



Arsenal Energy Inc.

TORONTO STOCK EXCHANGE: AEI
FRANKFURT STOCK EXCHANGE: A1E

2008 SECOND QUARTER REPORT

PRESIDENT'S MESSAGE

ARSENAL ANNOUNCES SECOND QUARTER 2008 OPERATING AND FINANCIAL RESULTS

Arsenal is pleased to report its Q2 2008 results. Oil price increases through the second quarter resulted in strong netbacks and cash flows. Production volumes increased 11 % over the previous quarter and Q2 drills should result in a production increase again in the third quarter.

Subsequent to quarter end, Arsenal and Geocan Energy announced an arrangement providing for the acquisition by Arsenal of Geocan. The combination will add approximately 850 bbls/d of production and 1.8 million boe of proven producing reserves for a purchase price of \$30 million in cash and the issuance of 10.6 million shares of Arsenal. After closing in October, Arsenal is forecast to be producing at approximately 2830 boe/d and cash flowing approximately \$10.7 million per quarter. Net debt plus working capital after closing is forecast at approximately \$50 million

Q2 HIGHLIGHTS

- Average production of 1909 boe/d vs. 1725 boe/d in Q1
- Operating netbacks of \$51.77 per boe vs. \$32.82 per boe in Q1
- Quarterly cash flow from operations of \$8.1 million vs. \$3.8 million in Q1
- Quarter end total debt + working capital of \$14.3 million vs. \$18.7 million in Q1

PROFIT/LOSS

Arsenal showed a loss of \$1.9 million for the second quarter. Arsenal booked a mark to market loss of \$6.6 million on a 300 bbls/d hedge. Excluding that loss, Arsenal would have shown a pretax profit.

OPERATIONS IN REVIEW

The company has established three key plays at Evi Alberta, East Central Alberta, and Stanley, North Dakota. In the second quarter, Arsenal participated in the drilling of 9 gross (7.8 net) wells resulting in 5 gross (5.0 net) oil wells, 3 gross (1.8 net) dry holes, and 1 gross (1 net) water disposal well. All of the wells were in East Central Alberta. Arsenal expects to drill 5 gross (4.3 net) wells in the third quarter.

EVI

During Q1 all of Arsenal's production was tied in to a battery acquired in Q4. Operating costs for the field dropped from \$22.86 per bbl in Q1 to around \$9.00 per bbl currently. Five (2.1 net) locations have been selected for drilling in the fourth quarter and Arsenal has an additional 4 other locations in inventory.

EAST CENTRAL ALBERTA

At Galahad Arsenal drilled two (2 net) oil wells in Q2. An additional five (5 net) wells were drilled subsequent to quarter end. Five wells were cased as potential oil wells and two were abandoned. Five of the wells were exploratory tests on a new 400 acre structure. One well tested gas at 3mmcf/d, one tested oil at 180 bbls/d, one is awaiting completion, and two were abandoned. Based on drill results, Arsenal now interprets the project as three separate structures. Arsenal will formulate development plans for the new structures after a few months of production history.

Arsenal drilled three (3 net) wells at Provost in Q2. One well was completed as a Lloydminster oil well, one was completed as a Rex oil well and one was abandoned. The two new wells are anticipated to produce 60 bbls/d of net production when they come on stream in August.

STANLEY

Arsenal has 1896 net acres of Bakken deep rights in the Stanley area. The company has executed an AFE to participate in a horizontal Bakken well with a 3,000 meter lateral. Arsenal will have a 35% working interest. The well is expected to spud around the middle of August and take about 50 days to drill. Arsenal anticipates receiving a number of additional drilling AFEs in the coming quarters.



PRESIDENT'S MESSAGE

EGYPT

As previously disclosed, Arsenal has extensively shopped its Egyptian concession and did not generate any material interest. Arsenal has agreed to sell its Egyptian subsidiary for nominal value, effective June 30, 2008. Going forward Arsenal will have no interests in Egypt.

COMMODITY PRICING

The reference prices received for oil and natural gas continued to increase during the second quarter of 2008. Arsenal's mix of light vs. heavy oil also improved. The average Q2 2008 boe price before derivatives increased to \$96.02 per boe, up 33% from Q1 2008.

OPERATING EXPENSES

Operating costs averaged \$21.65 per boe during the second quarter. This is an improvement from \$22.65 per boe during Q1. During the quarter Arsenal undertook several facility turnarounds that cut volumes and added to operating costs. With these operations complete, Q3 unit operating costs should show additional improvement.

CASH FLOW

Cash flow from operations for the second quarter was \$8.1 million or \$0.09 per share. The large increase from Q1 2008 is due to higher realized prices, higher volumes, a better quality production mix, and a decrease in one time charges and prior period adjustments.

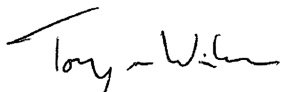
DEBT

Strong Q2 cash flows reduced total debt from \$18.7 million at the end of Q1 to \$14.3 million at the end of Q2. Current debt is less than 6 months cash flow. Arsenal's financial strategy is to target leverage at one times cash flow. The combination with Geocan will bring the debt to forward cash flow ratio to approximately 1.1 : 1.

OUTLOOK

Oil and gas prices have weakened recently but if they stabilize above \$100 per bbl, it is anticipated that the third quarter realizations should be close to those of Q2. It is also anticipated that volumes in Q3 will be slightly higher and costs should be lower. Arsenal recently added two additional oil hedges. For the third quarter Arsenal has total hedges of 800 bbls/d of oil at a combined reference price of Cdn \$117 per bbl. Head office initiatives and the dropping of the Egyptian concession are expected to lower overhead. Cash flows should continue to be strong.

Over the next six months Arsenal has a very exciting program. We plan to spud a high impact Bakken well at Stanley, North Dakota, to tie in production from our successful Q2 East Central Alberta drilling program, and to continue our highly successful drilling program at Evi. In October, with the closing of the Geocan transaction, Arsenal's production and reserves will grow by over 30%.



Tony van Winkoop
President and Chief Executive Officer

FINANCIAL HIGHLIGHTS

SUMMARY OF OPERATING & FINANCIAL RESULTS

	2008	2007	2008	2007
	(Three Months Ended June 30)		(Six Months Ended June 30)	
Financial				
Funds from operations ¹	8,050,518	1,078,581	11,840,223	2,920,590
Per share – basic and diluted	0.09	0.01	0.14	0.04
Net loss	(1,925,853)	(9,406,449)	(2,413,879)	(17,405,474)
Per share – basic and diluted	(0.02)	(0.13)	(0.03)	(0.24)
Total debt (excluding derivatives)	14,266,267	13,943,031	14,266,267	13,943,031
Capital expenditures	4,792,985	5,681,242	9,677,825	8,680,431
Property acquisitions	974,733	–	–	–
Property dispositions	1,225,792	14,000,000	1,235,792	14,000,000
Wells drilled				
Gross	9.00	1.00	17.00	4.00
Net	7.80	0.13	13.35	2.75
Shares outstanding – end of period	90,719,815	73,917,173	90,719,815	73,917,173
Trading range				
High	0.98	0.75	0.98	1.06
Low	0.57	0.33	0.40	0.33
Close	0.81	0.48	0.81	0.48
Average daily volume	225,920	160,414	211,694	183,289
Operations				
Daily production (average)				
Heavy oil (bbl)	517	685	535	704
Crude oil and NGLs (bbl)	957	527	909	672
Natural gas (mcf)	2,610	2,083	2,237	2,155
Total (boe)	1,909	1,559	1,817	1,734
Realized commodity prices (\$Cdn.)				
Heavy oil (bbl)	92.88	49.96	78.84	41.26
Crude oil and NGLs (bbl)	113.67	62.17	100.62	60.19
Natural gas (mcf)	10.15	7.31	9.01	7.48
Average (boe) ²	96.02	54.81	84.65	49.25
Reference pricing				
WTI (U.S.\$/bbl)	123.96	64.93	110.94	61.51
AECO gas (\$Cdn./mcf)	10.19	7.06	9.08	7.23
Foreign exchange (\$U.S./\$Cdn.)	0.99	0.91	1.00	4.11
Operating netback (per boe)				
Revenue	96.02	54.81	84.65	49.25
Royalty	(18.01)	(11.29)	(15.74)	(11.34)
Operating cost	(21.65)	(26.98)	(22.13)	(20.38)
Other expense	(1.23)	0.00	(0.64)	0.00
Hedging	(3.36)	0.00	(1.92)	0.00
Operating netback	51.77	16.53	44.22	17.52

(1) Funds from operations is calculated as cash provided by operating activities plus the change in non-cash working capital. Funds from operations is used to analyze the Company's operating performance and leverage. Funds from operations does not have a standardized measure prescribed by the Canadian Generally Accepted Accounting Principles and therefore may not be comparable with the calculations of similar measures for other companies.

(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 DISCUSSION AND ANALYSIS

INTRODUCTION AND LIMITATIONS

BASIS OF PRESENTATION

The following is management's discussion and analysis ("MD&A") of Arsenal Energy Inc.'s ("Arsenal" or the "Company") unaudited operating and financial results for the three and six months ended June 30, 2008. It should be read in conjunction with the audited financial statements for the year ended December 31, 2007 and other operating and financial information contained herein. This MD&A is dated August 12, 2008.

The financial data presented herein has in part been derived from the Company's annual audited financial statements prepared in accordance with Canadian Generally Accepted Accounting Principles ("GAAP") and in accordance with accounting policies as set out in Note 3 to the Company's annual financial statements. The reporting and the measurement currency is the Canadian dollar.

Effective January 1, 2008, Arsenal adopted with prospective effect certain new accounting standards introduced as part of GAAP as follows:

FINANCIAL INSTRUMENTS

In December 2006, the Accounting Financial Standards Board issued two new sections in relation to financial instruments: Financial Instruments - Disclosures, and Financial Instruments - Presentation. These new standards have replaced - Financial Instruments - Disclosure and Presentation. The new disclosure standard increases the Company's disclosure regarding the risks associated with financial instruments and how these risks are managed.

CAPITAL DISCLOSURES

The Company has adopted new standards for "Capital Disclosures", which requires the Company to disclose its objectives, policies and processes for managing capital. See "Bank Debt, Liquidity and Capital Resources".

GOODWILL

The Company has adopted new standards for "Goodwill and Intangible Assets", which defines the criteria for the recognition of intangible assets.

Additional information regarding Arsenal's financial and operating results may be obtained on the internet at www.sedar.com.

FORWARD-LOOKING STATEMENTS

Certain information set forth in this document, including management's assessment of Arsenal's future plans and operations, contains forward-looking statements. By their nature, forward-looking statements are subject to numerous risks and uncertainties, some of which are beyond the Company's control, including the effect of general economic conditions, industry conditions, volatility of commodity prices, currency fluctuations, imprecision of reserve estimates, environmental risks, competition from other industry participants, the lack of availability of qualified personnel or management, stock market volatility and ability to access sufficient capital from internal and external sources. Readers are advised that the assumptions used in the preparation of such information, although considered reasonable at the time of presentation, may prove to be imprecise and, as such, undue reliance should not be placed on forward-looking statements. Arsenal's actual results, performance or achievement could differ materially from those expressed in, or implied by, these forward-looking statements

MANAGEMENT DISCUSSION AND ANALYSIS

BOE PRESENTATION

For the purpose of calculating unit costs, natural gas is converted to barrel of oil equivalent (“Boe”) using six thousand cubic feet (“Mcf”) of natural gas to one barrel of oil unless otherwise stated. Boe may be misleading, particularly if used in isolation. A Boe conversion ratio of six Mcf to one barrel (“Bbl”) is based on an energy equivalency method primarily at the burner tip and does not represent a value equivalency at the wellhead. (This conversion conforms to National Instrument 51-101). References to natural gas liquids (“NGLs”) in this MD&A include condensate, propane, butane and ethane and one barrel of NGLs is considered to be equivalent to one barrel of crude oil equivalent (Boe).

NON-GAAP FINANCIAL MEASUREMENTS

Within the MD&A, references are made to terms having widespread use in the oil and gas industry in Canada. The measures discussed are widely accepted measures of performance and value within the industry, and are used by investors and analysts to compare and evaluate oil and gas exploration and producing entities. “Funds from operations”, “funds from operations per share” and “netbacks” are not defined by GAAP in Canada and are regarded as non-GAAP measures. Measurement of funds from operations is detailed on the Statement of Cash Flows, specifically; it is cash flow before the change in non-cash operating working capital. Funds from operations per share is calculated based on the weighted average number of common shares outstanding consistent with the calculation of net earnings per share. Netbacks equal total revenue less royalties, transportation and operating costs, calculated on a Boe basis. Total Boe is calculated by multiplying the daily production by the number of days in the year or quarter as the case may be.

THE COMPANY

Arsenal was incorporated under the laws of the province of Alberta.

The Company is continuing its focus on rationalizing its asset base with two small property transactions (one property purchased and one property sold in) completed in Q2 2008 and is concentrating its exploration and development program in areas that will provide the Company with a longer reserve life base. In addition, the Company is focused and making progress on reducing field operating costs in Canada and the US and is moving forward on its high impact Bakken targets in North Dakota, US. Operating costs to date in 2008 have averaged \$22.13 per Boe versus \$20.38 in 2007 and we are expecting to spud our first Bakken well in North Dakota in Q3 2008.

The Company participated in the drilling of 9 gross (7.80 net) wells in the second quarter of 2008. To date in 2008, the Company has participated in the drilling of 17 gross (13.35 net) wells resulting in 15 gross (11.35 net) oil wells and 2 gross (2.00 net) dry and abandoned wells. Capital expenditures in the second quarter were \$4,792,985 bringing the six month total to \$9,677,825. Production for the second quarter of 2008 averaged 1,909 Boe/d versus 1,725 Boe/d for the first quarter of 2008. For the six months ended June 30, 2008, production averaged 1,817 Boe/d versus 1,734 Boe/d for the comparable period in 2007.

The Company operates in the United States under, Arsenal Energy USA Inc., and produced an average of 378 Boe/d in the US for the second quarter of 2008. During the quarter, the Company gave notice, effective June 30, 2008, that it was withdrawing from further participation in the Egypt concession.

Arsenal Energy Inc.'s common shares are listed and posted for trading on the Toronto Stock Exchange under the symbol “AEI” and on the Frankfurt Stock Exchange under the symbol “A1E”.



MANAGEMENT DISCUSSION AND ANALYSIS

OPERATIONAL AND FINANCIAL RESULTS

PRODUCTION AND REVENUE

Average Daily Production

The Company has production in the provinces of Alberta and Saskatchewan in Canada (80% of total Q2 2008 production) and in the state of North Dakota in the US (20% of total Q2 2008 production).

Average second quarter 2008 production increased 22% to 1,909 Boe/d from 1,559 Boe/d in the second quarter of 2007. Production for the second quarter of 2008 increased 11% from 1,725 Boe/d in Q1 2008 and 13% from Q4 2007. For the six month period ended June 30, 2008, average production was 1,817 Boe/d versus 1,734 Boe/d for the comparable 2007 six month period. Q2 2008 and year to date 2008 production increased as a result of Arsenal's successful Q4 2007 and Q1 2008 drilling program at Evi and Galahad. The Company must continue its active drilling program to offset its steep production declines.

Approximately 80% (1,531 Boe/d) of the Company's Q2 2008 total production came from the Canadian operation with the US contributing the remaining 20% (378 Boe/d). In Canada, the Company's drilling program to date has been focused on light oil. The Company is expected to drill a potentially high impact Bakken oil well in North Dakota in Q3 which, if successful, could significantly alter the percentage of production from the US.

For the second quarter of 2008, light oil and NGLs comprised approximately 50% of the Company's production base consistent with the percentage of light oil and NGL's for the six month period in 2007. The Company continues its focus on increasing its light oil production base with new drilling.

	2008	2007	% Change	2008	2007	% Change
	(Three Months Ended June 30)			(Six Months Ended June 30)		
Heavy oil (bbl/d)	517	685	(25)	535	704	(24)
Light oil and NGLs (bbl/d)	957	527	82	909	672	35
Natural gas (mcf/d)	2,610	2,083	25	2,237	2,155	4
Total (boe/d)	1,909	1,559	22	1,817	1,734	5
Production split						
Heavy oil	27%	44%	(38)	29%	41%	(27)
Light oil and NGLs (bbl/d)	50%	34%	48	50%	39%	29
Natural gas (mcf/d)	23%	22%	2	21%	21%	(0)

Production Profile and Per Unit Prices

The Company's light oil and NGLs production in Canada is now much higher than its heavy oil production. Light oil and NGLs comprise 40% of total Canadian production while heavy oil comprises 34% of total Canadian production. Natural gas contributes 26% to total production in Canada. US production was 90% (339 barrels per day) light crude oil for Q2 2008.

Crude oil is sold under 30-day evergreen contracts while natural gas production is sold in the spot market.

MANAGEMENT DISCUSSION AND ANALYSIS

	2008	2007	% Change	2008	2007	% Change
(\$CDN)	(Three Months Ended June 30)			(Six Months Ended June 30)		
Prices - Before Derivatives						
Heavy oil (bbl/d)	92.88	49.96	86	78.84	41.26	91
Light oil and NGLs (bbl/d)	113.67	62.17	83	100.62	60.19	67
Natural gas (mcf/d)	10.15	7.31	39	9.01	7.48	20
Total (boe/d)	96.02	54.81	75	84.65	49.25	72
Reference Pricing						
WTI Cushing (\$U.S./bbl)	123.96	64.93	91	110.94	61.51	80
Oil Edmonton Light (\$Cdn./bbl)	126.37	72.60	74	112.34	70.17	60
Heavy Oil Lloyd blend (\$Cdn./bbl)	102.79	49.35	108	89.64	48.88	83
AECO gas (\$Cdn./mcf)	10.19	7.06	44	9.08	7.23	26
NYMEX gas (\$U.S./mmbtu)	10.93	7.55	45	9.48	7.11	33
Foreign exchange (\$Cdn./\$U.S.)	0.99	0.91	9	1.00	4.11	(76)

The price received for oil and natural gas continued to increase during the second quarter of 2008. The average Q2 2008 Boe price increased to \$96.02 per Boe up 33% from Q1 2008 and 75% from Q2 2007. For the six month period, the average Boe price increased 72% to \$84.65 per Boe in 2008 from \$49.25 per Boe for the 2007 comparable period.

The increase in the average price per Boe for the second quarter of 2008 versus the second quarter of 2007 is primarily attributable to an 86% increase in the price received for heavy oil due to general crude price increases and increased demand resulting in a narrowing of the differential between heavy oil and light oil and a 83% increase in the price of light oil due to market factors. The differential between heavy and light crude for Q2 2007 was approximately \$21.62 per barrel versus \$23.46 per barrel for Q2 2008 and \$21.44 for Q1 2008. These differentials narrow during spring and summer thereby increasing heavy oil prices and netbacks and widen in the winter months when heavy oil demand generally declines.

The prices received by the Company reflect the market movement of the various commodities.

In Q2 2008, the Company realized increased crude oil prices. This increase is due to the 2007 and to date 2008 increase in the average price of West Texas Intermediate ("WTI"). WTI increased 91% to average \$123.96 in Q2 2008 up from \$97.87 US per barrel in Q1 2008 and from \$72.60 US per barrel in Q2 2007.

Production by Area

AREA	2008		2007	
	(Three Months Ended June 30)			
	Boe/d	% of Total	Boe/d	% of Total
Canada				
Maidstone	151	8	115	7
Galahad	317	17	127	8
Wildmere	127	7	138	9
Evi	354	19	56	4
Others	582	29	707	45
Total Canada	1,531	80	1,143	73
US				
Stanley	116	6	127	8
Lindahl	67	4	72	5
Tioga	46	2	57	4
Others	149	8	160	10
Total US	378	20	416	27
Total boe/d production	1,909	100	1,559	100



MANAGEMENT DISCUSSION AND ANALYSIS

Production Revenue

(\$CDN)	2008	2007	% Change	2008	2007	% Change
	(Three Months Ended June 30)			(Six Months Ended June 30)		
Heavy oil	4,370,425	3,115,399	40	7,675,355	5,256,399	46
Light oil and NGLs	9,897,963	3,072,851	222	16,642,780	7,278,926	129
Natural gas sales	2,410,256	1,501,972	60	3,669,660	2,921,094	26
Oil and gas revenues	16,678,644	7,690,222	117	27,987,795	15,456,419	81
Realized hedging losses	(584,216)	-	-	(632,989)	-	-
Unrealized hedging losses	(6,574,725)	-	-	(7,050,838)	-	-
Oil and gas revenue after hedging	9,519,703	7,690,222	24	20,303,968	15,456,419	31
Per boe after realized hedging losses	92.65	54.81	69	82.74	49.25	68
Per boe after all hedging losses	54.80	54.81	(0)	61.41	49.25	25

Total oil and gas revenue in Q2 2008 increased 117% to \$16,678,644 from Q2 2007 (\$7,690,222) and by 47% from Q1 2008 (\$11,309,151). The Q2 2008 increase from Q2 2007 is due to increase in the average price received for heavy oil (up 86%), light oil (up 83%) and natural gas (up 39%) and due to a 22% increase in average production.

In February 2008, the Company put in place a financial contract covering 200 barrels of oil per day for the period March 1, 2008 to December 31, 2009 at \$97.55 Canadian per barrel. During the period thereafter, the price of WTI increased almost daily. In response to these higher prices, the Company, in late April put another financial hedge in place covering an additional 100 barrels of oil per day for the period June 1, 2008 to December 31, 2009 at \$109.80 Canadian per barrel. As a result of increases in the price of WTI in Canadian dollars, the Company recorded a realized hedging loss on these contracts for the second quarter of 2008 of \$584,216 and an unrealized hedging loss on the remaining term of the contracts of \$6,574,725. On a year to date basis for 2008, the realized hedging loss is \$632,989 and the unrealized hedging loss recorded at June 30, 2008 is \$7,050,838. The unrealized loss will fluctuate up or down depending on the price in Canadian dollars of WTI at each quarter end.

Royalties

(\$CDN)	2008	2007	% Change	2008	2007	% Change
	(Three Months Ended June 30)			(Six Months Ended June 30)		
Heavy oil	851,217	547,534	55	1,372,432	1,180,567	16
Light oil and NGLs	1,703,989	668,107	155	3,022,267	1,725,942	75
Natural gas sales	572,465	368,616	55	809,755	652,034	24
Total royalties	3,127,671	1,584,257	97	5,204,454	3,558,543	46
% of gross oil and gas revenue	19	21	(9)	19	23	(19)
Per boe	18.01	11.29	59	15.74	11.34	39

During the second quarter of 2008, the Company paid \$3,127,671 or 21% of oil and gas revenues in royalties versus \$1,584,257 or 19% in the second quarter of 2007. The Q2 2008 royalty rate is consistent with that experienced in Q4 2007. During both quarters, the Company put on production wells that qualified for a royalty holiday. Once the royalty holiday expires, it is expected that the average royalty rate will increase. For the current quarter, the heavy oil royalty rate was 19%, the light oil and NGL royalty rate averaged 17% and natural gas royalties totaled 24%. For the current six month period, the heavy oil royalty rate averaged 18%, the light oil and NGL royalty rate averaged 18% and the royalty rate on natural gas averaged 22%. The royalty rate per Boe went up from \$11.29 per Boe in Q2 2007 to \$18.01 per Boe in Q2 2008 due to the increase in oil prices.

MANAGEMENT DISCUSSION AND ANALYSIS

Operating Costs

(\$CDN)	2008	2007	% Change	2008	2007	% Change
	(Three Months Ended June 30)			(Six Months Ended June 30)		
Heavy oil	1,167,192	1,883,614	(38)	2,958,659	2,258,643	31
Light oil and NGLs	1,879,331	1,623,339	16	3,465,421	3,594,445	(4)
Natural gas sales	715,043	279,264	156	893,114	544,647	64
Total operating expenses	3,761,566	3,786,217	(1)	7,317,194	6,397,735	14
Per boe	21.65	26.98	(20)	22.13	20.38	9

Operating costs decreased 1% to \$3,761,566 in Q2 2008 from \$3,786,217 in Q2 2007 and increased from \$6,397,735 for the six month period in 2007 to \$7,317,194 for the six month period in 2008. On a Boe basis, operating costs in Q2 2008 were \$21.65 per Boe versus \$22.65 per Boe in Q1 2008 and \$26.98 per Boe in Q2 2007. During the current quarter, operating cost efficiencies were offset by a number of significant and unusual expenses. The Company was required to rebuild the compressor at Nevis at a cost of approximately \$240,000, had to shut in production for major maintenance of the facilities at Galahad and incurred major and unusual maintenance and repairs on some of the Company's US wells and facilities. For the six months ended June 30, 2008, operating costs averaged \$22.13 versus \$20.38 for the comparable period in 2007.

Operating costs for the Company's operations are higher for heavy oil than light oil. For the current six month period, heavy oil operating costs averaged \$24.80 per barrel versus \$21.58 for light oil. Heavy oil operating costs are high due to the cost to operate the wells which are almost all single well batteries. This results in high costs for propane, trucking of oil, water and emulsion and routine maintenance and repairs.

Operating costs for natural gas were \$3.01 per mcf for Q2 2008 and \$2.19 for the current six month period. These costs increased from the prior year comparatives due to inclusion in the current quarter of the major compressor work over at Nevis noted above.

The Company has reviewed and continues to review and implement initiatives to bring operating costs to a more acceptable level. This has included the purchase of some properties in order to achieve economies of scale and the sale of other properties over which we have little control. In addition, the Company is examining its field operations and equipment specifications to maximize production and lower costs.

Operating Netback

(\$CDN PER BOE)	2008	2007	% Change	2008	2007	% Change
	(Three Months Ended June 30)			(Six Months Ended June 30)		
Net revenue after realized hedging loss	92.65	54.81	69	82.74	49.25	68
Royalties	18.01	11.29	59	15.74	11.34	39
Operating costs	21.65	26.98	(20)	22.13	20.38	9
Other expenses	1.23	-	-	0.64	-	-
Operating netback	51.77	16.53	213	44.22	17.52	152

The operating netback realized during the second quarter of 2008 was \$51.77 per Boe versus \$16.53 per Boe for the second quarter of 2007. The operating netback for the six month period ending June 30, 2008 was \$44.22 per Boe



MANAGEMENT DISCUSSION AND ANALYSIS

versus \$17.52 for the same period in 2007. Increased crude and natural gas prices and lower operating costs were responsible for the increased netback in Q2 2008 and for the year. On an individual product basis, the net back for heavy oil was \$49.98 for light crude the netback was \$65.80 and for natural gas the netback was \$4.73 for the second quarter of 2008 and \$34.35, \$57.57 and \$4.83 respectively for the six month period ending June 30, 2008.

With the recent drop in crude and natural gas prices, future operating netbacks may not be as high as that realized in Q2 2008 but are expected to be sufficient to support its planned capital program for the last half of 2008.

General and Administrative

(\$CDN)	2008	2007	% Change	2008	2007	% Change
	(Three Months Ended June 30)			(Six Months Ended June 30)		
Gross expenditures	606,118	1,105,727	(45)	2,047,428	2,433,482	(16)
Overhead recovery	(93,255)	(13,028)	616	(205,692)	(203,911)	1
Capitalized overhead	(57,500)	(411,678)	(86)	(115,000)	(603,478)	(81)
Net general and administrative expense	455,363	681,021	(33)	1,726,736	1,626,093	6
Net general and administrative per boe	2.62	4.85	(46)	5.22	5.18	1

Gross general and administrative expenditures were lower by 45% totaling \$606,118 for the current quarter when compared to \$1,105,727 for the second quarter of 2007. For the six month period, gross general and administrative expenditures totaled \$2,047,428 for 2008 versus \$2,433,482 for 2007. The Company expensed general and administrative expenditures related to the Company's Egypt operation of \$88,943 for Q2 2008 and \$225,225 for the current six month 2008 period. During the prior year quarter and to June 30, 2007, these expenditures were capitalized to property plant and equipment and totaled \$88,973 for Q2 2007 and \$225,225 for the prior six month period. The Company has given notice of its intention to withdraw from further participation in the concession effective June 30, 2008 and therefore no further obligations related to the Egyptian concession will be incurred.

During the current quarter, the Company recorded additional costs related to its March 31, 2008 engineering evaluation update. For the six month period in 2008, the Company experienced increases in reservoir engineering fees, audit fees and paid a severance to a former employee. Overhead recovery increased in the current quarter to \$93,255 from \$13,028 in Q2 2007, an increase resulting from the Company's Q2 2008 operated drilling program. The Company operated four 100% working interest wells in the first quarter of 2008 and seven 100% working interest wells in the second quarter of 2008.

The Company capitalizes overhead directly related to exploration and development. For Q2 2008, capitalized overhead totaled \$57,500 (\$411,678 - Q2 2007) and for the six month period capitalized \$115,000 (\$603,478 six month 2007).

On a net basis, general and administrative costs decreased 19% during the second quarter of 2008 when compared to the comparable 2007 quarter and increased 14% for the six month period ending June 30, 2008.

MANAGEMENT DISCUSSION AND ANALYSIS

Interest Expense

(\$CDN)	2008	2007	% Change	2008	2007	% Change
	(Three Months Ended June 30)			(Six Months Ended June 30)		
Bank line interest	118,812	561,706	(79)	261,563	850,523	(69)
Per boe	0.68	4.00	(83)	0.79	2.71	(71)

Interest is paid on the Company's revolving demand loan at prime plus 0.40% as net debt to trailing cash flow (cash flow for the last quarter annualized) exceeded 1.25:1 (see "Bank Debt, Liquidity and Capital Resources - Demand Operating Loan Facility"). The facility averaged approximately \$9.1 million for the second quarter of 2008 (\$9.9 for the six months ending June 30, 2008) versus approximately \$13.2 million during the second quarter of 2007 (\$16.1 for the six months ending June 30, 2007).

During the current period, the draw on credit facility increased from its December 31, 2007 balance of \$8.9 million to a high of \$15.2 million in mid-March 2008. During the second quarter, the draw on the facility was reduced by oil and gas revenues to close the current quarter at \$5.5 million. Increases in the draw will be required in Q3 2008 to reduce the working capital deficiency at June 30, 2008.

The Company is currently in negotiations with its lender regarding an increase in its facility based on reserve additions and price increases during the first quarter.

Interest on the Company's line of credit decreased 79% to \$118,812 for Q2 2008 primarily as a result of higher cash flows reducing the average borrowings under the facility and lower interest rates. For the current six month period, interest expense totaled \$261,563. During 2007, the Company paid various fees related to not meeting its bank covenants and experienced a higher level of bank borrowings, incurring interest expense for Q2 2007 of \$561,706 and for the six month period of \$850,523.

Interest on Convertible Debentures

(\$CDN)	2008	2007	% Change	2008	2007	% Change
	(Three Months Ended June 30)			(Six Months Ended June 30)		
Interest on debentures	69,030	69,410	(1)	138,439	138,056	0
Per boe	0.40	0.49	(20)	0.42	0.44	(5)

The Company pays interest at 8% per annum on the \$3,480,000 of convertible debentures acquired in the Tiverton acquisition. Interest is paid semi-annually on June 30 and December 31 and totaled \$69,030 for Q2 2008 and \$138,439 for the six months ended June 30, 2008.

For the quarter ended June 30, 2008, the Company recorded \$31,284 (\$56,915 for the six month period in 2008) of accretion expense relating to the amortization of the discount of the debenture. (see "Convertible Debentures" below).



MANAGEMENT DISCUSSION AND ANALYSIS

Other Expense

(\$CDN)	2008	2007	% Change	2008	2007	% Change
	(Three Months Ended June 30)			(Six Months Ended June 30)		
Other expense	213,056	-	-	213,056	-	-
Per boe	1.23	-	-	0.64	-	-

Other expense incurred during the second quarter of 2008 includes adjustments relating to a corporate acquisition and the cost of abandoning wells not included in the Company's asset retirement account.

Depletion, Depreciation and Accretion

(\$CDN)	2008	2007	% Change	2008	2007	% Change
	(Three Months Ended June 30)			(Six Months Ended June 30)		
Depletion, depreciation and accretion	3,929,111	3,945,000	(0.40)	7,395,159	8,735,018	(15)
Per boe	22.62	28.12	(20)	22.37	27.83	(20)

Depletion, depreciation and accretion for the current quarter totaled \$3,929,111 or \$22.62 per Boe versus \$3,945,000 or \$28.12 per Boe for Q2 2007 and \$21.64 for Q4 2007. For the six months ended June 30, 2008, depreciation, depletion and accretion totaled \$7,395,159 or \$22.37 per Boe versus \$8,735,018 or \$27.83 per Boe for the comparable 2007 period. The comparative period and year to date decreases result from the sale in June of Tower Creek and ceiling test write downs in 2007. During the first and second quarters of 2008, the Company added more proven reserves from drilling in Canada than it produced during the quarter thereby reducing the depletion rate in Canada from \$28.94 per Boe for the fourth quarter of 2007 to \$22.37 per Boe for the first six months of 2008.

Property Impairment

(\$CDN)	2008	2007	% Change	2008	2007	% Change
	(Three Months Ended June 30)			(Six Months Ended June 30)		
Property impairment	-	8,379,997	(100)	495,650	9,934,680	(95)
Per boe	-	59.72	(100)	1.50	31.65	(95)

In late 2007, Arsenal made a decision to seek strategic alternatives for its concession in Egypt. During the first quarter, the Company sought professional assistance in evaluating various alternatives including further participation in the upcoming drilling as well as the sale of its entire interest. As a result of the process, the Company did not receive any bids for the assets and determined that the project did not warrant additional drilling as the chances of success were low. As a result of this process, in the first quarter of 2008, the Company wrote off the remaining carrying amount of its Egypt property, recording a property impairment of \$495,650. During the first quarter of 2007, as a result of drilling a dry hole, the Company wrote down the carrying amount of its Egypt property by \$1,554,682. In the second quarter of 2008, the Company gave notice effective June 30, 2008, that it was withdrawing from further participation in the Egypt concession.

MANAGEMENT DISCUSSION AND ANALYSIS

Goodwill

(\$CDN)	2008	2007	% Change	2008	2007	% Change
	(Three Months Ended June 30)			(Six Months Ended June 30)		
Goodwill impairment	-	-	-	-	4,791,561	(100)

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. Goodwill is stated at cost and is not amortized. The goodwill balance is assessed for impairment each year end or more frequently if events or changes in circumstances indicate that the asset may be impaired. The test for impairment is conducted by comparing the book value to the fair value of the reporting entity, Impairment is charged to income in the period it occurs.

In Q1 2007, the Company compared the deemed fair value of goodwill to the carrying amount of goodwill. As a result of this test, the Company wrote off \$4,791,561 in goodwill in the first quarter of 2007.

Stock-based Compensation

(\$CDN)	2008	2007	% Change	2008	2007	% Change
	(Three Months Ended June 30)			(Six Months Ended June 30)		
Compensation expense	192,050	205,838	(7)	301,976	568,795	(47)

The Company accounts for its stock-based compensation program using the fair-value method. Under this method, compensation expense related to this program is recorded in the statement of operations over the vesting period of the options.

To date in 2008, the Company has granted 1,296,000 options at \$0.60 per share to officers and employees, 300,000 options at \$0.62 to an officer and 450,000 options at \$0.79 to directors. These options vest over eighteen months. To date in 2008, 216,918 options were exercised at a weighted average price of \$0.30 for proceeds of \$64,333. During the year, 350,000 options issued at a weighted average price of \$1.10 were forfeited.

Stock-based compensation expenses for the three months and six months ended June 30, 2008 totaled \$192,050 and \$301,976 respectively versus \$301,976 and \$568,795 for the three and six months versus in 2007. The decrease results from the timing and valuation of options issued and options reaching the end of the vesting period and therefore the expense recognition.

During the second quarter of 2008 the Company capitalized \$20,525 of stock based compensation to property plant and equipment bringing the year to date total to \$48,120.



MANAGEMENT DISCUSSION AND ANALYSIS

Taxes

(\$CDN)	2008	2007	% Change	2008	2007	% Change
	(Three Months Ended June 30)			(Six Months Ended June 30)		
Current income taxes	266,659	210,000	27	614,509	250,000	146
Future income taxes (reduction)	(1,357,596)	(2,245,999)	(40)	(1,621,755)	(3,929,155)	(59)
	(1,090,937)	(2,035,999)	(46)	(1,007,246)	(3,679,155)	(73)
Per boe	(6.28)	(14.51)	(57)	(3.05)	(11.79)	(74)

During Q2 2008, the Company recorded taxes payable on its US operations of \$266,659 (Q2 2007 - \$210,000) bringing the six month total for 2008 to \$614,509 (six month 2007 - \$250,000). At current commodity prices, the Company is taxable in the US and is currently exploring various options to reduce the amount of tax paid.

In Canada, during the three month period ended June 30, 2008, the Company reduced future income taxes by \$1,357,596. Arsenal does not expect to pay current tax in 2008 based on existing tax pools, planned expenditures and current commodity prices. It may however be taxable in 2009 depending on capital expenditures and commodity prices.

A future income tax balance of \$5,134,151 is recorded as a liability as at June 30, 2008.

Outlook

While commodity prices have gone through a bit of a correction in the past few weeks, the current prices for crude oil and natural gas are still attractive enough to result in some solid project economics. Arsenal's management believes with Arsenal's inventory of projects and drilling locations, the Company is well positioned to prosper in this current commodity environment. The cash being generated from Arsenal's crude oil production combined with the Company's current low debt level and low interest rates is creating an environment where acquisitions could form a more important part of the Company's growth.

At June 30, 2008, Arsenal had total bank debt and working capital deficiency (excluding \$3.4 million convertible debentures and \$4.7 million of current risk management liability) of \$10.9 million on a \$17.25 million bank facility. The capital expenditure program to June 30, 2008 of \$9,677,825 million has been very successful adding both reserves and production. The 2008 capital expenditure program was funded from Arsenal's first six months of funds from operations and from the private placement in the March and April of 2008. Arsenal's 2008 capital budget of \$14.1 million has been adjusted due to the volatility in commodity prices and recent corporate developments (see GEOCAN below) to total from between \$20.0 and \$22.0 million dependant on the number of Bakken wells drilled this year in North Dakota. The remainder of 2008 program of between \$10.0 and \$12.0 million is expected to be funded by funds from operations, and if needed, by the Company's available credit facility or by an equity offering.

While the 2008 drilling program has been successful, the Company has experience delays in getting wells drilled and production on-stream. Arsenal is expecting to average approximately 2,000 Boe per day for the remainder of 2008 averaging approximately 1,900 Boe per day for the year. Debt and working capital deficiency (excluding the convertible debentures of \$3.5 million at maturity) is projected to be between \$15.0 and \$16.5 million as at December 31, 2008. The Company expects the 2008 program to continue to improve the Company's liquidity and operating results. The Company expects to exit 2008 with its total debt within its approved credit facility and its debt to cash flow ratio well within established guidelines.

MANAGEMENT DISCUSSION AND ANALYSIS

Arsenal has made an offer to purchase all of the outstanding common shares of GEOCAN Energy Inc. ("GEOCAN") for consideration of \$0.70 per share (\$39.2 million total consideration), payable, at the election of each GEOCAN shareholder, in cash or 0.81 of a common share of Arsenal. A maximum aggregate of \$30,000,000 and a minimum aggregate of \$26,000,000 in cash will be payable to the GEOCAN shareholders under the arrangement.

Arsenal believes that the combination of the two corporations pursuant to the arrangement would have the following benefits:

- The increased size of the combined corporation will contribute to lower average operating expenses and cost of capital, overhead synergies and higher financial leverage;
- The combined corporation will have a complimentary fit of assets as approximately 40% of GEOCAN's current production is in Arsenal's core east central Alberta area; and
- The addition of GEOCAN's core Northeast British Columbia property, where approximately 40% of GEOCAN's current production is located, to the combined corporation will provide a further core property for development. Arsenal will also acquire new exploration plays in Ochre and Tomahawk as well as 82,000 net acres of undeveloped land, providing additional potential upside to the combined corporation's shareholders.

Closing of the arrangement is expected early in the fourth quarter of 2008.

Summary of Quarterly Results

(\$CDN)	2008		2007				2006	
	Q2	Q1	Q4	Q3	Q2	Q1	Q4	Q3
Oil and gas revenue	16,678,644	11,309,151	8,827,883	7,568,644	7,702,380	7,774,362	9,306,129	8,393,468
Net income (loss)	(1,925,853)	(488,026)	(2,944,193)	(3,029,332)	(9,406,449)	(7,999,026)	(25,795,319)	(1,200,629)
Per share – basic	(0.02)	(0.01)	(0.04)	(0.04)	(0.13)	(0.11)	(0.37)	(0.02)
Per share – diluted	(0.02)	(0.01)	(0.04)	(0.04)	(0.13)	(0.11)	(0.37)	(0.02)
Funds from operations	8,050,518	3,955,266	134,648	900,028	1,078,581	1,842,009	2,685,843	2,006,566
Per share – basic	0.09	0.05	-	0.01	0.01	0.03	0.04	0.04
Per share – diluted	0.09	0.05	-	0.01	0.01	0.03	0.03	0.03
Total assets	71,112,441	71,113,137	65,097,042	62,288,632	63,745,799	86,839,591	95,462,544	122,327,380
Total debt ⁽¹⁾	14,266,269	15,344,257	17,391,760	14,128,455	10,628,558	20,341,897	19,184,717	20,535,965
Shares outstanding	90,719,815	89,181,542	83,698,042	73,917,173	73,917,173	73,642,173	73,317,173	65,352,403

(1) Excludes convertible debentures of \$3,480,000 due February 2009 and risk management liability.

Arsenal's quarterly results have fluctuated significantly in the past eight quarters due to one-time items like tax audits, ceiling test write-downs and recognition of impairment of properties and goodwill. While quarterly results will fluctuate somewhat quarter over quarter due to commodity prices and the differentials in heavy oil, the Company believes its recent acquisition coupled with its improved operational efficiencies will lead to more stable results going forward.



MANAGEMENT DISCUSSION AND ANALYSIS

Summary of Annual Results by Country

	Canada	United States	Egypt	Corporate	Total Company
(\$CDN)					(Six Months Ended June 30)
Revenue					
Oil and gas	21,404,756	6,583,039	-	-	27,987,795
Realized hedging loss	(79,404)	(553,585)	-	-	(632,989)
Unrealized hedging loss	(1,887,191)	(5,163,647)	-	-	(7,050,838)
	19,438,161	865,807	-	-	20,303,968
Royalty expenses, net of ARTC	(2,935,417)	(2,269,037)	-	-	(5,204,454)
	16,502,744	(1,403,230)	-	-	15,099,514
Other operating revenue	(32)	2,329	-	-	2,296
	16,502,712	(1,400,902)	-	-	15,101,810
Expenses					
Operating	5,947,821	1,369,372	-	-	7,317,194
General and administrative	-	-	-	1,951,736	1,951,736
Interest expense	-	-	-	261,563	261,563
Convertible debenture interest	-	-	-	138,439	138,439
Other	146,173	66,883	-	-	213,056
Foreign exchange	(82,457)	160,059	313,645	-	391,247
Convertible debenture accretion	-	-	-	56,915	56,915
Depletion, depreciation and accretion	7,064,586	325,571	5,002	-	7,395,159
Property, plant and equipment impairment	-	-	495,650	-	495,650
Stock-based compensation	301,976	-	-	-	301,976
	13,378,098	1,921,885	814,297	2,408,653	18,522,935
Income (loss) before taxes	3,124,614	(3,322,788)	(814,297)	(2,408,653)	(3,421,125)
Income taxes					
Provision for current income taxes	-	614,509	-	-	614,509
Provision for future income taxes (reduction)	(1,621,755)	-	-	-	(1,621,755)
	(1,621,755)	614,509	-	-	(1,007,246)
Net income (loss)	4,746,369	(3,937,297)	(814,297)	(2,408,653)	(2,413,879)

MANAGEMENT DISCUSSION AND ANALYSIS

BANK DEBT, LIQUIDITY AND CAPITAL RESOURCES

Capital Management

In order to continue the Company's ongoing exploration and development program, the Company must maintain a strong capital base. A strong capital base results in increased market confidence, an essential factor to maintain existing shareholders and in attracting new investors. The Company is committed to establishing and maintaining a strong capital base to ensure the Company has access to the equity and debt markets when deemed advisable. In order to maintain a strong capital base, the Company continually monitors the risk reward profile of its exploration and development projects and the economic indicators in the market including commodity prices, interest rates and foreign exchange rates. It then determines increases or decreases to its capital budget.

The Company considers shareholders equity, bank debt and working capital as components of its capital base. Arsenal's convertible debentures are due in February of 2009 and therefore have become a consideration in the Company's management of its capital base. The Company can access or increase capital through the issuance of shares, through bank borrowings, that are based on reserves, and by building cash reserves by reducing its capital expenditure program.

The Company monitors its capital based primarily on its debt to annualized cash flow ratio and its debt to equity ratios. Debt includes bank debt plus or minus working capital. Annualized cash flow is calculated as cash flow from operations before changes in non-cash working capital from the Company's most recent quarter multiplied by four. The Company's strategy is to maintain this ratio at 1 : 1. This ratio may increase somewhat depending on the timing and nature of the Company's activities. To facilitate the management and control of this ratio, the Company prepares an annual operating and capital expenditure budget. The budget is updated when critical factors change. These factors include economic factors such as the state of equity markets, changes to commodity prices, interest rates and foreign exchange rates and non economic factors such as drilling results and production profiles. The Company's board of directors approves the budget and changes thereto.

At June 30, 2008, the Company's debt (excluding the Company's current risk management liability and convertible debentures) to cash flow (Q2 2008 annualized) was 0.34 : 1 (based on total debt 0.59 : 1) and its debt to equity ratio was 0.20 : 1 (based on total debt 0.35 : 1). The ratio is currently quite low as a result of cash generated from current high commodity prices applied to reduce debt. The ratio which may indicate underuse of debt currently can and does fluctuate over the year based on the timing of capital expenditures, equity financings and commodity prices.

The Company's credit facility has certain financial covenants that, without the written consent of the lender, would result in a breach of the agreement. The Company cannot permit:

- the working capital ratio to fall to below greater than 1 : 1 and
- the ratio of net debt to trailing funds flow annualized to exceed 3 : 1

The Company's share capital is not subject to external restrictions..

There were no changes in the Company's approach to capital management during the period.

Demand Operating Loan Facility

At June 30, 2008, the Company has available a demand operating loan facility in the amount of \$17,250,000. Debt under the facility, which includes working capital deficiency but excludes the current risk management liability and the convertible debenture, amounted to \$10,869,313 at June 30, 2008. Funds from operations for the three month



MANAGEMENT DISCUSSION AND ANALYSIS

period ended June 30, 2008 totaled \$8,050,518 resulting in a debt to funds from operations (Q2 2008 annualized) for purposes of our credit facility of 0.34 : 1. At December 31, 2007, this ratio was 4.4 : 1 based on 2007 funds from operations and 1 : 1 at March 31, 2008 based on Q1 2008 cash flow annualized. The improvement during Q2 2008 results from higher production and from operating funds generated from high commodity prices. Management's objective is to maintain this ratio at or close to a ratio of 1 : 1.

The facility can be utilized in either Canadian or US dollars, bears interest at Canadian or US bank prime plus 0.25%, increasing to Canadian or US bank prime plus 0.40% if net debt to trailing cash flow (cash flow for the last quarter annualized) exceeds 1.25:1. The facility is secured by a fixed and floating charge debenture providing a fixed charge over all present and after acquired petroleum and natural gas interests and a floating charge over all lands and a continuing guarantee from the Company's US subsidiary in the form of a Mortgage Security Agreement and Letter of Undertaking limited to \$8,000,000.

At December 31, 2007, the Company was in breach of two covenants under its loan agreement. The Company was in breach under the working capital covenant of no less than 1 : 1 and the net debt to trailing cash flow covenant. The bank waived these defaults at December 31, 2007 conditional on the Company being in compliance as of March 31. The Company is in compliance with its bank covenants at June 30, 2008.

Convertible Debenture

The Company, as part of the Tiverton acquisition in 2006, assumed the obligations under \$3,480,000 face value of convertible debentures. The convertible debentures are a debt security with an embedded conversion option and were segregated into a debt and equity component based on the respective fair value of each at the date of acquisition. The equity component, calculated at \$370,000, represents the holder's conversion right and was included in Shareholders' Equity. The remaining balance being \$3,110,000 was classified as debt and is being accreted over the remaining period to maturity.

Interest accrues on the debentures at 8% 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. 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. If the holder exercises the conversion right, they will receive accrued and unpaid interest up to and including the conversion date.

It is expected that the Company will repay the convertible debentures on February 15, 2009 from funds available on its then available line of credit.

Liquidity

The Company believes that with its current banking facilities, its funds flow from operations and with the issuance of equity to date this year, it has the financial resources necessary to complete its proposed capital program. In the event that commodity prices, interest or exchange rates, or other factors negatively impact funds flow from operations, or the Company is unable to raise the required equity funds, the Company would plan to reduce the proposed capital program so that the Company's debt remains within its existing banking facilities.

MANAGEMENT DISCUSSION AND ANALYSIS

In order to ensure that funds were available for its 2008 capital program, the Company completed a private placement in April that raised gross proceeds of \$4,787,059 (\$3,843,738 of these funds were received in March).

In addition, in order to solidify a portion of the Company's cash flow projection, the Company in February 2008 sold forward 200 barrels of oil per day for the period March 1, 2008 to December 31, 2009 at \$97.55 Canadian per barrel and in April 2008 sold an additional 100 barrels of oil per day for the period June 1, 2008 to December 31, 2009 at \$109.80 Canadian per barrel. During the second quarter of 2008, the Company realized a loss (due to average monthly market prices of WTI in Canadian dollars being higher than the hedge price) on these contracts totaling \$584,216 bringing the year to date realized loss total to \$632,989. As at June 30, 2008, the Company has recorded an unrealized loss on the remaining term of the contracts based on the difference of the WTI Canadian dollar price at June 30, 2008 and the contract hedged price of \$7,050,838. A portion of this liability (\$4,687,716) has been classified under current liabilities and a portion (\$2,363,122) has been recorded as a long term liability.

In July 2008, the Company hedged an additional 300 barrels of oil per day for the period August 1, 2008 to July 31, 2009 at \$130.10 Canadian per barrel and an additional 200 barrels of oil per day for the period ended August 1, 2008 to July 31, 2010 at \$125.80 Canadian per barrel.

Share Capital

At June 30, 2008, the Company has 90,719,815 common shares and 5,238,001 options outstanding.

In June 2008, the Company added to shareholders' equity \$225,000 representing the forgiveness (for past services rendered) of a loan made to a former officer and director to purchase 225,000 of the Company.

In April 2008, the Company completed a private placement, commenced in the first quarter of 2008, raising total gross proceeds of \$4,787,059 (\$943,321 of these funds were received in April 2008). In total, the Company issued 1,249,300 (289,500 issued in April 2008) common shares at \$0.63 per share for gross proceeds (before commission and expenses) of \$787,059 (\$182,385 received in April 2008) and 5,555,555 (1,056,855 issued in April 2008) flow-through shares at \$0.72 per share for gross proceeds (before commission and expenses) of \$4,000,000 (\$760,936 received in April 2008). An officer of the Company subscribed for 150,000 shares for gross proceeds of \$94,500.

The terms of the share issue require the Company to renounce to subscribers Canadian Exploration Expenditures in the amount of \$3,239,064 to be incurred prior to December 31, 2009.

Arsenal's 5,238,001 options outstanding have a weighted average exercise price of \$0.80. At June 30, 2008, 3,023,001 options were exercisable at a weighted average price of \$0.93 per share. During Q2 2008, 108,000 options were exercised at an exercise price of \$0.20 per share, 24,999 options were exercised at an exercise price of \$0.37 per share and 8,000 options were exercised at \$0.60 per share. During the current quarter 300,000 options were issued to an officer at an exercise price of \$0.62 and 450,000 options were issued to directors at an exercise price of \$0.79 per share.



MANAGEMENT DISCUSSION AND ANALYSIS

The following table outlines the common share issues and option exercises during the period:

COMMON SHARE	Six Months Ended June 30 2008		Year Ended December 31 2007	
	Shares	Amount (\$)	Shares	Amount (\$)
Balance - beginning of period	83,698,042	81,901,603	73,642,173	80,516,169
Private placement of common shares	1,249,300	787,059	-	-
Private placement of flow-through share	5,555,555	4,000,000	9,707,536	4,174,240
Tax effect of flow-through shares	-	(1,356,625)	-	(2,660,118)
Share issue costs	-	(370,904)	-	(443,855)
Tax effect of share issue costs	-	120,625	-	142,500
Issued on exercise of options	216,918	64,333	73,333	14,667
Allocated from contributed surplus	-	37,047	-	-
Issued to acquire property	-	-	275,000	158,000
Shares issued	90,719,815	85,183,138	83,698,042	81,901,603
Shares held in escrow	-	-	-	(225,000)
Balance - end of period	90,719,815	85,183,138	83,698,042	81,676,603

Capital Expenditures

(\$CDN)	Three Months Ended March 31 2008	Three Months Ended June 30 2008	Year To Date 2008
Property acquisitions	-	974,733	974,733
Property sales	10,000	1,225,792	1,235,792
Land	360,254	(180,028)	180,226
Seismic	238,104	182,508	420,612
Drilling and completions	2,502,222	3,847,144	6,349,366
Capitalized general and administrative	99,445	84,490	183,935
Production equipment, facilities and tie-ins	1,711,689	881,856	2,593,545
Other	176,371	276,572	452,943
Total capital	5,088,085	5,092,542	10,180,627
Non-cash additions	(203,245)	(299,557)	(502,802)
Capital expenditures	4,884,840	4,792,985	9,677,825

During the three months ended June 30, 2008, the Company participated in the drilling of 9 gross (7.80 net) wells bringing the total of wells drilled at June 30, 2008 to 17 gross (13.35 net) wells. All 2008 wells to date have been drilled in Canada.

Capital additions for Q2 2008 totaled \$5,092,542 of which \$4,792,985 are cash additions and \$299,557 were non cash additions. To June 30, 2008 total capital additions were \$10,180,627 of which \$9,677,825 are cash additions and \$502,802 were non cash additions. Non cash additions included asset retirement obligations on wells drilled or purchased and capitalized stock based compensation.

During the quarter, the Company added to its interest at Wildmere and sold to an industry partner some shut-in wells and reserves.

MANAGEMENT DISCUSSION AND ANALYSIS

COMMITMENTS AND CONTINGENCIES

Egyptian Concession

The Company gave notice, effective June 30, 2008, that it was withdrawing from further participation in the Egypt concession.

Flow-through shares

Pursuant to a flow-through share financing in late 2007, the Company committed to spend \$4,174,240 on qualifying expenditures by December 31, 2008. As at June 30, 2008, the Company had met this commitment.

Pursuant to a flow-through share financing in March and April of 2008, the Company committed to spend \$4,000,000 on qualifying expenditures by December 31, 2009. As at June 30, 2008, the Company had expended approximately \$760,936 leaving \$3,239,064 to be incurred prior to December 31, 2009.

NEW ACCOUNTING PRONOUNCEMENTS

International Financial reporting Standards ("IFRS")

In February 2008, the CICA Accounting Standards Board ("AcSB") confirmed the changeover to IFRS from Canadian GAAP will be required for publicly accountable enterprises interim and annual financial statements effective for fiscal years beginning on or after January 1, 2011. The AcSB issued the "omnibus" exposure draft of IFRS with comments due by July 31, 2008, wherein early adoption by Canadian entities is also permitted. The Canadian Securities Administrators ("CSA") has also issued Concept Paper 52-402, which requested feedback on the early adoption of IFRS as well as the continued use of US GAAP by domestic issuers. The eventual changeover to IFRS represents a change due to new accounting standards. The transition from current Canadian GAAP to IFRS is a significant undertaking that may materially affect the Company's reported financial position and results of operations.

The IASB has stated that it plans to issue an exposure draft relating to certain amendments and exemptions to IFRS 1 in order to make it more useful to Canadian entities adopting IFRS for the first time. One such exemption relating to full cost oil and gas accounting is expected to reduce the administrative burden in the transition from the current Canadian Accounting Guideline 16 to IFRS. It is anticipated that this exposure draft will not result in an amended IFRS 1 standard until late 2009. The amendment will potentially permit the Company to apply IFRS prospectively to their full cost pool, rather than the retrospective assessment of capitalized exploration and development expenses, with the proviso that a ceiling test, under IFRS standards, be conducted at the transition date.

Although, the Company has not completed development of its IFRS changeover plan, when finalized it will include project structure and governance, resourcing and training, an analysis of key GAAP differences and a phased plan to assess accounting policies under IFRS as well as potential IFRS 1 exemptions. The Company anticipates completing its project scoping, which will include a timetable for assessing the impact on data systems, internal controls over financial reporting, and business activities, such as financing and compensation arrangements, during 2009.



INTERIM CONSOLIDATED BALANCE SHEETS

(Unaudited)

As at	June 30, 2008	December 31, 2007
ASSETS		
Current assets		
Accounts receivable and prepaid expenses	\$ 7,622,362	\$ 3,789,284
Future income taxes	1,877,191	-
	9,499,553	3,789,284
Reclamation bonds	178,549	173,577
Property, plant and equipment (note 4)	63,311,530	61,134,541
	\$ 72,989,632	\$ 65,097,402
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable and accrued liabilities	\$ 12,198,062	\$ 10,510,147
Revolving demand loan (note 6)	6,293,612	10,670,897
Convertible debentures (note 9)	3,396,955	-
Risk management liability (note 3)	4,687,716	-
	26,576,345	21,181,044
Risk management liability (note 3)	2,363,122	-
Convertible debentures (note 9)	-	3,340,040
Asset retirement obligations (note 7)	4,253,612	3,697,721
Future income taxes	5,134,151	3,621,900
	38,327,230	31,840,705
Shareholders' equity		
Common shares (note 8)	85,183,138	81,676,603
Contributed surplus (note 8(ii))	3,744,014	3,430,965
Common share conversion rights (note 9)	370,000	370,000
Deficit	(54,634,750)	(52,220,871)
	34,662,402	33,256,697
	\$ 72,989,632	\$ 65,097,402

Basis of presentation (note 1)
 Segmented information (note 11)
 Commitments and contingencies (note 12)
 Subsequent event (note 13)

See accompanying notes to consolidated financial statements.

INTERIM CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS AND DEFICIT

(Unaudited)

	Three Months Ended June 30		Six Months Ended June 30	
	2008	2007	2008	2007
REVENUE				
Petroleum and natural gas	\$ 16,678,644	\$ 7,690,222	\$ 27,987,795	\$ 15,456,419
Realized loss on commodity contracts	(584,216)	-	(632,989)	-
Unrealized loss on commodity contracts	(6,574,725)	-	(7,050,838)	-
Royalties	(3,127,671)	(1,584,257)	(5,204,454)	(3,558,543)
	6,392,032	6,105,965	15,099,514	11,897,876
Other income	734	280,968	2,296	285,121
	6,392,766	6,386,933	15,101,810	12,182,997
EXPENSES				
Operating	3,761,566	3,786,217	7,317,194	6,397,735
General and administrative	455,363	681,021	1,726,736	1,626,093
Finance charges	118,812	561,706	261,563	850,523
Other Expense	438,056	-	438,056	-
Interest on debentures	69,030	69,410	138,439	138,056
Unrealized foreign exchange gain (loss)	414,284	174,692	391,247	174,164
Convertible debenture accretion	31,284	25,500	56,915	51,000
Depletion, depreciation and accretion	3,929,111	3,945,000	7,395,159	8,735,018
Property, plant and equipment impairment (note 4)	-	8,379,997	495,650	9,934,680
Goodwill impairment (note 4)	-	-	-	4,791,561
Stock-based compensation (note 8 (h))	192,050	205,838	301,976	568,795
	9,409,556	17,829,381	18,522,935	33,267,625
Loss before income taxes	(3,016,790)	(11,442,448)	(3,421,125)	(21,084,629)
Income taxes:				
Current income taxes	266,659	210,000	614,509	250,000
Future income tax reduction	(1,357,596)	(2,245,999)	(1,621,755)	(3,929,155)
	(1,090,937)	(2,035,999)	(1,007,246)	(3,679,155)
Net loss and comprehensive loss for the period	(1,925,853)	(9,406,449)	(2,413,879)	(17,405,474)
Deficit – beginning of period	(52,708,897)	(36,840,895)	(52,220,871)	(28,841,871)
Deficit – end of period	\$ (54,634,750)	\$ (46,247,344)	\$ (54,634,750)	\$ (46,247,344)
Loss per share – basic and diluted (note 8(f))	\$ (0.02)	\$ (0.13)	\$ (0.03)	\$ (0.24)

See accompanying notes to interim consolidated financial statements.



INTERIM CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Three Months Ended June 30		Six Months Ended June 30	
	2008	2007	2008	2007
Cash provided (used in):				
Operations:				
Net loss for the period	\$ (1,925,853)	\$ (9,406,449)	\$ (2,413,879)	\$ (17,405,474)
Add (subtract) items not affecting cash:				
Non-cash general and administrative	225,000	-	225,000	-
Unrealized loss on commodity contract	6,574,725	-	7,050,838	-
Depletion, depreciation and accretion	3,929,111	3,945,000	7,395,159	8,735,018
Property, plant and equipment impairment	-	8,379,997	495,650	9,934,680
Goodwill impairment	-	-	-	4,791,561
Future income tax reduction	(1,357,596)	(2,245,999)	(1,621,755)	(3,929,155)
Convertible debenture accretion	31,284	25,500	56,915	51,000
Stock-based compensation	192,050	205,838	301,976	568,795
Unrealized foreign exchange gain	414,284	174,692	391,247	174,164
Asset retirement obligations settled	(32,487)	-	(40,928)	-
	8,050,518	1,078,579	11,840,223	2,920,589
Net change in non-cash working capital items (note 10)	298,511	2,003,538	(2,382,479)	4,711,065
	8,349,029	3,082,117	9,457,744	7,631,654
Financing:				
Issue of shares for cash	943,321	-	4,787,059	-
Issue of shares for cash on exercise of stock options	53,833	-	64,333	-
Share issue expenses	(89,953)	-	(370,904)	-
Revolving demand loan	(5,605,942)	-	(4,377,285)	(12,736,976)
Net change in non-cash working capital (note 10)	(1,773,898)	(11,843,073)	(24,632)	-
	(6,472,639)	(11,843,073)	78,571	(12,736,976)
Investments:				
Additions to property, plant and equipment	(4,792,985)	(5,365,242)	(9,677,825)	(8,364,431)
Purchase of property, plant and equipment	(974,733)	-	(974,733)	-
Sale of property	1,225,792	14,000,000	1,235,792	14,000,000
Net change in non-cash working capital items (note 10)	(2,665,536)	126,198	(119,549)	(530,247)
	(1,876,390)	8,760,956	(9,536,315)	5,105,322
Change in cash during the period	-	-	-	-
Cash - beginning of period	-	-	-	-
Cash - end of period	\$ -	\$ -	\$ -	\$ -

Supplemental information (note 10)

See accompanying notes to interim consolidated financial statements.

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

Three and six months ended June 30, 2008

1. BASIS OF PRESENTATION:

These interim unaudited 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 same accounting principles and methods as used in the financial statements for the year ended December 31, 2007 except as described below. The interim consolidated financial statement note disclosures do not include all disclosures applicable for annual financial statements. Accordingly, the interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto contained in the Company's annual report for the year ended December 31, 2007. These interim consolidated financial statements include the accounts of Arsenal and its wholly owned subsidiaries.

Changes in accounting policies:

Capital Disclosures

On January 1, 2008, the Company adopted the new standards for Capital Disclosures requiring disclosures regarding an entity's objectives, policies, and processes for managing capital. These disclosures include a description of what the company manages as capital, the nature of externally imposed capital requirements, how the requirements are incorporated into the company's management of capital, whether the requirements have been complied with, or consequences of non-compliance and an explanation of how the company is meeting its objectives for managing capital. In addition, quantitative data about capital and whether the company has complied with all capital requirements are also required (see note 5).

Financial Instruments - Disclosures and Presentation

On January 1, 2008, the Company adopted the new standards relating to "Financial Instruments - Disclosures" and "Financial Instruments - Presentation", which replaced the previous standard "Financial Instruments - Disclosure and Presentation".

The new disclosure standard outlines the disclosure requirements for financial instruments and non-financial derivatives. The guidance prescribes an increased importance on risk disclosures associated with recognized and unrecognized financial instruments and how such risks are managed. Specifically, it requires disclosure of the significance of financial instruments for a company's financial position. In addition, the guidance outlines revised requirements for the disclosure of qualitative and quantitative information regarding exposure to risks arising from financial instruments.

The new presentation standard requirements are relatively unchanged from the previous presentation requirements.

International Financial reporting Standards ("IFRS")

In February 2008, the CICA Accounting Standards Board ("AcSB") confirmed the changeover to IFRS from Canadian GAAP will be required for publicly accountable enterprises interim and annual financial statements effective for fiscal years beginning on or after January 1, 2011. The AcSB issued the "omnibus" exposure draft of IFRS with comments due by July 31, 2008, wherein early adoption by Canadian entities is also permitted. The Canadian Securities Administrators ("CSA") has also issued Concept Paper 52-402, which requested feedback on the early adoption of IFRS as well as the continued use of US GAAP by domestic issuers. The eventual changeover to IFRS represents a change due to new accounting standards. The transition from current Canadian GAAP to IFRS is a significant undertaking that may materially affect the Company's reported financial position and results of operations.

The IASB has stated that it plans to issue an exposure draft relating to certain amendments and exemptions to IFRS 1 in order to make it more useful to Canadian entities adopting IFRS for the first time. One such exemption relating to full cost oil and gas accounting is expected to reduce the administrative burden in the transition from the current Canadian Accounting Guideline 16 to IFRS. It is anticipated that this exposure draft will not result in an amended IFRS 1 standard until late 2009. The amendment will potentially permit the Company to apply IFRS prospectively to their full cost pool, rather than the



NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

Three and six months ended June 30, 2008

retrospective assessment of capitalized exploration and development expenses, with the proviso that a ceiling test, under IFRS standards, be conducted at the transition date.

Although, the Company has not completed development of its IFRS changeover plan, when finalized it will include project structure and governance, resourcing and training, an analysis of key GAAP differences and a phased plan to assess accounting policies under IFRS as well as potential IFRS 1 exemptions. The Company anticipates completing its project scoping, which will include a timetable for assessing the impact on data systems, internal controls over financial reporting, and business activities, such as financing and compensation arrangements, during 2009.

2. RELATED PARTY TRANSACTIONS:

The Company issued shares in a prior year to a former officer and director of the Company, the proceeds of which were to be recognized when received. In June 2008, the Company, for past services rendered, forgave the loan in the amount of \$225,000 and released the shares from escrow (see note 8).

An officer of the Company is a partner in a law firm that provides legal services to the Company. During 2008 to date, the Company recorded a total of \$267,524 (December 31, 2007 - \$265,837) for legal fees and disbursements. As at June 30, 2008 accounts payable and accrued liabilities include \$75,000 (December 31, 2007 - \$142,170) relating to these payments.

In March 2008, an officer participated in the flow-through share offering of the Company on the same terms as the other subscribers (see note 8).

3. RISK MANAGEMENT AND FINANCIAL INSTRUMENTS:

a) Commodity price risk management:

The Company has two crude oil sales contracts in place fixing the price of future production. In February 2008, the Company fixed the price of 200 barrels per day at CDN \$97.55 per barrel. The contract is effective March 1, 2008 and terminates December 31, 2009. In April 2008, the Company fixed the price of 100 barrels per day at CDN \$109.80 per barrel. The contract is effective July 1, 2008 and terminates December 31, 2009. As at June 30, 2008, the Company recorded a realized hedging loss of \$632,989, an unrealized hedging loss totaling \$7,050,838 of which \$4,687,716 has been recorded as a current liability and \$2,363,122 has been recorded as a long term liability. The related future income tax asset amount of \$1,887,191 has been recorded as a current asset.

A \$1.00 change in the NYMEX WTI Canadian price would increase or decrease the hedging loss by \$164,700.

b) Fair value of financial instruments:

The Company's exposure under its financial instruments is limited to financial assets and liabilities, all of which are included in these financial statements. The fair values of financial assets, liabilities, and convertible debentures that are included in the balance sheet approximate their carrying amounts.

c) Credit risk:

A substantial portion of the Company's accounts receivable are with customers and joint interest partners in the oil and gas industry and are subject to normal industry credit risks.

Credit risk is the risk of financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligations, and arises principally from the Company's receivables from joint interest partners and petroleum and natural gas marketers. As at June 30, 2008 the Company's receivables

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

Three and six months ended June 30, 2008

consisted of \$1,361,806 (December 31, 2007 - \$1,120,874) from joint interest partners, \$5,553,373 (December 31, 2007 - \$2,414,957) of receivables from petroleum and natural gas marketers and \$542,471 (December 31, 2007 - \$224,740) of other trade receivables. Accounts receivable also includes \$164,712 (December 31, 2007 - \$28,711) of prepaid expenses.

Receivables from petroleum and natural gas marketers are normally collected on the 25th day of the month following production. The Company's policy to mitigate credit risk associated with these balances is to establish marketing relationships with large purchasers. The Company historically has not experienced any collection issues with its petroleum and natural gas marketers. Joint interest receivables are typically collected within one to three months of the joint interest bill being issued to the partner. The Company attempts to mitigate the risk from joint interest receivables by obtaining partner approval of significant capital expenditures and payment of cash advances prior to expenditure. However, the receivables are from participants in the petroleum and natural gas sector, and collection of the outstanding balances are dependent on industry factors such as commodity price fluctuations, escalating costs and the risk of unsuccessful drilling, in addition further risk exists with joint interest partners as disagreements occasionally arise that increase the potential for non-collection. The Company does not typically obtain collateral from petroleum and natural gas marketers or joint interest partners; however the Company does have the ability to withhold production from joint interest partners in the event of non-payment.

The carrying amount of accounts receivable represents the maximum credit exposure. The Company has an allowance for doubtful accounts as at June 30, 2008 and at December 31, 2007 of \$422,316. This allowance for doubtful accounts was provided during the year ended December 31, 2007.

d) Foreign currency exchange risk:

The Company is exposed to foreign currency fluctuations as crude oil and natural gas prices received are referenced to U.S. dollar denominated prices, and revenues earned and costs incurred in the United States and Egypt are denominated in U.S. dollars.

e) Interest rate risk:

The Company is exposed to interest rate risk to the extent that bank debt is at a floating rate of interest.

4. PROPERTY, PLANT AND EQUIPMENT:

	June 30, 2008	December 31, 2007
Petroleum and natural gas properties	\$ 94,590,811	\$ 87,712,152
Production equipment	14,432,804	11,912,419
	109,023,615	99,624,571
Office furniture, equipment and other	507,368	488,292
	109,530,983	100,112,863
Accumulated depletion and depreciation	(46,219,453)	(38,978,322)
	\$ 63,311,530	\$ 61,134,541

In Canada and the United States, costs of unproved properties have been capitalized, and subject to depletion during the first and second quarters of 2008 and for 2007. For the period ending June 30, 2008, future development costs totaling \$808,000 (December 31, 2007 - \$1,400,000) in Canada and \$1,276,800 (December 31, 2007 - \$1,276,000) in the U.S. were included in the depletion calculation.



NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

Three and six months ended June 30, 2008

During the first quarter of 2008, the Company recorded an impairment to its Egyptian property of \$495,650 (2007 - \$1,554,683). As at June 30, 2008, the Company has completely written off its interest in its Egyptian concession.

During 2007, the Company compared the fair value of goodwill to the carrying amount of goodwill. As a result of this test, the Company recorded impairment to goodwill of \$4,791,561 calculated as the excess of the Company's fair value over the identifiable net assets for its Canadian reporting unit.

For the period ended June 30, 2008, Arsenal capitalized general and administrative expenses of \$183,935 (2007 - \$287,800) including \$48,120 of stock based compensation and \$20,815 of tax related thereto.

5. CAPITAL MANAGEMENT:

In order to continue the Company's future exploration and development program, the Company must maintain a strong capital base. A strong capital base results in increased market confidence, an essential factor in maintaining existing shareholders and in attracting new investors. The Company's commitment is to establish and maintain a strong capital base to enable the Company to access the equity and debt markets when deemed advisable. In order to maintain a strong capital base, the Company continually monitors the risk reward profile of its exploration and development projects and the economic indicators in the market including commodity prices, interest rates and foreign exchange rates. It then determines increases or decreases to its capital budget.

The Company considers shareholders equity, bank debt and working capital as components of its capital base. The Company can access or increase capital through the issuance of shares, through bank borrowings, that are based on reserves, and by building cash reserves by reducing its capital expenditure program.

The Company monitors its capital based primarily on its total debt (including the convertible debentures) to annualized cash flow ratio. Debt includes bank debt plus or minus working capital. Annualized cash flow is calculated as cash flow from operations before changes in non-cash working capital from the Company's most recent quarter multiplied by four. The Company's strategy is to maintain this ratio at 1 : 1. This ratio may increase somewhat depending on the timing and nature of the Company's activities. To facilitate the management and control of this ratio, the Company prepares an annual operating and capital expenditure budget. The budget is updated when critical factors change. These factors include economic factors such as the state of equity markets, changes to commodity prices, interest rates and foreign exchange rates and non economic factors such as the Company's drilling results and its production profile. The Company's board of directors approves the budget and changes thereto.

At June 30, 2008, the Company's debt to cash flow ratio was 0.34 : 1. Including the convertible debentures in debt increases the ratio to 0.44 : 1. The ratio is particularly low due to the Company's current under utilization of its borrowing base and the unusually high commodity prices. The ratio fluctuates quarterly based on the timing of the Company capital expenditure program and equity offering.

The Company's credit facility has certain financial covenants that, without the written consent of the lender, would result in a breach of the agreement. The Company cannot permit:

- the working capital ratio to fall below 1 : 1 and
- the ratio of net debt to trailing cash flow annualized to exceed 3 : 1

The Company's share capital is not subject to external restrictions.

There were no changes in the Company's approach to capital management during the period.

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

Three and six months ended June 30, 2008

6. REVOLVING DEMAND LOAN:

At June 30, 2008, the Company has available a demand operating loan in the amount of \$17,250,000. The facility can be utilized in either Canadian or U.S. dollars, bears interest at Canadian or U.S. bank prime rate plus 0.25%, increasing to Canadian or U.S. bank prime rate plus 0.40% if net debt to trailing cash flow (cash flow for the last quarter annualized) exceeds 1.25:1. The facility is secured by a fixed and floating charge debenture providing a fixed charge over all present and after acquired petroleum and natural gas interests and a floating charge over all lands and a continuing guarantee from the Company's U.S. subsidiary in the form of a Mortgage Security Agreement and Letter of Undertaking limited to \$8,000,000.

7. ASSET RETIREMENT OBLIGATIONS:

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

Changes to the asset retirement obligations were as follows:

	Six Months Ended June 30, 2008	Year Ended December 31, 2007
Asset retirement obligations – beginning of period	\$ 3,697,721	\$ 2,638,520
Liabilities settled	(40,928)	(321,190)
Liabilities incurred or acquired	433,867	1,251,400
Change in estimate	14,723	(76,559)
Accretion expense	148,229	205,550
Asset retirement obligations - end of period	\$ 4,253,612	\$ 3,697,721

The total undiscounted amount of estimated cash flows required to settle the obligation at June 30, 2008 is \$9,367,648 (December 31, 2007 - \$8,625,648), which has been discounted using a credit-adjusted risk free rate of 8.0% and an inflation factor of 1.5% for both periods. The majority of these obligations will be incurred between 2014 and 2025; however certain obligations are not anticipated to be incurred until 2035.

8. SHAREHOLDER'S EQUITY:

a) Authorized:

Unlimited number of common shares

Unlimited number of non-voting preferred shares, issuable in series

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

Three and six months ended June 30, 2008

b) Issued:

	Six Months Ended June 30, 2008		Year Ended December 31, 2007	
	Number	Amount	Number	Amount
Common shares:				
Balance – beginning of period	83,698,042	\$ 81,901,603	73,642,173	\$ 80,516,169
Issued to acquire property	–	–	275,000	158,000
Issued on exercise of options	216,918	64,333	73,333	14,667
Allocated from contributed surplus	–	37,047	–	–
Issued for cash pursuant to private placement	1,249,300	787,059	–	–
Issued for cash pursuant to private placement flow-through shares	5,555,555	4,000,000	9,707,536	4,174,240
Tax effect of flow-through shares	–	(1,356,625)	–	(2,660,118)
Share issue costs	–	(370,904)	–	(443,855)
Tax effect of share issue costs	–	120,625	–	142,500
Balance – end of period	90,719,815	85,183,138	83,698,042	81,901,603
Shares held in escrow (note (e))	–	–	–	(225,000)
Balance – end of period	90,719,815	\$ 85,183,138	83,698,042	\$ 81,676,603

In April 2008, the Company issued 289,500 common shares at \$0.63 for gross proceeds of \$182,385.

An officer of the Company subscribed for 100,000 shares for gross proceeds of \$63,000.

In March 2008, the Company issued 959,800 common shares at \$0.63 for gross proceeds of \$604,674. An officer of the Company subscribed for 150,000 shares for gross proceeds of \$94,500.

c) Flow-through shares:

In April 2008, the Company issued 1,056,855 flow-through shares for gross proceeds of \$760,936. An officer of the Company subscribed for 14,000 flow-through shares for gross proceeds of \$10,800. The terms of the share issue require the Company to renounce to subscribers Canadian Exploration.

In March 2008, the Company issued 4,498,700 flow-through shares for gross proceeds of \$3,239,064. An officer of the Company subscribed for 20,000 flow-through shares for gross proceeds of \$14,400. The terms of the flow-through share issue require the Company to renounce to subscribers Canadian Exploration Expenditures in the amount of \$4,000,000 of which \$760,936 has been incurred, leaving \$3,239,064 to be incurred prior to December 31, 2009.

d) Exercise of options:

In June 2008, 50,000 stock options issued at \$0.36 were exercised for proceeds of \$18,000 and in May 2008, 108,919 stock options issued at \$0.20 were exercised for proceeds of \$27,784, 24,999 stock options issued at \$0.37 were exercised for gross proceeds of \$9,260 and 8,000 stock options issued at \$0.60 were exercised for proceeds of \$4,800.

In February 2008, 25,000 stock options issued at \$0.42 were exercised for proceeds of \$10,500.

The related contributed surplus amount of \$30,047 has been added to share capital for all options exercised to date.

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

Three and six months ended June 30, 2008

In 2007, 73,333 stock options issued in 2003 at \$0.20 were exercised for proceeds of \$14,667. No adjustment to share capital was required as no prior compensation expense had been recognized.

e) Escrowed shares:

The Company issued shares in a prior year to a former officer and director of the Company, the proceeds of which were to be recognized if and when received. In June 2008, the loan in the amount of \$225,000 (December 31, 2007 - \$225,000) was, for past services rendered, forgiven and added to share capital. The 225,000 previously escrowed shares were released to the former officer and director.

f) Per share amounts:

The following table shows the weighted average number of common and diluted shares.

	Three Months Ended June 30		Six Months Ended June 30	
	2008	2007	2008	2007
Basic and diluted:				
(Loss) per share basic and diluted	\$ (0.02)	\$ (0.13)	\$ (0.03)	\$ (0.24)
Shares outstanding:				
Basic	90,073,484	73,798,006	86,606,456	73,720,090
Diluted	90,453,104	74,043,577	86,915,724	73,965,661

The convertible debentures are convertible into 1,539,170 common shares representing a conversion price of \$2.26 per share. As a result of the high conversion price, they were excluded from the dilution calculation. No adjustments were required to reported earnings in computing diluted per share amounts.

g) Stock options:

The Company has a stock option plan in which the Company may grant options to its directors, officers, employees and consultants for up to 10% of its outstanding common shares. Under the plan, the exercise price of each option granted shall not be less than the market price of the Company's common shares on the date the option is granted and the contractual term of each option is not to exceed five years. All options vest over a period as determined by the board of directors. Stock options are granted periodically throughout the year.

The following table summarizes the status of the Company's stock option plan as at June 30, 2008 and December 31, 2007 and the changes during the periods ended on those dates:

	Six Months Ended June 30, 2008		Year Ended December 31, 2007	
	Number of options	Average exercise price	Number of options	Average exercise price
Balance – beginning of period	3,758,919	\$ 0.88	4,527,252	\$ 1.05
Granted	2,046,000	0.70	995,000	0.40
Exercised	(216,918)	0.30	(73,333)	0.20
Forfeited	(350,000)	1.10	(1,690,000)	1.08
Balance – end of period	5,238,001	\$ 0.80	3,758,919	\$ 0.88
Exercisable	3,023,001	\$ 0.93	2,854,752	\$ 1.01



NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

Three and six months ended June 30, 2008

The following table summarizes information about the stock options outstanding and exercisable at June 30, 2008:

Range	Options outstanding		Options exercisable		
	Options outstanding	Weighted average exercise price	Weighted average remaining terms (years)	Exercisable	Weighted average exercise price
\$ 0.20 – 0.59	1,210,001	\$ 0.44	3.00	825,001	\$ 0.46
\$ 0.60 – 1.10	2,538,000	0.72	4.58	708,000	0.91
\$ 1.11 – 1.25	1,335,000	1.19	1.35	1,335,000	1.19
\$ 1.26 – 2.00	155,000	1.37	2.21	155,000	1.37
Total	5,238,001	\$ 0.80	3.23	3,023,001	\$ 0.93

h) Stock-based compensation expense:

Options granted to employees and non-employees are accounted for using the fair value method. The fair value of stock options granted during 2008 is \$1,124,927 (\$0.33 per option) as estimated at the date of grant using the Black-Scholes option-pricing model with weighted average assumptions for grants as follows:

	2008	2007
Risk free rate	3.25 - 4.50%	4.5%
Expected life	5 years	5 years
Expected volatility	125%	152%
Expected dividend	nil	nil
Expected forfeitures	nil	nil

The fair value of the options issued will be recognized as stock based compensation expense over the 18 month vesting period of the options.

i) Contributed surplus:

The estimated fair value of the options is amortized and credited to contributed surplus over the option vesting period on a straight line basis. The change in the contributed surplus account is reconciled in the table below:

	Six Months Ended June 30, 2008	Year Ended December 31, 2007
Balance – beginning of period	\$ 3,430,965	\$ 2,422,423
Stock-based compensation expensed	301,975	704,811
Stock-based compensation capitalized	48,121	–
Reclassification of expiry of warrants	–	303,731
Transferred to shareholders' equity	(37,047)	–
Balance – end of period	\$ 3,744,014	\$ 3,430,965

9. CONVERTIBLE DEBENTURES:

Arsenal completed the corporate acquisition of Tiverton on March 14, 2006. A portion of Tiverton's capital structure was comprised of unsecured convertible debentures totaling \$3,480,000. The convertible debentures are a debt security with an embedded conversion option and were segregated into a debt and equity component based on the respective fair value of each at the date of acquisition. The equity component of \$370,000 represents the holder's conversion right and was included in Shareholders' Equity. The remaining balance was classified as debt and is being

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

Three and six months ended June 30, 2008

accreted over the remaining period to maturity to the face value of the debenture. The interest accrues on the debentures at 8%, 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. 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. If the holder exercises the conversion right, they will receive accrued and unpaid interest up to and including the conversion date.

At December 31, 2007, these debentures were classified as long term. At June 30, 2008, the debentures are classified as a current liability as they mature on February 15, 2009.

10. SUPPLEMENTAL CASH FLOW INFORMATION:

	Six Months Ended June 30, 2008	Year Ended December 31, 2007
Change in non-cash working capital items:		
Accounts receivable and prepaids expenses	\$ (3,833,078)	\$ 3,492,891
Accounts payable and accrued liabilities	1,306,418	5,866,240
	(2,526,660)	9,359,131
Amounts relating to operating activities	(2,382,479)	8,138,366
Amounts relating to investing activities	(119,549)	1,165,765
Amounts relating to financing activities	(24,632)	55,000
	(2,526,660)	9,359,131
Interest and taxes paid:		
Interest	400,002	1,238,218
Taxes	\$ 732,145	\$ -

11. SEGMENTED INFORMATION:

A portion of the Company's assets and revenues are earned in the United States and a portion of the Company's assets are located in Egypt, and are monitored as an identifiable reporting segment by management. The remaining assets and associated revenues are earned in Canada. Business risks and economic indicators are similar across all geographical regions.

2008 (\$CDN)	Canada	U.S.	Egypt
Oil and gas revenue	21,404,756	6,583,039	-
Income (loss) before income taxes	1,473,526	(3,855,131)	(1,039,519)
Operating income	12,442,114	2,391,045	-
Property, plant and equipment (note 4)	59,596,372	3,715,157	-
Capital expenditures (cash and non-cash)	10,141,051	34,574	5,002
Property acquisitions	974,733	-	-
Property dispositions	(1,225,792)	-	-
2007 (\$CDN)	Canada	U.S.	Egypt
Oil and gas revenue	10,785,727	4,670,692	-
Income (loss) before income taxes	(15,005,758)	552,983	(6,631,854)
Operating income	3,983,758	2,005,219	-
Property, plant and equipment (note 4)	53,111,698	3,489,542	2,404,180
Capital expenditures (cash and non-cash)	5,576,507	80,942	2,864,981



NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

Three and six months ended June 30, 2008

12. COMMITMENTS AND CONTINGENCIES:

a) Egyptian concession:

The Company's wholly owned subsidiary Quadra Egypt Ltd. entered into a concession agreement with the Egyptian government in 2004. In June 2008, the Company gave notice, effective June 30, 2008, that it was withdrawing from further participation in the Egypt concession.

b) Flow-through shares:

In connection with the flow-through shares issued in 2008, the Company incurred a commitment to incur \$4,000,000 of eligible expenditures by December 31, 2009. As at June 30, 2008, the Company had incurred \$712,997 of these eligible expenditures.

c) Letter of credit:

During the second quarter of 2006, the Company provided a letter of credit to the Egyptian government for U.S.D \$1.6 million. The letter of credit is to be held until April 10, 2010, or until certain performance measures are achieved by the Company and its partners. The Company has obtained a Performance Security Guarantee ("PSG") from the Canadian government which guarantees the Company against the call of the bond by the Egyptian government. There is no impact to the existing credit facility of the Company from providing the letter of credit due to the PSG, however the Company incurred approximately \$50,000 in stamping fees to obtain the PSG. As of June 30, 2008, the performance measures have been met and the letter of credit has been cancelled. The Company is awaiting confirmation of the cancellation of the PSG.

13. SUBSEQUENT EVENT:

- a) In July 2008, the Company fixed the price of an additional 300 barrels per day at CDN \$130.10 per barrel. The contract is effective August 1, 2008 and terminates July 31, 2009. In July, the Company fixed the price of an additional 200 barrels per day at CDN \$125.80 per barrel. The contract is effective August 1, 2008 and terminates July 31, 2010.
- b) In August 2008, the Company and GEOCAN Energy Inc. ("GEOCAN") announced that they entered into an arrangement agreement (the "Arrangement Agreement") providing for the acquisition by the Company of GEOCAN pursuant to a plan of arrangement under the Business Corporations Act (Alberta) (the "Arrangement"). Under the Arrangement, the Company will acquire all of the outstanding class "A" common shares of GEOCAN ("GEOCAN Shares") for consideration of \$0.70 per GEOCAN Share, payable, at the election of each GEOCAN shareholder, in cash or 0.81 of a common share of Arsenal ("Arsenal Shares"). The value of the total consideration to be paid by the Company for the GEOCAN Shares, based upon a share value of \$0.865 for each Arsenal share is approximately \$39.2 million.

A maximum aggregate of \$30,000,000 and a minimum aggregate of \$26,000,000 in cash will be payable to the GEOCAN shareholders under the Arrangement.

The Arrangement requires the approval of the holders of GEOCAN Shares. The Arrangement Agreement provides that GEOCAN shall call and hold a special meeting of the GEOCAN shareholders by no later than October 6, 2008 for the purposes of considering the Arrangement. The Arrangement is subject to the approval of the Court of Queen's Bench of Alberta, the TSX and all applicable regulatory authorities. Completion of the Arrangement is also subject to a number of additional conditions set out in the Arrangement Agreement.

Under the Arrangement Agreement, GEOCAN and Arsenal have each agreed that they will not solicit or initiate any discussions concerning any business combination or the sale of material assets. The Arrangement Agreement provides for a mutual non-completion fee of \$1.7 million if the Arrangement is not completed in certain circumstances.

CORPORATE INFORMATION

OFFICERS AND MANAGEMENT

President and Chief Executive Officer

Tony van Winkoop

Chief Financial Officer

Paul Lawrence

Controller

Brenlee Taylor

Vice President Land

Gjoa Taylor

Vice President Operations

Jay LaForge

EXCHANGE LISTING

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

Computer Share Trust Company of Canada

Privacy Officer

Brenlee Taylor

privacy@arsenalenergy.com

BOARD OF DIRECTORS

R. Neil MacKay (1) (4)

Chairman

William Hews (1) (3)

Bill Powers (1) (2)

Curtis Stewart (2) (3)

Harley Kempthorne (2) (4)

Tony van Winkoop

President and CEO

Donald Edwards (4)

Corporate Secretary

COMMITTEES OF THE BOARD OF DIRECTORS

(1) Audit Committee member

(2) Reserves Committee member

(3) Compensation Committee member

(4) Disclosure Committee member

HEAD OFFICE

Suite 1800, 505 - 3rd Street S.W.

Calgary, AB T2P 3E6

bus. 403.262.4854

fax. 403.265.6877

toll free. 1.866.405.4854

Website/Email

www.arsenalenergy.com

info@arsenalenergy.com



Arsenal Energy Inc.

Suite 1800, 505 - 3rd Street S.W.

Calgary, AB T2P 3E6

bus. 403.262.4854 / fax. 403.265.6877

toll free. 1.866.405.4854

Toronto Stock Exchange: AEI

Frankfurt Stock Exchange: A1E