



Arsenal Energy Inc.

From Arsenal's beginning as a junior capital pool company in 2002, our management team and board of directors were steadfast in our desire not to follow the pack. We intended to differentiate the Company in an attempt to generate true value for our shareholders. Domestically, we completed corporate and property acquisitions at North Dakota and Saskatchewan at an average cost of \$17,000 per flowing barrel of oil equivalent. We specifically targeted mature properties, and heavy oil for their lower acquisition cost, our intent was to utilize the cashflows generated from these assets to drill high quality, light sweet oil and natural gas wells in Northern Alberta. The second component of our development strategy was to obtain working interests internationally, where our board of directors and management believe there continues to be significant potential for growth.

During the third quarter we executed on our first mandate, of drilling high quality wells in Northern Alberta. The first two wells of our five well drilling program in Northern Alberta were successful, and are currently producing at an average rate of 190 and 155 barrels of oil per day respectively. Arsenal holds a 50% working interest in these wells. We are currently drilling two additional wells at Mitsue and Lubicon, and will complete the fifth and final well of this drilling program before year end. In addition to this drilling program, reprocessed 3D seismic covering approximately 3,000 acres has been interpreted to exhibit at least fourteen additional locations on

THIRD QUARTER CORPORATE HIGHLIGHTS

- Production averaged a record 1,562 boe/d.
- Record funds from operating activities of \$2.01 million, \$0.06/share basic, \$0.06/share diluted.
- Successful drilling of the first two wells at Evi in Northern Alberta. During completion, these wells swab tested at 390 bbl/d and 295 bbl/d, of high quality, 39 degree API oil, and were brought into production during October at a rate of 190 bbl/d and 155 bbl/d respectively. Three additional wells are planned in Northern Alberta during the fourth quarter.
- Drilling of eight oil wells at Lloydminster with an 88% success rate. An additional 10.0 gross (5.0 net) wells are planned on the lands during the fourth quarter.
- Completed the corporate acquisition of Quadra Resources Corp. ("Quadra"), an international oil and gas exploration Company for gross proceeds of \$5.5 million. Quadra's principal asset was a 40% working interest in the 7.5 million acre Nuqra concession in the Komombo rift basin in Egypt. Quadra was a Canadian Public company which traded on the CNQ and Frankfurt stock exchange.
- Obtained listing on the Frankfurt Stock Exchange, trading under the symbol "A1E".

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these lands. The parameters that our management team uses of maintaining operations, carrying high working interests and acquiring contiguous lands have all come together through our first successful exploration wells. Arsenal carries a 30 to 100% working interest in this new core area in and around the Peace River Arch in Northern Alberta. This is an exciting new core area for Arsenal, one we intend to rapidly expand production from this area during 2006.

We also executed on our second mandate during the third quarter through the corporate acquisition of Quadra Resources Corp., a Canadian public company which traded on the CNQ and Frankfurt Stock Exchanges for gross proceeds of \$5.5 million. Quadra's principle asset was the 7.5 million acre Nuqra concession in Egypt. The lands in the concession are located in South Eastern Egypt near the city of Luxor on the east bank of the Nile River and are situated in the heart of the Komombo Basin. The Komombo Basin is a rift basin analogous to the Gulf of Suez Basin in Egypt and the Muglad Basin in Sudan, both of which have major proven oil reserves in the order of 5 to 10 billion barrels of original oil in place. The concession is accompanied by 3,000 km of 2D seismic, covering less than twenty percent of the acquired acreage. Quadra has identified 13 seismically defined exploratory leads from existing technical data. Well data from the concession confirms the existence of Cretaceous and Jurassic sandstone formations which may hold the potential for discovery of significant accumulations of oil reserves.

Our management team has long held that the Western Canadian Sedimentary basin is mature, and the majority of significant reservoirs have been discovered. Valuations on many junior exploration companies in Canada have increased to the point where investors are pricing in a measure of growth that is not sustainable in a mature basin. We believe that Northern Africa, and Egypt in particular offer shareholders with an opportunity for both rapid and considerable growth, as these unexplored basins are developed for the first time.

OPERATIONS IN REVIEW

Northern Alberta

The first two wells were successfully completed at Evi, and were brought into production during October at an average rate of 190 and 155 barrels of oil per day respectively. Arsenal has a 50% working interest in these wells. We are currently drilling 2.0 gross (1.0 net) wells in Northern Alberta, and will spud a third well during December. These wells all target Granite Wash and Gilwood reservoirs, with high quality, light sweet oil, and if successful are anticipated to produce in excess of 150 boe/d. We continue to drill wells at this new core area in Northern Alberta by participating at land sales and pursuing additional farm-in opportunities.

North Dakota

Optimization initiatives undertaken during the fourth quarter of 2004 produced superb results for the Company during 2005 as operation costs decreased by approximately \$8.00 per barrel of oil equivalent over the prior year. Production for the quarter remained consistent at approximately 400 barrels of oil equivalent per day.

We are currently developing a 2.0 gross (2.0 net) well program in North Dakota, targeting the Red River, Winnipegosis and Bakken formations. We have obtained 3D seismic over the majority of our lands, and anticipate drilling during the summer of 2006, as there are no access issues in this area.

Western Saskatchewan

Arsenal drilled 8.0 gross (3.18 net) wells on these lands during the third quarter, achieving a 88% success rate. These wells came on stream with initial production rates ranging between 25 and 55 boe/d. We intend to drill an additional 10.0 gross (5.0 net) wells in this area during the fourth quarter. This drilling program will offset the production declines and wet weather issues faced earlier this year.

Egypt

The operator of the Nuqra concession is currently reprocessing the acquired seismic data on the concession, and has contracted a seismic crew to shoot an additional 800 km of seismic during the fourth quarter. The first exploratory wells are anticipated to be drilled during the third and fourth quarters of 2006. At this time, a three well exploratory program has been developed, with the preliminary locations to be chosen after the completion of the new seismic evaluation.

COMMODITY PRICING

Heavy oil pricing was significantly impacted by disruptions in the western Canadian synthetic crude oil and heavy crude markets during the first quarter of 2005. The heavy oil price differential has returned to historical averages of 30% of WTI, however diluent costs remain high. We anticipate that the differential will follow historical seasonality and widen during the fall and winter months, however it is unlikely the differential will be as large as it was during 2004 and early 2005.

Light sweet crude oil continues to set record highs with increasing demand from Asia, limited refining capacity, and stagnant global production. It is anticipated in the market that WTI will remain above \$50 USD for the remainder of the year.

With the effects of Hurricane Katrina, natural gas recently set all time highs in excess of \$14USD/mcf, however prices have declined sharply since the end of October, as inventories have risen in excess of expectations. As we enter into the winter months, we expect gas prices to increase as demand increases, consistent with historical seasonality.

OUTLOOK

We will continue to pursue acquisitions domestically and internationally while generating value through the drill bit on our lands in Canada. We will work along side our partners on the Nuqra concession in Egypt to develop and implement the drilling program there as quickly as possible.

With the completion of the two wells at Evi, we are currently producing approximately 1,800 barrels of oil equivalent per day, and target exiting the year in excess of 2,000 barrels of oil equivalent per day, comprised of 60% heavy oil and 40% light oil and natural gas.

I sincerely hope that shareholders view our corporate vision and direction with the same enthusiasm held by our management team and board of directors. We will continue to differentiate our company from the pack with our focus on world class international opportunities and development of our existing plays in Canada and the United States.

On behalf of the Board of Directors,



Michael S. Vandale—President

SELECTED FINANCIAL AND OPERATIONAL INFORMATION

FINANCIAL	Three Months Ended September 30		Nine Months Ended September 30	
	2005	2004	2005	2004
Funds from operations ¹	1,835,348	119,608	3,193,209	126,247
Per unit - basic	0.06	(0.00)	0.12	0.00
Per unit - diluted	0.06	(0.00)	0.12	0.00
Bank debt	12,443,478	-	12,443,478	-
Operating costs per boe	13.70	16.49	14.19	2.19
Operating netbacks per boe	17.47	27.49	16.17	40.07
Market				
Shares outstanding				
End of period	33,400,567	11,591,875	33,400,567	11,591,875
Weighted average - basic	30,942,600	11,396,541	25,915,932	11,375,898
Weighted average - diluted	32,028,838	12,506,417	27,002,170	12,485,774
Shares trading				
High	1.98	0.90	1.98	0.95
Low	1.21	0.58	0.88	0.60
Close	1.98	0.65	1.98	0.65
Average daily volume	99,000	15,500	67,000	14,200
OPERATIONS				
Daily production (average)				
Crude oil (bbl)	1,437	175	1,073	105
NGLs (bbl)	32	1	35	1
Natural gas (mcf)	562	6	463	6
Total (boe) ²	1,562	177	1,185	107
Realized commodity prices (\$Cdn.)				
Total crude oil (bbl)	44.56	54.23	41.79	45.09
NGLs (bbl)	51.78	52.38	43.40	38.01
Natural gas (mcf)	6.22	6.15	6.84	6.28
Average (boe) ²	44.81	53.53	42.53	44.09
Reference pricing				
WTI (U.S./bbl)	63.19	43.88	55.40	39.10
AECO gas (\$Cdn./mcf)	8.81	6.32	7.38	6.34
Foreign Exchange (\$U.S./\$Cdn.)	1.20	1.31	1.22	1.33

¹This release 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.

²The 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 and nine months ended September 30, 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 November 4, 2005.

RESULTS OF OPERATIONS**Drilling Activity**

Arsenal participated in 10.0 gross wells (5.18 net) during the third quarter, 2.0 gross wells (1.0 net) were drilled at Evi, and 8.0 gross (3.18 net) were drilled at Lloydminster. One dry hole was drilled at Lloydminster.

	Three Months Ended September 30				Nine Months Ended September 30			
	2005		2004		2005		2004	
Drilling Activity	Gross	Net	Gross	Net	Gross	Net	Gross	Net
Oil	9.0	4.18	2.0	1.0	12.0	6.58	8.0	2.375
Gas	0.0	0.0	0.0	0.0	0.0	0.0	2.0	1.400
Dry and abandoned	1.0	1.0	0.0	0.0	1.0	1.0	0.0	0.0
Total	10.0	5.18	2.0	1.0	13.0	7.58	10.0	3.775

Production and Marketing

Production volumes for the three and nine month periods ended September 30, 2005 increased to 1,562 boe/d and 1,185 boe/d, which represents a 783% and 1,008% increase respectively, over the same periods in 2004. The increase in volumes is attributable to the integration of corporate and property acquisitions and new wells drilled during the year.

For the three month period ended September 30, 2005, crude oil production increased 721%, attributable to the acquisition of properties in North Dakota and Lloydminster, and news drilled at Lloydminster, offsetting natural declines and losses from heavy oil wells shut in during the second quarter of this year. Natural gas production increased 3,067% and related natural gas liquids increased 9,262% over the prior year from properties acquired at Saskatchewan and North Dakota.

With the completion of the 4 well drilling program at Evi, Mitsue and Lubicon, Arsenal will be producing approximately 1,800 boe/d. These new wells produce high quality, light sweet oil, and have been swab tested between 250 and 390 bbl/d, with Arsenal holding a 50% working interest in the properties.

DEFINING MOMENTS

	Three Months Ended September 30			Nine Months Ended September 30		
	2005	2004	% Change	2005	2004	% Change
Crude oil (bbl/d)	1,437	175	721	1,073	105	922
NGL (bbl/d)	32	1	3,067	35	1	1,100
Natural gas (mcf/d)	562	6	9,262	463	6	1,267
Total (boe/d)	1,562	177	783	1,185	107	1,008
Production split						
Oil & NGLs	94%	99%	(5)	93%	99%	(6)
Natural Gas	6%	2%	200	7%	1%	597

Commodity Prices

Commodity price realizations during the three month and nine month period ended September 30, 2005 decreased 16% and 4% respectively, over the same periods in 2004. The impact of favourable crude oil prices was partly offset by an 8% decline in the value of the US dollar relative to the Canadian dollar during the year, as well as the impact of the forward contract which expires September 2006.

The decrease is also reflective of the asset portfolio of Arsenal at September 30, 2005, with approximately 60% of its oil production comprised of lower gravity heavy crude oil. The heavy oil differential traditionally widens over winter, as demand for heavy crude is highest in the summer. Arsenal does not expect the differential to grow to the levels experienced last winter, however current forecasts are demonstrating this winter effect, which will continue to become more pronounced as the winter approaches.

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 Indian and Asian demand in conjunction with ongoing tensions in the Middle East continues to put upward pressure on the WTI reference price.

	Three Months Ended September 30			Nine Months Ended September 30		
	2005	2004	% Change	2005	2004	% Change
<i>(\$Cdn.)</i>						
Prices - Before Derivatives						
Total crude oil (bbl)	44.56	54.23	(18)	41.79	45.09	(7)
NGLs (bbl)	51.78	52.38	(1)	43.40	38.01	14
Natural gas (mcf)	6.22	6.15	1	6.84	6.28	9
Total (boe)	44.81	53.53	(16)	42.53	44.09	(4)
Reference Pricing						
WTI (\$U.S./bbl)	63.19	43.88	44	55.40	39.10	42
AECO gas (\$Cdn./mcf)	8.81	6.32	40	7.38	6.34	16
NYMEX gas (\$U.S./mmbtu)	10.24	5.84	75	7.80	5.83	34
Foreign exchange (\$U.S./\$Cdn.)	1.20	1.31	(8)	1.22	1.33	(8)

Oil and Gas Revenue

Net oil and gas revenue for the three month and nine month period ended September 30, 2005 was 564% and 881% higher respectively, than the comparable periods in 2004, reflecting increased petroleum and natural gas production. Revenue per boe for the three and nine month period ended September 30, 2005 decreased 25% and 11% respectively, over the same periods in 2004 reflecting the impact of heavy oil price realizations, and the loss on the forward contract of 180 bbl/d of oil in North Dakota.

(\$Cdn.)	Three Months Ended September 30			Nine Months Ended September 30		
	2005	2004	% Change	2005	2004	% Change
Crude oil sales	5,938,348	888,549	568	12,233,827	1,283,356	853
NGL sales	103,800	1,040	9,881	418,366	1,806	23,065
Natural gas sales	368,937	8,977	4,010	862,050	11,445	7,432
Other	7,824	-	-	195,387	-	-
Loss on forward contracts	(450,199)	-	-	(993,140)	-	-
Gross oil and gas revenue	5,968,709	898,566	564	12,716,490	1,296,607	881
Per boe	41.53	55.18	(25)	39.29	44.39	(11)

Royalties

During the three and nine month period ended September 30, 2005, royalties as a percentage of gross oil and gas revenue increased 25% and 31% respectively, over the same periods in 2004 due to higher freehold royalties on the properties acquired in North Dakota and Canada during the year.

(\$Cdn.)	Three Months Ended September 30			Nine Months Ended September 30		
	2005	2004	% Change	2005	2004	% Change
Royalties	1,489,165	182,380	717	2,891,924	62,037	4,562
% of gross oil and gas revenue	20	16	25	21	16	31
Per boe	10.36	11.20	(7)	8.94	2.12	321

Operating Costs

Operating expenses per boe for the three month period ended September 30, 2005 decreased 17% over the same period in 2004. The decrease is attributable to workovers and optimization initiatives completed in North Dakota during the fourth quarter of 2004. Operating costs per boe have remained higher than anticipated, attributable to increased rig costs incurred to revive production that was shut in during the period as a result of the unseasonably warm and wet weather experience in Saskatchewan during the second quarter. Operating costs have declined from the second quarter when they averaged \$16.39/boe, Arsenal expects operating costs to continue to trend lower as the additional optimization initiatives are completed during the fourth quarter.

(\$Cdn.)	Three Months Ended September 30			Nine Months Ended September 30		
	2005	2004	% Change	2005	2004	% Change
Operating expense	1,968,431	268,595	633	4,590,643	63,947	7,079
Per boe	13.70	16.49	(17)	14.19	2.19	548

Product Netbacks¹

Netbacks for the three and nine month period ended September 30, 2005 decreased 36% and 60% over comparative periods reflecting the impact of heavy oil price realizations during 2005. Third quarter royalties and operating costs were 7% and 17% lower than comparative periods respectively, reflecting operating efficiencies and lower royalty rates on wells acquired and drilled in Canada compared to the properties in North Dakota.

(\$Cdn.)	Three Months Ended September 30			Nine Months Ended September 30		
	2005	2004	% Change	2005	2004	% Change
Net revenue after derivatives	41.53	55.18	(25)	39.29	44.39	(11)
Royalties	(10.36)	(11.20)	(7)	(8.94)	(2.12)	321
Operating expense	(13.70)	(16.49)	(17)	(14.19)	(2.19)	548
Operating netback	17.47	27.49	(36)	16.17	40.07	(60)

General, Administrative Compensation Expenses

General and administrative costs per boe for the three and nine month periods ended September 30, 2005 decreased by 87% and 75% respectively over comparative periods in 2004. 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 expense of \$367,948 was accrued during the second quarter reflecting grants made during the period and amortization of compensation expense incurred for options which vested during the period.

(\$Cdn.)	Three Months Ended September 30			Nine Months Ended September 30		
	2005	2004	% Change	2005	2004	% Change
General and administrative	317,859	266,788	19	1,440,617	518,923	178
Compensation expense	367,948	-	100	775,144	-	100
	685,807	266,788	157	2,215,761	518,923	327
General and administrative per boe	2.21	16.38	(87)	4.45	17.76	(75)
Compensation expense per boe	2.56	-	100	2.40	-	100

Finance Charges

Finance charges for the three and nine month periods ended September 30, 2005 increased 95% and 434% respectively, over comparative periods as the Company drew on its credit facility to fund both drilling and acquisition activities during 2005.

(\$Cdn.)	Three Months Ended September 30			Nine Months Ended September 30		
	2005	2004	% Change	2005	2004	% Change
Finance charges	110,387	56,611	95	302,572	56,611	434
Per boe	0.77	3.48	(78)	0.93	1.94	(52)

Depletion, Depreciation, and Accretion

Depletion, depreciation and accretion per boe decreased 16% for the nine month period ended September 30, 2005 compared to the same period in 2004. The decrease is attributable to the significantly increased reserve base over the prior year.

(\$Cdn.)	Three Months Ended September 30			Nine Months Ended September 30		
	2005	2004	% Change	2005	2004	% Change
Depletion, depreciation and accretion	1,440,866	163,105	783	2,601,853	278,548	834
Per boe	10.03	10.02	-	8.04	9.54	(16)

Taxes

During the first nine months of 2005, Arsenal accrued current income taxes totalling \$213,468 compared to \$nil during the same period in 2004. During the first nine months of 2005, Arsenal accrued future income taxes totalling \$228,641 compared to \$11,919 during the same period in 2004. A future income tax balance of \$7,950,785 is recorded as a liability as at September 30, 2005 (September 30, 2004 – 113,509).

(\$Cdn.)	Three Months Ended September 30			Nine Months Ended September 30		
	2005	2004	% Change	2005	2004	% Change
Current income taxes	213,468	-	100	213,468	-	100
Future income taxes	147,737	11,919	1,140	228,641	11,919	1,818
	361,205	11,919	2,930	442,109	11,919	3,609
Taxes per boe	2.51	0.73	243	1.37	0.41	235

SUMMARY OF QUARTERLY RESULTS

The following table highlights the Company's performance for the most recent eight quarters that comprise first three quarters 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, depletion, depreciation and accretion, and future income taxes.

(\$Cdn.)	2005				2004			2003
	Q3	Q2	Q1	Q4	Q3	Q2	Q1	Q4
Total net revenue	4,479,544	3,290,840	2,054,182	1,802,339	894,574	181,270	220,763	286,736
Net income (loss)	(200,436)	(157,408)	(156,261)	45,846	(38,913)	(77,695)	(55,747)	56,633
Per share - basic	(0.01)	(0.01)	(0.02)	-	(0.01)	(0.01)	(0.01)	0.01
Per share - diluted	(0.01)	(0.01)	(0.02)	-	(0.01)	(0.01)	(0.01)	0.01
Funds from operations	1,835,348	871,288	486,573	92,492	119,608	46,529	29,135	(77,159)
Per share - basic	0.06	0.03	0.02	0.01	0.01	(0.01)	0.01	(0.01)
Per share - diluted	0.06	0.03	0.02	0.01	0.01	(0.01)	0.01	(0.01)
Total assets	48,955,973	38,308,547	30,978,254	16,690,703	9,777,944	3,364,353	3,169,054	2,889,856
Total bank debt	12,443,478	12,668,469	7,601,583	3,743,852	3,700,000	-	-	-

LIQUIDITY

At September 30, 2005, the Company had a debt adjusted working capital surplus of approximately \$1.3 million, compared to a debt adjusted working capital deficiency of approximately \$1.5 million at December 31, 2004. The change in working capital subsequent to year end is attributable to cash flow generated from the assets acquired, drilling activities and private placements completed during the year.

CAPITAL RESOURCES

Revolving Demand Loan

At September 30, 2005, Arsenal has a revolving demand loan for \$14.2 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 September 30, 2005, the interest rate was bank prime plus 0.75% (December 31, 2004 – bank prime plus 1.0%).

Private Placement

On October 27, 2005, Arsenal completed the first closing of a brokered private placement and has issued 3,855,500 units ("Units") at a subscription price of \$1.60 per Unit for aggregate gross proceeds of \$6,168,800. Each Unit consists of one common share ("Common Share") in the share capital of the Corporation and one-half of one common share purchase warrant ("Warrant"). Every one Warrant is exercisable into one additional Common Share of the Corporation at an exercise price of \$2.50 per share on or before April 27, 2007. The Warrants contain a provision that should the Common Shares of Arsenal trade on the Toronto Stock Exchange or other recognized exchange at a price of \$3.00 or higher for 20 non-consecutive trading days, the holder of such Warrants will have 10 business days in which to exercise such Warrants, and any Warrants not so exercised within such time shall be cancelled and void.

CAPITAL EXPENDITURES

Capital expenditures for the nine month period ended September 30, 2005 totalled \$26.7 million. \$10.0 million was spent for the acquisition of IC Energy which closed March 31, 2005, \$6.9 million was spent on the property acquisition which closed June 29, 2005, and \$5.5 million was paid for the acquisition of Quadra Resources Corp., which closed August 11, 2005. Land costs relate to undeveloped lands acquired in northwestern Alberta and at Maidstone, Saskatchewan. Drilling and facility costs were incurred at Evi, Mitsue and Lloydminster.

(\$ Cdn.)	Total
Corporate, property and land acquisitions	22,217,797
Seismic	335,351
Drilling and completions	3,026,600
Production facilities	1,125,220
Total capital expenditures	26,704,969

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.

With the corporate acquisition of Quadra Resources Corp. on August 11, 2005, Arsenal has acquired the Nuqra Concession in Egypt. The Concession Agreement signed with the Egyptian government requires gross expenditures of USD\$11.0 million over an eight year period on seismic evaluation, exploratory drilling and developmental drilling. After completing a farm out agreement with a Canadian public company, Arsenal is responsible for incurring approximately USD\$2.0 million of expenditures to maintain the Concession.

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 September 30, 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 years 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

North America

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 2005 in order to establish high-quality drilling prospects.

The Company mandate was to acquire inexpensive production to take advantage of current high commodity prices, and utilize those cashflows to develop high impact, high quality plays in Alberta. At the end of the third quarter the first of these high impact wells were successfully drilled and completed. Arsenal intends to further develop these key areas, and with our partners actively adding to our land base in Northern Alberta. 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.

Egypt

Reprocessing of the 3,100 km of seismic that was acquired from Quadra is currently being completed, and approximately 850 km of new seismic is planned to be shot during the fourth quarter. Once the new seismic has been processed, Arsenal and the operator of the Nuqra concession will establish preliminary drilling locations with the intent of drilling three wells during the third and fourth quarters of 2006.

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

¹The 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.

CONSOLIDATED BALANCE SHEETS

	September 30, 2005	December 31, 2004
	Unaudited	Audited
ASSETS		
Current assets		
Cash	-	217,063
Accounts receivable (note 5)	3,157,936	582,762
	3,157,936	799,825
Reclamation bonds	215,145	210,960
Property, plant and equipment	40,791,331	15,679,918
Goodwill (note 3)	4,791,561	-
	48,955,973	16,690,703
LIABILITIES		
Current liabilities		
Accounts payable and accrued liabilities	3,742,519	2,265,903
Revolving demand loan (note 4)	12,443,478	3,743,852
Current portion of deferred revenue	352,650	352,650
	16,538,647	6,362,405
Deferred revenue	114,172	198,229
Future income taxes	7,950,785	1,443,129
Asset retirement obligation (note 6)	1,106,689	780,889
	25,710,293	8,784,652
SHAREHOLDERS' EQUITY		
Shareholders' equity (note 7)	23,433,661	7,458,134
Warrants (note 8)	185,027	988,760
Contributed surplus (note 9)	826,122	144,183
Deficit	(1,199,131)	(685,026)
	23,245,680	7,906,051
	48,955,973	16,690,703

Segmented information (note 11)

Commitments and contingencies (note 12)

Subsequent events (note 13)

DEFINING MOMENTS

CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT (UNAUDITED)

	Three Months Ended September 30		Nine Months Ended September 30	
	2005	2004	2005	2004
REVENUE				
Oil and gas	5,968,709	898,566	12,716,490	1,296,607
Royalties	(1,489,165)	(182,380)	(2,891,924)	(246,670)
	<u>4,479,544</u>	<u>716,186</u>	<u>9,824,566</u>	<u>1,049,937</u>
EXPENSES				
Operating	1,968,431	268,595	4,590,643	356,291
General and administrative	685,807	266,788	2,215,761	518,923
Finance charges	110,387	56,611	302,572	56,611
Depletion, depreciation and accretion	1,440,866	163,105	2,601,853	278,548
Foreign exchange	113,285	-	185,733	-
	<u>4,318,776</u>	<u>755,099</u>	<u>9,896,562</u>	<u>1,210,373</u>
Income (loss) before income taxes	160,768	(38,913)	(71,996)	(160,436)
Current income taxes	213,468		213,468	
Future income taxes	147,737	11,919	228,641	11,919
Net income (loss)	(200,436)	(50,832)	(514,105)	(172,355)
Deficit - beginning of period	(998,695)	(281,046)	(685,026)	(159,523)
Acquisition adjustment	-	(398,994)	-	(398,994)
Deficit - end of period	<u>(1,199,131)</u>	<u>(730,872)</u>	<u>(1,199,131)</u>	<u>(730,872)</u>
Income (loss) per share - basic and diluted	\$(0.01)	\$(0.01)	\$(0.02)	\$(0.02)

Segmented information (note 11)

CONSOLIDATED STATEMENT OF CASH FLOWS (UNAUDITED)

	Three Months Ended September 30		Nine Months Ended September 30	
	2005	2004	2005	2004
Cash flows from operating activities				
Net income (loss)	(200,436)	(50,832)	(514,105)	(172,355)
Items not affecting cash				
Depletion, depreciation and accretion	1,440,866	163,105	2,601,853	278,548
Future income taxes	147,737	11,919	228,641	11,919
Stock-based compensation expense (note 9)	367,948	25,645	775,144	38,364
Deferred revenue	(34,051)	(30,229)	(84,057)	(30,229)
Foreign exchange	113,285	-	185,733	-
Funds from operations	1,835,348	119,608	3,193,209	126,247
Net change in non-cash working capital items (note 10)	181,830	20,572	(1,667,299)	(434,388)
Net cash provided by (used in) operating activities	2,017,178	140,180	1,525,910	(308,141)
Cash flows from investing activities				
Corporate acquisitions (note 3)	-	-	(11,441,054)	-
Additions to property, plant and equipment	(3,219,160)	(5,239,623)	(6,034,030)	(6,020,615)
Reclamation bonds	-	(223,340)	-	(223,340)
Changes in non-cash working capital - investing items (note 10)	500,259	-	568,741	-
Net cash provided by (used in) investing activities	(2,718,901)	(5,462,963)	(16,906,343)	(6,243,955)
Cash flows from financing activities				
Issue of shares for cash	305,184	1,026,380	1,977,694	1,665,041
Issue of shares for cash upon exercise of stock options	-	-	193,784	-
Issue of shares for cash upon exercise of warrants	695,266	-	4,551,016	-
Share issue costs	(73,736)	-	(258,750)	-
Deferred revenue	-	735,529	-	735,529
Revolving demand loan	(224,991)	3,700,000	8,699,626	3,700,000
Net cash provided by (used in) financing activities	701,723	5,461,909	15,163,370	6,100,570
Change in cash during the period	-	139,126	(217,063)	(451,526)
Cash - Beginning of period	-	152,928	217,063	743,580
Cash - End of period	-	292,054	-	292,054

Supplemental information (note 10)

Segmented information (note 11)

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

3. BUSINESS ACQUISITION

Effective August 11, 2005 Arsenal acquired all of the issued and outstanding securities of Quadra Resources Corp. ("Quadra"). 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 each business combination and the allocation of the purchase price and consideration for each acquisition is as follows:

Net assets acquired at assigned values:	Quadra	IC Energy
Working capital deficiency	(500,000)	-
Property, plant and equipment	-	10,243,000
Undeveloped land	5,263,014	-
Seismic	720,000	-
Goodwill	2,126,363	2,665,198
Asset retirement obligation	-	(123,713)
Future income taxes	(2,126,363)	(2,784,485)
Net assets acquired	5,483,014	10,000,000
Financed by:		
Shares issued (note 7)	5,233,014	4,500,000
Cash	-	5,500,000
Acquisition costs	250,000	-
Purchase price	5,483,014	10,000,000

4. REVOLVING DEMAND LOAN

At September 30, 2005, The Company has available a demand operating loan in the amount of \$14.2 million (December 31, 2004 - \$4.0 million) bearing interest at the bank prime rate plus 0.75% 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.

5. RELATED PARTY TRANSACTIONS

At September 30, 2005, \$218,037 is due from an officer and director of the Company relating to salary advances. These advances are anticipated to be paid in full by December 31, 2005.

6. 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:

	Nine Months Ended September 30, 2005	Year Ended December 31, 2004
Asset retirement obligation - beginning of period	780,889	106,582
Liabilities acquired	242,159	609,300
Liabilities incurred	33,898	58,891
Foreign exchange	(14,022)	-
Accretion expense	63,765	6,116
Asset retirement obligation - end of period	1,106,689	780,889

7. SHAREHOLDERS' EQUITY

The per share calculations for the nine month period ended September 30, 2005 was based on weighted average shares outstanding of 25,915,932 (September 30, 2004 – 13,512,311). The per share calculations for the three month period ended September 30, 2005 was based on weighted average shares outstanding of 30,942,600 (September 30, 2004 – 13,688,148). In computing net income per share – diluted, 1,086,238 shares (September 30, 2004 – 1,806,645) were added to the weighted average number of shares outstanding for both the three and nine month periods, reflecting the dilutive effect of stock options and share purchase warrants.

	Nine Months Ended September 30, 2005		Year Ended December 31, 2004	
	Shares	Amount (\$)	Shares	Amount (\$)
Balance - beginning of period	18,989,706	7,458,134	8,740,836	2,163,533
Issued to acquire IC Energy	3,000,000	4,500,000	-	-
Issued to acquire Quadra	4,088,292	5,483,014	-	-
Issued to acquire Nahanni	-	-	1,000,000	750,000
Issued to acquire Orange	-	-	1,850,000	550,375
Issued for cash	1,254,710	1,977,694	7,298,870	4,270,532
Cost of shares issued	-	(258,750)	-	(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	5,163,582	4,551,016	-	-
Allocated from contributed surplus	-	93,205	-	-
Allocated from warrants	-	803,733	-	-
Balance - end of period	33,400,567	23,433,661	18,989,706	7,458,134

8. 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:

	Nine Months Ended September 30, 2005	Year Ended 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	(803,733)	-
Balance - end of period	185,027	988,760

9. STOCK OPTIONS

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

	Nine Months Ended September 30, 2005		Year Ended 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	1,870,000	1.22	1,455,000	0.58
Exercised	(904,277)	0.23	(100,000)	0.20
Cancelled	(435,723)	0.59	-	-
Balance - end of period	3,035,000	0.91	2,505,000	0.40
Exercisable - end of period	1,512,501	0.77	1,125,833	0.26

The Company incurred non-cash compensation expense of \$775,144 for the nine month period ended September 30, 2005 (2004 – nil) related to vested options issued under the Option Plan with a corresponding increase to contributed surplus. The Company incurred non-cash compensation expense of \$ 367,948 for the three month period ended September 30, 2005 (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:

	Nine Months Ended September 30, 2005	Year Ended December 31, 2004
Balance - beginning of period	144,183	59,990
Issuance of stock options	775,144	84,193
Reclassification to common shares on exercise of options	(93,205)	-
Balance - end of period	826,122	144,183

10. SUPPLEMENTAL CASH FLOW INFORMATION

	Three Months Ended September 30, 2005	Three Months Ended September 30, 2004	Nine Months Ended September 30, 2005	Nine Months Ended September 30, 2004
Change in non-cash working capital items				
Operating accounts receivable	(1,830,951)	(86,454)	(3,143,915)	(367,809)
Operating accounts payable	2,012,781	107,026	1,476,616	(66,579)
Amounts relating to operating activities	181,830	20,572	(1,667,299)	(434,388)
Amounts relating to investing activities	500,259	-	568,741	-
	682,089	20,572	(1,098,558)	(434,388)
Interest paid	67,996	56,661	238,022	56,661

11. SEGMENTED INFORMATION

A significant portion of the Company's assets and revenues are earned in the United States and Egypt and are monitored as an identifiable reporting segment by management. The remaining assets and associated revenues are earned in Canada by Arsenal Energy Inc. Business risks and economic indicators are similar in Canada and the United States. There are no comparative figures as Arsenal acquired the United States properties August 31, 2004 and the Egyptian concession on August 11, 2005.

(\$ Cdn.)	Canada	U.S	Egypt	Total
Oil and gas revenue	7,192,763	5,523,727	-	12,716,490
Net income before tax	(488,446)	529,646	(113,196)	(71,996)
Operating income	3,006,329	2,227,594	-	5,233,923
Capital assets	29,923,039	4,885,278	5,983,014	40,791,331
Capital expenditures (including acquisitions)	17,376,931	98,153	-	17,475,084

12. COMMITMENTS AND CONTINGENCIES

With the corporate acquisition of Quadra Resources Corp. on August 11, 2005, Arsenal has acquired the Nuqra Concession in Egypt. The Concession Agreement signed with the Egyptian government requires gross expenditures of USD\$11.0 million over an eight year period on seismic evaluation, exploratory drilling and developmental drilling. After completing a farm out agreement with a Canadian public company, Arsenal is responsible for incurring approximately USD\$2.0 million of expenditures to maintain the Concession.

13. SUBSEQUENT EVENTS

Private Placement

On October 27, 2005, Arsenal completed the first closing of a brokered private placement and has issued 3,855,500 units ("Units") at a subscription price of \$1.60 per Unit for aggregate gross proceeds of \$6,168,800. Each Unit consists of one common share ("Common Share") in the share capital of the Corporation and one-half of one common share purchase warrant ("Warrant"). Every one Warrant is exercisable into one additional Common Share of the Corporation at an exercise price of \$2.50 per share on or before April 27, 2007. The Warrants contain a provision that should the Common Shares of Arsenal trade on the Toronto Stock Exchange or other recognized exchange at a price of \$3.00 or higher for 20 non-consecutive trading days, the holder of such Warrants will have 10 business days in which to exercise such Warrants, and any Warrants not so exercised within such time shall be cancelled and void. The private placement securities are subject to a hold period of four months, expiring February 28, 2006.



Arsenal Energy Inc.

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

Exchange Listing

Toronto Stock Exchange: **AEI**
Frankfurt Stock Exchange: **AIE**

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
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Privacy Officer

Jesse Meidl CA
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Board of Directors

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William Hews (1) (3) (4)

Errol Stewart (2) (4)

Greg Belzberg (1)

R. Neil MacKay (2)

Alain Gaucher (1)

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Lyle Skaien (3)

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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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