

## MANAGEMENT'S REPORT

The consolidated financial statements of Zargon Energy Trust were prepared by management in accordance with Canadian generally accepted accounting principles. The financial and operating information presented in this annual report is consistent with that shown in the consolidated financial statements.

Management has designed and maintains a system of internal accounting controls that provide reasonable assurance that all transactions are accurately recorded, that the financial statements reliably report the Trust's operations and that the Trust's assets are safeguarded. Timely release of financial information sometimes necessitates the use of estimates when transactions affecting the current accounting period cannot be finalized until future periods. Such estimates are based on careful judgments made by management.

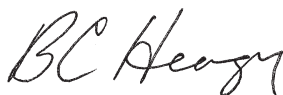
Ernst & Young LLP, an independent chartered accountant firm, was appointed by a resolution of the unitholders to audit the consolidated financial statements of the Trust and provide an independent opinion. They have conducted an independent examination of the Trust's accounting records in order to express their opinion on the consolidated financial statements.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal control. The Board exercises this responsibility through its Audit Committee. The Audit Committee, which consists of non-management directors, has met with Ernst & Young LLP and management in order to determine that management has fulfilled its responsibilities in the preparation of the consolidated financial statements. The Audit Committee has reported its findings to the Board of Directors, who have approved the consolidated financial statements.



**C.H. Hansen**

*President and Chief Executive Officer*



**B.C. Heagy**

*Executive Vice President and  
Chief Financial Officer*

Calgary, Canada  
March 12, 2007

## AUDITORS' REPORT

To the Unitholders of Zargon Energy Trust

We have audited the consolidated balance sheets of Zargon Energy Trust as at December 31, 2006 and 2005 and the consolidated statements of earnings and accumulated earnings and cash flows for the years then ended. These financial statements are the responsibility of the Trust's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Trust as at December 31, 2006 and 2005 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

*Ernst + Young LLP*

Calgary, Canada  
March 12, 2007

Chartered Accountants

## CONSOLIDATED BALANCE SHEETS

As at December 31 (\$ thousand)	2006	2005
<b>ASSETS</b> [note 5]		
<b>Current</b>		
Accounts receivable [note 11]	18,362	21,835
Prepaid expenses and deposits	3,281	2,710
Unrealized risk management asset [note 11]	5,817	-
	27,460	24,545
<b>Property and equipment, net</b> [notes 3 and 4]	283,108	253,315
	310,568	277,860
<b>LIABILITIES</b>		
<b>Current</b>		
Accounts payable and accrued liabilities	28,410	30,570
Cash distributions payable [note 17]	3,022	11,122
Unrealized risk management liability [note 11]	20	3,756
	31,452	45,448
<b>Long term debt</b> [note 5]	30,037	10,339
<b>Asset retirement obligations</b> [note 6]	17,307	15,859
<b>Future income taxes</b> [note 9]	47,891	48,928
	126,687	120,574
<b>Commitments and contingencies</b> [notes 11, 12 and 13]		
<b>NON-CONTROLLING INTEREST</b>		
Exchangeable shares [note 8]	18,319	12,673
<b>UNITHOLDERS' EQUITY</b>		
Unitholders' capital [note 7]	82,868	71,644
Contributed surplus [note 7]	2,475	1,347
Accumulated earnings	164,267	119,768
Accumulated cash distributions [note 17]	(84,048)	(48,146)
	165,562	144,613
	310,568	277,860

See accompanying notes to the consolidated financial statements.

On behalf of the Board:



J.O. McCutcheon  
Director



K.D. Kitagawa  
Director

## CONSOLIDATED STATEMENTS OF EARNINGS AND ACCUMULATED EARNINGS

For the years ended December 31  
(\$ thousand, except per unit amounts)

	2006	2005
<b>REVENUE</b>		
Petroleum and natural gas revenue	154,039	162,722
Unrealized risk management gain/(loss) [note 11]	9,553	(3,756)
Realized risk management loss	(569)	(7,754)
Royalties	(33,431)	(37,319)
	129,592	113,893
<b>EXPENSES</b>		
Production	26,416	24,035
General and administrative [note 18]	6,973	6,053
Unit-based compensation [note 7]	1,856	902
Interest and financing charges [note 5]	1,532	786
Unrealized foreign exchange (gain)/loss	24	(201)
Accretion of asset retirement obligations [note 6]	1,244	1,196
Depletion and depreciation	41,136	37,484
	79,181	70,255
<b>EARNINGS BEFORE INCOME TAXES</b>	50,411	43,638
<b>INCOME TAXES</b> [note 9]		
Current	1,598	1,801
Future (recovery)	(2,824)	474
	(1,226)	2,275
<b>EARNINGS FOR THE YEAR BEFORE NON-CONTROLLING INTEREST</b>	51,637	41,363
Non-controlling interest – exchangeable shares [note 8]	(7,138)	(5,994)
<b>NET EARNINGS FOR THE YEAR</b>	44,499	35,369
<b>ACCUMULATED EARNINGS, BEGINNING OF YEAR</b>	119,768	84,399
<b>ACCUMULATED EARNINGS, END OF YEAR</b>	164,267	119,768
<b>NET EARNINGS PER UNIT</b> [note 10]		
Basic	2.68	2.21
Diluted	2.68	2.19

See accompanying notes to the consolidated financial statements.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

For the years ended December 31 (\$ thousand)	2006	2005
<b>OPERATING ACTIVITIES</b>		
Net earnings for the year	44,499	35,369
Add (deduct) non-cash items:		
Non-controlling interest – exchangeable shares	7,138	5,994
Unrealized risk management (gain)/loss	(9,553)	3,756
Depletion and depreciation	41,136	37,484
Accretion of asset retirement obligations	1,244	1,196
Unit-based compensation	1,856	902
Unrealized foreign exchange (gain)/loss	24	(201)
Future income taxes (recovery)	(2,824)	474
	<b>83,520</b>	<b>84,974</b>
Asset retirement expenditures	(627)	(604)
Changes in non-cash working capital [note 14]	842	(1,401)
	<b>83,735</b>	<b>82,969</b>
<b>FINANCING ACTIVITIES</b>		
Advances (repayment) of bank debt	19,698	(3,891)
Cash distributions to unitholders	(35,902)	(37,444)
Exercise of unit rights	4,018	2,723
Changes in non-cash working capital [note 14]	(8,099)	8,974
	<b>(20,285)</b>	<b>(29,638)</b>
<b>INVESTING ACTIVITIES</b>		
Additions to property and equipment	(67,909)	(55,986)
Proceeds on disposal of property and equipment	4,543	2,446
Changes in non-cash working capital [note 14]	(84)	209
	<b>(63,450)</b>	<b>(53,331)</b>
<b>CHANGE IN CASH, AND CASH END OF YEAR</b>	<b>–</b>	<b>–</b>

See supplementary information contained in note 15.

See accompanying notes to the consolidated financial statements.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

For the years ended December 31, 2006 and 2005.  
All amounts are stated in Canadian dollars unless otherwise noted.

### 1. STRUCTURE OF THE TRUST

On July 15, 2004, Zargon Oil & Gas Ltd. (the "Company") was reorganized into Zargon Energy Trust (the "Trust" or "Zargon") as part of a Plan of Arrangement (the "Arrangement"). Shareholders of the Company received one trust unit or one exchangeable share for each common share held. The unitholders of the Trust are entitled to receive cash distributions paid by the Trust. Holders of exchangeable shares are not eligible to receive cash distributions paid, but rather, on each payment of a distribution, the number of trust units into which each exchangeable share is exchangeable is increased on a cumulative basis in respect of the distribution. The Trust is an unincorporated open-end investment trust established under the laws of the Province of Alberta and was created pursuant to a trust indenture ("Trust Indenture").

The Trust's principal business activity is the exploration for and development and production of petroleum and natural gas in Canada and the United States ("US").

### 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

#### Consolidation and Basis of Presentation

These consolidated financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles. Because a precise determination of many assets and liabilities is dependent upon future events, the preparation of periodic financial statements necessarily involves the use of estimates and approximations. Accordingly, actual results could differ from those estimates. The consolidated financial statements have, in management's opinion, been properly prepared within reasonable limits of materiality and within the framework of the Trust's accounting policies summarized below.

The consolidated financial statements include the accounts of Zargon Energy Trust, all subsidiaries and a partnership. All subsidiaries and the partnership are directly or indirectly owned and their operations are fully reflected in the consolidated financial statements.

#### Revenue Recognition

Petroleum and natural gas revenue is recognized in earnings when reserves are produced and delivered to the purchaser.

#### Joint Operations

The majority of the petroleum and natural gas operations of the Trust are conducted jointly with others, and accordingly, these consolidated financial statements reflect only the proportionate interests of the Trust in such activities.

#### Property and Equipment

The Trust follows the full cost method of accounting for its oil and natural gas operations whereby all costs relating to the acquisition, exploration and development of oil and natural gas reserves are capitalized and accumulated in separate cost centres for Canada and the United States. Such costs include land acquisition costs, annual carrying charges of non-producing properties, geological and geophysical costs, and costs of drilling and equipping wells.

Depletion and depreciation of petroleum, natural gas properties and equipment is computed using the unit of production method based on the estimated proved reserves of petroleum and natural gas before royalties determined by independent consultants. For purposes of this calculation, reserves are converted to common units on the basis that six thousand cubic feet of natural gas is equivalent to

one barrel of oil. A portion of the cost of petroleum and natural gas rights relating to undeveloped properties is excluded from the depletion calculation. Twenty percent of the year end balance of these costs is added to the depletion base each year. Proceeds on the disposal of petroleum and natural gas properties are applied against capitalized costs, with gains or losses not ordinarily recognized, unless such a disposal would result in a change in the depletion rate of 20 percent or more.

Depreciation of office equipment is provided using the declining balance method at an annual rate of 20 percent.

### **Impairment Test**

The Trust applies an impairment test to petroleum, natural gas properties and equipment costs on a quarterly basis or more frequently as events or circumstances dictate. This impairment test is performed on both the Canadian and US cost centres. An impairment loss exists when the carrying amount of the Trust's petroleum, natural gas properties and equipment exceeds the estimated undiscounted future net cash flows associated with the Trust's proved reserves (before royalties). If an impairment loss is determined to exist, the costs carried on the balance sheet in excess of the fair value of the Trust's proved and probable reserves are charged to income. Reserves are determined pursuant to evaluation by independent engineers as dictated by National Instrument 51-101.

### **Asset Retirement Obligations**

Zargon recognizes the fair value of an Asset Retirement Obligation ("ARO") in the period in which it is incurred when a reasonable estimate of the fair value can be made. The fair value of the estimated ARO is recorded as a liability, with a corresponding increase in the carrying amount of the related asset. The capitalized amount is depleted on the unit of production method based on proved reserves (before royalties). The liability amount is increased each reporting period due to the passage of time and the amount of accretion is expensed in the period. Actual costs incurred upon the settlement of the ARO are charged against the liability. Differences between the actual costs incurred and the fair value of the liability recorded are recognized to earnings in the period incurred.

### **Financial Instruments**

Derivative financial instruments are utilized to reduce commodity price risk associated with the Trust's production of oil and natural gas. The base prices for the commodities are sometimes denominated in US dollars and the Trust may also use such financial instruments to reduce the related foreign currency risk. Financial instruments may also be used from time to time to reduce interest rate risk on outstanding debt. The Trust does not enter into financial instruments for trading or speculative purposes.

The Trust follows a policy of using risk management instruments such as fixed price swaps, forward sales, puts and costless collars. The objective is to partially offset or mitigate the wide price swings commonly encountered in oil and natural gas commodities and in so doing protect a minimum level of cash flow in periods of low commodity prices.

For financial risk management contracts entered into prior to December 31, 2004, the Trust's policy was to designate each derivative financial instrument employed as a hedge of a specific portion of projected production over the term of the instrument. The Trust formally documented its risk management objectives and strategies for undertaking the hedged transactions, the hedging item, the nature of the specific risk exposures being hedged, the intended term of the hedge relationship, the method for assessing effectiveness and the method of accounting for the hedging relationship. The effectiveness of the derivative was assessed on an ongoing basis to ensure that the derivatives entered into were highly effective in offsetting changes in fair values of the hedged items. The instruments employed could have been denominated in US or Canadian dollars. Gains or losses from all hedging contracts, other than forward sales settled by physical delivery, were recognized as hedging gains or losses when the sale of hedged production occurred. The Trust believed these derivative financial instruments used were

effective as hedges over their term. In the event that a designated hedged item ceased to exist, any realized or unrealized gain or loss on such derivative commodity instruments were to be recognized in income immediately. If the hedge relationship was terminated, either via ineffectiveness or via termination of the designation, gains or losses previously deferred continued to be deferred and recognized when they were realized. As at June 30, 2006, all designated hedge contracts had expired.

For financial risk management contracts entered into after December 31, 2004, the Trust does consider these contracts to be effective on an economic basis but has decided not to designate these contracts as hedges for accounting purposes and, accordingly, for outstanding contracts not designated as hedges, an unrealized gain or loss is recorded based on the fair value (mark-to-market) of the contracts at the period end. These instruments have been recorded as an unrealized risk management asset/liability in the consolidated balance sheets.

In the case of forward sales, the instrument can sometimes be satisfied by physical delivery. In the case of physical delivery, the payment is recorded as part of the normal revenue stream.

Foreign currency swap agreements may be used from time to time to manage the risk inherent in producing commodities whose price is based directly or indirectly on US dollars, using a notional principal amount equal to the projected monthly revenue from their sale. Payments or charges are calculated and paid according to the terms of the agreement, usually with monthly settlement. At December 31, 2006 and 2005 the Trust had no such financial instruments.

#### **Income Taxes**

The Trust follows the liability method of tax allocation in accounting for income taxes. Under this method, the Trust records future income taxes for the effect of any differences between the accounting and income tax basis of an asset or liability using income tax rates expected to apply in the years in which these temporary differences are expected to be recovered or settled. The effect on future income tax assets and liabilities of a change in tax rates is recognized in net earnings in the period in which the change is substantively enacted.

#### **Foreign Currency Translation**

The Trust uses the temporal method of foreign currency translation whereby the monetary assets and liabilities recorded in a foreign currency are translated into Canadian dollars at year end exchange rates, and non-monetary assets and liabilities at the exchange rates prevailing when the assets were acquired or liability incurred. Revenues and expenses are translated at the average rate of exchange for the year. Gains and losses on translation are included in the consolidated statements of earnings.

#### **Trust Unit Rights and Unit-Based Compensation**

Under the Trust's unit rights incentive plan (the "Plan"), rights to purchase trust units are granted to directors, officers and employees at current market prices. The Plan allows for the exercise price of rights to be reduced in future periods by an amount that distributions exceed a stated return on assets. Under the fair value method of accounting for unit-based compensation the cost of the option is charged to earnings with an offsetting amount recorded to contributed surplus, based on an estimate of the fair value using a Black-Scholes option-pricing model. Forfeiture of rights are recorded as a reduction in expense in the period in which they occur.

### Per Unit Amounts

Per unit amounts are calculated using the weighted average number of trust units outstanding during the period. Diluted per unit amounts are calculated using the treasury stock method to determine the dilutive effect of unit-based compensation. The Trust follows the treasury stock method, which assumes that the proceeds received from “in-the-money” trust unit rights and unrecognized future unit-based compensation expense are used to repurchase units at the average market rate during the period. Diluted per unit amounts also include exchangeable shares using the “if-converted” method, whereby it is assumed the conversion of the exchangeable securities occurs at the beginning of the reporting period (or at the time of issuance if later).

### Measurement Uncertainty

The amounts recorded for depletion and depreciation of property and equipment and the assessment of these assets for impairment are based on estimates of proved reserves, production rates, petroleum and natural gas prices, future costs and other relevant assumptions. By their nature, these estimates are subject to measurement uncertainty and the impact on the consolidated financial statements of changes in such estimates in future periods could be material.

Inherent in the fair value calculation of asset retirement obligations, are numerous assumptions and judgments including the ultimate settlement amounts, inflation factors, credit adjusted discount rates, timing of settlement, and changes in the legal and regulatory environments. To the extent future revisions to these assumptions impact the fair value of the existing asset retirement obligation liability, a corresponding adjustment is made to the property and equipment balance.

### Cash Distributions

The Trust declares monthly distributions of cash to unitholders of record on the last day of each calendar month. Pursuant to the Trust’s policy, it will pay distributions to its unitholders subject to satisfying its financing covenants. Such distributions are recorded as distributions of equity upon declaration of the distribution.

### 3. ACQUISITION

On November 15, 2005, a subsidiary of the Trust acquired all of the outstanding shares of Simoil Resources Ltd. (“Simoil”), a private oil and gas company, for consideration of \$1.19 million. Consideration consisted of \$0.04 million cash and the issuance of 40,000 Zargon trust units valued at \$28.60 per unit.

The results of operations for Simoil have been included in the consolidated financial statements since November 15, 2005.

The acquisition was accounted for by the purchase method as follows:

(\$ thousand)	2005
Property and equipment	1,702
Future income tax liability	(415)
Asset retirement obligations	(101)
<b>Total consideration</b>	<b>1,186</b>

#### 4. PROPERTY AND EQUIPMENT

		December 31, 2006		
(\$ thousand)	Cost	Accumulated Depletion and Depreciation	Net Book Value	
Petroleum, natural gas properties and equipment*	457,865	175,585	282,280	
Office equipment	1,841	1,013	828	
	<b>459,706</b>	<b>176,598</b>	<b>283,108</b>	
December 31, 2005				
(\$ thousand)	Cost	Accumulated Depletion and Depreciation	Net Book Value	
Petroleum, natural gas properties and equipment*	387,113	134,614	252,499	
Office equipment	1,664	848	816	
	<b>388,777</b>	<b>135,462</b>	<b>253,315</b>	

\* As a result of shareholders redeeming exchangeable shares, property and equipment has cumulatively increased \$42.94 million, \$6.73 million relating to 2006, \$24.93 million relating to 2005 and \$11.28 million relating to 2004. The effect of these increases has resulted in additional depletion and depreciation expense of approximately \$10.56 million, \$5.48 million relating to 2006 and \$5.08 million relating to 2005.

At December 31, 2006, petroleum, natural gas properties and equipment include \$20.99 million (2005 – \$14.72 million) relating to undeveloped properties that have been excluded from the depletion calculation.

An impairment test calculation was performed on the Trust's petroleum, natural gas properties and equipment at December 31, 2006 in which the estimated undiscounted future net cash flows associated with the proved reserves exceeded the carrying amount of the Trust's petroleum, natural gas properties and equipment. This impairment calculation was performed separately on both the Canadian and US cost centres.

The following table outlines benchmark prices used in the impairment test at December 31, 2006:

Year	WTI Crude Oil (\$US/bbl)	Exchange Rate (\$US/\$Cdn)	WTI Crude Oil (\$Cdn/bbl)	AECO Gas (\$Cdn/gj)
2007	66.26	0.88	75.30	6.65
2008	68.20	0.88	77.50	7.71
2009	67.06	0.88	76.21	7.67
2010	65.44	0.88	74.36	7.37
2011	65.08	0.88	73.95	7.07
Thereafter (inflation %)	2.0%	0.88	2.0%	2.0%

Actual prices used in the impairment test were adjusted for commodity price differentials specific to Zargon.

#### 5. LONG TERM DEBT

On September 30, 2005, a Canadian subsidiary and a US subsidiary of the Trust entered into syndicated committed credit facilities with a borrowing base of \$80 million which replaced its former demand facility of \$50 million. These facilities consisted of a \$60 million tranche available to the Canadian borrower and a US \$15 million tranche available to the US borrower. On June 30, 2006, Zargon amended and renewed these syndicated committed credit facilities, the result of which is an increase in the available facilities and borrowing base to \$100 million from the previous amount of \$80 million. These facilities consist of an \$80 million tranche available to the Canadian borrower and a US \$15 million tranche available to the US borrower. A \$150 million demand debenture on the assets of the subsidiaries of the Trust has been provided as security for these facilities. The facilities are fully

revolving for a 364 day period with the provision for an annual extension at the option of the lenders and upon notice from Zargon's management. The next renewal date is July 31, 2007. Should the facilities not be renewed, they convert to one year non-revolving term facilities at the end of the revolving 364 day period. Repayment would not be required until the end of the non-revolving term, and as such, these facilities have been classified as long term debt. Interest rates fluctuate under the syndicated facilities with Canadian prime, US prime, and US base rates plus an applicable margin between zero basis points and 25 basis points, as well as with Canadian banker's acceptance and LIBOR rates plus an applicable margin between 90 basis points and 150 basis points. At December 31, 2006, \$30.04 million (2005 – \$10.34 million) had been drawn on the syndicated committed credit facilities bearing interest at Canadian prime (December 31, 2006 – 6.0 percent; December 31, 2005 – 5.0 percent) with any unused amounts subject to standby fees. In the normal course of operations Zargon enters into various letters of credit. At December 31, 2006, the approximate value of outstanding letters of credit totalled \$0.47 million (2005 – \$0.47 million).

#### 6. ASSET RETIREMENT OBLIGATIONS

The total future asset retirement obligation was estimated by management based on Zargon's net working interest in all wells and facilities, estimated costs to reclaim and abandon wells and facilities and the estimated timing of the costs to be incurred in future periods. Zargon has estimated the net present value of its total asset retirement obligations to be \$17.31 million as at December 31, 2006 (2005 – \$15.86 million), based on a total future liability of \$65.08 million (2005 – \$62.54 million). These payments are expected to be made over the next 30 years with the majority of the costs being incurred after 2012. Commencing July 1, 2005, incremental asset retirement obligations are calculated using a revised credit adjusted risk-free rate of 7.5 percent. Asset retirement obligations prior to this period were calculated using a credit adjusted risk-free rate of 8.5 percent. An inflation rate of two percent used in the calculation of the present value of the asset retirement obligation remains unchanged. The following table reconciles Zargon's asset retirement obligations:

(\$ thousand)	Year Ended December 31,	
	2006	2005
Balance, beginning of year	15,859	14,390
Net liabilities incurred	826	906
Liabilities settled	(627)	(604)
Accretion expense	1,244	1,196
Foreign exchange	5	(29)
Balance, end of year	17,307	15,859

#### 7. UNITHOLDERS' EQUITY

Pursuant to the Plan of Arrangement on July 15, 2004, 14.87 million units of the Trust and 3.66 million exchangeable shares (see note 8) of the Company were issued in exchange for all of the outstanding shares of the Company on a one-for-one basis.

The Trust is authorized to issue an unlimited number of voting trust units.

## Trust Units

(thousand)	December 31, 2006		December 31, 2005	
	Number of Units	Amount (\$)	Number of Units	Amount (\$)
Balance, beginning of year	16,355	71,644	15,341	45,755
Unit rights exercised for cash	208	4,018	153	2,723
Unit-based compensation recognized on exercise of unit rights	-	728	-	725
Issued on conversion of exchangeable shares	226	6,478	821	21,297
Issued on corporate acquisition [note 3]	-	-	40	1,144
Balance, end of year	16,789	82,868	16,355	71,644

## Trust Unit Rights Incentive Plan

The Trust has a unit rights incentive plan (the "Plan") that allows the Trust to issue rights to acquire trust units to directors, officers, employees and other service providers. The Trust is authorized to issue up to 1.82 million unit rights; however, the number of trust units reserved for issuance upon exercise of the rights shall not at any time exceed 10 percent of the aggregate number of issued and outstanding trust units of the Trust. At the time of grant, unit right exercise prices approximate the market price for the trust units. At the time of exercise, the rights holder has the option of exercising at the original grant price or the exercise price as calculated per the Arrangement. Rights granted under the Plan generally vest over a three-year period and expire approximately five years from the grant date. Zargon uses a fair value methodology to value the unit rights grants.

The following table summarizes information about the Trust's unit rights:

	December 31, 2006		December 31, 2005	
	Number of Unit Rights (thousand)	Weighted Average Exercise Price (\$/unit right)	Number of Unit Rights (thousand)	Weighted Average Exercise Price (\$/unit right)
Outstanding at beginning of year	915	22.80	579	17.79
Unit rights granted	518	29.70	505	26.89
Unit rights exercised	(208)	19.30	(153)	17.77
Unit rights cancelled	(17)	25.59	(16)	18.13
Outstanding at end of year	1,208	26.32	915	22.80
Unit rights exercisable at year end	212	24.11	48	17.70

The following table summarizes information about unit rights outstanding at December 31, 2006:

Range of Exercise Prices (\$/unit right)	Unit Rights Outstanding			Unit Rights Exercisable	
	Number Outstanding at 12/31/06 (thousand)	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price (\$/unit right)	Number Exercisable at 12/31/06 (thousand)	Weighted Average Exercise Price (\$/unit right)
17.70 – 19.25	239	2.1 years	17.77	70	17.70
22.00 – 25.06	281	3.6 years	23.45	42	22.10
27.40 – 29.93	272	3.5 years	28.55	45	27.40
31.09 – 33.05	416	3.7 years	31.74	55	31.09
	1,208		26.32	212	24.11

## Unit-Based Compensation

The weighted average assumptions made for unit rights granted for 2006 include a volatility factor of expected market price of 26.6 percent, a risk-free interest rate of 4.1 percent, a dividend yield of 7.4 percent and an expected life of the unit rights of four years. These unit rights, together with the continued vesting of unit rights granted in prior years resulted in unit-based compensation expense in 2006 of \$1.86 million (2005 – \$0.90 million).

Compensation expense associated with rights granted under the Plan is recognized in earnings over the vesting period of the Plan with a corresponding increase in contributed surplus. The exercise of trust unit rights is recorded as an increase in trust units with a corresponding reduction in contributed surplus. Forfeiture of rights are recorded as a reduction in expense in the period in which they occur.

The following table summarizes information about the Trust's contributed surplus account:

### Contributed Surplus

(\$ thousand)

<b>Balance, December 31, 2004</b>	<b>1,170</b>
Unit-based compensation expense	902
Unit-based compensation recognized on exercise of unit rights	(725)
<b>Balance, December 31, 2005</b>	<b>1,347</b>
Unit-based compensation expense	<b>1,856</b>
Unit-based compensation recognized on exercise of unit rights	<b>(728)</b>
<b>Balance, December 31, 2006</b>	<b>2,475</b>

### Unit Redemption

Under the terms of the Trust Indenture, unitholders may require the Trust to redeem all or any part of the trust units at a price and under certain terms and conditions as specified in the Trust Indenture. The redemption price per trust unit will be equal to the lesser of: (i) 90 percent of the "market price" of the trust units on the principal market on which the trust units are quoted for trading during the 10 trading day period commencing immediately after the date on which the trust units are tendered to Zargon for redemption; and (ii) the closing market price on the principal market on which the trust units are quoted for trading on the date that the trust units are so tendered for redemption. Trust units tendered for redemption in any calendar month shall be paid on the last day of the third following month by, at the Trust's option: (i) a cash payment; or (ii) a distribution of notes and/or redemption notes. It is anticipated that this redemption right will not be the primary mechanism for holders of trust units to dispose of their trust units. Notes or redemption notes which may be distributed in specie to unitholders in connection with a redemption will not be listed on any stock exchange and no market is expected to develop for such notes or redemption notes. Notes or redemption notes may not be qualified investments for trusts governed by registered retirement savings plans, registered retirement income funds, deferred profit sharing plans and registered education savings plans. To date, no trust units have been tendered for redemption.

## 8. NON-CONTROLLING INTEREST-EXCHANGEABLE SHARES

Zargon Oil & Gas Ltd. is authorized to issue an unlimited number of exchangeable shares. The exchangeable shares are convertible into trust units at the option of the shareholder, based on the exchange ratio, which is adjusted monthly to reflect the distribution paid on the trust units. Cash distributions are not paid on the exchangeable shares. During the year, a total of 0.20 million (2005 – 0.78 million) exchangeable shares were converted into 0.23 million (2005 – 0.82 million) trust units based on the exchange ratio at the time of conversion. At December 31, 2006, the exchange ratio was 1.19403 (December 31, 2005 – 1.09629) trust units per exchangeable share. As set out in the

Arrangement, the exchangeable shares are entitled to vote equally to the number of trust units for which each exchangeable share is convertible into a trust unit on the record date. The Board of Directors of Zargon Oil & Gas Ltd. hold the option to redeem all outstanding exchangeable shares for trust units on or before July 15, 2014. At such time, should the Board not extend the term of the shares, there would be no remaining non-controlling interest.

Pursuant to EIC-151 "Exchangeable Securities Issued by a Subsidiary of an Income Trust", if certain conditions are met, the exchangeable shares issued by a subsidiary must be reflected as non-controlling interest on the consolidated balance sheets and in turn, net earnings must be reduced by the amount of net earnings attributed to the non-controlling interest.

The non-controlling interest on the consolidated balance sheets consists of the book value of exchangeable shares at the time of the Plan of Arrangement, plus net earnings attributable to the exchangeable shareholders, less exchangeable shares (and related cumulative earnings) redeemed. The net earnings attributable to the non-controlling interest on the consolidated statements of earnings represents the cumulative share of net earnings attributable to the non-controlling interest based on the trust units issuable for exchangeable shares in proportion to total trust units issued and issuable each period end.

#### Non-Controlling Interest – Exchangeable Shares

	December 31, 2006		December 31, 2005	
	Number of Shares	Amount (\$)	Number of Shares	Amount (\$)
(thousand, except exchange ratio)				
Balance, beginning of year	2,402	12,673	3,186	9,529
Exchanged for trust units at book value and including earnings attributed since Plan of Arrangement	(195)	(1,492)	(784)	(2,850)
Earnings attributable to non-controlling interest	–	7,138	–	5,994
<b>Balance, end of year</b>	<b>2,207</b>	<b>18,319</b>	2,402	12,673
Exchange ratio, end of year	1.19403		1.09629	
Trust units issuable upon conversion of exchangeable shares, end of year	2,635		2,633	

The proforma total units outstanding at December 31, 2006, including trust units outstanding, and trust units issuable upon conversion of exchangeable shares and after giving rise to the exchange ratio at the end of the year is 19.42 million units (2005 – 18.99 million units).

The effect of EIC-151 on Zargon's unitholders' capital and exchangeable shares is as follows:

(\$ thousand)	Zargon Energy Trust Units	Zargon Oil & Gas Ltd. Exchangeable Shares	Total
<b>Balance at December 31, 2004</b>	45,755	9,529	55,284
Issued on redemption of exchangeable shares at book value	1,909	(1,909)	–
Effect of EIC-151	19,388	5,053	24,441
Unit-based compensation recognized on exercise of unit rights	725	–	725
Unit rights exercised for cash	2,723	–	2,723
Issued on corporate acquisition	1,144	–	1,144
<b>Balance at December 31, 2005</b>	<b>71,644</b>	<b>12,673</b>	<b>84,317</b>
Issued on redemption of exchangeable shares at book value	477	(477)	–
Effect of EIC-151	6,001	6,123	12,124
Unit-based compensation recognized on exercise of unit rights	728	–	728
Unit rights exercised for cash	4,018	–	4,018
<b>Balance at December 31, 2006</b>	<b>82,868</b>	<b>18,319</b>	<b>101,187</b>

On January 19, 2005, the CICA issued EIC-151 "Exchangeable Securities Issued by Subsidiaries of Income Trusts" that states that exchangeable securities issued by a subsidiary of an Income Trust should be reflected as either a non-controlling interest or debt on the consolidated balance sheets unless they meet certain criteria. The exchangeable shares issued by Zargon Oil & Gas Ltd., a corporate subsidiary of the Trust, are publicly traded and have an expiry term, which could be extended at the option of the Board of Directors. Therefore, these securities are considered, by EIC-151, to be transferable to third parties and to have an indefinite life. EIC-151 states that if these criteria are met, the exchangeable shares should be reflected as a non-controlling interest. Prior to 2005, these exchangeable shares were reflected as a component of unitholders' equity.

As a result of EIC-151, the Trust has increased its unitholders' equity and non-controlling interest for 2006 by \$12.12 million (2005 – \$24.44 million) on the Trust's consolidated balance sheet. Consolidated net earnings for 2006 have been reduced for net earnings attributable to the non-controlling interest of \$7.14 million (2005 – \$5.99 million). In accordance with EIC-151 and given the circumstances in Zargon's case, each redemption is accounted for as a step-purchase, which for 2006 additionally resulted in an increase in property and equipment of \$6.73 million (2005 – \$24.93 million), and an increase in future income tax liability of \$1.75 million (2005 – \$6.48 million). Funds flow from operations were not impacted by this change.

The cumulative impact to date of the application of EIC-151 has been to increase gross property and equipment by \$42.94 million, (for depletion impact see note 4), unitholders' equity and non-controlling interest by \$46.71 million, future income tax liability by \$11.23 million and an allocation of net earnings to exchangeable shareholders' of \$15.00 million.

## 9. INCOME TAXES

The Trust is a taxable entity under the Income Tax Act (Canada) and is taxable only on income that is not distributed or distributable to the unitholders. As the Trust allocates all of its Canadian taxable income to the unitholders in accordance with the Trust Indenture, and meets the requirements of the Income Tax Act (Canada) applicable to the Trust, no current tax provision for Canadian income tax expense has been made in the Trust. Canadian large corporation tax, capital taxes, and US income taxes are provided for under current income tax expense.

In the Trust structure, payments are made between the Company and the Trust that result in the transferring of taxable income from the Company to individual unitholders. These payments may reduce future income tax liabilities previously recorded by the Company that would be recognized as a recovery of income tax in the period incurred.

On October 31, 2006, the Federal Government announced tax proposals pertaining to taxation of distributions paid by trusts and the personal tax treatment of trust distributions. Currently, the Trust does not pay tax on distributions as tax is paid by the unitholders. If enacted, the proposals would result in taxation of distributions at the Trust level at a rate of 31.5 percent effective January 1, 2011. As the proposals are not yet enacted, there was no impact on the results of the Trust for the year ended December 31, 2006. The Trust is currently assessing the proposals and the potential implications to the Trust.

Income taxes differ from the amounts which would be obtained by applying statutory income tax rates to earnings before income taxes as follows:

(\$ thousand)	2006	2005
Statutory income tax rate	<b>36.30%</b>	38.86%
Expected income taxes	<b>18,300</b>	16,958
Add (deduct) income tax effect of:		
Non-deductible Crown charges, net of Alberta Royalty Credit	<b>2,145</b>	5,058
Resource allowance	<b>(2,397)</b>	(5,062)
Rate adjustment	<b>(8,865)</b>	(1,674)
Cash distributions	<b>(13,032)</b>	(14,551)
Large corporation tax, capital taxes, and US income taxes	<b>1,598</b>	1,801
Other	<b>1,025</b>	(255)
	<b>(1,226)</b>	2,275

The future income tax provision for the year ended December 31, 2006 includes a recovery of \$6.01 million relating to a reduction in future federal and provincial income tax rates substantively enacted and recorded during the 2006 second quarter. The Federal Government budget also eliminated the Canadian large corporation tax effective January 1, 2006.

Future income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. The components of Zargon's net future income tax liability are as follows:

(\$ thousand)	2006	2005
Net book value of property and equipment in excess of tax pools	<b>46,336</b>	46,088
Deferred partnership earnings	<b>6,024</b>	10,178
Asset retirement obligations	<b>(6,333)</b>	(5,631)
Unrealized risk management asset/liability	<b>2,104</b>	(1,319)
Share issue costs	<b>(8)</b>	(19)
Alberta Royalty Credit	<b>(232)</b>	(369)
	<b>47,891</b>	48,928

As at December 31, 2006, Zargon's tax pools are as follows:

(\$ thousand)	December 31, 2006
Canadian oil and gas property expenses in the Trust	41,947
Canadian oil and gas property expenses in other entities	5,892
Canadian development expenses	24,681
Canadian exploration expenses	23,488
Capital cost allowance	30,161
US tax pools	4,555
Partnership deferral	(18,190)
Other	269
	<b>112,803</b>

#### 10. WEIGHTED AVERAGE NUMBER OF TOTAL UNITS

(thousand units)	2006	2005
Basic	16,600	16,003
Diluted	19,244	18,848

Dilution amounts of 2.64 million units (2005 – 2.85 million) were added to the weighted average number of units outstanding during the year in the calculation of diluted per unit amounts. These unit additions represent the dilutive effect of unit rights according to the treasury stock method, and also include exchangeable shares using the “if-converted” method. An adjustment to the numerator amount was required in the diluted calculation to provide for the earnings of \$7.14 million (2005 – \$5.99 million) attributable to the non-controlling interest pertaining to the exchangeable shareholders.

#### 11. FINANCIAL INSTRUMENTS

##### Fair Value of Financial Assets and Liabilities

Financial instruments of the Trust consist of accounts receivable, deposits, accounts payable, cash distributions payable, unrealized risk management assets and liabilities and long term debt. As at December 31, 2006 and 2005, there are no significant differences between the carrying values of these amounts and their estimated market values.

##### Credit Risk Management

Accounts receivable include amounts receivable for petroleum and natural gas sales that are generally made to large credit-worthy purchasers, and amounts receivable from joint venture partners that are recoverable from production. Accordingly, management views credit risks on these amounts as low. Of Zargon's significant individual accounts receivable at December 31, 2006, approximately 26 percent was owing from one company (2005 – 32 percent).

The Trust is exposed to losses in the event of non-performance by counterparties to financial risk management contracts. The Trust minimizes credit risk associated with possible non-performance to these financial instruments by entering into contracts with only investment grade counterparties, limits on exposures to any one counterparty, and monitoring procedures. Management believes these risks are minimal.

##### Interest Rate Risk Management

Borrowings under bank credit facilities are market-rate-based (variable interest rates); thus carrying values approximate fair values.

### Foreign Currency Risk Management

The Trust is exposed to fluctuations in the exchange rate between the Canadian dollar and the US dollar. Crude oil, and to a large extent natural gas prices, are based upon reference prices denominated in US dollars, while the majority of the Trust's expenses are denominated in Canadian dollars. When appropriate, the Trust enters into agreements to fix the exchange rate of Canadian dollars to US dollars in order to manage this risk.

### Commodity Price Risk Management

The Trust is a party to certain financial instruments that have fixed the price of a portion of its oil and natural gas production. The Trust enters into these contracts for risk management purposes only, in order to protect a portion of its future cash flow from the volatility of oil and natural gas commodity prices. The Trust has outstanding contracts at December 31, 2006 as follows:

#### Financial Contracts at December 31, 2006:

	Rate	Weighted Average Price	Range of Terms	Fair Market Value Gain/(Loss) (\$ thousand)
Oil swaps	500 bbl/d	\$67.33 US/bbl	Jan. 1/07–Jun. 30/07	393
	500 bbl/d	\$72.70 US/bbl	Jan. 1/07–Dec. 31/07	1,641
	500 bbl/d	\$72.10 US/bbl	Jul. 1/07–Dec. 31/07	609
	300 bbl/d	\$66.70 US/bbl	Jan. 1/08–Mar. 31/08	(20)
	300 bbl/d	\$68.29 US/bbl	Apr. 1/08–Jun. 30/08	30
Natural gas swaps	3,000 gj/d	\$9.13/gj	Jan. 1/07–Mar. 31/07	729
	4,000 gj/d	\$8.47/gj	Apr. 1/07–Oct. 31/07	1,676
	1,000 gj/d	\$8.77/gj	Nov. 1/07–Mar. 31/08	97
Natural gas collars	1,000 gj/d	\$9.50/gj Put \$12.50/gj Call	Jan. 1/07–Mar. 31/07	276
	1,000 gj/d	\$10.50/gj Put \$13.18/gj Call	Jan. 1/07–Mar. 31/07	366
<b>Net Fair Market Value, Financial Contracts</b>				<b>5,797</b>

#### Physical Contracts at December 31, 2006:

	Rate	Weighted Average Price	Range of Terms	Fair Market Value Gain/(Loss) (\$ thousand)
Natural gas fixed price	2,000 gj/d	\$9.23/gj	Jan. 1/07–Mar. 31/07	503
	1,000 gj/d	\$7.88/gj	Apr. 1/07–Oct. 31/07	293
Natural gas collars	1,000 gj/d	\$8.50/gj Put \$12.85/gj Call	Jan. 1/07–Mar. 31/07	186
	1,000 gj/d	\$9.50/gj Put \$13.50/gj Call	Jan. 1/07–Mar. 31/07	276
<b>Total Fair Market Value, Physical Contracts</b>				<b>1,258</b>

Oil swaps and collars are settled against the NYMEX pricing index, whereas natural gas swaps and collars are settled against the AECO pricing index.

For financial risk management contracts, the Trust considers these contracts to be effective on an economic basis but has decided not to designate these contracts as hedges for accounting purposes and accordingly any unrealized gains or losses are recorded based on the fair value (mark-to-market) of the contracts at the period end. The unrealized gain for 2006 was \$9.55 million and the unrealized loss for 2005 was \$3.76 million.

Contracts settled by way of physical delivery are recognized as part of the normal revenue stream. These instruments have no book values recorded in the consolidated financial statements.

## 12. COMMITMENTS

The Trust is committed to future minimum payments for natural gas transportation contracts in addition to operating leases for office space, office equipment, vehicles and field equipment. Payments required under these commitments for each of the next five years are: 2007 – \$1.93 million; 2008 – \$1.39 million; 2009 – \$1.25 million; 2010 – \$1.21 million; 2011 – \$1.21 million; thereafter – \$0.70 million.

## 13. CONTINGENCIES AND GUARANTEES

In the normal course of operations, Zargon executes agreements that provide for indemnification and guarantees to counterparties in transactions such as the sale of assets and operating leases.

These indemnifications and guarantees may require compensation to counterparties for costs and losses incurred as a result of various events, including breaches of representations and warranties, loss of or damages to property, environmental liabilities or as a result of litigation that may be suffered by counterparties.

Certain indemnifications can extend for an unlimited period and generally do not provide for any limit on the maximum potential amount. The nature of substantially all of the indemnifications prevents the Trust from making a reasonable estimate of the maximum potential amount that might be required to pay counterparties as the agreements do not specify a maximum amount, and the amounts depend on the outcome of future contingent events, the nature and likelihood of which cannot be determined at this time.

The Trust indemnifies its directors and officers against any and all claims or losses reasonably incurred in the performance of their service to the Trust to the extent permitted by law. The Trust has acquired and maintains liability insurance for its directors and officers. The Trust is party to various legal claims associated with the ordinary conduct of business. The Trust does not anticipate that these claims will have a material impact on the Trust's financial position.

## 14. CHANGES IN NON-CASH WORKING CAPITAL

(\$ thousand)	Year Ended December 31,	
	2006	2005
<b>Changes in non-cash working capital items:</b>		
Accounts receivable	<b>3,473</b>	(7,560)
Prepaid expenses and deposits	<b>(571)</b>	243
Accounts payable and accrued liabilities	<b>(2,160)</b>	6,417
Cash distributions payable	<b>(8,100)</b>	8,912
Other	<b>17</b>	(230)
	<b>(7,341)</b>	7,782
Changes relating to operating activities	<b>842</b>	(1,401)
Changes relating to financing activities	<b>(8,099)</b>	8,974
Changes relating to investing activities	<b>(84)</b>	209
	<b>(7,341)</b>	7,782

**15. SUPPLEMENTAL CASH FLOW INFORMATION**

(\$ thousand)	2006	2005
Cash interest and financing charges paid	1,593	1,044
Cash taxes paid	2,216	1,911

**16. SEGMENTED INFORMATION**

Zargon's entire operating activities are related to exploration, development and production of oil and natural gas in the geographic segments of Canada and the US.

(\$ thousand)	2006		
	Canada	United States	Combined
Petroleum and natural gas revenue	129,967	24,072	154,039
Earnings before income taxes	39,797	10,614	50,411
Property and equipment, net	248,440	34,668	283,108
Total assets	273,748	36,820	310,568
Net capital expenditures	58,040	5,326	63,366

(\$ thousand)	2005		
	Canada	United States	Combined
Petroleum and natural gas revenue	141,869	20,853	162,722
Earnings before income taxes	34,890	8,748	43,638
Property and equipment, net	221,664	31,651	253,315
Total assets	244,416	33,444	277,860
Net capital expenditures <sup>(1)</sup>	49,251	5,433	54,684

1. Amounts include capital expenditures acquired for cash and equity issuances.

## 17. CASH DISTRIBUTIONS

During the year, the Trust declared distributions to the unitholders in the aggregate amount of \$35.90 million (2005 – \$37.44 million) in accordance with the following schedule:

2006 Distributions	Record Date	Distribution Date	Per Trust Unit
January	January 31, 2006	February 15, 2006	\$0.18
February	February 28, 2006	March 15, 2006	\$0.18
March	March 31, 2006	April 17, 2006	\$0.18
April	April 30, 2006	May 15, 2006	\$0.18
May	May 31, 2006	June 15, 2006	\$0.18
June	June 30, 2006	July 17, 2006	\$0.18
July	July 31, 2006	August 15, 2006	\$0.18
August	August 31, 2006	September 15, 2006	\$0.18
September	September 30, 2006	October 16, 2006	\$0.18
October	October 31, 2006	November 15, 2006	\$0.18
November	November 30, 2006	December 15, 2006	\$0.18
December	December 31, 2006	January 15, 2007	\$0.18

2005 Distributions	Record Date	Distribution Date	Per Trust Unit
January	January 31, 2005	February 15, 2005	\$0.14
February	February 28, 2005	March 15, 2005	\$0.14
March	March 31, 2005	April 15, 2005	\$0.14
April	April 30, 2005	May 16, 2005	\$0.14
May	May 31, 2005	June 15, 2005	\$0.14
June	June 30, 2005	July 15, 2005	\$0.14
July	July 31, 2005	August 15, 2005	\$0.14
August	August 31, 2005	September 15, 2005	\$0.16
September	September 30, 2005	October 17, 2005	\$0.16
October	October 31, 2005	November 15, 2005	\$0.16
November	November 30, 2005	December 15, 2005	\$0.18
December	December 31, 2005	January 16, 2006	\$0.18
December (Supplemental)	December 31, 2005	January 16, 2006	\$0.50

## 18. RELATED PARTY TRANSACTIONS

Zargon paid \$0.05 million (2005 – \$0.04 million) for vehicle leases to a company owned by a Board member; \$0.09 million (2005 – \$0.12 million) for legal services to a law firm in which a Board member is a partner; \$0.02 million (2005 – \$0.01 million) for field services to a company of which a senior Zargon officer is a Board member and nominal shareholder; and \$0.06 million (2005 – \$0.13 million) in consulting fees to a company owned by the Chairman of the Board. These payments were in the normal course of operations, on commercial terms, and therefore were recorded at the exchange amount.