

ZARGON OIL & GAS LTD.

Zargon Oil & Gas Ltd. is pleased to announce financial and operating results for the six months ended June 30, 2004, the final period in which the Company operated in its historical corporate format as a junior oil and gas company. On July 15, 2004, the securityholders of Zargon Oil & Gas Ltd. voted overwhelmingly in favour of a Plan of Arrangement that reorganized the Company into a sustainable energy trust, named Zargon Energy Trust, with the announced intention of distributing approximately 50 percent of the cash flow from operations attributed to the outstanding unitholders.

Buoyed by high commodity prices and record production volumes, Zargon delivered very strong financial results in the 2004 second quarter. Second quarter 2004 revenues of \$30.96 million were 28 percent above the comparative prior year period and 12 percent above the 2004 first quarter. Second quarter 2004 cash flow from operations of \$16.53 million (\$0.88 per diluted share) was 22 percent above the 2003 second quarter and five percent above the preceding quarter levels. Second quarter 2004 net earnings of \$5.54 million (\$0.29 per diluted share) were three percent below the preceding quarter and well below the 2003 second quarter which contained a large one-time adjustment relating to legislated changes in future federal tax rates.

Average production in the second quarter of 2004 of 8,150 barrels of equivalent per day was 13 percent higher than the 2003 second quarter levels and three percent higher than the preceding quarter. On a per share basis, second quarter production also showed a ten percent year-over-year increase and a three percent increase over the preceding quarter. Natural gas production rates of 29.30 million cubic feet per day rose a strong 28 percent over the comparative prior year period due to successful exploration and development drilling programs at our West Central Alberta and Alberta Plains (Jarrow) gas properties. When compared to the prior year's quarter and the preceding quarter, the 2004 second quarter oil and liquids production declined four and three percent respectively, due to spring break-up field access issues, the impact of limited capital program allocations in recent months and the lack of any material property acquisitions. Net capital expenditures in the 2004 first half of \$17.38 million were 16 percent higher than the same prior year period and were mostly expended on drilling 23 gross (18.3 net) wells. Land purchases at Crown sales continued at a reduced rate and no significant property acquisitions occurred until after June 30. Consequently, the first half capital expenditures were only 54 percent of cash flow from operations, a level roughly consistent with the new Trust policies. With cash flows significantly exceeding capital programs, Zargon was able to eliminate its bank debt and move to a positive working capital position of \$3.08 million at June 30, 2004.

CORPORATE
HIGHLIGHTS

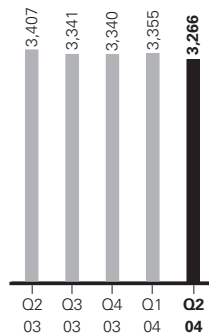
FOR THE THREE AND
SIX MONTHS ENDED
JUNE 30, 2004

(unaudited)	Three months ended June 30			Six months ended June 30		
	2004	2003	Percent Change	2004	2003	Percent Change
FINANCIAL						
Income and Investments (\$ million)						
Petroleum and natural gas revenue	31.0	24.2	28	58.7	53.4	10
Cash flow from operations	16.5	13.5	22	32.3	28.8	12
Net earnings (note 1)	5.5	9.2	(40)	11.1	15.8	(30)
Net capital expenditures	7.6	8.1	(6)	17.4	15.0	16
Per Common Share, Diluted						
Cash flow from operations (\$/share)	0.88	0.74	19	1.72	1.57	10
Net earnings (\$/share) (note 1)	0.29	0.50	(42)	0.59	0.87	(32)
Balance Sheet at Period End (\$ million)						
Property and equipment, net (note 1)				172.9	153.8	12
Bank indebtedness				0.0	11.5	(100)
Shareholders' equity (note 1)				125.2	103.3	21
Shares Outstanding at Period End (million)				18.28	17.87	2
OPERATIONS						
Average Daily Production						
Oil and liquids (bbl/d)	3,266	3,407	(4)	3,310	3,233	2
Natural gas (mmcf/d)	29.30	22.89	28	28.25	23.45	20
Equivalent (boe/d) (note 2)	8,150	7,222	13	8,019	7,142	12
Equivalent per million shares (boe/d) (note 2)	446	406	10	440	402	9
Average Selling Price (before hedges)						
Oil and liquids (\$/bbl)	44.32	34.26	29	42.11	38.77	9
Natural gas (\$/mcf)	6.67	6.52	2	6.47	7.23	(11)
Wells Drilled, Net	8.4	6.0	40	18.3	11.0	66
Undeveloped Land at Period End (thousand net acres)				405	348	16

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)

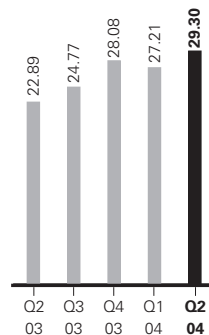


PRODUCTION*

Natural gas production volumes have continued the growth progression that began in the first half of 2003, with rates reaching 28.25 million cubic feet per day in the 2004 first half, a 20 percent increase over the comparative 2003 half. The major part of the increase has come from successful exploration initiatives in West Central Alberta with substantial new volumes coming from the Highvale, Pembina and Peace River Arch properties. The continuing exploration and development program in Zargon's principal gas property of Jarrow in the Alberta Plains has been successful in maintaining production volumes and on occasion providing a modest amount of growth. During the second quarter, good production additions at Jarrow, Pembina and Hamelin Creek (Peace River Arch) brought the average daily rate to 29.30 million cubic feet per day and the exit rate at June 30 to better than 30 million cubic feet per day.

Oil and liquid production of 3,310 barrels per day in first half 2004 provided a two percent gain over the comparable period last year. During the last 12 months, Zargon has drilled only 6.9 net oil wells as capital programs have concentrated on natural gas exploration. Second quarter oil and liquid production was also held back by the annual access related challenges of the spring break-up season. Without any material acquisitions, the modest oil production drilling additions were challenged to offset the natural production declines. Going forward, Zargon plans to increase oil exploitation drilling programs and when appropriate, oil related acquisitions that will continue to build Zargon's production base of exploitable long-life, shallow-decline waterflood Williston Basin properties in Southeast Saskatchewan and North Dakota.

NATURAL GAS PRODUCTION
(mmcf/d)

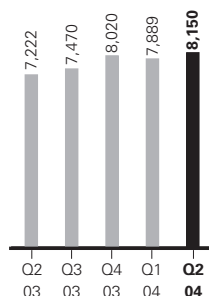


EXPLORATION AND EXPLOITATION*

During the 2004 second quarter, Zargon drilled 11 gross wells (8.4 net) that delivered 6.4 net natural gas wells, 1.0 net oil well and 1.0 net dry hole for an 88 percent success ratio. Of the gas wells, two were earning wells drilled in support of Zargon's farm-in on the extensive lands held by K2 Energy Corp. on the Blackfeet reservation in Montana. These two exploration wells have subsequently been completed and production tested with minor natural gas flows. The remaining gas wells included three wells in the Peace River Arch area of the West Central Alberta core area and four smaller participations in non-operated wells in Alberta. The extensive summer drilling program planned for Jarrow did not get underway until after June 30. The oil well was a successful vertical development well at our Pinto, Saskatchewan property. For the first half, Zargon drilled 18.3 net wells resulting in 13.3 net gas wells, 2.0 net oil wells and 3.0 net dry holes.

An extensive summer drilling program is currently underway with wells planned for Jarrow and Hamilton Lake in the Alberta Plains, at Highvale, Judy Creek and Pembina in West Central Alberta, at Hamelin Creek, Progress and Valhalla in the Peace River Arch plus three Williston Basin locations, two of which are at Haas, North Dakota. Since quarter-end, six operated and one non-operated wells have been drilled in Jarrow with good success plus three wells in the Peace River Arch that are in the process of being evaluated. A further 15 operated locations have been approved for drilling in the remainder of the year and we continue to budget a total of 41 net wells for the 2004 drilling program of which the majority will be directed to natural gas exploration.

PRODUCTION
(boe/d)



Because of very competitive bidding and accompanying expensive price levels at Crown sales, Zargon has been increasingly selective with its Crown land purchases. Undeveloped land inventories have however been maintained at 404,700 net acres as of June 30 and provide an excellent base for continued natural gas exploration.

ACQUISITIONS/DISPOSITIONS

Although Zargon has historically acquired both producing properties and undeveloped land on a regular basis, no significant property acquisition expenditures were made in the first half of 2004 and purchases at Crown land sales were substantially reduced. The Canadian property acquisition market has been and continues to be extremely competitive and we have found it difficult to find acquisitions that meet our value expectations. However, subsequent to quarter-end we did acquire a portfolio of operated producing

oil property interests in the Weyburn area of Southeast Saskatchewan from a group of private companies. These properties which include operated interests in six small Units, integrate well with our existing properties and are interpreted to hold significant exploitation potential in terms of waterflood enhancements or expansions. The purchase was closed on July 26 for approximately \$10 million and brought an additional 250 barrels per day of oil production to Zargon.

REORGANIZATION TO ZARGON ENERGY TRUST*

At a special meeting of the securityholders of Zargon Oil & Gas Ltd. held on July 15, 2004, overwhelming approval was given to a resolution in favour of a Plan of Arrangement reorganizing the Company into Zargon Energy Trust. The Plan of Arrangement received court approval and also became effective on July 15, 2004.

The Trust will function by distributing approximately 50 percent of the cash flow from operations attributed to the outstanding unitholders. The Trust will seek to sustain production levels on a per trust unit basis through the reinvestment of the remaining cash flow from operations. These exploration and production (E&P) capital programs will continue to follow Zargon's successful complementary strategies of exploring for natural gas reserves and exploiting existing oil reservoirs. Property acquisition programs funded by bank debt or possibly equity issues will continue to be sought to provide per unit production growth, but only on a value added opportunistic basis.

Several important advantages become available through this reorganization. A capital structure has been created to allocate cash flow efficiently between oil and gas reinvestment and distributions to unitholders in widely varying commodity price environments. Zargon's management team remains essentially unchanged and the entrepreneurial environment that has fostered our success is preserved. Zargon's reserve base, undeveloped land holdings and our intellectual capital remain fully available to support ongoing operations and growth prospects. Overall the Company will operate much as before but in a tax-efficient structure.

GUIDANCE*

In the 2004 first quarter report, Zargon reduced its field related exploration and production (E&P) capital budget from \$40 million to \$35 million, and also removed the \$5 million acquisition component of the budget due to uncertainties that appropriate value-added acquisitions could be sourced. To June 30, 2004, Zargon's E&P capital expenditures were \$16.86 million and we are on track to successfully spend the budgeted \$35 million of E&P capital expenditures for the year. In recognition of the July completion of the \$10 million acquisition of Weyburn, Saskatchewan properties, Zargon's 2004 capital budget has now been increased to \$45 million and is comprised of \$35 million of E&P capital expenditures and \$10 million of property acquisitions. The revised budget does not make an allowance for any further property acquisitions, although, should value added property or corporate acquisition opportunities become available (particularly in the Williston Basin), our unutilized bank lines will permit us to greatly expand the acquisition component of our budget.

In the May 17, 2004 press release announcing Zargon's reorganization into a sustainable energy trust, initial third quarter production guidance for the new trust was set at 8,400 barrels of equivalent per day comprised of 30 million cubic feet per day of natural gas and 3,400 barrels per day of oil and liquids, while post reorganization net debt levels were forecast to be about \$12 million. With current production volumes slightly exceeding both of these natural gas and oil production rates and with net debt levels currently in the \$12-\$15 million range, Zargon is well underway to meet these initial trust targets.

The initial distribution of the Zargon Energy Trust will be paid on September 15, 2004 to unitholders of record on August 31, 2004. The initial distribution will be \$0.14 per trust unit and the ex-distribution date is August 27, 2004. Given the current production volumes and forward price curves, it is anticipated that the \$0.14 distribution rate can be maintained for the foreseeable future and the taxable component of these distributions will be essentially 100 percent. Currently there are 14.87 million trust units outstanding and an additional 3.66 million exchangeable shares outstanding. After giving effect to the conversion privileges of the exchangeable shares, a total of 18.53 million trust units would be outstanding.

* 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 and six months ended June 30, 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 August 12, 2004.

FINANCIAL ANALYSIS

With commodity prices maintaining historically high levels and production volumes averaging 12 percent above the comparative 2003 six-month period, Zargon reported strong gains in petroleum and natural gas revenue in the 2004 second quarter and throughout the 2004 first half. The largest contributing factor was the increasing strength in oil prices received which averaged \$44.32 per barrel before hedges in second quarter 2004 compared to \$34.26 in the 2003 second quarter and \$39.96 in the preceding quarter, gains of 29 percent and 11 percent respectively. Natural gas prices also averaged a very strong \$6.67 per thousand cubic feet before hedges in the second quarter and showed increases of two percent and seven percent, respectively, over the 2003 second quarter and the preceding quarter levels. With higher prices and production volumes, second quarter 2004 revenues of \$30.96 million were 28 percent higher than the 2003 second quarter and 12 percent higher than the preceding quarter levels.

Natural gas production volumes of 29.30 million cubic feet per day in the 2004 second quarter increased 28 percent over the 2003 second quarter levels and eight percent from the preceding quarter due to successful Alberta Plains (Jarrow) and West Central Alberta drilling programs. Oil and liquids production volumes have changed little in the past 12 months as capital programs have emphasized natural gas exploration. Also, in the second quarter field access for remedial oil well workovers was restricted due to spring wet field conditions and consequently second quarter oil volumes of 3,266 barrels per day showed a four percent and three percent decline when respectively compared to the prior year's second quarter and the preceding quarter.

Hedging losses in second quarter 2004 were \$1.31 million compared to \$0.47 million in the 2003 second quarter and \$0.27 million in the preceding quarter. The primary driver for these losses was the record high oil prices recorded in the current quarter. Zargon's policy of hedging 20-35 percent of working interest production has been consistently followed throughout the year, but in the 2004 first quarter the oil hedge losses were partially offset by profitable gas hedges that expired on March 31, 2004.

Because our hedging strategy is designed to protect the Company against the extreme negative effects on cash flow from sudden falls in prices and revenues, upward price trends or spikes tend to produce overall hedge losses. An upward natural gas price spike in the 2003 first quarter brought about a net hedging loss of \$2.22 million in the quarter and \$2.70 million in the 2003 first half. A similarly sharp gain in oil pricing in 2004 is being sustained and has brought a hedging loss of \$1.31 million in the second quarter and \$1.58 million in the first half. If record high oil prices persist, further substantial hedging losses can be expected in the third quarter.

Royalties, inclusive of Alberta Royalty Tax Credit and Saskatchewan Resource Surcharge tracked the changes in gross revenue and totaled \$6.89 million for the second quarter of 2004, an increase of 16 percent from the preceding quarter and 36 percent from \$5.05 million in the 2003 second quarter. As a percentage of gross revenue, royalty rates have moved in a narrow range from 20.9 percent in second quarter of 2003 to 21.4 percent in the first quarter of 2004 and 22.2 percent in the second quarter of 2004.

On a unit of production basis, production costs have shown a modest increase to \$6.79 per barrel of equivalent in second quarter 2004 compared with \$6.43 in the preceding quarter and \$6.05 in second quarter 2003. Longer reporting periods tend to smooth out fluctuations and the 2004 first half cost of \$6.61 per barrel of equivalent, showed a four percent increase from the \$6.35 per barrel of equivalent reported in the first half of 2003. During the 2004 first half significantly higher costs on a per unit basis were recorded for third party gas processing fees, gas compression charges and gas processing chemicals. In 2003, Zargon had managed to deliver a significant cost improvement on a per unit basis over the prior years through the disposition of smaller, higher cost properties. During this current period of significantly increased industry-wide cost pressures, Zargon is attempting to maintain stable per unit operating costs through field-related cost containment programs.

OPERATING NETBACKS

Six months ended June 30	2004		2003	
	Oil and Liquids (\$/bbl)	Natural Gas (\$/mcf)	Oil and Liquids (\$/bbl)	Natural Gas (\$/mcf)
Production revenue	42.11	6.47	38.77	7.23
Hedging	(2.34)	(0.03)	(1.47)	(0.43)
Royalties	(8.72)	(1.47)	(7.36)	(1.65)
Production costs	(9.53)	(0.76)	(9.09)	(0.68)
Operating netbacks	21.52	4.21	20.85	4.47

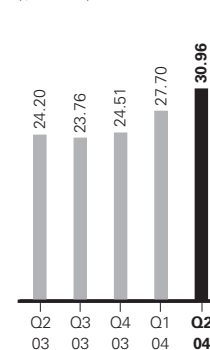
Measured on a unit of production basis, general and administrative expenses remained steady at \$1.34 per barrel of equivalent net of recoveries in both quarters of the first half of 2004. Comparative values are \$1.28 per barrel of equivalent in the first half of 2003, \$1.30 in all of 2003 and \$1.49 in 2002. In 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. Looking forward, Zargon's now concluded reorganization into a Trust structure in combination with the industry-wide increased regulatory reporting requirements will generate additional upward general and administrative cost pressures on a per unit of production basis.

Expensing of stock-based compensation benefits 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 half 2003 but added \$0.31 million or \$0.21 per barrel of equivalent of expense in first half 2004.

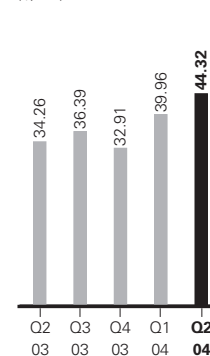
Due to the high cash flows experienced since December 31, 2003, Zargon's bank debt plus working capital deficiency balance of \$13.09 million has been replaced by a \$3.08 million working capital surplus as of June 30, 2004. Coupled with an exceptionally low interest rate environment, interest charges have fallen steeply to \$0.13 million in first half 2004 compared to \$0.51 million in the first half of 2003. Subsequent to quarter-end, Zargon concluded a trust conversion by Plan of Arrangement and a Southeast Saskatchewan property purchase, which collectively have returned Zargon's bank debt plus working capital deficiency balance into the \$12-\$15 million range.

Zargon did not pay material current income taxes in the first half of 2004, but incurred \$0.27 million of federal and provincial capital taxes, unchanged from the first half of 2003. Although not cash taxable in the first half of 2004, significant amounts of cash tax were forecast to be paid over the next few quarters if Zargon did not proceed with a corporate reorganization. With the now completed trust conversion, Zargon does not anticipate paying material cash taxes in the foreseeable future.

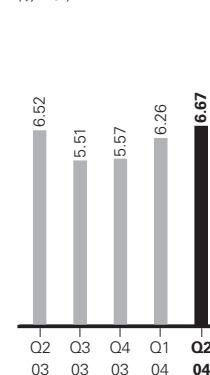
PETROLEUM AND NATURAL GAS REVENUE
(\$ million)



OIL AND LIQUID PRICES
(\$/bbl)



NATURAL GAS PRICES
(\$/mcf)



CORPORATE NETBACKS

Six months ended June 30 (\$/boe)	2004	2003
Petroleum and natural gas revenue	40.20	41.31
Hedging	(1.09)	(2.09)
Royalties	(8.78)	(8.74)
Production costs	(6.61)	(6.35)
Operating netbacks	23.72	24.13
General and administrative	(1.34)	(1.28)
Interest	(0.09)	(0.39)
Capital and current income taxes	(0.19)	(0.21)
Cash flow netbacks	22.10	22.25
Depletion and depreciation (note 1)	(8.66)	(6.51)
Accretion of asset retirement obligations (note 1)	(0.36)	(0.45)
Stock-based compensation	(0.21)	–
Unrealized foreign exchange	(0.02)	0.22
Future income taxes (note 1)	(5.26)	(3.26)
Net earnings	7.59	12.25

Note:

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

The second quarter 2004 depletion and depreciation unit expense of \$8.66 per barrel of equivalent has remained roughly stable over the last three quarters, but is approximately one third higher than the charges booked in the first half of 2003. The large increase in per unit depletion and depreciation expenses was derived primarily from 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.

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. For the first half of 2004, the non-cash accretion expense is \$0.53 million, 10 percent less than the \$0.59 million of restated accretion charges now booked in the first half 2003.

The provision for future taxes of \$3.67 million for the first quarter of 2004 represents an effective tax rate of 39.3 percent. Because of the very high commodity prices experienced in 2004, our utilization of tax pools is accelerating and the effective tax rate for the second quarter was increased to 41.3 percent, leading to a future tax provision of \$4.01 million in the second quarter and \$7.68 million for the first half, an effective tax rate of 40.4 percent. Comparisons with the 2003 periods are distorted by the significant one-time tax rate adjustment that was booked to future taxes in the 2003 second quarter.

Cash flow from operations in second quarter 2004 of \$16.53 million (see note at the beginning of the MD&A section) was \$0.79 million or five percent higher than the preceding quarter and \$3.00 million or 22 percent higher than the 2003 second quarter. The 2004 first half cash flow of \$32.26 million was 12 percent higher than the prior year's comparative period, which roughly matches the 12 percent gain in production volumes over the same six-month period. Reflecting excellent commodity prices in both the 2003 and 2004 six-month periods, Zargon's cash flow netback averaged a strong \$22.10 per barrel of equivalent in the first half of 2004, essentially unchanged from the prior year's comparable period netback. Cash flow per diluted share showed similar gains with the 2004 second quarter cash flow of \$0.88 per diluted share increasing five percent over the first quarter levels and the 2004 first half cash flow of \$1.72 per diluted share improving 10 percent over the 2003 comparable period.

Net earnings of \$5.54 million for the second quarter of 2004 were unchanged from the preceding quarter but 40 percent below the second quarter of 2003 which contained a large one-time adjustment for future taxes. The net earnings track the cash flow from operations for the respective periods modified by non-cash charges which in the 2004 period include increased depletion and depreciation, increased future taxes and stock-based compensation referred to above. Net earnings per diluted share were \$0.30 and \$0.29 respectively in the first and second 2004 quarters.

CAPITAL EXPENDITURES

Six months ended June 30 (\$ million)	2004	2003
Undeveloped land	1.85	3.20
Geological and geophysical (seismic)	2.36	2.37
Drilling and completion of wells	9.73	4.79
Well equipment and facilities	2.92	2.53
Exploration and development	16.86	12.89
Property acquisitions	0.79	7.12
Property dispositions	(0.27)	(5.05)
Net property acquisitions	0.52	2.07
Total capital expenditures (net)	17.38	14.96

LIQUIDITY AND CAPITAL RESOURCES

Capital expenditures of \$17.38 million in the first half of 2004 were 16 percent higher than in first half 2003 reflecting a very active field program of 23 gross (18.3 net) wells. Drilling and completion expenditures doubled from the previous year to \$9.73 million while undeveloped land purchases fell 42 percent as Zargon reduced its land acquisition budget as Crown sales became increasingly more competitive and expensive. No material property acquisitions were completed in the first half of 2004, although a \$10 million purchase of producing oil assets in the Weyburn area of Southeast Saskatchewan was closed on July 26, 2004. Cash flow from operations in the first half of \$32.26 million and proceeds from the exercise of stock options of \$1.33 million covered the capital program and applied \$16.21 million to working capital and the repayment of bank debt. As of June 30, 2004, the Company had positive working capital of \$3.08 million. Since June 30, Zargon has made a \$10 million oil property acquisition and as part of the trust conversion process paid approximately \$1.50 million of transaction fees and purchased all of the remaining employee and director stock options for an additional \$7.88 million. Currently, with a bank debt plus working capital deficiency balance in the \$12-\$15 million range, Zargon continues to show a very strong balance sheet.

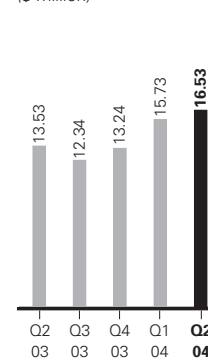
At August 12, 2004, Zargon Energy Trust has 14.87 million trust units and 3.66 million exchangeable shares outstanding. Assuming full conversion of exchangeable shares, there would be 18.53 million trust units outstanding. Pursuant to the shareholder approved new employee incentive plan there are currently an additional 0.55 million trust unit incentive rights issued and outstanding.

CAPITAL SOURCES

Six months ended June 30 (\$ million)	2004	2003
Cash flow from operations	32.26	28.76
Changes in working capital and other	(9.23)	(0.82)
Change in bank indebtedness	(6.98)	(13.81)
Issuance of common shares	1.33	0.83
Total capital sources	17.38	14.96

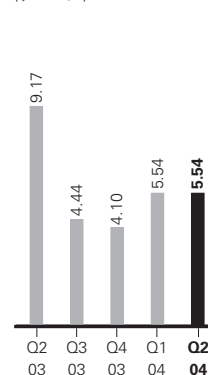
CASH FLOW FROM OPERATIONS

(\$ million)



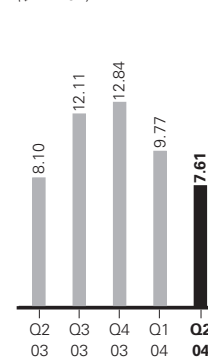
NET EARNINGS

(\$ 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 June 30, 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

Moving forward with a trust structure, Zargon continues to be well positioned with 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 capital spending approach that has served us well to date while distributing approximately half of our cash flows to our equity holders. 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 Q2	\$5.54	\$0.29	\$16.53	\$0.88	\$30.96	\$189.80	–
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

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
August 12, 2004

(\$ thousand)	June 30, 2004 (unaudited)	December 31, 2003 (restated – note 2)
ASSETS		
Current		
Cash	1,205	–
Accounts receivable	14,222	12,183
Prepaid expenses and deposits	1,496	980
	<u>16,923</u>	<u>13,163</u>
Property and equipment, net	<u>172,880</u>	<u>167,888</u>
	<u>189,803</u>	<u>181,051</u>
LIABILITIES		
Current		
Bank indebtedness	–	6,978
Accounts payable and accrued liabilities	13,846	19,277
	<u>13,846</u>	<u>26,255</u>
Asset retirement obligations <i>[notes 2 and 3]</i>	<u>12,849</u>	<u>12,194</u>
Future income taxes	<u>37,919</u>	<u>30,133</u>
	<u>64,614</u>	<u>68,582</u>
SHAREHOLDERS' EQUITY		
Share capital <i>[note 4]</i>	43,568	42,200
Contributed surplus	535	264
Retained earnings	81,086	70,005
	<u>125,189</u>	<u>112,469</u>
	<u>189,803</u>	<u>181,051</u>

**C O N S O L I D A T E D
B A L A N C E
S H E E T S**

See accompanying notes.

**CONSOLIDATED
STATEMENTS
OF EARNINGS
AND RETAINED
EARNINGS**

(unaudited)	Three months ended June 30		Six months ended June 30	
	2004	2003	2004	2003
(\$ thousand, except per share amounts)		(restated – note 2)		(restated – note 2)
Revenue				
Petroleum and natural gas revenue	30,959	24,198	58,663	53,391
Hedging <i>[note 8]</i>	(1,310)	(473)	(1,583)	(2,696)
Royalties	(6,886)	(5,052)	(12,809)	(11,296)
	22,763	18,673	44,271	39,399
Expenses				
Production	5,036	3,976	9,651	8,206
General and administrative	996	766	1,958	1,654
Stock-based compensation <i>[note 4]</i>	218	–	309	–
Interest	49	247	134	509
Foreign exchange (gain) loss	65	(279)	24	(279)
Accretion of asset retirement obligations <i>[notes 2 and 3]</i>	266	293	525	586
Depletion and depreciation	6,422	4,277	12,639	8,418
	13,052	9,280	25,240	19,094
Earnings before income taxes	9,711	9,393	19,031	20,305
Income taxes				
Future	4,013	72	7,680	4,219
Current	156	154	270	268
	4,169	226	7,950	4,487
Net earnings for the period	5,542	9,167	11,081	15,818
Retained earnings, beginning of period				
As previously reported	75,544	52,335	70,125	45,598
Change in accounting policies <i>[note 2]</i>	–	(40)	(120)	46
As restated	75,544	52,295	70,005	45,644
Retained earnings, end of period	81,086	61,462	81,086	61,462
Earnings per common share <i>[note 5]</i>				
Basic	0.30	0.52	0.61	0.89
Diluted	0.29	0.50	0.59	0.87

See accompanying notes.

**CONSOLIDATED
STATEMENTS
OF CASH FLOW**

(unaudited)	Three months ended June 30		Six months ended June 30	
(\$ thousand)	2004	2003 (restated – note 2)	2004	2003 (restated – note 2)
Operating activities				
Net earnings for the period	5,542	9,167	11,081	15,818
Add (deduct) non-cash items:				
Depletion and depreciation	6,422	4,277	12,639	8,418
Accretion of asset retirement obligations <i>[notes 2 and 3]</i>	266	293	525	586
Stock-based compensation	218	–	309	–
Unrealized foreign exchange (gain) loss	65	(279)	24	(279)
Future income taxes	4,013	72	7,680	4,219
Cash flow from operations	16,526	13,530	32,258	28,762
Asset retirement expenditures	(14)	(21)	(56)	(51)
Changes in non-cash working capital	(2,898)	3,057	(3,210)	1,159
	13,614	16,566	28,992	29,870
Financing activities				
Repayment of bank indebtedness	(3,675)	(9,303)	(6,978)	(13,805)
Exercise of stock options	336	549	1,330	826
	(3,339)	(8,754)	(5,648)	(12,979)
Investing activities				
Additions to property and equipment	(7,883)	(13,123)	(17,651)	(20,005)
Proceeds on disposal of property and equipment	275	5,020	275	5,045
Changes in non-cash working capital	(1,462)	291	(4,763)	(1,931)
	(9,070)	(7,812)	(22,139)	(16,891)
Change in cash	1,205	–	1,205	–
Cash, beginning of period	–	–	–	–
Cash, end of period	1,205	–	1,205	–

See accompanying notes.

**NOTES TO THE
CONSOLIDATED
FINANCIAL
STATEMENTS**

FOR THE THREE
AND SIX MONTHS
ENDED JUNE 30,
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, except as described in note 2 below. 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

On January 1, 2004, the Company 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 cost 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 impact on net earnings and per share amounts for the three and six months ended June 30, 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:

(\$ thousand)	Six months ended June 30	
	2004	2003
Balance, beginning of year	12,194	10,560
Liabilities incurred	255	376
Liabilities settled	(56)	(51)
Accretion expense	525	586
Other	(69)	—
Balance, end of period	12,849	11,471

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

(thousand)	June 30, 2004		June 30, 2003	
	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	289	1,330	229	826
Stock-based compensation recognized	—	38	—	—
Balance, end of period	18,281	43,568	17,866	41,823

A summary of the status of the Company's stock option plan as at June 30, 2004 and 2003, and changes during the six months ended on those dates is presented below:

STOCK OPTIONS

	June 30, 2004		June 30, 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	415	9.32
Exercised	(289)	4.60	(229)	3.62
Cancelled	(9)	9.61	(17)	9.30
Outstanding at end of period	1,429	10.22	1,384	6.55
Options exercisable at period end	696	6.94	968	5.38

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 in 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 relating to 2002 stock option grants, the Company's net earnings for the six months ended June 30, 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 six month period. 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

(thousand)	Three months ended June 30		Six months ended June 30	
	2004	2003	2004	2003
Basic	18,257	17,785	18,208	17,747
Diluted	18,851	18,296	18,797	18,268

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.

(\$ thousand)	Three months ended June 30		Six months ended June 30	
	2004	2003	2004	2003
Petroleum and Natural Gas Revenue				
Canada	27,379	21,408	51,748	47,780
United States	3,580	2,790	6,915	5,611
Total	30,959	24,198	58,663	53,391
Net Capital Expenditures				
Canada	5,976	2,914	15,434	9,719
United States	1,632	5,189	1,942	5,241
Total	7,608	8,103	17,376	14,960
Total Assets*				
Canada			164,209	142,861
United States			25,594	23,122
Total			189,803	165,983

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

7. SUPPLEMENTAL CASH FLOW INFORMATION

(\$ thousand)	Three months ended June 30		Six months ended June 30	
	2004	2003	2004	2003
Cash interest paid	34	181	108	423
Cash taxes paid	49	154	188	268

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 June 30, 2004 as follows:

	Volume	Rate	Price	Terms
Oil swaps	73,600 bbl	400 bbl/d	\$28.78 US/bbl	Jul. 1/04–Dec. 31/04
	55,200 bbl	300 bbl/d	\$54.05 Cdn/bbl	Jul. 1/04–Dec. 31/04
	27,000 bbl	300 bbl/d	\$35.45 US/bbl	Jan. 1/05–Mar. 31/05
Oil collars	36,800 bbl	200 bbl/d	\$24.00 US/bbl Put	Jul. 1/04–Dec. 31/04
			\$27.80 US/bbl Call	
	54,300 bbl	300 bbl/d	\$43.50 Cdn/bbl Put \$54.50 Cdn/bbl Call	Jan. 1/05–Jun. 30/05
Natural gas swaps	738,000 gj	6,000 gj/d	\$5.92/gj	Jul. 1/04–Oct. 31/04
	302,000 gj	2,000 gj/d	\$6.27/gj	Nov. 1/04–Mar. 31/05
Natural gas collars	246,000 gj	2,000 gj/d	\$5.00/gj Put	Jul. 1/04–Oct. 31/04
			\$6.85/gj Call	
	604,000 gj	4,000 gj/d	\$6.75/gj Put \$9.68/gj Call	Nov. 1/04–Mar. 31/05
Natural gas put	428,000 gj	2,000 gj/d	\$5.10/gj	Apr. 01/05–Oct. 31/05

At June 30, 2004, the cost to settle the above contracts would have been approximately \$1.75 million.

9. SUBSEQUENT EVENT

On May 17, 2004, the Company announced a reorganization initiative that would result in its conversion to an income trust, Zargon Energy Trust, through the exchange of trust units and/or exchangeable shares for all outstanding common shares. Zargon Energy Trust will make monthly cash distributions to investors while retaining sufficient cash flow for capital expenditures. The reorganization was subject to certain conditions including the approval of the Company's shareholders, court approval, and applicable regulatory approvals. A special meeting of shareholders was held on July 15, 2004, at which time the proposed reorganization was approved. An information circular containing details of the proposed reorganization and Plan of Arrangement dated June 18, 2004 was mailed out to shareholders on June 21, 2004.

10. 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

Toronto Stock Exchange

Trading Symbols:

- prior to trust conversion
ZAR – common shares
- subsequent to trust conversion
ZAR.UN – trust units
ZOG.B – exchangeable shares

TRANSFER AGENT

Valiant Trust Company
510, 550 – 6th Avenue S.W.
Calgary, Alberta T2P 0S2

HEAD OFFICE

700, 333 – 5th Avenue S.W.
Calgary, Alberta T2P 3B6
Telephone: (403) 264-9992
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Email: zargon@zargon.ca

WEBSITE

www.zargon.ca

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 August 12, 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.