloydminster, Saskatchewan

Arsenal entered the Lloydminster area through the corporate acquisition of Nahanni Oil & Gas Ltd. on December 15, 2004. The fields in this area are Tangleflags, Lashburn and Dee Valley. This acquisition added approximately 190 barrels of oil equivalent per day to Arsenal's existing production base. Four wells were drilled in December 2004 and two wells were drilled in January 2005 plus one oil well reactivation. The activity lifted the production rate for this area to approximately 500 barrels of oil equivalent per day. Six additional drill locations have been identified for 2005.

### Maidstone, Saskatchewan

Maidstone was acquired through the corporate acquisition of IC Energy Ltd. on March 31, 2005. The Maidstone area is in close proximity and is a complement to the Lloydminster area. Arsenal acquired a stand alone water disposal facility in addition to the 775 barrels of oil equivalent per day of production. This facility will aid in reducing Arsenal's operating costs in both areas. The Maidstone field also has numerous

reactivation-workover candidates based on previous successful workover attempts coupled with further production optimization. Arsenal has identified twelve drilling locations for the Maidstone field for 2005.



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### **Kerrobert, Saskatchewan**

No new activities undertaken in 2004 or planned for 2005 for the Kerrobert area.

### **North Dodsland, Saskatchewan**

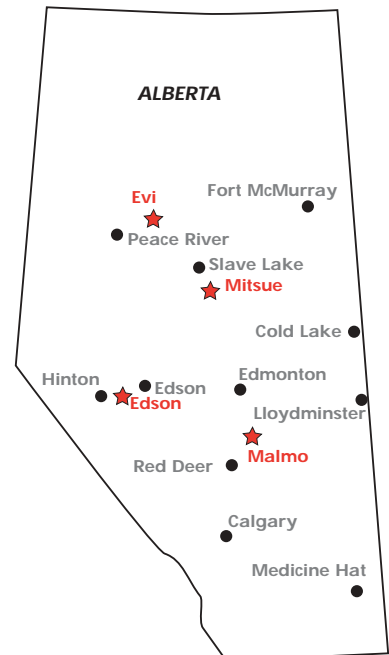
No new activities were undertaken in 2004 or planned for 2005 by the Company in the North Dodsland Viking Voluntary Unit.

### **Edson, Alberta**

Arsenal entered this area through a farm-in agreement during the fourth quarter of 2004. One well was drilled during December 2004 resulting in a standing cased gas well. The completion, testing and evaluation are slated to be completed during the first quarter of 2005. Arsenal acquired an additional five sections of land in the area in February 2005. The completion of the cased gas well and tie-in is anticipated to conclude during the second quarter of 2005. One additional well is scheduled to be drilled during the summer of 2005.

### **Northern Alberta**

Arsenal has signed a farm-in agreement for a three well drilling program in the Evi (South) and Mitsue fields. Arsenal has an option for additional drill locations in the Kaybob and Evi fields. Arsenal will be the designated operator in these areas.



## RESERVES

Arsenal obtained an evaluation of its reserves at December 31, 2004. In conjunction with the acquisition of IC Energy Ltd. on March 31, 2005, the Company obtained an update of its properties and has filed a Notice of Material Change which can be found at [www.sedar.com](http://www.sedar.com) along with the Statement of Reserves Data and Other Oil and Gas Information Form, dated and filed April 13, 2005.

Arsenal's reserves were evaluated by AJM Petroleum Consultants ("AJM") effective as at March 31, 2005 in a report dated April 7, 2005. The Reserve Committee of the Board of Directors, consisting entirely of independent directors, has met with a representative of AJM and has reviewed the report in accordance with its mandate.

The AJM report was prepared in accordance with National Instrument 51-101, Standards of Disclosure for Oil and Gas Activities ("NI 51-101"). This instrument adopted by the Canadian Securities Administrators, sets out standards of disclosure for oil and gas activities and mandates the application of evaluation standards defined in the Society of Petroleum Evaluation Engineers (SPEE) Canadian Oil and Gas Evaluation Handbook (COGEH). The information that follows has been derived from the AJM evaluation.

The estimates of reserves are subject to revisions as additional reservoir and performance information becomes available, and contain judgments of future events for which actual results may vary materially from those disclosed. The estimated future net revenues are reduced for estimated future abandonment costs and Saskatchewan Capital tax costs.

### SUMMARY OF OIL AND GAS RESERVES AND NET PRESENT VALUES AS OF MARCH 31, 2005

	Crude Oil (mdbl)	Natural Gas (mmcf)	NGL (mdbl)	Oil Equiv. (mboe)
<b>FORECAST PRICES AND COSTS</b>				
<b>Marketable reserves</b>				
Proved producing	2,343	1,855	280	2,932
Proved undeveloped	94	-	-	94
Total proved	2,437	1,855	280	3,026
Probable	673	94	4	693
Total proved plus probable	3,110	1,949	284	3,719
Possible	1,300	-	-	1,300
Total proved plus probable plus possible	4,410	1,949	284	5,019
<b>Present values before income taxes in (000's) (SCdn.)</b>				
	<b>Undisc.</b>	<b>5%</b>	<b>10%</b>	<b>15%</b>
Proved producing	51,794	36,492	30,317	26,733
Proved undeveloped	1,099	846	672	549
Total proved	52,893	37,338	30,989	27,282
Probable	10,190	7,392	5,722	4,958
Total proved plus probable	63,083	44,730	36,711	32,240
Possible	17,615	14,990	12,877	12,526
Total proved plus probable plus possible	80,698	59,720	49,588	44,766



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### SUMMARY OF OIL AND GAS RESERVES AND NET PRESENT VALUES AS OF MARCH 31, 2005

	Crude Oil (mdbl)	Natural Gas (mmcf)	NGL (mdbl)	Oil Equiv. (mboe)
<b>CONSTANT PRICES AND COSTS</b>				
<b>Market Reserves</b>				
Proved producing	2,413	1,869	278	3,003
Proved undeveloped	98	-	-	98
Total proved	2,511	1,869	278	3,101
Probable	699	95	4	719
Total proved plus probable	3,210	1,964	282	3,819
Possible	1,300	-	-	1,300
Total proved plus probable plus possible	4,510	1,964	282	5,119
<b>Present values before income taxes in (000's) (\$Cdn.)</b>				
	<b>Undisc.</b>	<b>5%</b>	<b>10%</b>	<b>15%</b>
Proved producing	74,960	52,766	42,519	36,392
Proved undeveloped	2,637	1,947	1,504	1,201
Total proved	77,597	54,713	44,023	37,593
Probable	18,068	12,369	9,144	7,136
Total proved plus probable	95,665	67,082	53,167	44,729
Possible	27,546	23,174	19,765	17,055
Total proved plus probable plus possible	123,211	90,256	72,932	61,784



## FINDING AND DEVELOPMENT COSTS

Finding and development costs ("F&D") costs per oil-equivalent barrel is a performance measure ratio. F&D costs per barrel are costs incurred in property acquisition and exploration (finding), plus costs incurred in development activities divided by oil-equivalent reserves additions, excluding sales.

(SCdn.)	2004	
	Proved	Proved Plus Probable
<b>FORECAST PRICING</b>		
<b>Capital</b>		
Exploration and development	2,542,586	2,542,586
Acquisition <sup>1</sup>	18,593,478	18,593,478
Total capital incurred during the year	21,136,064	21,136,064
Future capital at March 31, 2005	3,540,000	4,054,00
Future capital at January 1, 2004	2,320,000	2,320,000
Change in future capital	1,220,000	1,734,000
Total capital	22,356,064	22,870,064
<b>Reserves (boe)</b>		
Reserves at March 31, 2005	3,026,167	3,718,833
Reserves at December 31, 2004	137,000	153,000
Reserve additions (boe)	2,889,167	3,565,833
Finding and development costs	7.74	6.41

<sup>1</sup> Includes acquisition of IC Energy Ltd. which closed March 31, 2005.

## RESERVE LIFE INDEX

The reserve life index is calculated by dividing reserves as at the effective date of the report, March 31, 2005, by the production for the applicable period. This represents a measure of the amount of time production could be sustained at the production rates based on the reserves at the applicable point in time. Based on March 31, 2005 reserves and production at that time, sufficient reserves exist to continue production at the current rate for approximately seven years based on proved plus probable reserves, and eight years based on proved reserves.

	2004	
	Proved	Proved Plus Probable
<b>Reserve life years</b>		
Crude oil and NGL's <sup>1</sup>	6.63	7.31
Natural Gas <sup>1</sup>	8.43	9.43
Total boe	6.86	8.23

<sup>1</sup> Forecast pricing

## RESERVE RECYCLE RATIO

The reserve recycle ratio is calculated by dividing the operating netback (sales less royalties less operating costs) on a per share basis by the finding and developing cost. This indicator of efficiency measures the deployment of operating cash flow relative to reserve additions.

	2004
<b>Forecast pricing</b>	
Operating netback (\$/boe)	18.26
Proved	2.36
Proved plus probable	2.85



**PRODUCTION REPLACEMENT RATIO**

The production replacement ratio measures the number of times the current year production has been replaced by net reserve additions. The production replacement ratio reflects the addition of reserves at a cost effective rate.

	2004
<b>Forecast pricing</b>	
Proved	4.64
Proved plus probable	5.73

*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.*



## MANAGEMENT'S DISCUSSION AND ANALYSIS

*This Management's Discussion and Analysis ("MD&A") for Arsenal Energy Inc. ("Arsenal" or the "Company") should be read in conjunction with the December 31, 2004 and 2003 audited annual consolidated financial statements ("consolidated financial statements") and related note disclosures. The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("Canadian GAAP") and are presented in Canadian currency (except where indicated as being in another currency). Arsenal is an oil and gas issuer and disclosures pertaining to oil and gas activities are presented in accordance with National Instrument 51-101 ("NI 51-101"). For additional disclosures as required under NI 51-101 please refer to [www.sedar.com](http://www.sedar.com)*

### RESULTS OF OPERATIONS

#### Production and Marketing

Production volumes for the year ended December 31, 2004 increased to 177 barrels of oil equivalent per day, which represents a 195% increase over 2003. Production volumes for the three month period ending December 31, 2004 averaged 442 barrels of oil equivalent per day, a 514% increase over the same period in 2003. The increase in volumes for both the three and twelve months ended December 31, 2004 is attributable to the integration of corporate and property acquisitions and a successful drilling program.

Crude oil production increased 162% during the year ended December 31, 2004, attributable to the acquisition of properties in North Dakota during the second quarter. Natural gas production increased 1267% and related natural gas liquids increased 1100% over the year from properties acquired at North Dakota.

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, however the Company is committed to increasing its natural gas production through the continued development of the Edson natural gas play with its joint venture partners.

With the full impact of Nahanni Oil and Gas Ltd. ("Nahanni") and the anticipated close of the acquisition of IC Energy Ltd. ("IC Energy") on March 31, 2005, Arsenal expects corporate production to total 1,800 barrels of oil equivalent per day effective April 1, 2005.

	Three Months Ended December 31			Twelve Months Ended December 31		
	2004	2003	% Change	2004	2003	% Change
Crude oil (bbl/d)	369	70	427	152	58	162
NGL (bbl/d)	32	1	3,100	11	1	1,100
Natural gas (mcf/d)	245	6	3,983	82	6	1,267
<b>Total (boe/d)</b>	<b>442</b>	<b>72</b>	<b>514</b>	<b>177</b>	<b>60</b>	<b>195</b>
<b>Production split</b>						
Oil & NGLs (%)	91	99	(8)	92	98	(6)
Natural Gas (%)	9	1	565	8	2	363



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### Commodity Prices

Commodity price realizations during 2004 increased 11% over 2003. Fourth quarter crude oil prices before realized derivatives losses increased 28% compared to the same quarter in 2003, attributable to the increase in WTI over the same period. The impact of favourable crude oil prices was partly offset by a 7% decline in the value of the US dollar relative to the Canadian dollar during the quarter. Fourth quarter natural gas prices before realized derivatives increased 18% over the prior quarter, while the benchmark AECO and NYMEX prices increased 27% and 50% respectively over the same period.

The net impact of realized crude oil derivatives during the fourth quarter reduced the price of crude oil before derivatives by 10% to 49.62 barrels of oil equivalent per day. The Company received a pre-payment on these derivative contracts, which will be recognized over the life of the contract.

Arsenal anticipates continued high commodity prices as supply issues continue to impact natural gas, while ongoing tensions in the Middle East continues to put upward pressure on the WTI reference price.

	Three Months Ended December 31			Twelve Months Ended December 31		
	2004	2003	% Change	2004	2003	% Change
<b>Prices - Before Derivatives (\$Cdn.)</b>						
Total crude oil (bbl)	55.21	43.12	28	49.83	42.84	16
NGLs (bbl)	49.54	31.37	58	47.01	32.55	44
Natural gas (mcf)	7.77	6.61	18	7.52	6.49	16
Total (boe)	51.27	42.24	21	46.36	41.94	11
<b>Reference Pricing</b>						
WTI (\$U.S./bbl)	48.28	31.18	55	41.40	31.04	33
AECO gas (\$Cdn./mcf)	7.08	5.59	27	6.79	6.70	1
NYMEX gas (\$U.S./mmbtu)	6.87	4.58	50	6.09	5.44	12
Foreign exchange (\$U.S./\$Cdn.)	1.22	1.32	(7)	1.33	1.40	(5)



## Oil and Gas Revenue

Net oil and gas revenue for the fourth quarter of 2004 was 594% higher than the comparable period in 2003, reflecting increased crude oil production resulting from the North Dakota property acquisition combined with higher commodity prices. Net oil and gas revenue for the twelve months ended December 31, was 211% higher in 2004 when compared to the prior period.

(SCdn.)	Three Months Ended December 31			Twelve Months Ended December 31		
	2004	2003	% Change	2004	2003	% Change
Crude oil sales	1,669,198	258,987	545	2,775,998	906,922	206
NGL sales	146,137	2,886	4,964	197,021	11,880	1,558
Natural gas sales	175,144	9,230	1,798	226,122	65,785	244
Deferred revenues	90,687	-	100	120,916	-	100
Loss on forward contracts	(198,674)	-	(100)	(262,583)	-	(100)
Gross oil and gas revenue	1,882,492	271,103	594	3,057,473	984,587	211
Per boe	46.31	40.93	13	47.16	44.96	5

## Royalties

During the fourth quarter, royalties as a percentage of gross oil and gas revenue increased 36% due to higher freehold royalties on the properties acquired in North Dakota. Royalties as a percentage of gross oil and gas revenue increased 41% for the 12 months ending December 31, 2004 compared to 2003 reflecting the different asset portfolio of the Company. Arsenal's production is not subject to Crown royalties in Canada.

(SCdn.)	Three Months Ended December 31			Twelve Months Ended December 31		
	2004	2003	% Change	2004	2003	% Change
Freehold royalties	485,960	46,614	943	732,630	154,199	375
% of gross oil and gas revenue	23.4	17.2	36	22.1	15.7	41
Per boe	11.96	7.04	70	11.30	7.04	60

## Operating Costs

Operating expenses per boe for the three and twelve months ended December 31, 2004 increased 58% and 53%, respectively, over the prior periods. The increase is due to considerable field optimization costs on newly acquired properties and higher energy costs compared to the prior year. Arsenal plans to continue with field optimization initiatives in Canada and North Dakota, and expects costs to trend lower during 2005.

(SCdn.)	Three Months Ended December 31			Twelve Months Ended December 31		
	2004	2003	% Change	2004	2003	% Change
Operating expense	784,873	80,767	872	1,141,164	252,193	352
Per boe	19.31	12.19	58	17.60	11.52	53



## Production Netbacks

Netbacks for both the three and twelve month periods ending December 31, 2004 decreased over comparative periods as higher revenues were offset by higher royalty and operating costs.

(SCdn. per boe)	Three Months Ended December 31			Twelve Months Ended December 31		
	2004	2003	% Change	2004	2003	% Change
Net revenue after derivatives	46.31	40.93	13	47.16	44.96	5
Royalties	(11.96)	(7.04)	70	(11.30)	(7.04)	60
Operating expense	(19.31)	(12.19)	58	(17.60)	(11.52)	53
Operating netback	15.05	21.70	(31)	18.26	26.40	(31)

## General and Administrative

General and administrative costs increased by approximately 80% during both the three and twelve month periods ending December 31, 2004. The increase is attributable to acquisition costs and additional employees brought on during the year to facilitate the Company's growth. Costs on a per boe basis decreased over the prior periods reflecting increases in production during the year. Arsenal anticipates general and administrative costs to increase in absolute terms but decrease on a per barrel basis as the company continues to grow from the acquisition of IC Energy Ltd.

(SCdn.)	Three Months Ended December 31			Twelve Months Ended December 31		
	2004	2003	% Change	2004	2003	% Change
General and administrative	362,563	200,267	81	843,122	438,805	92
Per boe	8.92	30.23	(70)	13.01	20.04	(35)

## Finance Charges

Finance charges for both the three and twelve month periods ending December 31, 2004 increased over comparative periods as the Company drew on its credit facility to fund both drilling and acquisition activities during the year.

(SCdn.)	Three Months Ended December 31			Twelve Months Ended December 31		
	2004	2003	% Change	2004	2003	% Change
Finance charges	37,655	4,221	792	94,266	36,247	160
Per boe	0.93	0.64	45	1.45	1.66	(12)



## Depletion, Depreciation, and Accretion

Depletion, depreciation and accretion ("DD&A") per boe decreased 78% and 45%, respectively, for the three and twelve months ended December 31, 2004 compared to the same periods in 2003. The decrease is attributable to the significantly increased reserve and asset base over the prior year.

(SCdn.)	Three Months Ended December 31			Twelve Months Ended December 31		
	2004	Restated 2003	% Change	2004	Restated 2003	% Change
Depletion, depreciation and accretion	<b>237,910</b>	177,508	29	<b>507,458</b>	309,844	64
Per boe	<b>5.85</b>	26.80	(78)	<b>7.83</b>	14.15	(45)

## Stock Based Compensation

Arsenal prospectively adopted the CICA Handbook Section 3870 – "Stock Based Compensation" during the fourth quarter of 2003. As per the transitional provisions of the new standard, companies that adopted the standard prior to December 31, 2003 were required to recognize compensation expense for those options granted during 2003 and later, with proforma disclosure of options granted during 2002. Comparative figures for 2003 have been restated to reflect the impact of stock-based compensation.

For the three and twelve months ended December 31, 2004, Arsenal recorded compensation expense of \$45,829 and \$84,193, respectively, compared \$16,700 for both periods in 2003. The increase is due to the granting of options to new employees and contractors during 2004, as well as a higher underlying share price in 2004 compared to 2003.

(SCdn.)	Three Months Ended December 31			Twelve Months Ended December 31		
	2004	Restated 2003	% Change	2004	Restated 2003	% Change
Compensation expense	<b>45,829</b>	16,700	108	<b>84,193</b>	16,700	338
Per boe	<b>1.13</b>	2.52	100	<b>1.30</b>	0.76	100

## Taxes

Arsenal does not expect to pay any cash taxes in 2005 based on existing tax pools, planned capital expenditures and the most recent forecast of 2005 taxable income. Although current tax horizons depend on product prices, production levels, and the nature, magnitude and timing of capital spending, the Company currently believes that no cash income tax will be payable for three years.

Future income taxes are recorded to the extent that the carrying value of the assets of Arsenal is materially 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. This future income tax liability increases the book cost of the assets acquired.

Future income tax recoveries 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 2004, Arsenal recovered \$228,093 in future income taxes compared to a future tax recovery of \$328,000 in 2003. A future income tax balance of \$1,443,129 is recorded as a liability as at December 31, 2004 (2003 – \$183,760).

(SCdn.)	Three Months Ended December 31			Twelve Months Ended December 31		
	2004	Restated 2003	% Change	2004	Restated 2003	% Change
Provision for (recovery of) future taxes	<b>(228,093)</b>	(328,000)	(30)	<b>(216,174)</b>	(328,000)	(34)
Per boe	<b>(5.61)</b>	(49.52)	(89)	<b>(3.33)</b>	(14.98)	(78)

### SUMMARY OF ANNUAL RESULTS

Total revenue has increased commensurate with production and higher price realizations due to a strong commodity environment. Higher price realizations are offset by higher royalty rates in North Dakota, as well as the optimization of North Dakota properties during the fourth quarter.

Net income per share has decreased due to higher DD&A rates resulting from a larger property, plant and equipment base, additional stock-based compensation expense and higher general and administrative costs when compared to prior periods.

Total assets and long-term liabilities have increased commensurate with corporate and property acquisitions completed over the past three years along with internal development activities.

(SCdn.)	2004	Twelve Months Ended December 31	
		Restated 2003	Restated 2002
Total revenue	<b>3,098,946</b>	830,388	54,471
Net income	<b>(126,509)</b>	104,599	(150,912)
Per share - basic and diluted	<b>(0.01)</b>	0.02	(0.03)
Cash flow from operations	<b>287,764</b>	103,143	(58,344)
Per share - basic and diluted	<b>0.02</b>	0.06	(0.01)
Total assets	<b>16,690,703</b>	2,889,856	1,031,038
Total debt	<b>3,743,852</b>	-	340,000



## SUMMARY OF QUARTERLY RESULTS

The following table highlights the Company's performance for the most recent eight quarters that comprise the 2004 and 2003 fiscal years. Total revenue is primarily impacted by commodity prices, production volumes and royalties. Net income and net income per share are primarily impacted by operating, general and administrative costs DD&A and future income taxes.

(SCdn.)	2004				
	Q4	Q3	Q2	Q1	Total
Total revenue	1,802,339	894,574	181,270	220,763	3,098,946
Net income	45,846	(38,913)	(77,695)	(55,747)	(126,509)
Per share - basic and diluted	0.00	(0.01)	(0.01)	(0.01)	(0.01)
Cash flow from operations	92,492	119,608	46,529	29,135	287,764
Per share - basic and diluted	0.01	0.01	(0.01)	0.01	0.01
Total assets	16,690,703	9,777,944	3,364,353	3,169,054	16,690,703
Total bank debt	3,743,852	3,700,000	-	-	3,743,852

(SCdn.)	2003 Restated				
	Q4	Q3	Q2	Q1	Total
Total revenue	286,736	174,180	132,048	284,038	877,002
Net income	56,633	(2,146)	(39,624)	89,736	104,599
Per share - basic and diluted	0.01	(0.01)	(0.01)	0.02	0.02
Cash flow from operations	(77,159)	37,990	(12,823)	155,135	103,143
Per share - basic and diluted	(0.01)	0.01	(0.01)	0.03	0.02
Total assets	2,889,856	2,059,738	1,741,488	1,519,870	2,889,856
Total bank debt	-	700,000	710,000	750,000	-

## LIQUIDITY

At December 31, 2004, the Company had a working capital deficit of approximately \$5.4 million, compared to a working capital surplus of \$0.3 million at December 31, 2003. The decrease in working capital position was due to a combination of increased drilling activity during the fourth quarter, optimization costs for the North Dakota properties, and the acquisition of Nahanni.

The working capital deficiency is mitigated through the increase of the revolving demand loan which was increased to \$8,600,000 by the Company's lenders on March 31, 2005. Cash flows generated from both the acquired and existing production will also mitigate the deficiency.

At December 31, 2004 Arsenal had approximately 6.6 million warrants outstanding, for aggregate proceeds of \$6.0 million. During March 2005, holders of the Company's share purchase warrants and stock options had exercised an aggregate of 4,307,603 warrants and options for total proceeds of \$3,005,130.

## CAPITAL RESOURCES

### Revolving Demand Loan

At December 31, 2004, Arsenal had a revolving demand loan for \$4.0 million (2003 - nil) with a Canadian financial institution. The facility may be drawn down or repaid at any time and there are no scheduled repayment terms. The debt is secured by a demand debenture containing a first fixed charge on all crude oil and natural gas assets of Arsenal. At December 31, 2004, the interest rate was bank prime plus 1.0% (2003 - nil).



On March 31, 2005, the Arsenal's lenders agreed to increase the loan to \$8,600,000 bearing interest at a rate of bank prime plus 0.75%.

### Share and Warrant Offerings

At December 31, 2004, Arsenal had 18.9 million shares outstanding (2003 – 8.7 million) and a market capitalization of approximately \$16.1 million (2003 - \$3.5 million). During 2004, Arsenal completed the following share and warrant issues:

- **December 30, 2003:** Issued 2.0 million flow-through shares at \$0.70 per share to fund a portion of the 2004 capital program.
- **March 24, 2004:** Issued 1.85 million shares at \$0.50 per share and 1.2 million warrants for the acquisition of Orange Exploration Inc. Each warrant is exercisable into one common share of Arsenal at an exercise price of \$0.53 per share on or before March 24, 2005.
- **May 16, 2004:** Issued 1.0 million shares at \$1.00 per share on a private placement basis to fund a portion of the 2004 capital program.
- **August 31, 2004:** Issued 1,734,499 units at \$0.60 per unit for gross proceeds of \$1,040,699. Each unit consists of one common share and one-half of one common share purchase warrant. Each whole warrant is exercisable into one additional common share at an exercise price of \$1.00 per share. Proceeds from this offering were used to acquire producing properties in North Dakota.
- **December 15, 2004:** Issued 1.0 million shares at \$0.75 per share for the acquisition of Nahanni Oil and Gas Ltd.
- **December 15, 2004:** Issued 4.4 million units at \$0.75 per unit for gross proceeds of \$3.3 million. Each unit consists of one common flow-through share and one share purchase warrant with an exercise price of \$1.00. Proceeds from this offering were used to fund a portion of the 2005 capital program.

### CAPITAL EXPENDITURES

Capital expenditures for the year ended December 31, 2004 totalled \$12.8 million. Of that amount, \$5.5 million was spent on acquiring and optimizing properties in North Dakota, while \$7.2 million was spent in Canada, primarily on the \$4.4 million acquisition of Nahanni. Canadian drilling and completion costs are attributable to wells drilled at Edson, Tangleflags and Lashburn.

(\$ Cdn.)	U.S	Canada	Total
Corporate and property acquisitions	4,427,410	4,593,675	9,021,085
Seismic	-	33,843	33,843
Drilling and completions	-	2,419,368	2,419,368
Production facilities	1,156,694	155,525	1,312,219
Other	1,175	77,317	78,492
<b>Total capital expenditures</b>	<b>5,585,279</b>	<b>7,279,728</b>	<b>12,865,007</b>



## COMMITMENTS AND CONTINGENCIES

Arsenal is involved in various legal claims associated with the normal course of operations. The Company is required to determine whether a contingent loss is probable and whether that loss can be reasonably estimated. When the loss has satisfied both criteria it is charged to net income. Arsenal has made adequate provision for such legal claims.

The Company leases its office premises through an arrangement deemed to be an operating lease for accounting purposes. As such, Arsenal is not required to record its lease obligation as a liability nor does it record its leased premises as an asset. The estimated operating lease commitments relating to leased office premises for the next five years are as follows:

(SCdn.)	
2005	48,000
2006	48,000
2007	48,000
2008	48,000
thereafter	nil

## RISK MANAGEMENT

### Commodity Price Risk

Commodity price risk is defined as fluctuations in crude oil, natural gas, and natural gas liquid prices. Arsenal uses derivative instruments as part of its risk management approach to manage commodity price fluctuations and stabilize cash flows available for future development programs. Arsenal does not enter into derivative contracts for speculative purposes. At December 31, 2004 Arsenal has entered into one forward contract fixing the price of sales on 180 bbl per day at \$46.93. Arsenal has received a prepayment on the contract equal to an incremental \$5.59 per barrel, which will be recognized as revenue based on deliveries over the life of the contract.

### Production Risk

Production risk relates to the Company's ability to produce, process and transport crude oil and natural gas. To manage this risk to an acceptable level, the Company performs regular and proactive maintenance on its wells, facilities and pipelines. The Company operates approximately 90% of its production, which affords greater control over operations.

### Natural Decline and Reserve Replacement Risk

Natural decline risk relates to the Company's ability to replace reserves in excess of annual production declines through development activities such as drilling, well completions, well workovers and other capital activities. The Company manages its business using a portfolio approach whereby capital is allocated across a number of areas so that significant capital is not risked on any one activity. Capital is spent only after strict economic criteria for production and reserve additions are assessed.

Arsenal's reserves are evaluated on an annual basis by independent third-party consultants reporting to the Company's Reserves Committee of the Board of Directors. Arsenal's approach is to invest in mature, long-life properties with a high proved producing component combined with low-risk development opportunities where the reserve risk is generally lower and cash flows are more stable and pre-



dictable. The Company will engage in wildcat exploration activities only after considerable due diligence has been completed on the play, including geological, geophysical and total capital required.

### **Environmental Health and Safety Risk**

Environment, health and safety risks relate primarily to field operations associated with oil and gas assets. To mitigate this risk, a preventative environmental, health and safety program is in place as well as operational loss insurance coverage. Arsenal employees and contractors adhere to the Company's environment, health and safety program, which is routinely reviewed and updated to ensure Arsenal operates in a manner consistent with best practices in the industry. The Board of Directors is actively involved in the risk assessment and risk mitigation process

### **Regulation, Tax and Royalty Risk**

Regulation, tax and royalty risk relates to changing government royalty regulations, income tax laws and incentive programs impacting the Company's financial and operating results. Management and oversight committees, with the assistance of legal counsel, stay informed of proposed changes in laws and regulations and proactively respond to and plan for the effects of these changes.

### **Capital Market Risk**

Arsenal's ability to maintain its financial strength and liquidity is dependent upon its ability to access Canadian capital markets. If Canadian debt or equity markets were to become less accessible to the Company, it may affect the ability of Arsenal to continue to replace production.

## **SIGNIFICANT ACCOUNTING POLICIES AND ESTIMATES**

### **Consolidation**

The consolidated financial statements include the accounts of Arsenal Energy Inc. and Arsenal Energy USA Inc. and are collectively referred to as Arsenal or the Company.

### **Revenue Recognition**

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

### **Property, Plant, and Equipment**

Arsenal uses the full cost method for oil and gas exploration, development and production activities as set out in CICA Accounting Guideline 16 ("ACG-16"), "Oil and Gas Accounting – Full Cost". The cost of acquiring oil and natural gas properties as well as subsequent development costs are capitalized and accumulated in a cost center. 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%.

AcG-16 requires that a ceiling test be performed at least annually to assess the carrying value of oil and gas assets. A cost center is tested for recoverability using undiscounted future cash flows from proved reserves and forward indexed commodity prices, adjusted for contractual obligations and prod-



uct 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.

### **Depreciation, Depletion, 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 proved oil and gas reserves calculated in accordance with National Instrument 51-101.

### **Oil and Gas Reserves**

The Canadian Securities Administrators' National Instrument 51-101 (NI 51-101) defines proved oil and gas reserves as estimated quantities of crude oil, natural gas liquids, oil condensate, and natural gas that geological and engineering data demonstrate with reasonable certainty can be recovered in future years from known reservoirs under existing economic and operating conditions. Proved reserves are those reserves that can be estimated with a high degree of certainty to be recoverable. The level of certainty should result in at least a 90% probability that the quantities ultimately recovered will be equal to, or in excess of the estimated proved reserves. The level of certainty for proved plus probable should result in at least a 50% probability that the quantities actually recovered will be equal to, or exceed the sum of the estimated proved plus probable reserves.

The estimation of reserves is a subjective process. Forecasts 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 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. 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 significantly from estimates.

## **CHANGES IN ACCOUNTING POLICES AND ESTIMATES**

### **Asset Retirement Obligations**

Effective January 1, 2004, Arsenal retroactively adopted CICA Handbook Section 3110, "Asset Retirement Obligations" (ARO). The new standard requires that the fair value of an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made.



The present value of the asset retirement obligation is recognized as a liability with the corresponding asset retirement cost capitalized as part of property, plant and equipment. The asset retirement obligation will increase over time due to accretion and the asset retirement cost will be depreciated on a basis consistent with depreciation and depletion. Arsenal previously used the unit-of-production method to match estimated future retirement costs with the revenues generated over the life of the petroleum and natural gas properties based on total estimated proved reserves and an estimated future liability.

The impact of this change has been disclosed in Note 3 to the consolidated financial statements.

### **Compensation Expense**

Effective December 31, 2003, Arsenal prospectively adopted CICA Handbook Section 3870, "Stock-Based Compensation and other Stock-Based Payments." The standard requires that equity instruments awarded to employees be measured at fair value and recognized over the related period of service ("vesting period").

Under this standard, compensation cost, attributable to all stock options granted is measured at fair value at the grant date and expensed over the vesting period with a corresponding increase in contributed surplus. Consideration paid upon the exercise of the stock options is recorded as an increase to share capital together with corresponding amounts previously recognized in contributed surplus.

The impact of this change has been disclosed in Note 3 to the consolidated financial statements.

### **Derivative Instruments and Hedging Relationships**

Effective January 1, 2004, Arsenal prospectively adopted CICA Accounting Guideline 13 ("AcG-13"), "Hedging Relationships" and the amended Emerging Issues Committee 126 ("EIC-126"), "Accounting for Trading, Speculative or Non Trading Derivative Financial Instruments". In accordance with the new guideline, all unrealized derivative instruments that either do not qualify as a hedge under AcG-13, or are not designated as a hedge, 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. The Company has received a prepayment on the forward contract it has entered into at December 31, 2004, as such no derivative gain or loss has been accrued.

## **OUTLOOK**

### **Strategy**

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 2004 and in early 2005 in order to establish high-quality drilling prospects. The Company also entered into a six well farm-in agreement on lands in north western Alberta. These lands target high quality light sweet crude oil and deep natural gas.

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. One of the key components of the Nahanni Oil and Gas Ltd. acquisition and IC Energy Ltd. acquisition is the existence of a high quality drilling inventory which Arsenal intends to quickly develop during 2005. Arsenal believes that over the long term, outlook for both crude oil and natural gas pricing remains strong.



## 2005 Capital Budget

(\$Cdn.)

<b>Drilling</b>	
Western Alberta	2,500,000
Western Saskatchewan	4,000,000
<b>Optimization</b>	
North Dakota	750,000
Western Saskatchewan	1,000,000
<b>Total Capital</b>	<b>8,250,000</b>

Arsenal will fund its 2005 capital program through cash flow and long-term debt. The Company has a \$3.3 million and a \$0.675 million flow-through obligation which will be satisfied through exploratory drilling in western Alberta and western Saskatchewan during 2005.

## 2005 Production Volumes

The production forecast for 2005 will be principally impacted by weather, timing of new production and economic activity and are derived based on management's assumptions utilized for 2005 planning purposes. Assumptions include certain levels and profiles of capital expenditures, operating costs, projected sales volumes, interest rates, foreign currency exchange rates, and other assumptions that impact operations. These assumptions can vary significantly from actual events and may result in material variances from the expected results. This forecast includes the impact of the IC Energy Ltd. acquisition, which closed on March 31, 2005.

	Minimum	Maximum	2004 Actual
Crude oil and NGLs (bbl/d)	1,700	2,750	163
Natural gas (mcf/d)	450	3,000	82
Total (boe/d)	1,775	3,250	177
<b>Production split</b>			
Oil & NGLs (%)	96	85	92
Natural gas (%)	4	15	8

The following table provides estimates for 2005 of the sensitivity of the Company's 2005 net income and cash flow to changes in commodity prices and the U.S./Cdn. Dollar exchange rate:

Variable	Change	Cash Flow (\$Cdn.)
Crude oil price	\$ U.S. 1/bbl	350,000
Natural gas price	\$ Cdn. 0.10/mcf	50,000
S.U.S./\$Cdn. exchange rate	0.01	50,000
Interest rate	1.00%	60,000
Crude oil production	100 bbl/d	750,000
Natural gas production	100 mcf/d	125,000



## MANAGEMENT'S REPORT

### **To the Shareholders of Arsenal Energy Inc.:**

The consolidated financial statements of Arsenal Energy Inc. were prepared by and are the responsibility of management. The financial statements have been prepared in conformity with Canadian generally accepted accounting principles appropriate in the circumstances and include some amounts that are based on management's best estimates and judgments.

The company maintains systems of internal accounting controls designed to provide reasonable assurance that all transactions are properly recorded in the company's books and records, that policies and procedures are adhered to and that the assets are protected from unauthorized use. The systems of internal accounting controls are complemented by selection, training and development of qualified staff.

The consolidated financial statements have been audited by the independent accounting firm KPMG LLP whose appointment is ratified yearly by the shareholders at the annual shareholders' meeting. The independent accountants perform such tests and related procedures as they deem necessary to arrive at an opinion on the fairness of the financial statements.

The audit committee of the board of directors periodically meets with the independent auditors and management to satisfy itself that it is properly discharging its responsibilities. The independent auditors have unrestricted access to the audit committee, without management present, to discuss the results of their examination and the quality of financial reporting and internal accounting control.



**Michael S. Vandale**  
*President and Chief Executive Officer*  
April 20, 2005



**Jesse Meidl, CA**  
*Chief Financial Officer*  
April 20, 2005

## AUDITORS' REPORT TO THE SHAREHOLDERS

We have audited the consolidated balance sheets of Arsenal Energy Inc. (the "Company") as at December 31, 2004 and 2003 and the statements of operations and deficit and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2004 and 2003 and the results of its operations and its cash flow for the years then ended in accordance with Canadian generally accepted accounting principles.

*KPMG LLP*

**Chartered Accountants**

*Calgary, Canada*

*April 11, 2005*



## CONSOLIDATED BALANCE SHEETS

As at December 31

2004

2003

	2004	2003
		Restated (note 3)
<b>ASSETS</b>		
<b>Current assets</b>		
Cash	\$ 217,063	\$ 743,580
Accounts receivable	582,762	93,439
	799,825	837,019
<b>Reclamation bonds</b> (note 7)	210,960	-
<b>Property, plant and equipment</b> (note 6)	15,679,918	2,052,837
	<b>\$ 16,690,703</b>	<b>\$ 2,889,856</b>
<b>LIABILITIES</b>		
<b>Current liabilities</b>		
Accounts payable and accrued liabilities	\$ 2,265,903	\$ 535,514
Revolving demand loan (note 9)	3,743,852	-
Current portion of deferred revenue	352,650	-
	6,362,405	535,514
<b>Deferred revenue</b> (note 8)	198,229	-
<b>Future income taxes</b> (note 10)	1,443,129	183,760
<b>Asset retirement obligation</b> (note 11)	780,889	106,582
	<b>8,784,652</b>	<b>825,856</b>
<b>SHAREHOLDERS' EQUITY</b>		
Shareholders' equity (note 12)	7,458,134	2,163,533
Warrants (note 13)	988,760	-
Contributed surplus (note 14)	144,183	59,990
Accumulated deficit	(685,026)	(159,523)
	7,906,051	2,064,000
	<b>\$ 16,690,703</b>	<b>\$ 2,889,856</b>

Segmented information (note 16)

Subsequent events (notes 9 and 17)

Approved by the Board:



Director



Director



## CONSOLIDATED STATEMENTS OF OPERATIONS AND ACCUMULATED DEFICIT

For the year ended December 31	2004	2003 Restated (note 3)
<b>REVENUE</b>		
Oil and gas	\$ 3,057,473	\$ 922,055
Other income	41,473	62,532
Royalties expense, net of Alberta Royalty Tax Credit	(732,630)	(154,199)
	<b>2,366,316</b>	<b>830,388</b>
<b>EXPENSES</b>		
Operating	1,141,164	252,193
General and administrative	843,122	438,805
Finance charges	94,266	36,247
Depletion, depreciation and accretion	507,458	309,844
Stock-based compensation expense (note 14)	84,193	16,700
Foreign exchange	38,796	-
	<b>2,708,999</b>	<b>1,053,789</b>
Income (loss) before future income taxes	(342,683)	(223,401)
Provision for (recovery of) future income taxes (note 10)	(216,174)	(328,000)
Net income	(126,509)	104,599
Deficit - beginning of year, as previously reported	(159,523)	(200,098)
Change in accounting policy (note 3)	-	(64,024)
Acquisition adjustment (note 5)	(398,994)	-
Deficit - end of year, as restated	<b>\$ (685,026)</b>	<b>\$ (159,523)</b>
Net income (loss) per share - basic and diluted	<b>\$ (0.01)</b>	<b>\$ 0.02</b>

Segmented information (note 16)



## CONSOLIDATED STATEMENTS OF CASH FLOWS

For the year ended December 31

2004

2003

Restated (note 3)

<b>Cash flows from operating activities</b>		
Net income (loss)	\$ (126,509)	\$ 104,599
Items not affecting cash		
Depletion, depreciation and accretion	507,458	309,844
Future income tax provision (recovery)	(216,174)	(328,000)
Stock-based compensation expense	84,193	16,700
Foreign exchange	38,796	-
Funds flow from operations	287,764	103,143
Net change in non-cash working capital items (note 15)	131,421	365,891
Net cash provided by (used in) operating activities	419,185	469,034
<b>Cash flows from investing activities</b>		
Corporate acquisitions (note 4)	(2,118,879)	257,455
Additions to property, plant and equipment	(9,017,185)	(1,277,951)
Changes in non-cash working capital - investing items	1,109,645	-
Net cash provided by (used in) investing activities	(10,026,419)	(1,020,496)
<b>Cash flows from financing activities</b>		
Issue of shares for cash	4,270,532	1,400,006
Issue of warrants for cash	988,760	-
Issue of promissory notes	-	310,000
Deferred revenue	550,879	-
Issue of shares for cash upon exercise of stock options	20,000	-
Share issue costs	(493,306)	(77,955)
Net proceeds (repayment) of revolving demand loan	3,743,852	(340,000)
Net cash provided by (used in) financing activities	9,080,717	1,292,051
Change in cash during the period	(526,517)	740,589
Cash - Beginning of period	743,580	2,991
Cash - End of period	\$ 217,063	\$ 743,580

Supplemental information (note 15)

Segmented information (note 16)



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2004 and 2003

### 1. ORGANIZATION AND BASIS OF PRESENTATION

Arsenal Energy Inc. ("Arsenal")

Arsenal Capital Inc. was incorporated under the laws of the province of Alberta in 2001. During 2002, Arsenal completed its qualifying transaction and changed its name to Arsenal Energy Inc.

### 2. SIGNIFICANT ACCOUNTING POLICIES

#### Consolidation

These consolidated financial statements include the accounts of Arsenal and its wholly owned subsidiaries from the date of acquisition (note 4). These accounts are referred to collectively as "Arsenal" or "the Company". Investments in unincorporated joint ventures 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 a cost center. 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, explo-



ration, 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 proved oil and gas reserves calculated in accordance with NI 51-101. All other equipment is depreciated over the estimated useful life of the respective assets.

### **Oil and Gas Reserves**

The estimation of reserves is a subjective process. Forecasts 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 significantly from estimates.

### **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 ("GAAP") 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.

## **3. CHANGES IN ACCOUNTING POLICIES**

### **Asset Retirement Obligations**

Effective January 1, 2004, Arsenal retroactively adopted new Canadian accounting standards for asset retirement obligations. The standard requires that the fair value of an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made.

The present value of the asset retirement obligation is recognized as a liability with the corresponding asset retirement cost capitalized as part of property, plant and equipment. The asset retirement obligation will increase over time due to accretion and the asset retirement cost will be depreciated on a basis consistent with depreciation and depletion. Arsenal previously used the unit-of-production method to match estimated future retirement costs with the revenues generated over the life of the petroleum and natural gas properties based on total estimated proved reserves and an estimated future liability.

As a result of adopting the new standard January 1, 2004, property, plant and equipment increased \$90,307 and retained earnings decreased \$20,734.

There was no impact on the Company's cash flow as a result of adopting this new standard. See Note 11 for additional information on the asset retirement obligation.

### **Compensation Expense**

Effective December 31, 2003, Arsenal prospectively adopted new Canadian accounting standards for stock-based compensation and other stock-based payments. The standard requires that equity instruments awarded to employees be measured at fair value and recognized over the related period of service ("vesting period").

Under this standard, compensation cost, attributable to all stock options granted is measured at fair value at the grant date and expensed over the vesting period with a corresponding increase in contributed surplus. Consideration paid upon the exercise of the stock options is recorded as an increase to share capital together with corresponding amounts previously recognized in contributed surplus. Pursuant to the transitional rules, the expense recognized applies to stock options granted on or after January 1,



2003. The Company elected to apply the standard retroactively with restatement, resulting in an increase to contributed surplus and corresponding decrease to retained earnings of \$43,290.

There was no impact on the Company's cash flow as a result of adopting the new standard. See Note 14 for additional information on compensation expense.

### Derivative Instruments and Hedging Relationships

Effective January 1, 2004, Arsenal adopted new Canadian accounting standards for hedging relationships and accounting for trading, speculative or non trading derivative financial instruments. In accordance with the new standards, all unrealized derivative instruments that either do not qualify as a hedge, or are not designated as a hedge, 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. Prior to January 1, 2004, Arsenal recognized gains and losses on derivative contracts at the time of settlement.

The Company did not enter into any contractual relationships that qualify for hedge accounting during 2004. The Company has received a prepayment on the forward contract it has entered into at December 31, 2004, and as such no derivative gain or loss has been recognized.

## 4. ACQUISITIONS

Effective March 24, 2004 Arsenal acquired all of the issued and outstanding shares of Orange Exploration Inc. ("Orange Exploration"). Effective December 15, 2004 Arsenal acquired all of the issued and outstanding shares of Nahanni Oil and Gas Ltd. ("Nahanni"). During 2003, Arsenal entered into a business combination with Legend Capital Corp. ("Legend"), which resulted in the amalgamation of the Company and Legend. The purchase method of accounting was used for each business combination and the allocation of the purchase price and consideration for each acquisition is as follows:

	Nahanni 2004	Orange 2004	Legend 2003
<b>Net assets acquired at assigned values:</b>			
Working capital	\$ (234,988)	\$ -	\$ 257,455
Property, plant and equipment	4,965,504	325,080	-
Debt assumed	(193,851)	-	-
Asset retirement obligation	(88,123)	-	-
Future income taxes	(1,579,663)	(92,880)	-
Net assets acquired	<b>\$ 2,868,879</b>	<b>\$ 232,200</b>	<b>\$ 257,455</b>
<b>Financed by:</b>			
Shares issued	\$ 750,000	\$ 550,375	\$ 257,455
Warrants issued	-	80,819	-
Cash	2,118,879	-	-
Acquisition adjustment (note 5)	-	(398,994)	-
Purchase price	<b>\$ 2,868,879</b>	<b>\$ 232,200</b>	<b>\$ 257,455</b>



## 5. RELATED PARTY TRANSACTIONS

### Acquisition of Orange Exploration Inc.

On March 24, 2004 the Company acquired 100% of the issued and outstanding shares of Orange Exploration Inc. 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 of \$398,994 was recorded 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 of \$0.07 per warrant.

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

## 6. PROPERTY, PLANT AND EQUIPMENT

	2004	Restated 2003
Property, plant, and equipment	\$ 16,504,432	\$ 2,376,009
Accumulated depletion and depreciation	(824,514)	(323,172)
	<b>\$ 15,679,918</b>	<b>\$ 2,052,837</b>

All costs of unproved properties, net of any associated revenues, have been capitalized and depleted during 2004 and 2003. Included in property, plant, and equipment are asset retirement costs of \$752,743 (2003 - \$90,307). The prices used in the ceiling test evaluation of Arsenal's natural gas, crude oil, and natural gas liquids reserves at December 31, 2004 were as follows:

Year	WTI Oil (\$U.S./bbl)	Foreign Exchange (\$U.S./\$Cdn.)	Heavy Oil (\$Cdn./bbl)	NYMEX Gas (\$U.S./mcf)	AECO Gas (\$Cdn./mcf)
2005	42.00	1.25	30.90	6.40	6.66
2006	42.80	1.25	31.85	6.30	6.57
2007	39.55	1.25	30.30	6.15	6.57
2008	38.20	1.25	31.15	6.00	6.17
2009	36.80	1.25	29.40	5.80	5.93
2010 - 2024	41.16	1.25	29.49	7.85	5.66
Remainder <sup>1</sup>	2.00%				

<sup>1</sup> Percentage change represents the annual change each year from 2010 to the end of the reserve life.

During the year, Arsenal capitalized general and administrative expenses of \$88,000.



## **7. RECLAMATION BONDS**

At December 31, 2004 the Company had \$210,960 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.

## **8. RISK MANAGEMENT AND FINANCIAL INSTRUMENTS**

### **Commodity Price Risk Management**

The Company entered into a crude oil sale contract during the period fixing the price of future production of 180 barrels per day at \$46.93 per barrel. This crude oil contract ends September 2006. The Company received a prepayment on the contract equal to an incremental \$5.59 per barrel which will be recognized as revenue based on deliveries over the life of the contract.

### **Fair Value of Financial Instruments**

The fair values of financial instruments presented on the consolidated balance sheet, other than long-term borrowings, approximate their carrying amount due to the short-term nature of those instruments. The estimated fair values of long-term borrowings are based on market information or by discounting future payments of interest and principal at current interest rates that would be available to the Company at year end.

### **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.

## **9. REVOLVING DEMAND LOAN**

At December 31, 2004, 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 Canadian and U.S. assets.

At December 31, 2004, the Company is in breach of a bank covenant relating to its working capital ratio. Management has informed the bank of the situation and the bank has issued a letter to the Company stating that the bank will review the financial statements in order to determine future covenant requirements.

Effective March 31, 2005, the bank has approved to increase the demand operating loan to \$8,600,000 bearing interest at the bank prime rate plus 0.75% per annum.



## 10. INCOME TAXES

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

	2004	Restated 2003
Income before income taxes	\$ (342,683)	\$ (223,401)
Statutory tax rate (%)	41.37	40.62
Expected tax provision (recovery)	\$ (141,768)	\$ (90,745)
<b>Adjustments:</b>		
Change in valuation allowance	-	(136,500)
Resource allowance	(2,500)	4,000
Differences in tax pools	-	(129,500)
Rate reduction	(60,900)	10,000
Stock-based compensation	30,000	-
Other	(41,006)	14,745
Provision for (recovery of) future income taxes	\$ (216,174)	\$ (328,000)
<b>Future tax liability comprised of:</b>		
Accounting basis for capital assets in excess of tax basis	(2,353,334)	(559,901)
Non-capital losses	458,983	292,134
Share issue costs	167,212	40,713
Asset retirement obligations	284,010	43,294
	\$ (1,443,129)	\$ (183,760)

## 11. 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:

	2004	Restated 2003
Asset retirement obligation - beginning of year	\$ 106,582	\$ 68,840
Liabilities acquired	609,300	-
Liabilities incurred	58,891	23,034
Accretion expense	6,116	14,708
Asset retirement obligation, end of year	\$ 780,889	\$ 106,582

The total undiscounted amount of estimated cash flows required to settle the obligation is \$1,119,750 (2003 - \$142,750), which has been discounted using a credit-adjusted risk free rate of 8% (2003 - 6.5%) and an inflation factor of 1.5%. The majority of these obligations will be incurred between 2014 and 2024, however certain obligations are not anticipated to be incurred until 2033.



## 12. SHAREHOLDERS EQUITY

### Authorized

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

Common shares	December 31, 2004		December 31, 2003	
	Shares	Amount	Shares	Amount
Balance - beginning of year	<b>8,740,836</b>	<b>\$ 2,163,533</b>	6,660,000	\$ 784,027
Issued to acquire Orange Exploration Inc.	<b>1,850,000</b>	<b>550,375</b>	-	-
Issued to acquire Nahanni Oil and Gas Ltd.	<b>1,000,000</b>	<b>750,000</b>	-	-
Converted to Arsenal shareholders	-	-	(1,860,000)	-
Converted to Legend shareholders	-	-	1,165,836	257,455
Issued for cash	<b>7,298,870</b>	<b>4,270,532</b>	2,000,000	1,400,006
Tax effect of flow-through shares	-	-	-	(541,000)
Cost of shares issued	-	<b>(493,306)</b>	-	(77,955)
Tax effect of share issue costs	-	<b>197,000</b>	-	31,000
Issued on exercise of options/rights	<b>100,000</b>	<b>20,000</b>	-	-
Settlement of related party debt	-	-	775,000	310,000
Balance - end of year	<b>18,989,706</b>	<b>\$ 7,458,134</b>	8,740,836	\$ 2,163,533

### Per Share Amounts

The per share calculations for the year ended December 31, 2004 were based on weighted average shares outstanding of 11,838,661 (2003 – 5,965,439). In computing net income per share – diluted, 843,032 (2003 – 275,712) 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 December 2004 the Company issued 4,400,000 flow-through shares for gross proceeds of \$3,300,000. Future tax adjustments relating to the flow-through shares will be recorded as the qualifying expenditures are renounced during 2005.

In May 2004 the Company issued 675,000 flow-through shares for gross proceeds of \$675,000. Future tax adjustments relating to the flow-through shares will be recorded as the qualifying expenditures are renounced during 2005.

In December 2003 the Company issued 2,000,000 flow-through shares for gross proceeds of \$1,400,000. A future tax adjustment of \$541,000 has been recorded as the tax pools were renounced as qualifying expenditures were incurred in 2004.



### 13. WARRANTS

The Company issued share purchase warrants in conjunction with the Orange acquisition and on a private placement basis during 2004. 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:

Risk free rate	4%
Expected life	1 - 2 years
Expected volatility	80% to 110%
Expected dividend	nil
Weighted average value per warrant	0.15

Warrants	December 31, 2004
Balance - beginning of year	-
Warrants issued on acquisition of Orange Exploration (note 4)	<b>80,820</b>
Private placement	<b>907,940</b>
Balance - end of year	<b>988,760</b>

### 14. 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.

	December 31, 2004		December 31, 2003	
	Options	Weighted Average Price (\$)	Options	Weighted Average Price (\$)
Balance - beginning of year	<b>1,150,000</b>	<b>0.21</b>	<b>243,600</b>	0.25
Granted	<b>1,455,000</b>	<b>0.58</b>	<b>974,432</b>	0.20
Exercised	<b>(100,000)</b>	<b>0.20</b>	-	-
Cancelled	-	-	-	-
Reduction on amalgamation	-	-	<b>(68,032)</b>	0.25
Balance - end of period	<b>2,505,000</b>	<b>0.40</b>	<b>1,150,000</b>	0.21
Exercisable - end of year	<b>1,125,833</b>	<b>0.26</b>	<b>1,150,000</b>	0.21
Weighted-average contractual life (years)	<b>3.93</b>		<b>3.65</b>	



## 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 the following weighted average assumptions:

Risk free rate	4%
Expected life	5 years
Expected volatility	80%
Expected dividend	nil
Expected forfeitures	nil
Weighted average value per vested option	0.06

Contributed surplus	December 31, 2004
Balance - beginning of year	<b>59,990</b>
Issuance of stock options	<b>84,193</b>
Balance - end of year	<b>144,183</b>

## 15. SUPPLEMENTAL CASH FLOW INFORMATION

	2004	2003
<b>Change in non-cash working capital items</b>		
Operating accounts receivable	\$ (489,323)	\$ (63,514)
Operating accounts payable	131,421	429,405
Capital accounts payable	1,109,645	-
	<b>751,743</b>	<b>365,891</b>
<b>Interest and taxes paid</b>		
Interest	61,818	36,247
Taxes	nil	nil

## 16. SEGMENTED INFORMATION

Arsenal USA Inc. acquired producing properties in North Dakota on August 31, 2004. As a result of this acquisition, a significant portion of the Company's assets and revenues are earned in the United States, 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 in both geographical regions.

(\$ Cdn.)	Canada	U.S	Total
Gross revenue	\$ 927,268	\$ 2,171,678	\$ 3,098,946
Net income before tax	(754,492)	411,809	(342,683)
Operating income	514,313	710,839	1,225,152
Assets	10,195,320	6,495,383	16,690,703
Capital expenditures	7,372,608	5,492,399	12,865,007



## **17. SUBSEQUENT EVENTS**

### **Acquisition of IC Energy Ltd.**

On March 31, 2005 the Company acquired 100% of the issued and outstanding shares of IC Energy Ltd. for total consideration of \$10,000,000. The consideration was paid through the issuance of 3,000,000 common shares of the Company at a deemed price of \$1.50 per share and a cash payment of \$5,500,000.

### **Increase to Credit Facility Limit**

On March 31, 2005 the Company's lending institution increased the total credit available under the demand operating loan to \$8,600,000 bearing interest at the bank prime rate plus 0.75%.

### **Exercise of Warrants and Stock Options**

During March 2005, holders of the Company's share purchase warrants and stock options had exercised an aggregate of 4,307,603 warrants and options for total proceeds of \$3,005,130.



# CORPORATE INFORMATION

## Officers and Management

**Michael S. Vandale**

President and Chief Executive Officer

**Jesse Meidl CA (4)**

Chief Financial Officer

**Bernie Dumanowski P. Eng.**

Vice President Operations

**Jock Graham P. Geo.**

Vice President Geology

## Exchange Listing

Toronto Stock Exchange -  
Venture, AEI

## Legal Counsel

Borden Ladner Gervais LLP

## Auditors

KPMG LLP

## Bankers

ATB Financial

## Evaluation Engineers

AJM Petroleum Consultants

## Registrar and Transfer Agent

Computer Share Trust Company  
of Canada

## Privacy Officer

Jesse Meidl CA

[privacy@arsenalenergy.com](mailto:privacy@arsenalenergy.com)

## Board of Directors

Michael Vandale

William Hews (1) (3) (4)

Errol Stewart (2) (4)

Greg Belzberg (1)

R. Neil MacKay (2)

Alain Gaucher (1)

Curtis Stewart (2) (3)

Lyle Skaien (3)

Donald Edwards  
Corporate Secretary

## Head Office

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## Website/Email

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[info@arsenalenergy.com](mailto:info@arsenalenergy.com)



## Committees of the Board of Directors

- (1) Audit Committee member
- (2) Reserves Committee member
- (3) Compensation Committee member
- (4) Corporate Governance  
Committee member



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