Q1 2004

Zargon

ZARGON OIL & GAS LTD.

CORPORATE HIGHLIGHTS

FOR THE THREE MONTHS ENDED MARCH 31, 2004

Zargon Oil & Gas Ltd. is pleased to announce the results for the three months ended March 31, 2004.

The first quarter of 2004 provided Zargon strong financial results, solid operations and an active and successful exploration program. First quarter revenues of $27.70 million, cash flow from operations of $15.73 million ($0.84 per diluted share) and net earnings of $5.54 million ($0.30 per diluted share) were 13 percent, 19 percent and 35 percent higher respectively than the preceding quarter and roughly comparable to the first quarter of 2003. Year-over-year, the quarter's revenue decreased five percent, cash flow from operations increased three percent and net earnings declined 17 percent due to increased depletion charges. Financial results were price-driven and reflect first quarter 2004 commodity price increases over fourth quarter 2003 levels to values that were very high but failed to match the record numbers of first quarter 2003.

Average production in first quarter 2004 of 7,889 barrels of equivalent per day exceeded the prior year's first quarter by 12 percent but was two percent less than the preceding quarter. The year-over-year gains have come from our successful West Central Alberta natural gas exploration initiative. The small quarter-over-quarter decline reflected the natural production decline from flush rates in newly tied-in natural gas wells. Net capital expenditures in the current quarter of $9.77 million were 42 percent higher than in the prior year first quarter and were largely expended on drilling, but still represented only 62 percent of the quarter's cash flow from operations. The quarter's drilling program included 12 gross wells (9.9 net) of which seven were exploratory. Zargon continued to purchase land at Crown sales but was increasingly selective as bid prices escalated. Similarly, Zargon was not active in the property acquisition market as oil and natural gas property prices continue to reach new lofty levels. Operating cash flows in the quarter easily funded the capital expenditures and also helped reduce debt net of working capital by $6.92 million to $6.17 million at March 31, 2004, an amount equivalent to less than two months of the current cash flow from operations.

Three months ended March 31	2004	2003	Percent Change
	(unaudited)		
FINANCIAL			
Income and Investments ($ million)			
Petroleum and natural gas revenue	**27.7**	29.2	(5)
Cash flow from operations	**15.7**	15.2	3
Net earnings (note 1)	**5.5**	6.7	(17)
Net capital expenditures	**9.8**	6.9	42
Per Common Share, Diluted			
Cash flow from operations ($/share)	**0.84**	0.84	–
Net earnings ($/share) (note 1)	**0.30**	0.36	(17)
Balance Sheet at Period End ($ million)			
Property and equipment, net (note 1)	**171.6**	149.7	15
Bank indebtedness	**3.7**	20.8	(82)
Shareholders' equity (note 1)	**119.1**	93.6	27
Shares Outstanding at Period End (million)	**18.24**	17.73	3
OPERATIONS			
Average Daily Production			
Oil and liquids (bbl/d)	**3,355**	3,057	10
Natural gas (mmcf/d)	**27.21**	24.02	13
Equivalent (boe/d) (note 2)	**7,889**	7,060	12
Equivalent per million shares (boe/d) (note 2)	**435**	399	9
Average Selling Price (before hedges)			
Oil and liquids ($/bbl)	**39.96**	43.85	(9)
Natural gas ($/mcf)	**6.26**	7.92	(21)
Wells Drilled, Net	**9.9**	5.0	98
Undeveloped Land at Period End (thousand net acres)	**405**	341	19

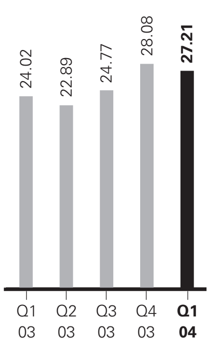
Notes:

1 Comparative period numbers reflect retroactive restatement due to a change in accounting policy.

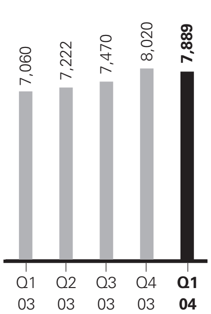
2 The calculation of barrels of equivalent (boe) is based on the conversion ratio that six thousand cubic feet of natural gas is equivalent to one barrel of oil. Average daily production per million shares uses the weighted average number of shares for the period.

OIL AND LIQUID PRODUCTION
(bbl/d)

NATURAL GAS PRODUCTION
(mmcf/d)



PRODUCTION
(boe/d)



PRODUCTION*

Natural gas production volumes averaged 27.21 million cubic feet per day in first quarter 2004, a 13 percent increase over the 24.02 million cubic feet per day reported in the 2003 first quarter but a three percent decline from the preceding 2003 fourth quarter. Over the last seven quarters starting with the 2002 second quarter, Zargon has increased natural gas production volumes by 43 percent through successful exploration initiatives in West Central Alberta with substantial new volumes coming from the Highvale, Pembina and Peace River Arch properties. Over this period the Alberta Plains gas production volumes have been maintained at steady levels through successful modest maintenance drilling programs. At the end of the 2003 third quarter, a significant wholly owned natural gas producer was completed and tied-in at the Peace River Arch Progress property with initial flush production rates approaching five million cubic feet per day that were reduced to a more sustainable rate of three million cubic feet per day in the 2004 first quarter. During the quarter, production additions at Jarrow (Alberta Plains) and Pembina (West Central Alberta) were able to offset some of this well's flush production decline. In the second quarter, further tie-ins at Jarrow and Pembina plus the tie-in of the new Hamelin Creek (Peace River Arch) dual Dunvegan and Gething discovery should take average quarter production rates to about 28.5 million cubic feet per day, despite some anticipated outages due to scheduled third party gas plant turnarounds.

Production of oil and liquids averaged 3,355 barrels per day in first quarter 2004, level with the preceding quarter and 10 percent higher than first quarter 2003. Zargon's oil and liquids production is founded on the key Williston Basin (Southeast Saskatchewan and North Dakota) long-life, shallow-decline waterflood properties where production gains are derived from exploitation and enhancement activities plus, when appropriately priced, acquisitions of complementary exploitable properties. These properties provide Zargon a solid foundation since production levels can be maintained or grown slightly with only moderate expenditures on exploitation and enhancement activities. Although our balance sheet would permit sizeable oil property acquisitions, we are not at this time comfortable with the evaluation levels for Canadian assets and we choose to wait for better values. In the meantime, we will continue with our exploitation programs that should yield average second quarter production rates of about 3,400 barrels per day, despite some anticipated spring road ban shut-ins.

EXPLORATION AND EXPLOITATION*

During the 2004 first quarter, Zargon drilled 12 gross wells (9.9 net) that delivered 6.9 net natural gas wells, 1.0 net oil well and 2.0 net dry holes for an 80 percent success ratio. Consistent with Zargon's policy of balancing higher risk exploration with lower risk development, five (4.4 net) of the wells were located in the West Central Alberta core area and six (4.5 net) wells located in the Alberta Plains properties. During the quarter, only one horizontal development well at Forget was drilled in the Williston Basin oil properties. Of the five West Central Alberta exploration locations, three were exploratory tests at our Pembina shallow gas play and the two dry holes were located at the Highvale and the Peace River Arch properties.

Currently, the first quarter natural gas successes at Pembina and Jarrow (Alberta Plains) are in the process of being tied-in. Second quarter tie-ins will also include Zargon's fourth quarter 2003 new pool discoveries located on the Peace River Arch. The Hamelin Creek Dunvegan/Gething natural gas discovery well was tied-in during April 2004 and is now producing at rates of about one million cubic feet per day. The current geological mapping suggests that as many as three additional Dunvegan gas wells may be drilled on this Hamelin Creek prospect later this year. At Progress, a fourth quarter 2003 new pool Triassic gassy sour oil well will be placed on extended production test in June to evaluate further drilling and facility options.

Zargon continues to base its growth on the complementary strategies of exploring for natural gas reserves and exploiting existing oil reservoirs. The key input resource for our natural gas exploration program is undeveloped land, and through aggressive activity at Crown land sales in prior years, Zargon has built a 405 thousand net acre undeveloped land inventory. Following spring breakup, Zargon will proceed with a very interesting natural gas exploration program focused on our 181 thousand net acres of undeveloped lands in the West Central core area. Over the next five months 14 to 16 gross wells are scheduled including five wells on prospective Peace River Arch sites, two wells at Highvale and two earning wells on our 28 thousand acre natural gas prospective farm-in at the Blackfeet Reservation in Montana.

The upcoming spring/summer drilling program now underway is slanted to higher-risk areas and has more potential for reward than any of our previous programs. The five scheduled Peace River Arch drills represent exploration ideas based on data from recent successful wells and each is potentially interesting. The two wells in Montana are pure exploration but are supported by geological and seismic interpretation. If successful, this could lead to a much larger play on the available land base. We see similarities in the area to our successful low-pressure, shallow-depth Pembina program and believe that the drilling and completion techniques that we have learned may be transferable. The current program also includes four exploitation wells in our Williston Basin oil properties in Southeast Saskatchewan and North Dakota, directed to sustaining and growing our oil production.

ACQUISITIONS/DISPOSITIONS

During the 2004 first quarter, Zargon did not make significant property acquisition expenditures due in part to an extremely competitive Canadian property acquisition market. During the quarter, Zargon continued to purchase land at Crown sales but was increasingly selective as bid prices escalated. With resource inventories of 405 thousand net acres of undeveloped land available for natural gas exploration and with properties holding 158 million barrels of potentially exploitable oil-in-place, Zargon perceives 2004 as year to focus on the substantial opportunities available in its existing properties.

GUIDANCE*

Zargon's 2004 capital program budget was initially set at $45 million and called for the drilling of 45 net wells. This budget allocated $40 million to exploration and development field activities and $5 million to property acquisitions. With our industry's current record level of activity and enthusiasm, there is a significant upward cost pressure for undeveloped land, property acquisitions and field services. In these high cost times, we will continue with our disciplined approach, adhering to a focused strategy of exploring and exploiting our existing large asset base, while executing value added acquisitions, if and only when they become available. Zargon is not an aggressive spender in these expensive times and consequently we have elected to reduce our capital budget and related guidance targets accordingly.

Our new 2004 capital budget will be set at $35 million directed to exploration and development field activities, and includes the drilling of 41 net wells. The budget does not make an allowance for any acquisitions, although, should value added property or corporate acquisition opportunities be sourced (particularly in the North Dakota portion of the Williston Basin), our unutilized bank lines will permit us to greatly expand the acquisition component of our budget.

In November 2003, Zargon set mid-year 2004 production guidance levels at 30 million cubic feet of natural gas per day and 3,750 barrels of oil per day, for a combined rate of 8,750 barrels of equivalent per day. The guidance for the oil production rate assumed that Zargon would be successful in making a small Williston Basin oil acquisition. It is now apparent that we will not be acquiring any additional Williston Basin oil properties by mid-year, and we need to adjust our mid-year guidance accordingly to a 3,400 barrel per day rate. The mid-year natural gas guidance of 30 million cubic feet per day remains unchanged and is projected to be delivered from on-going second quarter tie-ins and drilling programs. The revised guidance calls for a combined mid-year rate of 8,400 barrels of equivalent per day, which would represent a 13 percent increase over the average 2003 production rate (10 percent gain on a production per outstanding share basis).

** Please see comments on "Forward-Looking Statements" on the last page of this report.*

MANAGEMENT'S DISCUSSION AND ANALYSIS

Management's discussion and analysis (MD&A) should be read in conjunction with the unaudited interim consolidated financial statements for the three months ended March 31, 2004 and the audited consolidated financial statements and MD&A for the year ended December 31, 2003. In the MD&A, reserves and production are commonly stated in barrels of equivalent (boe) using a conversion of six thousand cubic feet of natural gas being equal to one barrel of oil.

Non-GAAP Measurements: The MD&A contains the term "cash flow from operations"("cash flow") which should not be considered an alternative to, or more meaningful than, "cash flow from operating activities" as determined in accordance with Canadian GAAP as an indicator of the Company's financial performance. Zargon's determination of cash flow from operations may not be comparable to that reported by other companies. The reconciliation between net earnings and cash flow from operations can be found in the consolidated statements of cash flows in the consolidated financial statements. The Company evaluates its performance based on net earnings and cash flow from operations. The Company considers cash flow from operations to be a key measure as it demonstrates the Company's ability to generate the cash necessary to repay debt and to fund future growth through capital investment. Cash flow from operations per share is calculated using the diluted weighted average number of shares for the period.

This MD&A has been prepared as of May 13, 2004.

FINANCIAL ANALYSIS

In the first quarter of 2004, Zargon continued to report high levels of petroleum and natural gas revenue and cash flow from operations. First quarter 2004 revenue of $27.70 million was 13 percent above $24.51 million in fourth quarter 2003 and five percent below $29.19 million in first quarter 2003. First quarter 2003 had exceptional commodity pricing related to the impending Iraqi war plus a much weaker Canadian dollar that, on a comparative basis, by itself accounted for slightly more than the year-over-year quarterly revenue difference. Hedging losses in first quarter 2004 were $0.27 million, but much smaller than the $2.22 million recorded in first quarter 2003 when commodity prices rose very sharply, rising well beyond values anticipated when the hedges were placed. Cash flow from operations in first quarter 2004 of $15.73 million was 19 percent above the preceding quarter and three percent above first quarter 2003. Net earnings for first quarter 2004 of $5.54 million were 35 percent above the preceding quarter and 17 percent below the prior year first quarter. On a year-over-year basis the first quarter earnings were negatively impacted by increased depletion and depreciation expenses resulting in part from negative revisions made in the 2003 year-end proved reserves evaluation.

Natural gas production eased three percent in first quarter 2004 to 27.21 million cubic feet per day from 28.08 million cubic feet per day in fourth quarter 2003 but was 13 percent above the 2003 first quarter. The year-over-year volume gains came from successful West Central Alberta gas exploration drilling initiatives throughout 2003 and the small first quarter 2004 decline reflected the natural declines from the flush production rates of the new natural gas discoveries. Oil and liquids production has been relatively constant since the second quarter of 2003 with the additions coming from a modest drilling program offsetting natural declines. On a year-over-year basis, first quarter 2004 oil and liquids production was 10 percent above the 2003 first quarter, stemming primarily from the acquisition of the Truro Unit in North Dakota in April 2003.

Zargon's commodity price risk management policy uses forward sales, options, puts and costless collars for, on average, 20 to 30 percent of our net petroleum and natural gas production in order to partially offset the effects of large price fluctuations. As both Canadian oil and natural gas field prices are closely correlated to US dollar denominated markets, Zargon will also place US/Cdn. currency exchange hedges when considered prudent. Because our hedging strategy is protective in nature and is designed to guard the Company against extreme effects on cash flow from sudden falls in prices and revenues, upward price spikes tend to produce overall losses. Thus the 2003 first quarter's extremely high oil and natural gas prices brought about a net hedging loss of $2.22 million that compares to a $0.17 million gain in fourth quarter 2003 and a $0.27 million loss in first quarter 2004.

Royalties, inclusive of Alberta Royalty Tax Credit and Saskatchewan Resource Surcharge, were $5.92 million for the first quarter of 2004, an increase of seven percent from the preceding quarter and a decrease of five percent from $6.24 million in the 2003 first quarter. The variations primarily track changes in production prices and volumes. As a percentage of gross revenue, royalty rates ranged from 21.4 percent in first quarter 2003 to 22.5 percent in fourth quarter 2003 and back to 21.4 percent in the first quarter of 2004.

On a unit of production basis, production costs of $6.43 per barrel of equivalent in first quarter 2004 compare with $6.30 in the preceding quarter and $6.66 in first quarter 2003. These costs were brought down progressively throughout 2003 from an average of $6.75 per barrel of equivalent in 2002. The chief instrument of change was the disposition in 2003 of $5.22 million of smaller, higher cost properties. The preservation of these improved per unit operating costs through expanded field-related cost containment programs will be a key ongoing initiative for Zargon during this current period of increasing cost pressures.

OPERATING NETBACKS

	2004		2003	
Three months ended March 31	**Oil and Liquids ($/bbl)**	**Natural Gas ($/mcf)**	Oil and Liquids ($/bbl)	Natural Gas ($/mcf)
Production revenue	**39.96**	**6.26**	43.85	7.92
Hedging	**(1.93)**	**0.13**	(2.82)	(0.67)
Royalties	**(8.30)**	**(1.37)**	(8.29)	(1.83)
Production costs	**(9.29)**	**(0.72)**	(9.97)	(0.69)
Operating netbacks	**20.44**	**4.30**	22.77	4.73

Measured on a unit of production basis, general and administrative expenses are also showing good control. Net of recoveries, general and administrative expenses were $1.34 per barrel of equivalent in first quarter 2004 compared to $1.37 in the preceding quarter, $1.40 in first quarter 2003 and $1.49 per barrel of equivalent in all of 2002. Over the last two years, reductions in general and administrative costs on a per unit of production basis have been accomplished through increased production volumes, increased cost recoveries from expanded field capital programs and the disposition of some small, overhead-intensive properties. In light of the substantially increased regulatory reporting requirements that have been mandated in the last year, we are experiencing upward cost pressures that may result in future modest increases on a general and administrative expense per unit of production basis.

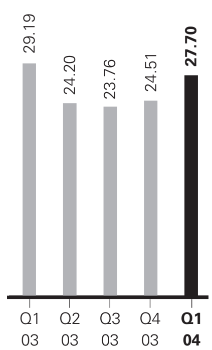
Expensing of stock-based compensation in the consolidated statements of earnings began in the fourth quarter of 2003, which contained an adjustment for the entire 2003 year. Zargon calculates this non-cash expense using the Black-Scholes option-pricing model and it covers the earned portion of employee and director stock options during the reporting period. This expense was not recorded in first quarter 2003 but added $0.09 million or $0.13 per barrel of equivalent of expense in first quarter 2004 and $0.36 per barrel of equivalent (four quarters of expense booked in one quarter) in fourth quarter 2003.

High cash flows since January 2003 have progressively reduced debt net of working capital from $28.74 million at December 31, 2002 to $6.17 million at March 31, 2004 and interest charges have fallen proportionately to $0.08 million in first quarter 2004 compared to $0.11 million in the preceding quarter and $0.26 million in first quarter 2003. In the absence of major corporate capital expenditures, Zargon can be expected to be close to debt-free by the end of the second quarter 2004.

Zargon did not pay current income taxes in the first quarter of 2004, but incurred $0.11 million of federal and provincial capital taxes, which was unchanged from the $0.11 million incurred in the first quarter of 2003. Zargon reorganized its operations into a partnership structure effective July 10, 2001 and acquired significant excess tax pools with both the 2001 Herc Oil Corp. and 2002 Hadrian Energy Corp. acquisitions. These transactions helped shelter 2003 and a portion of 2004 taxable income. However, tax pools at December 31, 2003 were only approximately $79 million and it is expected that they may not be sufficient to shelter all of the budgeted 2004 taxable income.

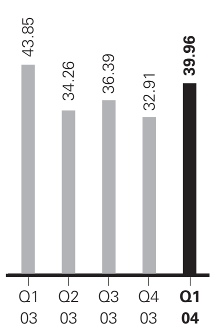
PETROLEUM AND NATURAL GAS REVENUE

($ million)



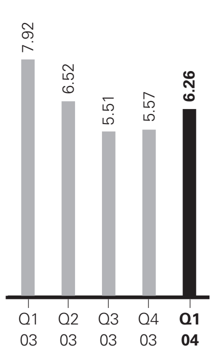
OIL AND LIQUID PRICES

($/bbl)



NATURAL GAS PRICES

($/mcf)



CORPORATE NETBACKS

Three months ended March 31 ($/boe)	2004	2003
Petroleum and natural gas revenue	**38.59**	45.94
Hedging	**(0.38)**	(3.50)
Royalties	**(8.25)**	(9.83)
Production costs	**(6.43)**	(6.66)
Operating netbacks	**23.53**	25.95
General and administrative	**(1.34)**	(1.40)
Interest	**(0.12)**	(0.41)
Capital and current income taxes	**(0.16)**	(0.18)
Cash flow netbacks	**21.91**	23.96
Depletion and depreciation (note 1)	**(8.66)**	(6.51)
Accretion of asset retirement obligations (note 1)	**(0.36)**	(0.46)
Stock-based compensation	**(0.13)**	–
Unrealized foreign exchange	**0.06**	–
Future income taxes (note 1)	**(5.11)**	(6.53)
Net earnings	**7.71**	10.46

Note:
1 Comparative period numbers reflect retroactive restatements due to a change in accounting policy.

Depletion and depreciation expense is calculated quarterly and increased sharply in the fourth quarter of 2003 to $8.69 per barrel of equivalent, a level that was consistent with the $8.66 per barrel of equivalent that was recorded in first quarter 2004. The fourth quarter per unit of production depletion and depreciation expense represents a 33 percent increase from the $6.51 per barrel of equivalent booked in first quarter 2003. This large increase in depletion and depreciation expense is primarily related to a December 31, 2003 year-over-year 14 percent reduction in the Company's proved reserves as evaluated under the new policies of National Instrument 51-101.

As disclosed in a note at the end of this report, in 2003 the CICA approved a new Section 3110 "Asset Retirement Obligations" that effectively requires site restoration expense to be treated as a discounted future liability that is amortized over the useful life of the related assets. The liability accretes until the retirement obligations are settled. Zargon changed to this standard effective January 1, 2004 and the expense line formerly termed Site Restoration is now called Accretion of Asset Retirement Obligations. The amounts are not directly comparable as they were formerly calculated on a more generalized fixed amount per well. For first quarter 2004, the accretion amount is $0.26 million, 12 percent less than $0.29 million in both fourth quarter 2003 and first quarter 2003.

Cash flow from operations in first quarter 2004 of $15.73 million (see note at the beginning of the MD&A section) was $2.49 million or 19 percent higher than the preceding quarter and $0.50 million or three percent higher than the prior year first quarter. The gain in cash flow over the preceding quarter was primarily due to increased commodity pricing and the resulting increased revenue. With the prior year quarterly comparison, commodity prices were in fact higher in the prior year first quarter, but the impact of increased production volumes and a large 2003 first quarter hedge loss resulted in an increase in cash flow from operations in the 2004 first quarter. On a per share basis, the three percent increase gain in cash flow per operations was offset by an increase in the average number of shares, with the result that the first quarter 2004 cash flow from operations remained steady at $0.84 per diluted share as compared to the 2003 first quarter, but 17 percent higher than the fourth quarter 2003 cash flow of $0.72 per diluted share.

The provision for future taxes of $3.67 million for the first quarter of 2004 was 53 percent higher than the preceding quarter and 12 percent lower than in first quarter 2003. Except for the impact of tax rate changes announced in 2003, this provision has been effectively tracking the Company's before tax earnings. For the 2004 first quarter, future taxes were 39 percent of before tax earnings, which compares respectively with the 2003 first quarter and 2003 fourth quarter rates of 38 percent and 37 percent.

Net earnings of $5.54 million for the first quarter of 2004 were 35 percent above $4.10 million in the preceding quarter and 17 percent below $6.65 million in first quarter 2003. The net earnings reflect the same trends as the cash flow from operations for the respective periods modified by the previously discussed impacts of the additional charges for depletion and depreciation and stock-based compensation booked in the 2003 fourth quarter and 2004 first quarter. On a per share basis, the first quarter 2004 net earnings were $0.30 per diluted share, 36 percent higher than the $0.22 reported in the 2003 fourth quarter, but 17 percent lower than 2003 first quarter net earnings of $0.36 per diluted share.

CAPITAL EXPENDITURES

Three months ended March 31 ($ million)	2004	2003
Undeveloped land	**1.08**	1.39
Geological and geophysical (seismic)	**1.42**	1.09
Drilling and completion of wells	**5.06**	2.78
Well equipment and facilities	**1.78**	1.14
Exploration and development	**9.34**	6.40
Property acquisitions	**0.43**	0.48
Property dispositions	**–**	(0.02)
Net property acquisitions	**0.43**	0.46
Total capital expenditures (net)	**9.77**	6.86

LIQUIDITY AND CAPITAL RESOURCES

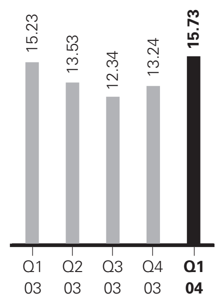
Capital expenditures of $9.77 million were 42 percent higher than $6.86 million expended in the prior year quarter, reflecting a more active field program in the current period. Field related drilling, completion and facility expenses of $6.84 million were 74 percent higher than the prior years field related capital program. Conversely, undeveloped land purchases decreased 22 percent as Crown land sales reached new high price levels that Zargon did not find commensurate with the risks involved. Capital expenditures in the preceding 2003 fourth quarter were higher at $12.84 million, consistent with Zargon's historical practice of scheduling larger fall drilling programs during periods of relatively lower cost. No material acquisitions were made in either period. Cash flow from operations in the current quarter of $15.73 million and proceeds from the exercise of stock options of $0.99 million covered the capital program and applied $3.30 million to the repayment of bank debt. At March 31, 2004, the Company has an exceptionally strong balance sheet with no long-term bank debt and a total working capital deficit of only $6.17 million, which represents less than two months of the first quarter 2004 cash flow.

As at May 13, 2004, Zargon has issued 18.28 million common shares and has granted stock options to acquire an additional 1.43 million shares.

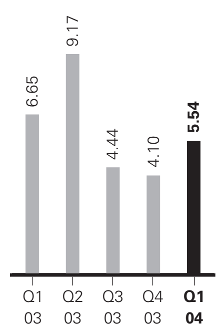
CAPITAL SOURCES

Three months ended March 31 ($ million)	2004	2003
Cash flow from operations	**15.73**	15.23
Changes in working capital and other	**(3.65)**	(4.15)
Change in bank indebtedness	**(3.30)**	(4.50)
Issuance of common shares	**0.99**	0.28
Total capital sources	**9.77**	6.86

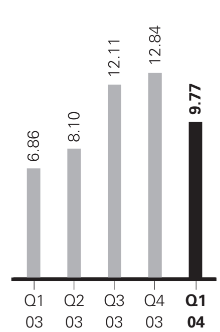
CASH FLOW FROM OPERATIONS
($ million)



NET EARNINGS
($ million)



NET CAPITAL EXPENDITURES
($ million)



CHANGES IN ACCOUNTING POLICIES

The following changes have been made to Zargon's accounting policies effective January 1, 2004.

PETROLEUM AND NATURAL GAS ASSETS – FULL COST ACCOUNTING

The new CICA Guideline 16, "Oil and Gas Accounting – Full Cost" (AcG-16) is effective for fiscal years beginning on or after January 1, 2004. The most significant change between AcG-16 and the former guideline is that AcG-16 limits the carrying value of petroleum and natural gas properties to their fair value. The fair value is equal to estimated future cash flows from proved and probable reserves using future price forecasts and costs discounted at a risk-free rate. This differs from the former cost recovery ceiling test that used undiscounted cash flows, and constant prices, less general and administrative and financing costs. No write-down of the Company's petroleum and natural gas properties was required when the new guideline was adopted on January 1, 2004 or as at March 31, 2004.

ASSET RETIREMENT OBLIGATIONS

The new CICA Section 3110, "Asset Retirement Obligations" requires liability recognition for retirement obligations associated with the Company's property, plant and equipment. The obligations are initially measured at fair value, which is the discounted future value of the liability. The fair value is capitalized as part of the cost of the related assets and depleted on a unit of production basis over their useful lives. The liability accretes until the retirement obligations are settled. Section 3110 is effective for fiscal years beginning on or after January 1, 2004 on a retroactive basis with restatement of prior periods. The site restoration liability on the balance sheet at December 31, 2003 was replaced with a new "Asset Retirement Obligation" liability in the amount of $12.19 million on January 1, 2004.

OUTLOOK

Zargon continues to be well positioned. It has a very strong balance sheet, 405 thousand net acres of undeveloped land and a promising project inventory. Zargon and the industry are in a period of high commodity prices in a cycle that appears to have an unusually long life. Upward cost pressures are present in all sectors of our business and property acquisitions are at very high price levels. Zargon intends to continue with the disciplined approach that has served us well to date. We will adhere to a focused strategy of exploring and exploiting our existing asset base while executing value-added property acquisitions if and when they become available.

($ million, except per share amounts)

Quarter	Net Earnings (note 1)	Earnings/ Diluted Share (note 1)	Cash Flow	Cash Flow/ Diluted Share	Petroleum and Natural Gas Revenue	Total Assets (note 1)	Bank Debt
2004 Q1	$5.54	$0.30	$15.73	$0.84	$27.70	$186.18	$3.68
2003 Q4	$4.10	$0.22	$13.24	$0.72	$24.51	$181.05	$6.98
2003 Q3	$4.44	$0.24	$12.34	$0.67	$23.76	$172.81	$8.92
2003 Q2	$9.17	$0.50	$13.53	$0.74	$24.20	$165.98	$11.47
2003 Q1	$6.65	$0.36	$15.23	$0.84	$29.19	$165.12	$20.78

Note:
1 Comparative period numbers reflect retroactive restatements due to a change in accounting policy.

"Signed" C.H. Hansen
President and Chief Executive Officer

Calgary, Alberta
May 13, 2004

CONSOLIDATED BALANCE SHEETS

($ thousand)	March 31, 2004 (unaudited)	December 31, 2003 (restated – note 2)
ASSETS		
Current		
Accounts receivable	**13,099**	12,183
Prepaid expenses and deposits	**1,504**	980
	14,603	13,163
Property and equipment, net	**171,576**	167,888
	186,179	181,051
LIABILITIES		
Current		
Bank indebtedness	**3,675**	6,978
Accounts payable and accrued liabilities	**17,101**	19,277
	20,776	26,255
Asset retirement obligations *[notes 2 and 3]*	**12,469**	12,194
Future income taxes	**33,841**	30,133
	67,086	68,582
SHAREHOLDERS' EQUITY		
Share capital *[note 4]*	**43,213**	42,200
Contributed surplus	**336**	264
Retained earnings	**75,544**	70,005
	119,093	112,469
	186,179	181,051

See accompanying notes.

CONSOLIDATED STATEMENTS OF EARNINGS AND RETAINED EARNINGS

Three months ended March 31 (unaudited) ($ thousand, except per share amounts)	**2004**	2003 (restated – note 2)
Revenue		
Petroleum and natural gas revenue	**27,704**	29,193
Hedging *[note 8]*	**(273)**	(2,223)
Royalties	**(5,923)**	(6,244)
	21,508	20,726
Expenses		
Production	**4,615**	4,230
General and administrative	**962**	888
Stock-based compensation *[note 4]*	**91**	–
Interest	**85**	262
Foreign exchange (gain) loss	**(41)**	–
Accretion of asset retirement obligations *[notes 2 and 3]*	**259**	293
Depletion and depreciation	**6,217**	4,141
	12,188	9,814
Earnings before income taxes	**9,320**	10,912
Income taxes		
Future	**3,667**	4,147
Current	**114**	114
	3,781	4,261
Net earnings for the period	**5,539**	6,651
Retained earnings, beginning of period		
As previously reported	**70,125**	45,598
Change in accounting policies *[note 2]*	**(120)**	46
As restated	**70,005**	45,644
Retained earnings, end of period	**75,544**	52,295
Earnings per common share *[note 5]*		
Basic	**0.31**	0.38
Diluted	**0.30**	0.36

See accompanying notes.

CONSOLIDATED STATEMENTS OF CASH FLOW

Three months ended March 31 (unaudited) ($ thousand)	2004	2003 (restated – note 2)
Operating activities		
Net earnings for the period	**5,539**	6,651
Add (deduct) non-cash items:		
Depletion and depreciation	**6,217**	4,141
Accretion of asset retirement obligations *[notes 2 and 3]*	**259**	293
Stock-based compensation	**91**	–
Unrealized foreign exchange (gain) loss	**(41)**	–
Future income taxes	**3,667**	4,147
Cash flow from operations	**15,732**	15,232
Site restoration expenditures	**(42)**	(30)
Changes in non-cash working capital	**(312)**	(1,898)
	15,378	13,304
Financing activities		
Advances (repayment) of bank indebtedness	**(3,303)**	(4,502)
Exercise of stock options	**994**	277
	(2,309)	(4,225)
Investing activities		
Additions to property and equipment	**(9,768)**	(6,882)
Proceeds on disposal of property and equipment	**–**	25
Changes in non-cash working capital	**(3,301)**	(2,222)
	(13,069)	(9,079)
Change in cash	**–**	–
Cash, beginning of period	**–**	–
Cash, end of period	**–**	–

See accompanying notes.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

FOR THE THREE MONTHS ENDED MARCH 31, 2004 AND 2003 (UNAUDITED)

1. BASIS OF PRESENTATION

The interim unaudited consolidated financial statements of Zargon Oil & Gas Ltd. (the "Company") have been prepared by management in accordance with Canadian generally accepted accounting principles. The interim unaudited consolidated financial statements have been prepared following the same accounting policies and methods in computation as the consolidated financial statements for the fiscal year ended December 31, 2003. The interim unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto in the Company's annual report for the year ended December 31, 2003.

2. CHANGES IN ACCOUNTING POLICIES

FULL COST ACCOUNTING

The Company has adopted the new CICA Accounting Guideline 16 "Oil and Gas Accounting – Full Cost". The new guideline modifies how the ceiling test is performed, and requires that costs centres be tested for recoverability using undiscounted future cash flows from proved reserves which are determined by using forward indexed prices. When the carrying amount of a cost centre is not recoverable, the cost centre would be written down to its fair value. Fair value is estimated using accepted present value techniques, which incorporate risks and other uncertainties when determining expected cash flows. There is no impact on the Company's reported financial results as a result of applying the new Accounting Guideline 16.

ASSET RETIREMENT OBLIGATIONS

On January 1, 2004, the Company retroactively adopted the Canadian accounting standard outlined in CICA Handbook Section 3110, "Asset Retirement Obligations". Previously, estimated future site restoration costs were provided for over the life of the proved reserves on a unit of production basis.

Under the new accounting standard, the Company records the fair value of legal obligations associated with the retirement of long-lived tangible assets, such as petroleum and natural gas assets, in the period in which they are acquired or drilled and a corresponding increase in the carrying amount of the long-lived asset. The liability accretes until the Company expects to settle the retirement obligation. The asset retirement costs are depleted using the unit of production method. Actual costs to retire the tangible assets are deducted from the liability as incurred.

As required by the new standard, all prior periods have been restated for the change in accounting policy. The effect of this change on the consolidated balance sheet as of January 1, 2004 is an increase in net capital assets of $5.98 million, recognition of an asset retirement obligation liability of $12.19 million, elimination of the site restoration liability of $6.03 million, recognition of a future tax recovery of $0.06 million, and a decrease to retained earnings of $0.12 million. The change also results in a decrease in net earnings of $0.04 million for the three months ended March 31, 2004 (2003—$0.09 million). The impact on basic and diluted per share amounts for the three months ended March 31, 2004 and 2003 is negligible as a result of adopting this new policy.

3. ASSET RETIREMENT OBLIGATIONS

The total future asset retirement obligation was estimated by management based on the Company'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. The Company has estimated the net present value of its total asset retirement obligations to be $12.19 million as at January 1, 2004 based on a total future liability of $50.85 million. These payments are expected to be made over the next 32 years with the majority of the costs not being incurred until after 2012. The Company used a credit adjusted risk-free rate of 8.5 percent and an inflation rate of two percent to calculate the present value of the asset retirement obligation.

The following table reconciles the Company's asset retirement obligation:

	Three months ended March 31	
($ thousand)	**2004**	2003
Balance, beginning of year	**12,194**	10,560
Liabilities incurred	**137**	60
Liabilities settled	**(42)**	(30)
Accretion expense	**259**	293
Other	**(79)**	–
Balance, end of period	**12,469**	10,883

4. SHARE CAPITAL

The Company is authorized to issue an unlimited number of common shares with no par value and an unlimited number of first preferred shares and second preferred shares.

COMMON SHARES

	March 31, 2004		March 31, 2003	
(thousand)	**Number of Shares**	**Amount ($)**	Number of Shares	Amount ($)
Shares issued				
Balance, beginning of year	**17,992**	**42,200**	17,637	40,997
Stock options exercised	**246**	**994**	91	277
Stock-based compensation recognized	**–**	**19**	–	–
Balance, end of period	**18,238**	**43,213**	17,728	41,274

A summary of the status of the Company's stock option plans as at March 31, 2004 and 2003, and changes during the three months ended on those dates is presented below:

STOCK OPTIONS

	March 31, 2004		March 31, 2003	
	Number of Shares (thousand)	**Weighted Average Exercise Price ($)**	Number of Shares (thousand)	Weighted Average Exercise Price ($)
Outstanding at beginning of year	**1,297**	**7.05**	1,215	5.10
Granted	**430**	**16.00**	405	9.30
Exercised	**(246)**	**4.04**	(91)	3.06
Cancelled	**(9)**	**9.61**	–	–
Outstanding at end of period	**1,472**	**10.15**	1,529	6.33
Options exercisable at period end	**739**	**6.99**	1,106	5.20

STOCK-BASED COMPENSATION

The Company calculated the value of stock-based compensation using a Black-Scholes option-pricing model to estimate the fair value of stock options at the date of grant.

Compensation expense for options granted is based on the estimated fair values at the time of the grant and the expense is recognized over the vesting period of the option.

The assumptions made for the options granted for 2004 include a volatility factor of expected market price of 26.30 percent, a weighted average risk-free interest rate of 3.33 percent, no dividend yield and a weighted average expected life of options of four years.

In the fourth quarter of 2003, the Company recognized the entire $0.26 million of compensation expense for options granted during 2003 with a corresponding increase to contributed surplus on the Company's consolidated balance sheet. This expense has not been allocated over the prior quarters.

For purposes of pro forma disclosures, the Company's net earnings for the three months ended March 31, 2003, would be reduced by $0.20 million. Basic and diluted earnings per share figures would have both been reduced by $0.01 for the 2003 quarter. There is no effect in 2004 pertaining to 2002 stock option grants because the options were fully vested prior to 2004.

5. WEIGHTED AVERAGE NUMBER OF COMMON SHARES

	Three months ended March 31	
(thousand)	**2004**	2003
Basic	**18,140**	17,708
Diluted	**18,725**	18,240

6. SEGMENTED INFORMATION

The Company'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.

	Three months ended March 31	
($ thousand)	**2004**	2003
Petroleum and Natural Gas Revenue		
Canada	**24,369**	26,372
United States	**3,335**	2,821
Total	**27,704**	29,193
Net Capital Expenditures		
Canada	**9,458**	6,805
United States	**310**	52
Total	**9,768**	6,857
Total Assets*		
Canada	**162,475**	146,806
United States	**23,704**	18,317
Total	**186,179**	165,123

* Total asset amounts from prior year have been reclassified in part from Canada to the US for consistency with the current year presentation.

7. SUPPLEMENTAL CASH FLOW INFORMATION

	Three months ended March 31	
($ thousand)	**2004**	2003
Cash interest paid	**74**	242
Cash taxes paid	**139**	114

8. FINANCIAL INSTRUMENTS

The Company is a party to certain off-balance sheet derivative financial instruments that have fixed the price of a portion of its oil and natural gas production. The Company enters into these contracts for hedging purposes only, in order to protect a portion of its future Canadian cash flow from the volatility of oil and natural gas commodity prices.

The Company has outstanding contracts at March 31, 2004 as follows:

	Volume	Rate	Price	Terms
Oil swaps	18,200 bbl	200 bbl/d	$26.44 US/bbl	Apr. 1/04–Jun. 30/04
	36,800 bbl	200 bbl/d	$27.10 US/bbl	Jul. 1/04–Dec. 31/04
	36,800 bbl	200 bbl/d	$30.45 US/bbl	Jul. 1/04–Dec. 31/04
Oil collars	18,200 bbl	200 bbl/d	$22.50 US/bbl Put	Apr. 1/04–Jun. 30/04
			$26.85 US/bbl Call	
	18,200 bbl	200 bbl/d	$24.00 US/bbl Put	Apr. 1/04–Jun. 30/04
			$27.65 US/bbl Call	
	36,800 bbl	200 bbl/d	$24.00 US/bbl Put	Jul. 1/04–Dec. 31/04
			$27.80 US/bbl Call	
Natural gas swaps	856,000 gj	4,000 gj/d	$5.15/gj	Apr. 1/04–Oct. 31/04
	302,000 gj	2,000 gj/d	$6.27/gj	Nov. 1/04–Mar. 31/05
Natural gas collars	428,000 gj	2,000 gj/d	$5.00/gj Put	Apr. 1/04–Oct. 31/04
			$6.85/gj Call	

At March 31, 2004, the cost to settle the above contracts would have been approximately $1.96 million.

9. COMPARATIVE FIGURES

Certain comparative figures have been restated to conform with the current year's financial statement presentation.

CORPORATE INFORMATION

BOARD OF DIRECTORS

Craig H. Hansen
Calgary, Alberta

K. James Harrison
Oakville, Ontario

H. Earl Joudrie
Toronto, Ontario

Kyle D. Kitagawa
Calgary, Alberta

John O. McCutcheon
Vancouver, British Columbia

Jim Peplinski
Calgary, Alberta

Byron J. Seaman
Calgary, Alberta

J. Graham Weir
Calgary, Alberta

William J. Whelan
Calgary, Alberta

Grant A. Zawalsky
Calgary, Alberta

OFFICERS

John O. McCutcheon
Chairman

Craig H. Hansen
President and Chief Executive Officer

Mark I. Lake
Vice President, Exploration

Daniel A. Roulston
Vice President, Operations

Sheila A. Wares
Vice President, Accounting

Kenneth W. Young
Vice President, Land

STOCK EXCHANGE LISTING

The Toronto Stock Exchange
Trading Symbol: ZAR

TRANSFER AGENT

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FORWARD-LOOKING STATEMENTS

This document contains statements that are forward-looking, such as those relating to results of operations and financial condition, capital spending, financing sources, commodity prices, costs of production and the magnitude of oil and natural gas reserves. By their nature, forward-looking statements are subject to numerous risks and uncertainties that could significantly affect anticipated results in the future and, accordingly actual results may differ materially from those predicted. The forward-looking statements contained in this quarterly report are as of May 13, 2004 and are subject to change after this date. Readers are cautioned that the assumptions used in the preparation of such information, although considered reasonable at the time of preparation, may prove to be imprecise and, as such, undue reliance should not be placed on forward-looking statements. Zargon disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.