



Drilling, recompletions, and other optimization activities grew Arsenal's production to record highs, as the Company spent the first quarter focused on internally generated opportunities to create value for shareholders. At March 31, 2005 we acquired IC Energy Inc, a privately held company at Maidstone, Saskatchewan for total consideration of \$10.0 million.

On May 17, 2005 we announced the acquisition of approximately 350 barrels of oil per day from a private vendor, subject to certain conditions. The acquisition is anticipated to close June 30, 2005. The acquired properties are located in the Buzzard, Lashburn, Marsden and Rush Lake areas of western Saskatchewan. The acquisition will also include properties at Wildmere in eastern Alberta. All areas are complementary to Arsenal's operations at Lloydminster and Maidstone in western Saskatchewan.

FIRST QUARTER CORPORATE HIGHLIGHTS

- Production averaged 828 barrels of oil equivalent per day.
- Forecast price P+P+P at 10% NPV: \$1.60/share, \$1.44/share fully diluted (adjusted for debt) at March 31, 2005.
- Constant price P+P+P at 10% NPV: \$2.47/share, \$2.20/share fully diluted (adjusted for debt) at March 31, 2005.
- Record cashflow of \$0.02/share for the period ended March 31, 2005.
- Optimization initiatives undertaken during the fourth quarter reduced operation costs from \$19.31 per barrel of oil equivalent at December 31, 2004 to \$11.36 barrels of oil equivalent at March 31, 2005.
- 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.

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OPERATIONS IN REVIEW

North Dakota

Optimization initiatives undertaken during the fourth quarter of 2004 produced superb results for the Company during the first quarter of 2005 as operations costs decreased by approximately \$8.00 per barrel of oil equivalent. Production for the quarter remained consistent at approximately 400 barrels of oil equivalent per day. We intend to further optimize these properties in the second quarter of 2005, and anticipate production increases of approximately 50 barrels of oil equivalent per day and additional cost savings once those initiatives are completed.

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 10 locations on our existing lands, which will be undertaken during 2005 and 2006.

Maidstone

These properties were acquired on March 31, 2005 through acquisition of IC Energy Inc. 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.

Alberta

We continued to acquire land and enter into farm-in agreements on lands throughout 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 during the first quarter.

We signed farm-in agreements for a three well program at Evi South and Malmo, with an option for additional locations at Kaybob and Evi. Drilling on these lands is scheduled to begin in August of 2005 and continue through the remainder of the year.

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. 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 \$40 U.S. for the remainder of the year, and potentially could increase from current 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

Our corporate mandate remains unchanged. We will continue to seek acquisitions that are accretive, while also generating value through the drill bit. We will further optimize and exploit our acquired production in Saskatchewan and North Dakota, to achieve maximum return on our invested capital.

As we enter the second quarter, we have developed an 18 well drilling program at Lloydminster and Maidstone which is scheduled to begin during the second quarter, and with IC Energy production will exceed 1,700 barrels of oil equivalent. Shrinking heavy oil differentials combined with increased production and reduced operations costs ensure that further record production and cashflows will be realized in upcoming periods.

On behalf of the Board of Directors,



Michael S. Vandale
President



HIGHLIGHTS

SUMMARY OF OPERATING & FINANCIAL RESULTS

FINANCIAL	Three Months Ended March 31	
	2005	2004
Funds from operations ¹	486,573	29,135
Per unit - basic	0.02	-
Per unit - diluted	0.02	-
Bank debt	7,601,583	-
Operating costs per boe	11.36	11.58
Operating netbacks per boe	15.62	23.75
Market		
Shares outstanding		
End of period	26,407,303	11,265,836
Weighted average - basic	20,134,963	11,265,836
Weighted average - diluted	21,454,309	12,240,178
Shares trading		
High	1.92	0.95
Low	0.88	0.60
Close	1.48	0.70
Average daily volume	49,700	13,600
OPERATIONS		
Daily production (average)		
Crude oil (bbl)	758	58
NGLs (bbl)	31	1
Natural gas (mcf)	231	6
Total (boe) ²	828	60
Realized commodity prices (\$Cdn.)		
Total crude oil (bbl)	38.67	44.09
NGLs (bbl)	38.53	32.48
Natural gas (mcf)	7.46	6.49
Average (boe) ²	38.59	41.94
Reference pricing		
WTI (U.S./bbl)	49.84	35.15
AECO gas (\$Cdn./mcf)	6.63	6.61
Foreign Exchange (\$U.S./\$Cdn.)	1.23	1.32

¹ Management's Discussion and Analysis contains the term funds from operations, funds from operations per share, and operating netbacks, 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 funds from operations per share whereby per share amounts are calculated consistent with the calculation of earnings per share.

² The term barrels of oil equivalent ("boe") may be misleading, particularly if used in isolation. A boe conversion ratio of six thousand cubic feet per barrel (6mcf/bbl) of natural gas to barrels of oil equivalence is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead. All boe conversions in the report are derived from converting gas to oil in the ratio mix of six thousand cubic feet of gas to one barrel of oil.



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 unaudited interim consolidated financial statements for the three months ended March 31, 2005 and 2004 and with the audited consolidated financial statements and MD&A for the year ended December 31, 2004. 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. This MD&A is dated May 30, 2005.

RESULTS OF OPERATIONS**Production and Marketing**

Production volumes for the three month period ended March 31, 2005 increased to 828 boe/d, which represents a 1,279% increase over 2004. The increase in volumes is attributable to the integration of corporate and property acquisitions and a successful drilling program completed in January.

Crude oil production increased 1,207%, attributable to the acquisition of properties in North Dakota and Lloydminster, and the completion of the six well drilling program at Lloydminster. Natural gas production increased 1,100% and related natural gas liquids increased 1,267% over the year from properties acquired at Saskatchewan and North Dakota.

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 the production acquired through the acquisition of IC Energy Inc. ("IC Energy"), Arsenal expects corporate production to exceed 1,700 boe/d effective April 1, 2005. With the full impact of the asset purchase expected to close on June 30, 2005, Arsenal expects production to exceed 2,050 boe/d.

	Three Months Ended March 31		
	2005	2004	% Change
Crude oil (bbl/d)	758	58	1,207
NGL (bbl/d)	31	1	1,100
Natural gas (mcf/d)	231	6	1,267
Total (boe/d)	828	60	1,279
Production split			
Oil & NGLs	95%	98%	(3)
Natural Gas	5%	2%	179



Commodity Prices

Commodity price realizations during the first quarter decreased 12% over the same period in 2004. 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 year. The decrease is also reflective of the asset portfolio of Arsenal at March 31, 2005, with approximately 40% of its oil production comprised of lower gravity heavy crude oil.

Natural gas produced in North Dakota is high heat and has historically achieved a price in excess of the NYMEX Henry Hub reference price.

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.

Prices - Before Derivatives (\$Cdn.)	Three Months Ended March 31		
	2005	2004	% Change
Total crude oil (bbl)	38.67	44.09	(12)
NGLs (bbl)	38.53	32.48	19
Natural gas (mcf)	7.46	6.49	15
Total (boe)	38.59	41.94	(8)

Reference Pricing

WTI (\$U.S./bbl)	49.84	35.15	42
AECO gas (\$Cdn./mcf)	6.63	6.61	0
NYMEX gas (\$U.S./mmbtu)	6.53	6.14	6
Foreign exchange (\$U.S./\$Cdn.)	1.23	1.32	(7)

Oil and Gas Revenue

Net oil and gas revenue for the first quarter of 2005 was 1,007% higher than the comparable period in 2004, reflecting increased crude oil production resulting from the corporate and property acquisitions. Revenues per boe decreased 17% over the same period in 2004 reflecting the impact of heavy oil price realizations.

(\$Cdn.)	Three Months Ended March 31		
	2005	2004	% Change
Crude oil sales	2,527,059	228,381	1,007
NGL sales	155,737	766	20,231
Natural gas sales	108,665	2,468	4,303
Other	93,613	-	-
Loss on forward contracts	(231,216)	-	-
Gross oil and gas revenue	2,653,858	231,615	1,046
Per boe	34.86	41.96	(17)



Royalties

During the first quarter, royalties as a percentage of gross oil and gas revenue increased 19% over the same period in 2004 due to higher freehold royalties on the properties acquired in North Dakota.

(Cdn.)	Three Months Ended March 31		
	2005	2004	% Change
Freehold royalties	599,676	36,573	1,540
% of gross oil and gas revenue	20.8	15.8	32
Per boe	7.88	\$6.63	19

Operating Costs

Operating expenses per boe for the three months ended March 31, 2005 decreased 2%, over the same period in 2004. Arsenal completed numerous optimization initiatives in North Dakota and Lloydminster during 2004, and notes that operating costs have declined substantially from the fourth quarter of 2004, when they averaged \$19.31/boe. Arsenal expects operating costs to continue to trend lower as the initiatives are completed in the second quarter of 2005.

(Cdn.)	Three Months Ended March 31		
	2005	2004	% Change
Operating expense	864,897	63,947	1,253
Per boe	11.36	11.58	(2)

Product Netbacks¹

Netbacks for the three month period ending March 31, 2005 decreased over the comparative period reflecting the impact of heavy oil price realizations and higher royalty rates during 2005.

(\$ per boe)	Three Months Ended March 31		
	2005	2004	% Change
Net revenue after derivatives	34.86	41.96	(17)
Royalties	(7.88)	(6.63)	19
Operating expense	(11.36)	(11.58)	(2)
Operating netback	15.62	23.75	(34)

General and Administrative

General and administrative costs per boe decreased by 51% during the three month period ending March 31, 2005. Costs on a per boe basis decreased over the prior period 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 production. Stock-based compensation expenses totaling \$85,241 are included in general and administrative costs at March 31, 2005.

(Cdn.)	Three Months Ended March 31		
	2005	2004	% Change
General and administrative	693,044	101,960	580
Per boe	9.10	18.47	(51)



Finance Charges

Finance charges for the three month period ending March 31, 2005 increased \$64,730 compared to \$nil in the comparative period as the Company drew on its credit facility to fund both drilling and acquisition activities during the first quarter of 2005, but had not drawn on its facility during the comparative period.

(Cdn.)	Three Months Ended March 31		
	2005	2004	% Change
Finance charges	64,730	-	100
Per boe	0.85	-	100

Depletion, Depreciation, and Accretion

Depletion, depreciation and accretion ("DD&A") per boe decreased 51% for the three months ended March 31, 2005 compared to the same period in 2004. The decrease is attributable to the significantly increased reserve and asset base over the prior year.

(Cdn.)	Three Months Ended March 31		
	2005	2004	% Change
Depletion, depreciation and accretion	513,623	71,963	614
Per boe	6.75	13.04	(48)

Stock-Based Compensation Expense

Stock-based compensation expense increased \$85,241 compared to \$nil in the comparative period in 2004. During the first quarter of 2004, Arsenal did not grant any options and as such no compensation expense was accrued. This expense is included in general and administrative costs at March 31, 2005.

(Cdn.)	Three Months Ended March 31		
	2005	2004	% Change
Compensation expense	85,241	-	100
Per boe	1.12	-	100

Taxes

During the first quarter of 2005, Arsenal accrued future income taxes totalling \$36,614 compared to \$1,430 during the same period in 2004. A future income tax balance of \$5,632,396 is recorded as a liability as at March 31, 2005 (March 31, 2004 – 456,215).

(Cdn.)	Three Months Ended March 31		
	2005	2004	% Change
Provision for future taxes	36,614	1,430	2,460
Per boe	0.48	0.26	86



SUMMARY OF QUARTERLY RESULTS

The following table highlights the Company's performance for the most recent eight quarters that comprise first quarter of 2005 and 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.

(Cdn.)	2004					2003		
	Q1	Q4	Q3	Q2	Q1	Q4	Q3	Q2
Total revenue	2,054,182	1,802,339	894,574	181,270	220,763	286,736	174,180	132,048
Net income (loss)	(156,261)	45,846	(38,913)	(77,695)	(55,747)	56,633	(2,146)	(39,624)
Per share - basic	(0.01)	-	(0.01)	(0.01)	(0.01)	0.01	(0.01)	(0.01)
Per share - diluted	(0.01)	-	(0.01)	(0.01)	(0.01)	0.01	(0.01)	(0.01)
Funds from Operations ¹	486,573	92,492	119,608	46,529	29,135	(77,159)	37,990	(12,823)
Per share - basic	0.02	0.01	0.01	(0.01)	0.01	(0.01)	0.01	(0.01)
Per share - diluted	0.02	0.01	0.01	(0.01)	0.01	(0.01)	0.01	(0.01)
Total assets	30,978,254	16,690,703	9,777,944	3,364,353	3,169,054	2,889,856	2,059,738	1,741,488
Total bank debt	7,601,583	3,743,852	3,700,000	-	-	-	700,000	710,000

Liquidity

At March 31, 2005, the Company had a debt adjusted working capital deficit of approximately \$1.2 million, compared to a working capital deficiency of \$1.5 million at December 31, 2004. The working capital deficit is due to a combination of drilling activity during the first quarter, optimization costs for the North Dakota properties, and the acquisition of IC Energy.

The working capital deficiency is mitigated through the increase of the revolving demand loan which was increased to \$12.8 million by the Company's lenders on May 30, 2005. Cashflows generated from both acquired and existing production will also mitigate the deficiency.

CAPITAL RESOURCES**Revolving demand loan**

At March 31, 2005, Arsenal had a revolving demand loan for \$8.6 million (December 31, 2004 - \$4.0 million) 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 March 31, 2005, the interest rate was bank prime plus 0.75% (December 31, 2004 - bank prime plus 1.0%).

On May 30, 2005, the Company's lending institution increased the total credit available under the demand operating loan to \$12.8 million, bearing interest at the bank prime rate plus 0.75%.

Exercise of stock options and warrants

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 \$3,103,116. At March 31, 2005 there are approximately 3.0 million warrants outstanding, exercisable into one common share for one dollar per share. Approximately 0.5 million of these warrants expire during August 2005, with the remainder expiring during December 2005.



CAPITAL EXPENDITURES

Capital expenditures for the period ended March 31, 2005 totalled \$11.5 million. \$10.0 million was spent for the acquisition of IC Energy which closed March 31, 2005. Land costs relate to undeveloped lands acquired in northwestern Alberta and at Maidstone, Saskatchewan. Drilling and facility costs were incurred at Edson and Lloydminster.

\$ Cdn.	Total
Corporate and property acquisitions	10,000,000
Land	346,804
Seismic	60,640
Drilling and completions	762,860
Production facilities	376,228
Total capital expenditures	11,546,532

COMMITMENTS AND CONTINGENCIES

Arsenal has contractual obligations in the normal course of operations including purchase of assets and services, operating agreements, transportation commitments and sales commitments. These obligations are of a recurring and consistent nature and impact cash flow in an ongoing manner. There have been no changes to Arsenal's operating lease commitments from those disclosed in the Company's December 31, 2004 Annual Report.

RISK MANAGEMENT

Business risks affecting Arsenal are unchanged from those disclosed in the December 31, 2004 Annual Report.

SIGNIFICANT ACCOUNTING POLICIES AND ESTIMATES

The interim consolidated financial statements dated March 31, 2005 have been prepared following the same accounting policies and methods of computation as the consolidated financial statements for the fiscal year ended December 31, 2004, with the addition of the policy outlined below.

Goodwill

Goodwill is the residual amount that results when the purchase price of an acquired business exceeds the fair value of the net identifiable assets and liabilities of the acquired business. Net identifiable liabilities acquired include an estimate of future income taxes. In accordance with CICA Handbook Section 3062, "Goodwill and Other Intangibles", goodwill is tested at least annually for impairment. Impairment is charged to net income in the period in which it occurs.

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



FINANCIAL REPORTING UPDATE**Comprehensive Income**

The CICA has issued Section 1530 "Comprehensive Income" which establishes standards for reporting and display of comprehensive income. This Section is effective for annual and interim periods beginning on or after October 1, 2006 with early adoption permitted for fiscal year ending on or after December 31, 2004. Arsenal has assessed that this guideline is unlikely to have a material effect on the financial statements and does not anticipate adopting the standard until October 2006.

OUTLOOK**Strategy**

Arsenal emphasises 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 throughout the first quarter of 2005 in order to establish high-quality drilling prospects. The Company also entered into a four 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 and IC Energy acquisition is the existence of a high quality drilling inventory which Arsenal intends to quickly develop starting June 2005. Arsenal believes that over the long term, outlook for both crude oil and natural gas pricing remains strong.

Sensitivities

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
Crude oil price	\$ U.S. 1/bbl	\$ 350,000
Natural gas price	\$ Cdn. 0.10/mcf	\$ 50,000
\$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

1 Management's Discussion and Analysis contains the term funds from operations, funds from operations per share, and operating netbacks, 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 funds from operations per share whereby per share amounts are calculated consistent with the calculation of earnings per share.



DEFINING MOMENTS

CONSOLIDATED BALANCE SHEETS

	March 31, 2005	December 31, 2004
	Unaudited	Audited
ASSETS		
Current assets		
Cash	-	217,063
Accounts receivable	1,202,706	582,762
	1,202,706	799,825
Reclamation bonds	213,149	210,960
Property, plant and equipment	26,897,201	15,679,918
Goodwill (note 3)	2,665,198	-
	30,978,254	16,690,703
LIABILITIES		
Current liabilities		
Accounts payable and accrued liabilities	2,442,624	2,265,903
Revolving demand loan (note 4)	7,601,583	3,743,852
Current portion of deferred revenue	352,650	352,650
	10,396,857	6,362,405
Deferred revenue	168,050	198,229
Future income taxes	5,632,396	1,443,129
Asset retirement obligation (note 5)	885,701	780,889
	17,083,004	8,784,652
SHAREHOLDERS' EQUITY		
Shareholders' equity (note 6)	14,104,745	7,458,134
Warrants (note 7)	495,573	988,760
Contributed surplus (note 8)	136,219	144,183
Deficit	(841,287)	(685,026)
	13,895,250	7,906,051
	30,978,254	16,690,703



05: FIRST QUARTER

CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT (UNAUDITED)

For the three months ended	March 31, 2005	March 31, 2004
REVENUE		
Oil and gas	2,653,858	231,615
Royalties expense, net of Alberta Royalty Tax Credit	(599,676)	(36,573)
	2,054,182	195,042
EXPENSES		
Operating	864,897	63,947
General and administrative	693,044	101,960
Finance charges	64,730	-
Depletion, depreciation and accretion	513,623	71,963
Foreign exchange	37,535	-
	2,173,829	237,870
Loss before future income taxes	(119,647)	(42,828)
Provision for future income taxes	36,614	1,430
Net income	(156,261)	(44,258)
Deficit - beginning of period	(685,026)	(159,523)
Deficit - end of period	(841,287)	(203,781)
Loss per share - basic and diluted	\$ (0.01)	\$ (0.00)

Segmented information (note 10)



DEFINING MOMENTS

CONSOLIDATED STATEMENT OF CASH FLOWS (UNAUDITED)

For the three months ended	March 31, 2005	March 31, 2004
Cash flows from operating activities		
Net income (loss)	(156,261)	(44,258)
Items not affecting cash		
Depletion, depreciation and accretion	513,623	71,963
Future income tax provision	36,614	1,430
Stock-based compensation expense (note 8)	85,241	-
Deferred revenue	(30,179)	-
Foreign exchange	37,535	-
Funds from operations	486,573	29,135
Net change in non-cash working capital items (note 9)	(485,797)	(450,104)
Net cash provided by (used in) operating activities	776	(420,969)
Cash flows from investing activities		
Corporate acquisitions (note 3)	(5,500,000)	-
Additions to property, plant and equipment	(1,546,532)	(478,114)
Changes in non-cash working capital - investing items	42,574	-
Net cash provided by (used in) investing activities	(7,003,958)	(478,114)
Cash flows from financing activities		
Issue of shares for cash	-	675,000
Issue of shares for cash upon exercise of stock options	193,784	-
Issue of shares for cash upon exercise of warrants	2,909,332	-
Share issue costs	(174,728)	(7,775)
Revolving demand loan	3,857,731	-
Net cash provided by (used in) financing activities	6,786,119	667,225
Change in cash during the period	(217,063)	(231,858)
Cash - Beginning of period	217,063	743,580
Cash - End of period	-	511,722

Supplemental information (note 9)

Segmented information (note 10)



NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**1. SIGNIFICANT ACCOUNTING POLICIES**

The interim consolidated financial statements of Arsenal Energy Inc. ("Arsenal" or the "Company") have been prepared by management in accordance with accounting principles generally accepted in Canada. The interim consolidated financial statements have been prepared following the same accounting policies and methods of computation as the consolidated financial statements for the fiscal year ended December 31, 2004, with the addition of the policy outlined in note 2. The disclosures provided below are incremental to those included with the annual consolidated financial statements. The interim consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto in Arsenal's annual report for the year ended December 31, 2004.

2. GOODWILL

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

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

3. BUSINESS ACQUISITION

Effective March 31, 2005 Arsenal acquired all of the issued and outstanding shares of IC Energy Inc. ("IC Energy"). The purchase method of accounting was used for this business combination and the allocation of the purchase price and consideration for the acquisition is as follows:

Net assets acquired at assigned values:

Property, plant and equipment	10,243,000
Goodwill	2,665,198
Asset retirement obligation	(123,713)
Future income taxes	(2,784,485)
Net assets acquired	10,000,000

Financed by:

Shares issued	4,500,000
Cash	5,500,000
Purchase price	10,000,000



4. REVOLVING DEMAND LOAN

At March 31, 2005, The Company has available a demand operating loan in the amount of \$8.6 million (December 31, 2004 - \$4.0 million) 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 March 31, 2005, 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.

On May 30, 2005, the Company's lending institution increased the total credit available under the demand operating loan to \$12.8 million, bearing interest at the bank prime rate plus 0.75%.

5. ASSET RETIREMENT OBLIGATIONS

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

	Three Months Ended	
	March 31, 2005	Year Ended December 31, 2004
Asset retirement obligation - beginning of period	780,889	106,582
Liabilities acquired	123,713	609,300
Liabilities incurred	-	58,891
Adjustment	(32,045)	-
Accretion expense	13,144	6,116
Asset retirement obligation - end of period	885,701	780,889

6. SHAREHOLDERS' EQUITY

The per share calculations for the period ended March 31, 2005 was based on weighted average shares outstanding of 20,134,963 (March 31, 2004 – 11,265,836). In computing net income per share – diluted, 1,319,346 (March 31, 2004 – 974,342) were added to the weighted average number of shares outstanding for the quarter, reflecting the dilutive effect of stock options and share purchase warrants.

	Three Months Ended		Year Ended	
	March 31, 2005		December 31, 2004	
	Shares	Amount (\$)	Shares	Amount (\$)
Balance - beginning of period	18,989,706	7,458,134	8,740,836	2,163,533
Corporate acquisition	3,000,000	4,500,000	2,850,000	1,300,375
Issued for cash	-	-	7,298,870	4,270,532
Cost of shares issued	-	(174,728)	-	(493,306)
Tax effect of flow-through shares	-	(1,445,169)	-	-
Tax effect of share issue costs	-	77,000	-	197,000
Issued on exercise of options	904,277	193,784	100,000	20,000
Issued on exercise of warrants	3,513,320	2,909,332	-	-
Allocated from contributed surplus	-	93,205	-	-
Allocated from warrants	-	493,187	-	-
Balance - end of period	26,407,303	14,104,745	18,989,706	7,458,134



7. WARRANTS

When share purchase warrants are exercised, the consideration paid is recorded to the shareholders' equity account along with an allocation for the deemed value of the warrants previously recognized in the warrants account. The following table reconciles the movement in the warrant account balance:

	Three Months Ended	Year Ended
	March 31, 2005	December 31, 2004
Balance - beginning of period	988,760	-
Warrants issued on acquisition of Orange Exploration	-	80,820
Private placement	-	907,940
Reclassification to common shares on exercise of warrants	(493,187)	-
Balance - end of period	495,573	988,760

8. STOCK OPTIONS

A summary of the changes in the options outstanding under the Option Plan is as follows:

	Three Months Ended		Year Ended	
	March 31, 2005		December 31, 2004	
	Options	Weighted Average Price (\$)	Options	Weighted Average Price (\$)
Balance - beginning of period	2,505,000	0.40	1,150,000	0.21
Granted	290,000	0.98	1,455,000	0.58
Exercised	(904,277)	0.23	(100,000)	0.20
Cancelled	(185,723)	0.59	-	-
Balance - end of period	1,705,000	0.40	2,505,000	0.40
Exercisable - end of period	736,661	0.47	1,125,833	0.26

The Company incurred non-cash compensation expense of \$85,241 during the quarter (2004 – nil) related to vested options issued under the Option Plan with a corresponding increase to contributed surplus. When options are exercised by employees, contractors and directors of the Company, the consideration paid is recorded to the shareholders' equity account along with related non-cash compensation expense previously recognized in contributed surplus. The following table reconciles the movement in the contributed surplus balance:

	Three Months Ended	Year Ended
	March 31, 2005	December 31, 2004
Balance - beginning of period	144,183	59,990
Issuance of stock options	85,241	84,193
Reclassification to common shares on exercise of options	(93,205)	-
Balance - end of period	136,219	144,183



9. SUPPLEMENTAL CASH FLOW INFORMATION

	Three Months Ended March 31, 2005	Three Months Ended March 31, 2004
Change in non-cash working capital items		
Operating accounts receivable	(619,944)	(87,775)
Operating accounts payable	134,147	(362,329)
Capital accounts payable	42,574	-
	(443,223)	(450,104)
Interest paid	42,751	nil

10. SEGMENTED INFORMATION

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. There are no comparative figures as Arsenal acquired the United States properties August 31, 2004.

\$ Cdn.	Canada	U.S	Total
Oil and gas revenue	985,340	1,601,232	2,586,572
Net income before tax	7,070	233,079	240,149
Operating income	456,480	732,805	1,189,285
Assets	24,521,453	6,456,801	30,978,254
Capital expenditures	1,546,532	-	1,546,532

11. SUBSEQUENT EVENTS

Property acquisition

On May 17, 2005, the Company entered into an agreement to purchase oil and gas properties from a private vendor for a total purchase price of \$6.8 million. The acquisition is scheduled to close June 30, 2005.

Increase to Credit Facility Limit

On May 30, 2005, the Company's lending institution increased the total credit available under the demand operating loan to \$12.8 million, bearing interest at the bank prime rate plus 0.75%.

Granting of Stock Options

On April 25, 2005 Arsenal granted 1.325 million stock options to employees, directors and officers with an exercise price of \$1.21.



Officers and Management

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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

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Errol Stewart (2) (4)

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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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