

Clear direction. Global growth.



Arsenal Energy Inc.

LETTER TO SHAREHOLDERS

Shareholders of Arsenal have become used to growth and change and the first quarter of 2006 was no exception. We completed the \$46.0 million corporate acquisition of Tiverton Petroleum Inc. ("Tiverton") on March 14th, and are participating in one of the deepest wells to be drilled in Alberta this year. We reorganized two senior executive positions to unlock the latent value both acquired with Tiverton and developed organically by Arsenal over the past few years.

Since the inception of Arsenal, Michael Vandale has been President and Chief Executive Officer of the Company, and has been the catalyst for the property and corporate deals that we have secured both domestically and internationally. Upon completion of the Tiverton acquisition, Arsenal reorganized. Michael moved to Chairman of the Board, and Errol Stewart, a co-founder of Arsenal, assumed the position of President and Chief Executive Officer. Michael will continue to seek corporate and international opportunities for Arsenal and Errol while working with Michael in this regard, will focus the domestic staff of the company on maximizing and growing the value of the Arsenal domestic asset base. This will be accomplished through the tie-in of the standing Tiverton production and the execution of our drilling program as quickly and efficiently as possible.

FIRST QUARTER CORPORATE HIGHLIGHTS

- The corporate acquisition of Tiverton Petroleum Ltd., which closed March 14th.
- Completion of an 800 kilometer seismic acquisition program over the Nuqra concession in Egypt.
- Land sale success resulted in adding several sections of land at our new core area at Worsley.
- Spudded Tower Creek well in March, scheduled to reach total depth in late June of 2006.
- Cashflow of \$0.02 per share during the first quarter.
- Drilled and Cased one well at Armada on the Tiverton lands acquired, and one well on Arsenal's Worsley prospect. These wells will be completed and tested immediately after break-up.

ARSENAL ENERGY INC.

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OPERATIONS IN REVIEW

The first quarter of 2006 was challenging for Arsenal from an operational perspective. Record industry activity levels left many junior exploration and production companies unable to secure drilling and service rigs. We were able to drill discoveries at Armada and Worsley at the end of the quarter, however, we were unable to implement the winter drilling program at House Mountain and Evi. Several wells at Lloydminster were shut in awaiting a service rig for several weeks during the quarter. These factors resulted in our production lagging our forecast. We were able to replace our production declines during the quarter, but were unable to increase production from the fourth quarter of 2005.

The Armada well on the Tiverton lands and the Worsley well on the Arsenal lands were cased prior to spring break-up and are waiting on completion. We will be completing both of these wells immediately after break-up. In addition, we anticipate drilling additional wells at Worsley and Kaybob and will participate in two wells at Alderson/Princess on the Tiverton lands. As well, we will move to tie-in the standing production acquired from Tiverton, estimated at approximately 250 barrels of oil equivalent per day.

NORTH DAKOTA

Production has remained stable throughout the first quarter at 385 barrels of oil equivalent per day. We are currently identifying drilling locations for third quarter of 2006.

LLOYDMINISTER

Production at Lloydminster was impacted by service rig availability during the first quarter. We continue to actively pursue service rigs to regain our shut-in production after spring break-up and are reviewing alternative opportunities to provide a service rig during 2006.

WORSLEY

We were successful in adding to our land base through crown land sales and drilled and cased our first well at the end of the quarter just prior to spring break-up. This is a key growth area for the company as it has multi-zone potential and several other operators have drilled extremely prolific wells in the area during the past six months. During 2006 we intend to drill additional wells and shoot additional 3D seismic to expand on the potential identified by the first well. We will continue to add to our land position as opportunities are identified.

KAYBOB

We completed the seismic which has confirmed the existence of an anomaly and we will be drilling this structure in the second or third quarter subject to rig availability. If this well is successful, it will set up several additional locations with considerable upside potential.

EGYPT

An 800 km 2-D seismic acquisition program commenced in early January 2006 was completed during the first week of April. It is expected that the new data will be processed and mapped by the end of the second quarter. Arsenal, along with partners, are preparing for a two well exploration drilling program to commence in the fourth quarter of 2006. Production casing, wellheads and other long lead time items have been ordered with deliveries scheduled for early in the third quarter. Tenders for a drilling rig are out for bid. We have fulfilled the Period One work commitments and will commit to the Period Two

work commitments at the end of Period One on July 18, 2006. There is a mandatory relinquishment of 25% of the block at the end of Period One. Arsenal and partners are confident that our seismic data base will provide ample information to successfully high grade the lands in this concession and provide high quality drilling locations.

COMMODITY PRICING

Light sweet crude oil continues to test historical highs with increasing tension in the Middle East, and stagnant global production. It is anticipated in the market that West Texas Intermediate crude could remain above \$60 US for the remainder of the year.

Natural gas remained well above historical averages for the past year, however it has recently weakened as inventories rose as a result of unseasonably warm weather, particularly in the north eastern United States. Natural gas futures for winter 2006 and 2007 deliveries are presently above \$10 US on the NYMEX exchange.

The winter of 2005 and 2006 witnessed record heavy oil differentials in Canada, which had a significant impact on our corporate cashflow. The differential exceeded \$25 US per barrel for the majority of the first quarter, however it has recently contracted and is approaching the historical average of 20% of WTI. As a significant portion of our revenue stream continues to be heavy crude, we should see material increases in cashflow as a result of the tightened differential this summer.

Exposure to the heavy oil differential was a motivating factor in Arsenal's acquisition of Tiverton. We intend to continue to aggressively pursue light oil and natural gas opportunities this year, to mitigate our exposure to the heavy oil differential.

OUTLOOK

In the second quarter, we will aggressively move to put shut-in wells back on production, tie-in the standing wells acquired from Tiverton, and secure a drilling rig to execute our drilling program in Alberta. We will generate value through the drill bit and continue to seek acquisitions that are accretive. We will be selecting locations for the first wells on the Nuqra concession in Egypt which are slated to be drilled during the fourth quarter of 2006, and we will continue to pursue additional international opportunities that match our stringent guidelines. We would like to thank our shareholders for their support and look forward to continuing the growth in share value which you continue to expect from Arsenal Energy Inc.

On behalf of the Board of Directors,



Errol Stewart

President and Chief Executive Officer

SUMMARY OF OPERATING & FINANCIAL RESULTS

	Three Months Ended March 31	
	2006	2005
FINANCIAL		
Financial		
Funds from operations ¹	957,218	486,563
Per unit - basic	0.02	0.02
Per unit - diluted	0.02	0.02
Bank debt	11,128,145	7,601,583
Operating costs per boe	14.05	11.36
Operating netbacks per boe	16.74	15.62
Market		
Shares outstanding		
End of period	65,528,875	26,407,303
Weighted average - basic	46,466,361	20,134,963
Weighted average - diluted	47,598,407	21,454,309
Shares trading		
High	1.88	1.92
Low	1.38	0.88
Close	1.41	1.48
Average daily volume	137,000	49,700
OPERATIONS		
Daily production (average)		
Crude oil (bbl)	1,333	758
NGLs (bbl)	40	31
Natural gas (mcf)	600	231
Total (boe) ²	1,474	828
Realized commodity prices (\$Cdn.)		
Total crude oil (bbl)	38.83	38.67
NGLs (bbl)	49.77	38.53
Natural gas (mcf)	9.00	7.46
Average (boe) ²	44.02	38.59
Reference pricing		
WTI (U.S.\$/bbl)	63.48	49.84
AECO gas (\$Cdn./mcf)	8.79	6.63
Foreign Exchange (\$U.S./\$Cdn.)	1.15	1.23

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

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

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, 2006 and 2005 and with the audited consolidated financial statements and MD&A for the year ended December 31, 2005. 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 2, 2006.

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RESULTS OF OPERATIONS

PRODUCTION AND MARKETING

Production volumes for the three periods ended March 31, 2006 increased to 1,474 boe/d, which represents a 78% increase over the same period in 2005. The increase in volume is attributable to the integration of corporate and property acquisitions and new wells drilled during the year.

With the completion of the Tiverton Petroleum Inc. ("Tiverton") acquisition on March 14, 2006, Arsenal is producing approximately 2,000 boe/d with approximately 250 boe/d behind pipe which will be brought into production after spring break-up. The Tiverton production is comprised of approximately 2.16 mmcf/d of natural gas, and approximately 240 bbl/d of light and medium crude and liquids. Arsenal is committed to decreasing its exposure to heavy oil, and has established a target of exiting 2006 with 50% of its production being comprised of natural gas and light oil.

	Three Months Ended March 31		
	2006	2005	% Change
Crude oil (bbl/d)	1,333	758	76
NGL (bbl/d)	40	31	30
Natural gas (mcf/d)	600	231	160
Total (boe/d)	1,474	828	78
Production split			
Oil & NGLs	93%	95%	(2)
Natural Gas	7%	5%	46

COMMODITY PRICES

Commodity price realizations during the three month period ended March 31, 2006 increased 14% over the same period in 2005. The impact of favourable crude oil prices was partly offset by an 6% 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 March 31, 2006, 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. The differential exceeded \$25 per barrel for much of the first quarter, and has decreased starting in April reflecting historical seasonality. Arsenal expects the differential to return to the historical average of approximately 28% of WTI for the summer, and widening to more than 30% of WTI in winter.

Arsenal anticipates continued high commodity prices as supply issues continue to impact natural gas, while tensions in the Middle East, specifically Iran have resulted in the WTI price reaching record highs.

(\$Cdn.)	Three Months Ended March 31		
Prices - Before Derivatives	2006	2005	% Change
Total crude oil (bbl)	38.83	38.67	1
NGLs (bbl)	49.77	38.53	29
Natural gas (mcf)	9.00	7.46	21
Total (boe)	44.02	38.59	14

Reference Pricing

Reference Pricing	2006	2005	% Change
WTI (\$U.S./bbl)	63.48	49.84	27
AECO gas (\$Cdn./mcf)	8.79	6.63	33
NYMEX gas (\$U.S./mmbtu)	9.08	6.53	39
Foreign exchange (\$Cdn./\$U.S.)	1.15	1.23	(6)

OIL AND GAS REVENUE

Net oil and gas revenue for the three month period ended March 31, 2006 was 99% higher than the comparable period in 2005, reflecting increased petroleum and natural gas production and commodity prices. Revenue per boe for the three month period ended March 31, 2006 increased 14% over the same period in 2005, as the impact of the hedged production was offset by higher commodity prices.

(\$Cdn.)	Three Months Ended March 31		
	2006	2005	% Change
Crude oil sales	4,932,838	2,527,059	95
NGL sales	179,574	155,737	15
Natural gas sales	511,250	108,665	370
Other	61,800	93,613	(34)
Loss on forward contracts	(404,134)	(231,216)	75
Gross oil and gas revenue	5,281,327	2,653,858	99
Per boe	39.77	34.86	14

ROYALTIES

Royalties as a percentage of gross oil and gas revenue were consistent with comparable period in 2005 at 23%. The production acquired from Tiverton has fewer burdens than the existing production held by Arsenal, management anticipates the royalty rate decreasing in upcoming periods.

(\$Cdn.)	Three Months Ended March 31		
	2006	2005	% Change
Royalties	1,193,667	599,676	99
% of gross oil and gas revenue	23	21	1
Per boe	8.99	7.88	14

OPERATING COSTS

Operating expenses per boe for the three month period ended March 31, 2006 increased 24% over the same period in 2005. The increase is primarily attributable to record industry activity levels, which have resulted in oilfield service costs increasing more than 30% over the prior year. Costs have trended lower from the fourth quarter of 2005, when they averaged \$17.54/boe. The Tiverton production acquired by Arsenal has historically been less expensive than the current production, reflecting the natural gas weighting of the assets. As the impact of the new Tiverton production is realized, Arsenal expects operating costs per boe to trend lower.

(\$Cdn.)	Three Months Ended March 31		
	2006	2005	% Change
Operating expense	1,865,285	864,897	116
Per boe	14.05	11.36	24

PRODUCT NETBACKS¹

Netbacks for the three month period ended March 31, 2006 increased 7% over the comparative period. Higher commodity prices were partially offset by increased royalties and operating costs experienced in the first quarter.

(\$Cdn. per boe)	Three Months Ended March 31		
	2006	2005	% Change
Net revenue after derivatives	39.77	34.86	14
Royalties	(8.99)	(7.88)	14
Operating expenses	(14.05)	(11.36)	24
Operating netback	16.74	15.62	7

GENERAL AND ADMINISTRATIVE EXPENSES

General and administrative costs per boe for the three month period ended March 31, 2006 decreased by 13% over the comparative period in 2005. Included in general and administrative costs for the first quarter is \$275,000 relating to employee annual bonuses for 2005. 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.

(\$Cdn.)	Three Months Ended March 31		
	2006	2005	% Change
General and administrative	1,050,623	693,044	52
Per boe	7.91	9.10	(13)

FINANCE CHARGES

Finance charges for the three month period ended March 31, 2006 increased 21% over the comparative period as the Company drew on its credit facility to fund both drilling and acquisition activities during the first quarter.

(\$Cdn.)	Three Months Ended March 31		
	2006	2005	% Change
Finance charges	78,286	64,730	21
Per boe	0.59	0.85	(31)

DEPLETION, DEPRECIATION, AND ACCRETION

Depletion, depreciation and accretion per boe increased 255% for the three month period ended March 31, 2006 compared to the same period in 2005. The increase is attributable to the higher production rates, significantly higher asset base in 2006 compared to 2005, and additional accretion incurred on the asset retirement obligation.

(\$Cdn.)	Three Months Ended March 31		
	2006	2005	% Change
Depletion, depreciation and accretion	1,822,968	513,623	255
Per boe	13.73	6.75	103

TAXES

During the first quarter of 2006, Arsenal accrued current income taxes totalling \$13,000 compared to \$nil during the same period in 2005. Current taxes relate to Large Corporations Tax and Saskatchewan Capital Tax. During the first quarter, Arsenal recovered future income taxes totalling \$239,859 compared to an expense \$36,614 during the same period in 2005. A future income tax balance of \$16,493,897 is recorded as a liability as at March 31, 2006 (March 31, 2005 – \$5,632,396).

06: FIRST QUARTER

(\$Cdn.)	Three Months Ended March 31		
	2006	2005	% Change
Current income taxes	(13,000)	-	100
Future income taxes (reduction)	239,859	(36,614)	(755)
	226,859	(36,614)	(720)
Per boe	1.71	(0.48)	(455)

SUMMARY OF QUARTERLY RESULTS

The following table highlights the Company's performance for the most recent eight quarters that comprise first quarter of 2006, four quarters in 2005, and three quarters in 2004. Total revenue is primarily impacted by commodity prices and production volumes. Net income and net income per share are primarily impacted by royalties, operating costs, general and administrative costs, depletion, depreciation and accretion, and future income taxes.

Per share values for the first quarter of 2006 and fourth quarter of 2005 are also impacted by the significant increase in shares outstanding, reflecting the Tiverton acquisition and equity issues during the periods.

(\$Cdn.)	2006			2005			2004		
	Q1	Q4	Q3	Q2	Q1	Q4	Q3	Q2	
Total net revenue	5,281,327	4,568,443	4,479,544	3,290,840	2,054,182	1,802,339	716,186	138,709	
Net income (loss)	(848,458)	(611,180)	(200,436)	(157,408)	(156,261)	45,846	(50,832)	(77,265)	
Per share - basic	(0.02)	(0.04)	(0.01)	(0.01)	(0.01)	0.00	(0.01)	(0.01)	
Per share - diluted	(0.02)	(0.04)	(0.01)	(0.01)	(0.01)	0.00	(0.01)	(0.01)	
Funds from operations	957,218	1,122,820	1,835,348	871,288	486,573	92,492	119,608	(35,215)	
Per share - basic	0.02	0.03	0.06	0.03	0.02	0.01	0.01	(0.01)	
Per share - diluted	0.02	0.03	0.06	0.03	0.02	0.01	0.01	(0.01)	
Total assets	112,189,351	54,157,383	48,955,973	38,308,547	30,978,254	16,690,703	9,777,944	3,364,353	
Total bank debt	11,128,145	2,496,195	12,443,478	12,668,469	7,601,583	3,743,852	3,700,000	-	
Shares outstanding	65,528,875	42,231,244	33,400,567	28,015,244	26,407,303	18,989,706	13,588,667	11,591,875	

LIQUIDITY

(\$Cdn.)	Three Months Ended March 31, 2006
Sources	
Funds from operations	957,218
Issue of warrants	59,122
Change in non-cash working capital - operating items	(2,062,010)
Change in non-cash working capital - investing items	(957,863)
Total sources of cash	(2,003,533)
Uses	
Plant, property and equipment additions	(2,281,265)
Share issue costs	(647,152)
Tiverton acquisition assumed debt	(3,700,000)
Total uses of cash	(6,628,417)
Increase in bank debt	(8,631,950)

BANK DEBT PLUS WORKING CAPITAL DEFICIT

At March 31, 2006, the Company had \$11.4 million outstanding on its credit facility and a working capital deficit of \$0.028 million, for total debt plus working capital deficit of \$11.43 million, compared to total debt plus working capital of \$8.8 million at March 31, 2005. The Company's anticipated funds from operations before change in non-cash working capital is expected to be sufficient to meet the current working capital deficit. The capital intensive nature of the industry will generally result in the Company having a working capital deficit, however, the Company will maintain total debt plus working capital deficit below the Company's credit facility. At March 31, 2006, the Company had a credit facility of \$14.2 million. On May 9, 2006, the Company's lending institution increased the total credit available under the demand operating loan to \$16.0 million, bearing interest at the bank prime rate plus 0.75%.

CONVERTIBLE DEBENTURE

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

The Company can elect to prepay the debenture providing the Company's shares trade above \$2.60 per share for 22 consecutive days. Interest is payable semi-annually on June 30th and December 31st of each year. The convertible debentures are a debt security with an embedded conversion option and were segregated into their debt and equity components based on their respective fair values at the date of acquisition. The \$370,000 equity component represents the holder's conversion right and is included in Shareholders' Equity, the remaining balance of \$3,110,000 has been classified as debt. If the holder exercises the conversion right, they will receive accrued and unpaid interest up to and including the conversion date.

SHARE CAPITAL

The following table outlines the common share issues, warrant and option exercises during the year:

	Common shares
Opening	42,231,244
Issued to acquire Tiverton	23,237,671
Issued on exercise of warrants	59,960
Closing	65,528,875

CAPITAL RESOURCES

Revolving Demand Loan

At March 31, 2006, Arsenal has a revolving demand loan for \$14.2 million (March 31, 2005 – \$12.8 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, 2006, the interest rate was bank prime plus 0.75%. On May 9, 2006, the Company's lending institution increased the total credit available under the demand operating loan to \$16.0 million, bearing interest at the bank prime rate plus 0.75%.

CAPITAL EXPENDITURES

Capital expenditures for the three month period ended March 31, 2006 totalled \$41.8 million. \$41.2 million was spent for the acquisition of Tiverton which closed March 14, 2006. Land costs relate to undeveloped lands acquired in northwestern Alberta. Drilling and facility costs were incurred at Armada and Lloydminster.

(\$ Cdn.)	Total
Corporate, property and land acquisitions	45,441,649
Seismic	114,470
Drilling and completions	1,370,136
Production facilities	194,942
Other	30,818
Total capital expenditures	47,152,015

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 material changes to the commitments and contingencies disclosed in the MD&A dated March 21, 2006 prepared in conjunction with the December 31, 2005 and 2004 financial statements.

RISK MANAGEMENT

Business risks affecting Arsenal are unchanged from those disclosed in the MD&A dated March 21, 2006 prepared in conjunction with the December 31, 2005 and 2004 financial statements.

SIGNIFICANT ACCOUNTING POLICIES AND ESTIMATES

The interim consolidated financial statements dated March 31, 2006 have been prepared following the same accounting policies and methods of computation as the consolidated financial statements for the fiscal years ended December 31, 2005 and 2004.

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’s domestic production and cashflow has increased significantly over the past two years. The Company anticipates continued growth domestically both through the drill-bit and accretive acquisitions like Tiverton.

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

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

Egypt

The 800 km seismic evaluation program is was completed in April 2006, and the reprocessing of 3,900 km of seismic acquired over the concession has confirmed thirteen leads ranging in size between 9.0 million original barrels in place and more than 100.0 million original barrels in place. The first two wells are scheduled to be drilled in the fourth quarter of 2006, subject to rig availability.

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 2005 and 2006 in order to establish high-quality drilling prospects. The Company also obtained seismic options over considerable acreage in northern Alberta to further expand our core areas there.

The Company will continue to pursue acquisitions that will be accretive on a per share basis to cash flow, production, reserves and net asset value. One of the key components of the Tiverton acquisition is the existence of a high quality drilling inventory which Arsenal intends to quickly develop during this year. 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 2006 of the sensitivity of the Company's 2006 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

INTERIM CONSOLIDATED BALANCE SHEETS

As at	March 31, 2006	December 31, 2005
	Unaudited	Audited
ASSETS		
Current assets		
Accounts receivable	6,228,239	4,583,927
Reclamation bonds	203,291	203,291
Property, plant and equipment	87,393,829	44,578,604
Goodwill	18,363,990	4,791,561
	112,189,351	54,157,383
LIABILITIES		
Current liabilities		
Accounts payable and accrued liabilities	6,654,710	6,365,577
Revolving demand loan (note 3)	11,128,145	2,496,195
Deferred revenue	164,284	287,533
	17,947,139	9,149,305
Convertible debentures (note 8)	3,182,473	-
Future income taxes	16,493,897	7,509,044
Asset retirement obligations (note 4)	2,427,736	1,295,500
	40,051,246	17,953,849
SHAREHOLDERS' EQUITY		
Common shares (note 5)	72,582,023	36,514,809
Warrants (note 6)	303,731	303,731
Contributed surplus (note 7)	1,516,259	1,170,444
Common share conversion rights (note 8)	370,000	-
Deficit	(2,633,908)	(1,785,450)
	72,138,105	36,203,534
	112,189,351	54,157,383

Segmented information (note 10)

Subsequent event (note 11)

See accompanying notes to the interim financial statements.

Approved by the Board:



Director



Director

INTERIM CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT (UNAUDITED)

For the three months ended	March 31, 2006	March 31, 2005
REVENUE		
Oil and gas	5,281,327	2,653,858
Royalties expense, net of Alberta Royalty Tax Credit	(1,193,667)	(599,676)
	<u>4,087,660</u>	<u>2,054,182</u>
EXPENSES		
Operating	1,865,285	864,897
General and administrative	1,050,623	693,044
Finance charges	78,286	64,730
Depletion, depreciation and accretion	1,822,968	513,623
Stock-based compensation expense (note 7)	345,816	37,535
	<u>5,162,977</u>	<u>2,173,829</u>
Loss before income taxes	(1,075,317)	(119,647)
Income taxes		
Current tax expense	(13,000)	-
Future income tax (expense) recovery	239,859	(36,614)
	<u>226,859</u>	<u>(36,614)</u>
Net loss	(848,458)	(156,261)
Deficit - beginning of period	(1,785,450)	(685,026)
Deficit - end of period	<u>(2,633,908)</u>	<u>(841,287)</u>
Loss per share - basic and diluted	\$ (0.02)	\$ (0.04)
Segmented information (note 10)		

INTERIM CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

For the three months ended	March 31, 2006	March 31, 2005
Cash flows from operating activities		
Net loss	(848,458)	(156,261)
Items not affecting cash		
Depletion, depreciation and accretion	1,822,968	513,613
Future income tax expense (recovery)	(239,859)	36,614
Stock-based compensation expense (note 7)	345,816	85,241
Deferred revenue	(123,249)	(30,179)
Unrealized foreign exchange	-	37,535
	<u>957,218</u>	<u>486,563</u>
Change in non-cash working capital (note 9)	(2,062,010)	(485,797)
Cash provided by (used in) operating activities	<u>(1,104,792)</u>	<u>766</u>
Cash flows from investing activities		
Corporate acquisitions (note 2)	-	(5,500,000)
Additions to property, plant and equipment	(2,281,265)	(1,546,532)
Change in non-cash working capital (note 9)	(957,863)	42,574
Cash used in investing activities	<u>(3,239,128)</u>	<u>(7,003,958)</u>
Cash flows from financing activities		
Issue of shares for cash upon exercise of stock options	-	193,784
Issue of shares for cash upon exercise of warrants	59,122	2,909,332
Share issue costs	(647,152)	(174,728)
Revolving demand loan	4,931,950	3,857,731
Cash provided by financing activities	<u>4,343,920</u>	<u>6,786,119</u>
Change in cash during the period	-	(217,073)
Cash - beginning of period	-	217,063
Cash - end of period	-	-

Supplemental information (note 9)

Segmented information (note 10)

NOTES TO INTERIM 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, 2005. 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, 2005.

2. BUSINESS ACQUISITION

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

	Tiverton 2006	IC Energy 2005
Net assets acquired at assigned values:		
Working capital deficiency	(2,085,000)	-
Property, plant and equipment	42,740,000	10,243,000
Goodwill	13,572,428	2,665,198
Bank debt	(3,700,000)	-
Convertible debentures	(3,182,473)	-
Asset retirement obligation	(1,095,000)	(123,713)
Future income taxes	(6,937,798)	(2,784,485)
Common share conversion rights	(370,000)	-
Net assets acquired	38,942,157	10,000,000
Financed by:		
Shares issued	38,342,157	4,500,000
Cash	-	5,500,000
Acquisition costs	600,000	-
Purchase price	38,942,157	10,000,000

The above amounts are estimates made by management based on currently available information. Amendments may be made to the purchase allocations as the cost estimates and tax balances are finalized.

3. REVOLVING DEMAND LOAN

At March 31, 2006, the Company has available a demand operating loan in the amount of \$14.2 million (December 31, 2005 - \$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.

On May 9, 2006, the Company's lending institution increased the total credit available under the demand operating loan to \$16.0 million, bearing interest at the bank prime rate plus 0.75%.

4. ASSET RETIREMENT OBLIGATIONS

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

	Three Months Ended		Year Ended	
	March 31, 2006		December 31, 2005	
Asset retirement obligation - beginning of period	1,295,500		780,889	
Liabilities acquired	1,095,000		334,119	
Liabilities incurred	17,000		114,808	
Change in estimate	(6,764)		(14,022)	
Accretion expense	27,000		79,706	
Asset retirement obligation - end of period	2,427,736		1,295,500	

5. COMMON SHARES

	Three Months Ended		Year Ended	
	March 31, 2006		December 31, 2005	
	Shares	Amount (\$)	Shares	Amount (\$)
Balance - beginning of period	42,231,244	36,514,809	18,989,706	7,458,134
Issued to acquire Tiverton	23,237,671	38,942,157	-	-
Issued to acquire IC Energy	-	-	3,000,000	4,500,000
Issued to acquire Quadra	-	-	4,088,292	5,483,014
Issued for cash	-	-	8,760,496	13,573,157
Cost of shares issued	-	(647,152)	-	(723,785)
Tax effect of flow-through shares	-	(2,369,913)	-	(1,445,169)
Tax effect of share issue costs	-	83,000	-	247,000
Issued on exercise of options	-	-	972,025	207,334
Issued on exercise of warrants	59,960	59,122	6,745,725	6,133,159
Allocated from contributed surplus	-	-	-	93,205
Allocated from warrants	-	-	-	988,760
Shares issued	65,528,875	72,582,023	42,556,244	36,514,809
Shares held in escrow	(325,000)	-	(325,000)	-
Balance - end of period	65,203,875	72,582,023	42,231,244	36,514,809

The per share calculations for the three month period ended March 31, 2006 was based on weighted average shares outstanding of 46,466,361 (March 31, 2005 – 20,134,963). In computing net loss per share – diluted, 1,132,046 shares (March 31, 2005 – 974,342) were added to the weighted average number of shares outstanding for the three month period, reflecting the dilutive effect of stock options and share purchase warrants.

6. 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 details the changes in the warrant account balance:

	Three Months Ended		Year Ended	
	March 31, 2006		December 31, 2005	
	Warrants	Amount (\$)	Warrants	Amount (\$)
Balance - beginning of period	2,031,100	303,731	6,588,664	988,760
Private placement	-	-	2,031,100	303,731
Agents' warrants ⁽¹⁾	59,960	-	157,061	-
Allocated to common equity upon exercise of warrants	(59,960)	-	(6,745,725)	(988,760)
Balance - end of period	2,031,100	303,731	2,031,100	303,731

⁽¹⁾During 2006 the Company's underwriters and agents exercised their right to an additional 59,960 warrants pursuant to their respective agency agreements relating to equity offerings completed in 2004 and 2005.

7. 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, 2006		December 31, 2005	
	Options	Weighted Average Price (\$)	Options	Weighted Average Price (\$)
Balance - beginning of period	3,592,252	0.99	2,505,000	0.40
Granted	25,000	1.30	2,495,000	1.24
Exercised	-	-	(972,025)	0.23
Cancelled	-	-	(435,723)	0.59
Balance - end of period	3,617,252	1.00	3,592,252	0.99
Exercisable - end of period	2,627,252	0.90	1,977,259	0.90

The Company incurred non-cash compensation expense of \$345,815 for the three month period ended March 31, 2006 (2005 – \$37,535) 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, 2006		December 31, 2005	
Balance - beginning of period	1,170,444		144,183	
Issuance of stock options	345,816		1,119,466	
Reclassification to common shares on exercise of options	-		(93,205)	
Balance - end of period	1,516,259		1,170,444	

8. CONVERTIBLE DEBENTURE

As outlined in Note 2, Arsenal completed the corporate acquisition of Tiverton effective March 14, 2006. A portion of Tiverton's capital structure was comprised of unsecured convertible debentures totalling \$3,480,000. Interest accrues on the debentures at 8% on the debentures, payable semi-annually on June 30th and December 31st of each year. The debentures will mature on February 15, 2009 unless called for redemption earlier by Arsenal. After giving effect to the plan of arrangement, the debentures are convertible by the holders at any time prior to maturity into 1,539,170 shares of the Company, representing a conversion price of \$2.26 per Arsenal share.

The Company can elect to prepay the debenture providing the Company's shares trade above \$2.60 per share for 22 consecutive days. Interest is payable semi-annually on June 30th and December 31st of each year. The convertible debentures are a debt security with an embedded conversion option and were segregated into their debt and equity components based on their respective fair values at the date of acquisition. The \$370,000 equity component represents the holder's conversion right and is included in Shareholders' Equity, the remaining balance of \$3,110,000 has been classified as debt. If the holder exercises the conversion right, they will receive accrued and unpaid interest up to and including the conversion date.

9. SUPPLEMENTAL CASH FLOW INFORMATION

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2005
Change in non-cash working capital items		
Operating accounts receivable	(1,644,313)	(619,944)
Operating accounts payable	(417,698)	134,147
Amounts relating to operating activities	(2,062,010)	(485,797)
Amounts relating to investing activities	(957,863)	42,574
	(3,019,873)	(443,223)
Taxes paid	10,065	-
Interest paid	68,946	42,571

10. SEGMENTED INFORMATION

A significant portion of the Company's assets and revenues are earned in the United States and Egypt and are monitored as identifiable reporting segments by management. The remaining assets and associated revenues are earned in Canada by Arsenal Energy Inc. The following table outlines key operating results by entity:

(\$ Cdn.)	2005			
	Canada	U.S	Egypt	Total
Oil and gas revenue	3,141,274	2,140,053	-	5,281,327
Net loss before income taxes	(815,863)	(181,705)	(77,826)	(1,075,317)
Plant, property and equipment	77,391,835	4,641,762	5,360,232	87,393,829
Capital expenditures (including acquisitions)	2,183,112	98,153	-	2,281,265

(\$ Cdn.)	2004			
	Canada	U.S	Egypt	Total
Oil and gas revenue	985,340	1,601,232	-	2,586,572
Net income (loss) before income taxes	(352,726)	233,079	-	(119,647)
Plant, property and equipment	24,521,453	6,456,801	-	30,978,254
Capital expenditures (including acquisitions)	1,546,532	-	-	1,546,532

11. SUBSEQUENT EVENT

Increase to Credit Facility

On May 9, 2006, the Company's lending institution increased the total credit available under the demand operating loan to \$16.0 million, bearing interest at the bank prime rate plus 0.75%.

Officers and Management

Errol Stewart
President and Chief Executive Officer

Jesse Meidl CA (4)
Chief Financial Officer

Bernie Dumanowski P. Eng.
Vice President Operations

Robert K. Howard P. Land
Vice President Land

Exchange Listings

Toronto Stock Exchange: AEI
Frankfurt Stock Exchange: A1E

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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Privacy Officer

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Errol Stewart (2) (4)

Greg Belzberg (1)

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Alain Gaucher (1)

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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
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