

MANAGEMENT'S AND AUDITORS' REPORTS

MANAGEMENT'S REPORT

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

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

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

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

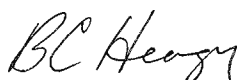


C.H. Hansen

President and Chief Executive Officer

Calgary, Canada

March 13, 2006



B.C. Heagy

Vice President, Finance and Chief Financial Officer

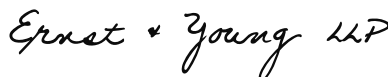
AUDITORS' REPORT

To the Unitholders of Zargon Energy Trust

We have audited the consolidated balance sheets of Zargon Energy Trust as at December 31, 2005 and 2004 and the consolidated statements of earnings and accumulated earnings and cash flows for the years then ended. These financial statements are the responsibility of the Trust's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Trust as at December 31, 2005 and 2004 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.



Calgary, Canada

March 13, 2006

Chartered Accountants

CONSOLIDATED BALANCE SHEETS

As at December 31 (\$ thousand)	2005	2004
ASSETS [note 6]		
Current		
Accounts receivable [note 12]	21,835	14,275
Prepaid expenses and deposits	2,710	2,953
	24,545	17,228
Property and equipment, net [notes 4 and 5]	253,315	209,736
	277,860	226,964
LIABILITIES		
Current		
Bank indebtedness [note 6]	-	14,230
Accounts payable and accrued liabilities	30,570	24,153
Cash distributions payable [note 18]	11,122	2,210
Unrealized risk management liability [note 12]	3,756	-
	45,448	40,593
Long term debt [note 6]	10,339	-
Asset retirement obligations [note 7]	15,859	14,390
Future income taxes [note 10]	48,928	41,830
	120,574	96,813
Commitments and contingencies [notes 12, 13 and 14]		
NON-CONTROLLING INTEREST		
Exchangeable shares [notes 3 and 9]	12,673	9,529
UNITHOLDERS' EQUITY		
Unitholders' capital [note 8]	71,644	45,755
Contributed surplus [note 8]	1,347	1,170
Accumulated earnings	119,768	84,399
Accumulated cash distributions [note 18]	(48,146)	(10,702)
	144,613	120,622
	277,860	226,964

See accompanying notes to the consolidated financial statements.

On behalf of the Board:



J.O. McCutcheon
Director



K.D. Kitagawa
Director

CONSOLIDATED STATEMENTS OF EARNINGS AND ACCUMULATED EARNINGS

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

	2005	2004
REVENUE		
Petroleum and natural gas revenue	162,722	123,968
Unrealized risk management loss [note 12]	(3,756)	–
Realized risk management loss [note 12]	(7,754)	(4,568)
Royalties (net of Alberta Royalty Credit)	(37,319)	(28,047)
	113,893	91,353
EXPENSES		
Production	24,035	21,692
General and administrative [note 20]	6,053	4,358
Unit-based compensation [note 8]	902	3,682
Interest and financing charges [note 6]	786	440
Unrealized foreign exchange gain	(201)	(564)
Accretion of asset retirement obligations [note 7]	1,196	1,076
Depletion and depreciation	37,484	27,414
	70,255	58,098
EARNINGS BEFORE INCOME TAXES	43,638	33,255
INCOME TAXES [note 10]		
Future	474	9,639
Current	1,801	1,114
	2,275	10,753
EARNINGS FOR THE YEAR BEFORE NON-CONTROLLING INTEREST	41,363	22,502
Non-controlling interest – exchangeable shares [notes 3 and 9]	(5,994)	(1,870)
NET EARNINGS FOR THE YEAR	35,369	20,632
ACCUMULATED EARNINGS, BEGINNING OF YEAR	84,399	70,005
Reorganization costs upon trust conversion [note 19]	–	(6,238)
ACCUMULATED EARNINGS, END OF YEAR	119,768	84,399
NET EARNINGS PER UNIT [note 11]		
Basic	2.21	1.23
Diluted	2.19	1.20

See accompanying notes to the consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the years ended December 31 (\$ thousand)	2005	2004
OPERATING ACTIVITIES		
Net earnings for the year	35,369	20,632
Add (deduct) non-cash items:		
Non-controlling interest – exchangeable shares	5,994	1,870
Unrealized risk management loss	3,756	–
Depletion and depreciation	37,484	27,414
Accretion of asset retirement obligations	1,196	1,076
Unit-based compensation	902	3,682
Unrealized foreign exchange gain	(201)	(564)
Future income taxes	474	9,639
	84,974	63,749
Asset retirement expenditures	(604)	(414)
Changes in non-cash working capital [note 15]	(1,401)	19
	82,969	63,354
FINANCING ACTIVITIES		
Advances (repayment) of bank debt	(3,891)	7,252
Cash distributions to unitholders	(37,444)	(10,702)
Exercise of unit rights	2,723	2,867
Changes in non-cash working capital [note 15]	8,974	2,148
	(29,638)	1,565
INVESTING ACTIVITIES		
Additions to property and equipment	(55,986)	(56,553)
Proceeds on disposal of property and equipment	2,446	280
Reorganization costs [note 19]	–	(9,443)
Changes in non-cash working capital [note 15]	209	797
	(53,331)	(64,919)
CHANGE IN CASH, AND CASH END OF YEAR	–	–

See supplementary information contained in note 16.

See accompanying notes to the consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

For the years ended December 31, 2005 and 2004.

All amounts are stated in Canadian dollars unless otherwise noted.

1. STRUCTURE OF THE TRUST

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

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

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

CONSOLIDATION AND BASIS OF PRESENTATION

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

While the Trust commenced operations on July 15, 2004, these consolidated financial statements follow the continuity of interest basis of accounting as if the Trust had always existed. This basis is intended to provide unitholders with meaningful and comparative financial information.

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

REVENUE RECOGNITION

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

JOINT OPERATIONS

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

PROPERTY AND EQUIPMENT

The Trust follows the full cost method of accounting for its oil and natural gas operations whereby all costs relating to the acquisition, exploration and development of oil and natural gas reserves are

capitalized and accumulated in separate cost centres for Canada and the United States. Such costs include land acquisition costs, annual carrying charges of non-producing properties, geological and geophysical costs, and costs of drilling and equipping wells.

Depletion and depreciation of petroleum, natural gas properties and equipment is computed using the unit of production method based on the estimated proved reserves of petroleum and natural gas before royalties determined by independent consultants. For purposes of this calculation, reserves are converted to common units on the basis that six thousand cubic feet of natural gas is equivalent to one barrel of oil. A portion of the cost of petroleum and natural gas rights relating to undeveloped properties is excluded from the depletion calculation. Twenty percent of the year end balance of these costs is added to the depletion base each year. Proceeds on the disposal of petroleum and natural gas properties are applied against capitalized costs, with gains or losses not ordinarily recognized, unless such a disposal would result in a change in the depletion rate of 20 percent or more.

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

IMPAIRMENT TEST

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

ASSET RETIREMENT OBLIGATIONS

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

FINANCIAL INSTRUMENTS

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

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

For financial risk management contracts entered into prior to December 31, 2004, the Trust's policy was to designate each derivative financial instrument employed as a hedge of a specific portion of projected production over the term of the instrument. The Trust formally documented its risk management objectives and strategies for undertaking the hedged transactions, the hedging item, the nature of the specific risk exposures being hedged, the intended term of the hedge relationship, the method for assessing effectiveness and the method of accounting for the hedging relationship. The effectiveness of the derivative is assessed on an ongoing basis to ensure that the derivatives entered into are highly effective in offsetting changes in fair values of the hedged items. The instruments employed may be denominated in US or Canadian dollars. Gains or losses from all hedging contracts, other than forward sales settled by physical delivery, are recognized as hedging gains or losses when the sale of hedged production occurs. The Trust believes these derivative financial instruments used are effective as hedges over their term. In the event that a designated hedged item ceases to exist, any realized or unrealized gain or loss on such derivative commodity instruments is recognized in income immediately. If the hedge relationship is terminated, either via ineffectiveness or via termination of the designation, gains or losses previously deferred continue to be deferred and recognized when they are realized.

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

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

Foreign currency swap agreements may be used from time to time to manage the risk inherent in producing commodities whose price is based directly or indirectly on US dollars, using a notional principal equal to the projected monthly revenue from their sale. Payments or charges are calculated and paid according to the terms of the agreement, usually with monthly settlement. At December 31, 2005 and 2004 the Trust had no such financial instruments.

INCOME TAXES

The Trust follows the liability method of tax allocation in accounting for income taxes. Under this method, the Trust records future income taxes for the effect of any differences between the accounting and income tax basis of an asset or liability using income tax rates expected to apply in the years in which these temporary differences are expected to be recovered or settled. The effect on future

income tax assets and liabilities of a change in tax rates is recognized in net earnings in the period in which the change is substantively enacted.

FOREIGN CURRENCY TRANSLATION

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

TRUST UNIT RIGHTS AND UNIT-BASED COMPENSATION

Under the Trust's unit rights incentive plan (the "Plan"), rights to purchase trust units are granted to directors, officers and employees at current market prices. The Plan allows for the exercise price of rights to be reduced in future periods by an amount that distributions exceed a stated return on assets. The unit-based compensation expense arising from unit rights granted upon the July 15, 2004 Plan of Arrangement and up to December 31, 2004 were originally calculated using the intrinsic value method. In response to an emphasis by securities regulators that fair value methodologies be used, new measurement techniques in 2005 have been developed utilizing a fair value option-pricing model for such unit rights grants. Zargon has reassessed the previous unit rights grants under this fair value model and there is no significant impact on amounts previously recorded as 2004 unit-based compensation expense. Zargon will continue to use fair value methodologies, where possible, for future unit rights grants. Under the fair value method of accounting for unit-based compensation the cost of the option is charged to earnings with an offsetting amount recorded to contributed surplus, based on an estimate of the fair value using a Black-Scholes option-pricing model. No compensation expense has been recorded on options issued prior to 2003 (see note 8). Forfeiture of rights are recorded as a reduction in expense in the period in which they occur.

PER UNIT AMOUNTS

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

MEASUREMENT UNCERTAINTY

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

Inherent in the fair value calculation of asset retirement obligations, are numerous assumptions and judgments including the ultimate settlement amounts, inflation factors, credit adjusted discount rates, timing of settlement, and changes in the legal and regulatory environments. To the extent

future revisions to these assumptions impact the fair value of the existing asset retirement obligation liability, a corresponding adjustment is made to the property and equipment balance.

CASH DISTRIBUTIONS

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

3. CHANGES IN ACCOUNTING POLICIES

EXCHANGEABLE SHARES – NON-CONTROLLING INTEREST

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

For the 2004 year end, the Trust retroactively restated prior periods back to the Plan of Arrangement dated July 15, 2004. As a result of this change in accounting policy, the Trust has increased its unitholders' equity and non-controlling interest for 2005 by \$24.44 million (2004 – \$10.15 million) on the Trust's consolidated balance sheet. Consolidated net earnings for 2005 have been reduced for net earnings attributable to the non-controlling interest of \$5.99 million (2004 – \$1.87 million). In accordance with EIC-151 and given the circumstances in Zargon's case, each redemption is accounted for as a step-purchase, which for 2005 additionally resulted in an increase in property and equipment of \$24.93 million (2004 – \$11.28 million), and an increase in future income tax liability of \$6.48 million (2004 – \$3.00 million). Cash flow was not impacted by this change.

The cumulative impact to date of the application of EIC-151 has been to increase gross property and equipment by \$36.21 million, (for depletion impact see note 5), unitholders' equity and non-controlling interest by \$34.59 million, future income tax liability by \$9.48 million and an allocation of net earnings to exchangeable shareholders' of \$7.86 million.

4. ACQUISITION

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

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

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

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

5. PROPERTY AND EQUIPMENT

(\$ thousand)	December 31, 2005		
	Cost	Accumulated Depletion and Depreciation	Net Book Value
Petroleum, natural gas properties and equipment*	387,113	134,614	252,499
Office equipment	1,664	848	816
	388,777	135,462	253,315

(\$ thousand)	December 31, 2004		
	Cost	Accumulated Depletion and Depreciation	Net Book Value
Petroleum, natural gas properties and equipment*	306,812	97,680	209,132
Office equipment	1,304	700	604
	308,116	98,380	209,736

* As a result of shareholders redeeming exchangeable shares, property and equipment has cumulatively increased \$36.21 million, \$24.93 million relating to 2005 and \$11.28 million relating to 2004. The effect of these increases has resulted in additional depletion and depreciation expense of approximately \$5.08 million which all relates to 2005.

At December 31, 2005, petroleum, natural gas properties and equipment include \$14.72 million (2004 – \$14.70 million) relating to undeveloped properties that have been excluded from the depletion calculation.

An impairment test calculation was performed on the Trust's petroleum, natural gas properties and equipment at December 31, 2005 in which the estimated undiscounted future net cash flows associated with the proved reserves exceeded the carrying amount of the Trust's petroleum, natural gas properties and equipment. This impairment calculation was performed separately on both the Canadian and US cost centres. The following table outlines benchmark prices used in the impairment test at December 31, 2005:

Year	WTI Crude Oil (\$US/bbl)	Exchange Rate (\$US/\$Cdn)	WTI Crude Oil (\$Cdn/bbl)	AECO Gas (\$Cdn/gj)
2006	64.37	0.88	73.15	9.93
2007	64.83	0.88	73.67	10.06
2008	62.87	0.88	71.44	9.33
2009	60.69	0.88	68.97	8.50
2010	59.51	0.88	67.62	7.86
Thereafter (inflation %)	2.0%	0.88	2.0%	2.0%

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

6. LONG TERM DEBT

On September 30, 2005, a Canadian subsidiary and a US subsidiary of the Trust entered into syndicated committed credit facilities with a borrowing base of \$80 million which replaces its former demand facility of \$50 million. These facilities consist of a \$60 million tranche available to the Canadian borrower and a US \$15 million tranche available to the US borrower. A \$150 million demand debenture on the assets of the subsidiaries of the Trust has been provided as security for these facilities. The facilities are fully revolving for a 364 day period with the provision for an annual extension at the option of the lenders and upon notice from the Company. Should the facilities not be renewed, they convert to one year non-revolving term facilities at the end of the revolving 364 day period. Repayment would not be required until the end of the non-revolving term, and as such, the revolving credit facility has been classified as long term debt. Interest rates fluctuate under the syndicated facility with Canadian prime, US prime, and US base rates plus an applicable margin between zero basis points and 25 basis points, as well as with Canadian banker's acceptance and LIBOR rates plus an applicable margin between 90 basis points and 150 basis points. At December 31, 2005, \$10.34 million had been drawn on the syndicated committed credit facilities bearing interest at Canadian prime (December 31, 2005 – 5.0 percent) with any unused amounts subject to standby fees. In the normal course of operations Zargon enters into various letters of credit. At December 31, 2005, the approximate value of outstanding letters of credit totalled \$0.47 million (2004 – \$0.46 million).

In 2004 and up until September 30, 2005, the Trust had a revolving demand credit facility that provided for a line of credit of \$50 million bearing interest at prime (December 31, 2004 – 4.25 percent) and had pledged an assignment of accounts receivable, a first floating charge on all of the Canadian assets and a fixed charge over certain property and equipment as collateral.

7. ASSET RETIREMENT OBLIGATIONS

The total future asset retirement obligation was estimated by management based on Zargon's net working interest in all wells and facilities, estimated costs to reclaim and abandon wells and facilities and the estimated timing of the costs to be incurred in future periods. Zargon has estimated the net present value of its total asset retirement obligations to be \$15.86 million (2004 – \$14.39 million) as at December 31, 2005, based on a total future liability of \$62.54 million (2004 – \$59.12 million). These payments are expected to be made over the next 30 years with the majority of the costs being incurred after 2012. Commencing July 1, 2005, incremental asset retirement obligations are calculated using a revised credit adjusted risk-free rate of 7.5 percent. Asset retirement obligations prior to this period were calculated using a credit adjusted risk-free rate of 8.5 percent. An inflation rate of two percent used in the calculation of the present value of the asset retirement obligation remains unchanged. The following table reconciles Zargon's asset retirement obligation:

(\$ thousand)	Year ended December 31,	
	2005	2004
Balance, beginning of year	14,390	12,194
Liabilities incurred	906	1,696
Liabilities settled	(604)	(414)
Accretion expense	1,196	1,076
Foreign exchange	(29)	(162)
Balance, end of year	15,859	14,390

8. UNITHOLDERS' EQUITY

Pursuant to the Plan of Arrangement on July 15, 2004, 14.87 million units of the Trust and 3.66 million exchangeable shares (see note 9) of the Company were issued in exchange for all of the outstanding shares of the Company on a one-for-one basis.

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

TRUST UNITS

(thousand)	December 31, 2005		December 31, 2004	
	Number of Units	Amount (\$)	Number of Units	Amount (\$)
Units issued				
Balance, beginning of year	15,341	45,755	–	–
Issued pursuant to Plan of Arrangement July 15, 2004	–	–	14,866	36,219
Unit rights exercised for cash	153	2,723	–	–
Unit-based compensation recognized	–	725	–	–
Issued on conversion of exchangeable shares	821	21,297	475	9,536
Issued on corporate acquisition	40	1,144	–	–
Balance, end of year	16,355	71,644	15,341	45,755

COMMON SHARES OF ZARGON OIL & GAS LTD.

(no par value) (thousand)	December 31, 2004	
	Number of Shares	Amount (\$)
Shares issued		
Balance, beginning of year	17,992	42,200
Stock options exercised for cash	534	2,867
Stock-based compensation recognized	–	69
Trust units issued	(14,866)	(36,219)
Exchangeable shares issued	(3,660)	(8,917)
Balance, end of year	–	–

COMPENSATION PLANS

A summary of the status of the Trust's compensation expense for the years ended December 31, 2005 and 2004 is presented below:

COMPENSATION EXPENSE

(\$ thousand)	Year ended December 31,	
	2005	2004
Stock-based compensation expense prior to Plan of Arrangement July 15, 2004	–	345
Accelerated vesting of unvested stock options pursuant to the Arrangement	–	2,167
Unit-based compensation recognized subsequent to trust conversion	902	1,170
Total for the year	902	3,682

A summary of the status of the Trust's compensation plans as at December 31, 2005 and 2004 and changes during the years ended on those dates is presented below:

TRUST UNIT RIGHTS INCENTIVE PLAN

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

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

	December 31, 2005		December 31, 2004	
	Number of Unit Rights (thousand)	Weighted Average Exercise Price (\$/unit right)	Number of Unit Rights (thousand)	Weighted Average Exercise Price (\$/unit right)
Outstanding at beginning of year	579	17.79	–	–
Unit rights granted	505	26.89	579	17.79
Unit rights exercised	(153)	17.77	–	–
Unit rights cancelled	(16)	18.13	–	–
Outstanding at end of year	915	22.80	579	17.79
Unit rights exercisable at year end	48	17.70	–	–

The following table summarizes information about unit rights outstanding at December 31, 2005:

Range of Exercise Prices (\$/unit right)	Unit Rights Outstanding			Unit Rights Exercisable	
	Number Outstanding at 12/31/05 (thousand)	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price (\$/unit right)	Number Exercisable at 12/31/05 (thousand)	Weighted Average Exercise Price (\$/unit right)
17.70 – 19.25	411	3.1 years	17.78	48	17.70
22.00	162	4.1 years	22.00	–	–
25.06 – 27.40	171	4.1 years	27.35	–	–
31.09	171	4.1 years	31.09	–	–
	915		22.80	48	17.70

UNIT-BASED COMPENSATION (See Compensation Expense Table Above)

The Plan allows for the exercise price of rights to be reduced in future periods by an amount that distributions exceed a stated return on assets. The unit-based compensation expense arising from unit rights granted upon the July 15, 2004 Plan of Arrangement and up to December 31, 2004 were originally calculated using the intrinsic value method. In response to an emphasis by securities regulators that fair value methodologies be used, new measurement techniques in 2005 have been developed utilizing a fair value option-pricing model for such unit rights grants. Zargon has reassessed the previous unit rights grants under this fair value model and there is no significant impact on amounts previously recorded as 2004 unit-based compensation expense. Zargon will continue to use fair value methodologies, where possible, for future unit rights grants.

The assumptions made for unit rights granted for 2005 include a volatility factor of expected market price of 27.9 percent, a weighted average risk-free interest rate of 3.6 percent, a dividend yield of 7.2 percent and a weighted average expected life of the unit rights of four years, resulting in unit-based compensation expense of \$0.90 million. In 2004, subsequent to the Arrangement, \$1.17 million of unit-based compensation expense was recognized.

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

STOCK OPTIONS

In 2004, as part of the Arrangement to reorganize Zargon Oil & Gas Ltd. into a Trust, all common share options, vested and unvested, were cancelled and the optionholders received a cash payment for the intrinsic value of the options.

	December 31, 2004	
	Number of Shares (thousand)	Weighted Average Exercise Price (\$/stock option)
Outstanding at beginning of year	1,297	7.05
Granted	430	16.00
Exercised	(534)	5.39
Cancelled prior to trust conversion	(9)	9.61
Cancelled immediately prior to trust conversion	(1,184)	11.03
Outstanding at end of year	-	-

STOCK-BASED COMPENSATION (See Compensation Expense Table Above)

Compensation expense of \$0.34 million was recognized for the 2004 year as a result of regular vesting of unvested stock options granted prior to the Arrangement. Additionally, as a result of cancelling the stock-option plan pursuant to the Arrangement, compensation expense for the year ended December 31, 2004 of \$2.17 million resulted from the acceleration of unvested stock options. Both of these non-cash expenses were recognized as part of unit-based compensation expense on the 2004 income statement for the twelve month period.

Under this stock-option plan, the Company had 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 under the stock-option plan was based on the estimated fair values at the time of the grant and the expense was recognized over the vesting period of the option.

The assumptions made for the options granted in 2004 include an annualized volatility factor of 26.3 percent, a weighted average risk-free interest rate of 3.3 percent, no dividend yield and a weighted average expected life of options of four years.

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

CONTRIBUTED SURPLUS

(\$ thousand)

Balance, January 1, 2004	264
Stock-based compensation expense prior to Plan of Arrangement July 15, 2004	345
Stock-based compensation recognized on exercise of stock options	(69)
Accelerated vesting of unvested stock options pursuant to the Arrangement	2,167
Stock-options cancelled immediately prior to trust conversion	(2,707)
Balance at trust conversion	–
Unit-based compensation recognized subsequent to trust conversion	1,170
Balance, December 31, 2004	1,170
Unit-based compensation expense	902
Unit-based compensation recognized on exercise of unit rights	(725)
Balance, December 31, 2005	1,347

9. NON-CONTROLLING INTEREST - EXCHANGEABLE SHARES

Zargon Oil & Gas Ltd. is authorized to issue a maximum of 3.66 million exchangeable shares. The exchangeable shares are convertible into trust units at the option of the shareholder based on the exchange ratio, which is adjusted monthly to reflect the distribution paid on the trust units. Cash distributions are not paid on the exchangeable shares. During the year, a total of 0.78 million (2004 – 0.47 million) exchangeable shares were converted into 0.82 million (2004 – 0.48 million) trust units based on the exchange ratio at the time of conversion. At December 31, 2005, the exchange ratio was 1.09629 (2004 – 1.02583) trust units per exchangeable share. As set out in the Arrangement, the exchangeable shares are entitled to vote equally to the number of trust units for which each exchangeable share is convertible into a trust unit on the record date. The Board of Directors of Zargon Oil & Gas Ltd. hold the option to redeem all outstanding exchangeable shares for trust units on or before July 15, 2014. At such time, should the Board not extend the term of the shares, there will be no remaining non-controlling interest.

The Trust retroactively applied EIC-151 “Exchangeable Securities Issued by a Subsidiary of an Income Trust” in 2004. Per EIC-151, if certain conditions are met, the exchangeable shares issued by a subsidiary must be reflected as non-controlling interest on the consolidated balance sheet and in turn, net earnings must be reduced by the amount of net earnings attributed to the non-controlling interest.

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

NON-CONTROLLING INTEREST - EXCHANGEABLE SHARES

(thousand, except exchange ratio)	December 31, 2005		December 31, 2004	
	Number of Shares	Amount (\$)	Number of Shares	Amount (\$)
Non-controlling interest – exchangeable shares issued				
Balance, beginning of year	3,186	9,529	–	–
Issued pursuant to Plan of Arrangement July 15, 2004	–	–	3,660	8,917
Exchanged for trust units at book value and including earnings attributed since Plan of Arrangement	(784)	(2,850)	(474)	(1,258)
Earnings attributable to non-controlling interest	–	5,994	–	1,870
Balance, end of year	2,402	12,673	3,186	9,529
Exchange ratio, end of year	1.09629		1.02583	
Trust units issuable upon conversion of exchangeable shares, end of year	2,633		3,268	

The proforma total units outstanding at year end, including trust units outstanding, and trust units issuable upon conversion of exchangeable shares and after giving rise to the exchange ratio at the end of the year is 18.99 million units (2004 – 18.61 million units).

Immediately prior to the July 15, 2004 Plan of Arrangement, the Company had \$45.14 million in share capital. Upon conversion to the Trust structure these amounts were allocated \$36.22 million to trust units and \$8.92 million to exchangeable shares, based on the terms of the Arrangement.

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

(\$ thousand)	Zargon Oil & Gas Ltd. Common Shares	Zargon Energy Trust Units	Zargon Oil & Gas Ltd. Exchangeable Shares	Total
Immediately prior to July 15, 2004				
Plan of Arrangement	45,136			
Plan of Arrangement July 15, 2004	(45,136)	36,219	8,917	
	–	36,219	8,917	45,136
Issued on redemption of exchangeable shares at book value	–	1,155	(1,155)	–
Effect of EIC-151	–	8,381	1,767	10,148
Balance at December 31, 2004	–	45,755	9,529	55,284
Issued on redemption of exchangeable shares at book value	–	1,909	(1,909)	–
Effect of EIC-151	–	19,388	5,053	24,441
Unit-based compensation recognized	–	725	–	725
Unit rights exercised for cash	–	2,723	–	2,723
Issued on corporate acquisition	–	1,144	–	1,144
Balance at December 31, 2005	–	71,644	12,673	84,317

10. INCOME TAXES

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

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

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

(\$ thousand)	2005	2004
Statutory income tax rate	38.86%	39.96%
Expected income taxes	16,958	13,289
Add (deduct) income tax effect of:		
Non-deductible Crown charges, net of Alberta Royalty Credit	5,058	4,928
Resource allowance	(5,062)	(4,438)
Rate adjustment	(1,674)	947
Cash distributions	(14,551)	(4,277)
Large corporation tax, capital taxes, and US income taxes	1,801	1,114
Other	(255)	(810)
	2,275	10,753

As at December 31, 2005, Zargon has exploration and development costs, unamortized petroleum and natural gas property expenditures, undepreciated capital costs and unamortized share issue costs available for deduction against future taxable earnings in aggregate of approximately \$90 million (2004 – \$79 million).

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

(\$ thousand)	2005	2004
Net book value of property and equipment in excess of tax pools	46,088	33,279
Deferred partnership earnings	10,178	14,153
Asset retirement obligation	(5,631)	(5,107)
Unrealized risk management liability	(1,319)	–
Share issue costs	(19)	(126)
Alberta Royalty Credit	(369)	(369)
	48,928	41,830

11. WEIGHTED AVERAGE NUMBER OF TOTAL UNITS

(thousand)	2005 (units)	2004 (units)
Basic	16,003	16,818
Diluted	18,848	18,723

Dilution amounts of 2.85 million units (2004 – 1.91 million) were added to the weighted average number of units outstanding during the year in the calculation of diluted per unit amounts. These unit additions represent the dilutive effect of unit rights according to the treasury stock method, and also include exchangeable shares using the “if-converted” method. An adjustment to the numerator amount was required in the diluted calculation to provide for the earnings of \$5.99 million (2004 – \$1.87 million) attributable to the non-controlling interest pertaining to the exchangeable shareholders.

12. FINANCIAL INSTRUMENTS**FAIR VALUE OF FINANCIAL ASSETS AND LIABILITIES**

Financial instruments of the Trust consist of accounts receivable, deposits, bank indebtedness, accounts payable, cash distributions payable, unrealized risk management liability and long term debt. As at December 31, 2005 and 2004, there are no significant differences between the carrying values of these amounts and their estimated market values.

CREDIT RISK MANAGEMENT

Accounts receivable include amounts receivable for petroleum and natural gas sales that are generally made to large credit-worthy purchasers, and amounts receivable from joint venture partners that are recoverable from production. Accordingly, the Trust views credit risks on these amounts as low. Of Zargon’s significant individual accounts receivable at December 31, 2005, approximately 32 percent was owing from one company (2004 – 28 percent).

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

INTEREST RATE RISK MANAGEMENT

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

FOREIGN CURRENCY RISK MANAGEMENT

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

COMMODITY PRICE RISK MANAGEMENT

The Trust is a party to certain financial instruments that have fixed the price of a portion of its oil and natural gas production. The Trust enters into these contracts for risk management purposes only, in order to protect a portion of its future cash flow from the volatility of oil and natural gas commodity prices. The Trust has outstanding contracts at December 31, 2005 as follows:

FINANCIAL CONTRACTS DESIGNATED AS HEDGES AT DECEMBER 31, 2005:

	Rate	Price	Range of Terms	Fair Market Value Gain/(Loss) (\$ thousand)
Oil collar	200 bbl/d	\$36.00 US/bbl Put \$48.40 US/bbl Call	Jan. 1/06–Jun. 30/06	(595)
Natural gas collar	3,000 gj/d	\$5.90/gj Put \$10.00/gj Call	Jan. 1/06–Mar. 31/06	(13)
Total Fair Market Value, Financial Contracts Designated as Hedges				(608)

FINANCIAL CONTRACTS NOT DESIGNATED AS HEDGES AT DECEMBER 31, 2005:

	Rate	Price	Range of Terms	Fair Market Value Gain/(Loss) (\$ thousand)
Oil swaps	200 bbl/d	\$48.50 US/bbl	Jan. 1/06–Jun. 30/06	(591)
	300 bbl/d	\$51.83 US/bbl	Jan. 1/06–Dec. 31/06	(1,447)
	200 bbl/d	\$51.12 US/bbl	Jul. 1/06–Dec. 31/06	(547)
Oil collars	200 bbl/d	\$40.00 US/bbl Put \$49.05 US/bbl Call	Jan. 1/06–Jun. 30/06	(568)
	200 bbl/d	\$52.00 US/bbl Put \$78.95 US/bbl Call	Jan. 1/06–Dec. 31/06	–
	200 bbl/d	\$55.00 US/bbl Put \$78.05 US/bbl Call	Jul. 1/06–Dec. 31/06	–
Natural gas swaps	1,000 gj/d	\$12.82/gj	Jan. 1/06–Mar. 31/06	249
	4,000 gj/d	\$9.31/gj	Apr. 1/06–Oct. 31/06	(501)
Natural gas collars	2,000 gj/d	\$6.50/gj Put \$8.80/gj Call	Jan. 1/06–Mar. 31/06	(225)
	2,000 gj/d	\$7.00/gj Put \$9.35/gj Call	Jan. 1/06–Mar. 31/06	(126)
	1,000 gj/d	\$9.50/gj Put \$12.50/gj Call	Nov. 1/06–Mar. 31/07	–
	1,000 gj/d	\$10.50/gj Put \$13.18/gj Call	Nov. 1/06–Mar. 31/07	–
Total Fair Market Value, Financial Contracts Not Designated as Hedges				(3,756)

PHYSICAL CONTRACTS AT DECEMBER 31, 2005:

	Rate	Price	Range of Terms	Fair Market Value Gain/(Loss) (\$ thousand)
Natural gas fixed price	4,000 gj/d	\$7.92/gj	Apr. 1/06–Oct. 31/06	(1,692)
Natural gas collars	1,000 gj/d	\$8.47/gj Put \$9.50/gj Call	Jan. 1/06–Mar. 31/06	(49)
	1,000 gj/d	\$8.50/gj Put \$12.85/gj Call	Nov. 1/06–Mar. 31/07	–
	1,000 gj/d	\$9.50/gj Put \$13.50/gj Call	Nov. 1/06–Mar. 31/07	–
Total Fair Market Value, Physical Contracts				(1,741)

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

Financial risk management contracts in place as at December 31, 2004 were designated as hedges for accounting purposes and the Trust continues to monitor these contracts in determining the continuation of hedge effectiveness. For these contracts, realized gains and losses are recorded in the statement of earnings as the contracts settle and no unrealized gain or loss is recognized. The realized losses for 2005 were \$7.75 million (2004 – \$4.57 million). At December 31, 2005, an additional \$0.61 million would have been required to settle the above designated hedge contracts which all related to financial hedges. At December 31, 2004, \$1.14 million would have been received to settle the designated hedge contracts, of this amount \$0.71 million related to financial hedges and \$0.43 million related to physical hedges. Contracts settled by way of physical delivery are recognized as part of the normal revenue stream. These instruments have no book values recorded in the consolidated financial statements.

For financial risk management contracts entered into after December 31, 2004, the Trust does consider these contracts to be effective on an economic basis but has decided not to designate these contracts as hedges for accounting purposes and accordingly, for outstanding contracts not designated as hedges, an unrealized gain or loss is recorded based on the fair value (mark-to-market) of the contracts at the period end. The unrealized losses as at December 31, 2005 were \$3.76 million (2004 – nil). These instruments have been recorded as a liability in the consolidated balance sheet.

13. COMMITMENTS

The Trust is committed to future minimum payments for natural gas transportation contracts in addition to operating leases for office space, office equipment, vehicles and field equipment. Payments required under these commitments for each of the next four years are: 2006 – \$1.44 million; 2007 – \$0.57 million; 2008 – \$0.07 million; 2009 – \$0.02 million.

14. CONTINGENCIES AND GUARANTEES

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

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

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

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

15. CHANGE IN NON-CASH WORKING CAPITAL

(\$ thousand)	Year ended December 31,	
	2005	2004
Changes in non-cash working capital items:		
Accounts receivable	(7,560)	(2,092)
Prepaid expenses and deposits	243	(1,973)
Accounts payable and accrued liabilities	6,417	4,876
Cash distributions payable	8,912	2,210
Other	(230)	(57)
	7,782	2,964
Changes relating to operating activities	(1,401)	19
Changes relating to financing activities	8,974	2,148
Changes relating to investing activities	209	797
	7,782	2,964

16. SUPPLEMENTAL CASH FLOW INFORMATION

(\$ thousand)	2005	2004
Cash interest and financing charges paid	1,044	448
Cash taxes paid	1,911	794

17. SEGMENTED INFORMATION

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

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

(\$ thousand)	2004		
	Canada	United States	Combined
Petroleum and natural gas revenue	108,484	15,484	123,968
Earnings before income taxes	27,614	5,641	33,255
Property and equipment, net	184,860	24,876	209,736
Total assets	200,171	26,793	226,964
Net capital expenditures	51,464	4,809	56,273

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

18. ACCUMULATED CASH DISTRIBUTIONS

During the year, the Trust paid or declared distributions to the unitholders in the aggregate amount of \$37.44 million (2004 – \$10.70 million) in accordance with the following schedule:

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

2004 Distributions	Record Date	Distribution Date	Per Trust Unit
August 2004	August 31, 2004	September 15, 2004	\$0.14
September 2004	September 30, 2004	October 15, 2004	\$0.14
October 2004	October 31, 2004	November 15, 2004	\$0.14
November 2004	November 30, 2004	December 15, 2004	\$0.14
December 2004	December 31, 2004	January 17, 2005	\$0.14

19. ZARGON ENERGY TRUST REORGANIZATION

In 2004, the following costs were incurred to reorganize Zargon Oil & Gas Ltd. into a trust effective July 15, 2004:

(\$ thousand)

Cash payout of stock options	7,875
Financial advisory, accounting and legal fees, and preparation and printing of the Information Circular	1,568
Total reorganization costs	9,443

Of the above amounts, \$2.71 million was charged to contributed surplus relating to recognized stock-based compensation under the previous stock option plan for the Company. The remaining \$6.73 million (\$6.24 million net of taxes) was charged directly against accumulated earnings.

20. RELATED PARTY TRANSACTIONS

Zargon paid \$0.13 million (2004 – \$0.15 million) in consulting fees to a company owned by the Chairman of the Board; \$0.04 million (2004 – \$0.05 million) for vehicle leases to a company owned by a Board member; and \$0.12 million (2004 – \$0.53 million) for legal services to a law firm in which a Board member is a partner. These payments were in the normal course of operations, on commercial terms, and therefore were recorded at the exchange amount.

21. COMPARATIVE FIGURES

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

SIX-YEAR SUMMARY

	2005	2004	2003	2002	2001	2000
FINANCIAL (\$ thousand, except per unit amounts)						
Petroleum and natural gas revenue	162,722	123,968	101,657	65,538	63,795	53,306
Less expenses – cash items						
Royalties (net of Alberta Royalty Credit)	37,319	28,047	22,508	13,508	14,222	10,716
Production	24,035	21,692	17,201	15,649	11,933	8,615
General and administrative	6,053	4,358	3,542	3,455	3,083	2,189
Realized risk management (gain)/loss	7,754	4,568	2,882	(669)	573	2,733
Interest and financing charges	786	440	771	1,100	957	1,269
Current and capital taxes	1,801	1,114	406	378	358	288
Cash flow from operations	84,974	63,749	54,347	32,117	32,669	27,496
Less expenses – non-cash items						
Depletion, depreciation and foreign exchange	37,283	26,850	19,363	14,148	11,067	7,061
Unrealized risk management loss	3,756	–	–	–	–	–
Future income tax	474	9,639	9,187	6,558	7,860	8,706
Accretion of asset retirement obligations	1,196	1,076	1,172	715	520	479
Unit-based compensation	902	3,682	264	–	–	–
Earnings before non-controlling interest	41,363	22,502	24,361	10,696	13,222	11,250
Less non-controlling interest						
– exchangeable shares	5,994	1,870	–	–	–	–
Net earnings	35,369	20,632	24,361	10,696	13,222	11,250
Per unit, diluted						
Cash flow from operations	4.51	3.40	2.96	1.81	2.03	1.86
Net earnings	2.19	1.20	1.33	0.60	0.82	0.76
Net capital expenditures	54,684	56,273	39,909	35,548	55,176	30,514
Cash distributions	37,444	10,702	–	–	–	–
Cash distributions (\$/trust unit)	2.32	0.70	–	–	–	–
Balance sheet at year end						
Property and equipment, net	253,315	209,736	167,888	147,404	124,020	78,030
Bank debt	10,339	14,230	6,978	25,279	24,137	15,902
Unitholders' equity	144,613	120,622	112,469	86,699	70,072	42,510
Unitholders' equity (\$/total units)	7.62	6.48	6.25	4.92	4.20	2.97
Year end total units outstanding (thousand)	18,988	18,610	17,992	17,637	16,666	14,315
OPERATING						
Total production (boe/d)	8,342	8,222	7,446	6,349	5,553	4,140
Oil and liquids (bbl/d)	3,697	3,416	3,287	2,968	2,441	1,725
Natural gas (mmcf/d)	27.87	28.84	24.95	20.29	18.67	14.49
Equivalent per million total units (boe/d)	445	447	418	368	357	287
Total proved reserves (mboe)	19,243	19,049	18,664	21,592	20,320	15,878
Proved oil and liquids (mdbl)	11,490	10,954	10,505	11,114	10,482	6,340
Proved natural gas (bcf)	46.52	48.57	48.96	62.87	59.03	57.23
Total proved and probable reserves (mboe)	26,771	25,955	24,745	23,983	22,859	18,343
Proved and probable oil and liquids (mdbl)	15,354	14,361	13,566	12,445	11,948	7,508
Proved and probable natural gas (bcf)	68.50	69.56	67.07	69.23	65.47	64.96
Equivalent per total unit (boe)	1.41	1.39	1.38	1.36	1.37	1.28
Average selling price before risk management gains or losses						
WTI crude oil price (\$US/bbl)	56.56	41.40	31.04	26.08	25.90	30.20
FOB Edmonton crude oil price (\$/bbl)	68.72	52.54	43.14	39.94	39.18	44.33
Zargon field oil and liquids price (\$/bbl)	57.15	45.37	36.66	34.45	31.86	40.73
NYMEX Henry Hub average spot natural gas price (\$US/mmbtu)	8.89	5.90	5.49	3.35	3.94	4.31
Alberta AECO average spot natural gas price (\$/mmbtu)	8.77	6.55	6.70	4.18	5.43	5.60
Zargon field natural gas price (\$/mcf)	8.41	6.37	6.33	3.81	5.19	5.20
Other data						
Wells drilled, net	53.5	49.5	38.6	31.6	47.7	38.6
Undeveloped land (thousand net acres)	367	376	398	331	241	213
Closing trust unit price (\$/unit)	31.75	23.85	13.50	9.00	7.20	4.45

NOTES:

Throughout this summary, the calculation of barrels of oil equivalent (boe) is based on the conversion ratio that six thousand cubic feet of natural gas is equivalent to one barrel of oil.

Cash flow from operations is a non-GAAP term that represents net earnings except for non-cash items. For a further discussion about this term, refer to page 29 of the report.

For net capital expenditures, amounts include capital expenditures acquired for cash and equity issuances.

Cash distributions to unitholders commenced subsequent to the reorganization of the Company into a Trust effective July 15, 2004.

Total units outstanding include trust units plus exchangeable shares outstanding at period end. The exchangeable shares are converted at the exchange ratio at the end of the period.

Average daily production per million units is calculated using the weighted average number of units outstanding during the period plus the weighted average number of exchangeable shares outstanding for the period converted at the average exchange ratio for the period.

In this table the established reserves (proved plus 50 percent probable) for the prior years (2000-2002) are used as a comparison to 2003, 2004 and 2005 proved and probable reserves. This adjustment is necessary due to the change in reserve risk assessments required to comply with NI 51-101 reserve guidelines.

Certain comparative period numbers reflect retroactive restatement due to a change in accounting policy.

CORPORATE INFORMATION

BOARD OF DIRECTORS

Craig H. Hansen
Calgary, Alberta

K. James Harrison^{(3) (4)}
Oakville, Ontario

H. Earl Joudrie⁽³⁾
Toronto, Ontario

Kyle D. Kitagawa⁽¹⁾
Calgary, Alberta

James J. Lawson⁽³⁾
Oakville, Ontario

John O. McCutcheon
Chairman of the Board
Vancouver, British Columbia

Jim Peplinski^{(2) (4)}
Calgary, Alberta

J. Graham Weir^{(1) (2)}
Calgary, Alberta

William J. Whelan^{(1) (4)}
Calgary, Alberta

Grant A. Zawalsky^{(2) (3)}
Calgary, Alberta

OFFICERS

Craig H. Hansen
President and Chief Executive Officer

Brent C. Heagy
Vice President, Finance and Chief Financial Officer

Mark I. Lake
Vice President, Exploration

Daniel A. Roulston
Executive Vice President, Operations

Sheila A. Wares
Vice President, Accounting

Kenneth W. Young
Vice President, Land

1 Audit Committee

2 Reserves Committee

3 Governance and Nominating Committee

4 Compensation Committee

STOCK EXCHANGE LISTING

The Toronto Stock Exchange

Zargon Energy Trust
Trust Units

Trading Symbol: ZAR.UN

Zargon Oil & Gas Ltd.
Exchangeable Shares

Trading Symbol: ZOG.B

TRANSFER AGENT

Valiant Trust Company
310, 606 - 4th Street S.W.
Calgary, Alberta T2P 1T1

BANKER

The Toronto Dominion Bank
910, 333 - 7th Avenue S.W.
Calgary, Alberta T2P 2Z1

LEGAL COUNSEL

Burnet, Duckworth & Palmer LLP
1400, 350 - 7th Avenue S.W.
Calgary, Alberta T2P 3N9

CONSULTING ENGINEERS

McDaniel & Associates Consultants Ltd.
2220, 255 - 5th Avenue S.W.
Calgary, Alberta T2P 3G6

AUDITORS

Ernst & Young LLP
1000, 440 - 2nd Avenue S.W.
Calgary, Alberta T2P 5E9

HEAD OFFICE

700, 333 - 5th Avenue S.W.
Calgary, Alberta T2P 3B6
Telephone: (403) 264-9992
Fax: (403) 265-3026
Email: zargon@zargon.ca

WEBSITE

www.zargon.ca

ANNUAL MEETING

The annual meeting of the Unitholders of Zargon Energy Trust will be held on Thursday, April 27, 2006 at 2:00 pm (Calgary time) in the Grand Lecture Theatre of the Metropolitan Conference Centre, 333 - 4th Avenue S.W., Calgary, Alberta.