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1992 – 2001 TEN YEARS CREATING **VALUE**

ZARGON
O I L & G A S L T D .

ANNUAL REPORT 2001

01

CORPORATE PROFILE

Zargon Oil & Gas Ltd. is a junior oil and natural gas exploration, development and production company headquartered in Calgary, Alberta and operating in the Canadian provinces of Alberta, Saskatchewan and Manitoba and in North Dakota, USA. Throughout its ten-year history, Zargon has adhered to a disciplined "value seeking" approach which has delivered 40 consecutive quarters of positive earnings (33 quarters as a public company), a weighted average 17.3 percent return on equity and a per share compounded proven reserve and production growth rate of 18 percent per year. Zargon's common shares trade on the Toronto Stock Exchange under the symbol "ZAR".

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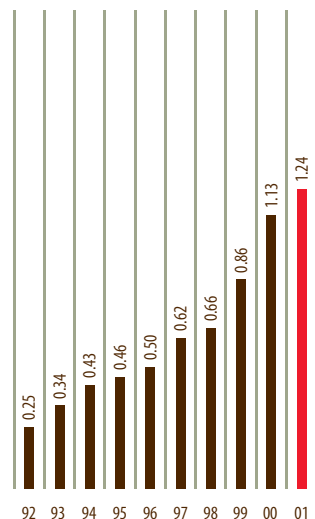
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ANNUAL MEETING

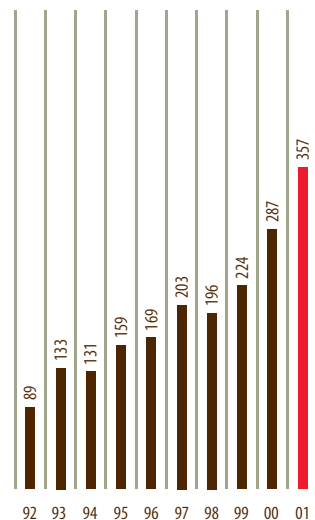
The Annual General and Special Meeting of Shareholders will be held on Thursday, May 16, 2002 at 3:00 p.m. in the McMurray Room at the Calgary Petroleum Club, 319 5th Avenue S.W., Calgary, Alberta. Shareholders are encouraged to attend.

**CORPORATE
HIGHLIGHTS**

Proven Reserves Per Share
(boe/share 6:1)



Production Per Share
(boe/d per million shares 6:1)



FINANCIAL (\$ million, except per share amounts)

INCOME AND INVESTMENTS

	2001	2000	Percent Change
Production revenue	63.80	53.31	20
Cash flow from operations	32.67	27.50	19
Earnings	13.14	11.26	17
Net capital expenditures	55.18	30.51	81

BALANCE SHEET AT YEAR-END

	2001	2000	Percent Change
Property and equipment	118.99	74.39	60
Long-term debt	24.14	15.90	52
Shareholders' equity	69.99	42.52	65
Common shares outstanding (million)	16.67	14.32	16

PER COMMON SHARE, DILUTED

	2001	2000	Percent Change
Cash flow from operations (\$/share)	2.03	1.86 *	9
Earnings (\$/share)	0.82	0.76 *	8

* Restated using the treasury stock method

OPERATING

AVERAGE DAILY PRODUCTION

	2001	2000	Percent Change
Crude oil and liquids (bbl/d)	2,441	1,725	42
Natural gas (mmcf/d)	18.67	14.49	29
Equivalents (boe/d 6:1)	5,553	4,140	34
Equivalents (boe/d 10:1)	4,308	3,174	36

AVERAGE SELLING PRICE (before hedges)

	2001	2000	Percent Change
Crude oil and liquids (\$/bbl)	31.86	40.73	(22)
Natural gas (\$/mcf)	5.19	5.20	(0)

PROVEN RESERVES (year-end)

	2001	2000	Percent Change
Crude oil and liquids (mmbbl)	10,482	6,340	65
Natural gas (bcf)	60.74	59.16	3
Equivalents (mboe 6:1)	20,605	16,199	27
Equivalents (mboe 10:1)	16,556	12,256	35

WELLS DRILLED, NET

	2001	2000	Percent Change
	47.7	38.6	24

UNDEVELOPED LAND (thousand net acres)

	2001	2000	Percent Change
	241	213	13

PER MILLION COMMON SHARES (year average)

	2001	2000	Percent Change
Production (boe/d 6:1)	357	287	24
Production (boe/d 10:1)	277	220	26

PER COMMON SHARE (year-end)

	2001	2000	Percent Change
Proven reserves (mboe 6:1)	1.24	1.13	10
Proven reserves (mboe 10:1)	0.99	0.86	15

President's Message

TEN YEARS OF CREATING VALUE

In 2001, Zargon celebrated both its tenth year of operations and a decade of strong consistent growth. Zargon monitors its progress by measuring four key parameters on a per share basis: proven reserves, production, cash flow and earnings. Using these parameters, our aggregate per share compounded growth rate is 27 percent over our 10-year history. Using only the fundamental parameters of proven reserves and production, both non-financial and non-price dependent, Zargon has averaged 18 percent per share growth per year. In recent years, even with a larger base, our rate of growth has not slowed appreciably. Over the last five years the per share parameters of proven reserves and production have shown a 17 percent compounded rate of growth. During its history, Zargon has posted positive earnings for 40 consecutive quarters, the last 33 quarters as a public entity. Also, the dollar weighted average return on equity over this period has exceeded 17 percent per year.



The management team at Zargon Oil and Gas Ltd. and the years they joined the company (left to right): Craig Hansen 1992, Yves Gauthier 1997, Sheila Wares 1992, Dan Roulston 1993, Mark Lake 1998, John McCutcheon 1988, Ken Young 1995.

Time-line

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Zargon Oil & Gas Ltd., a private company, amalgamated with two other private companies, Fairhill Oil Ltd. and Rubair Oil Ltd., and purchased the oil and gas assets of a third company in January 1992. In 1992, production averaged 256 bbl/d and 0.63 mmcf/d.

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Zargon purchased oil and gas assets and undeveloped land in East Central Alberta. In October 1993, Zargon went public, issuing 2.3 million shares at \$1.50 per share to raise \$3.5 million. In 1993, production averaged 426 bbl/d and 2.07mmcf/d.

POLICIES AND STRATEGIES

These solid 10-year results have been generated by adhering to a set of consistent business principles through all phases of the commodity price cycle. We have followed a clearly defined strategy characterized by financial discipline with exploration and operational expertise, implemented by a talented, focused staff.

In every phase of our industry's business cycle, two distinct yet complementary skills facilitate this growth – the efficient exploitation of oil properties, combined with the exploration for natural gas. From our inception, Zargon has been skilled at the efficient exploitation of oil properties. We start by identifying and acquiring properties with a large oil-in-place, and then we deploy improved recovery techniques or geologically driven exploitation concepts to develop additional reserves. To fully exploit each property and reduce risk, we combine seismic, geological, reservoir engineering and production engineering techniques. The resource inputs for our oil exploitation business are the acquisition of existing properties characterized by a large inventory of underdeveloped oil-in-place. Zargon's oil exploitation activities are currently focused in Southeast Saskatchewan and North Dakota.

Since 1998, we have broadened our capabilities to explore for shallow and medium depth natural gas reservoirs based on seismic, geological, and occasionally reservoir engineering concepts. Our strategy is to acquire large contiguous land blocks with multi-zone potential and reduce exploration risk by applying advanced seismic and detailed geological mapping. The resource inputs for our gas exploration business are seismically or geologically prospective undeveloped lands, preferably in areas where we control gas facilities. Our gas exploration and development activities have been centered in East Central Alberta, with selected gas exploration initiatives occurring in West Central Alberta.

On every project we apply our team's intellectual capital to reduce exploitation and exploration risk. Our multi-disciplined approach brings together geophysicists, geologists, engineers and land negotiators, whose collective goal is to lower finding and development costs. We also concentrate on improving the cash flow derived from existing properties by reducing costs. By increasing the ratio of corporate cash flows versus the cost of finding the reserves, we improve our recycle ratio, which ultimately enhances our financial returns.

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Zargon acquired oil assets in the Moose Valley and Frys areas of Southeast Saskatchewan and began an oil exploration and exploitation program. Zargon's first waterflood was implemented. In 1994, production averaged 616 bbl/d and 2.26 mmcf/d.

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Drilling successes were achieved at Moose Valley and Frys, Saskatchewan. Exploitable oil assets were purchased at Joarcam in East Central Alberta. A private placement of 1.0 million shares was made for \$1.55 million. In 1995, production averaged 885 bbl/d and 2.77 mmcf/d.

We have primarily used cash flow and debt to fund our growth internally. Because Zargon carries only a moderate level of debt and maintains a conservative balance sheet, we have the flexibility to capture opportunities as they arise. We supplement our capital funding and manage debt levels by selective equity issues or by periodically disposing of non-core assets, as well as mature assets with limited growth potential.

Finally, we attempt to employ the dynamics of the commodity price cycle in order to improve our returns. We believe that over time, market supply and demand conditions force oil and gas prices to revert to a mean price. We also have seen that over a longer term, oil and gas prices are strongly correlated. For this reason, we take a disciplined counter-cyclical approach to our business. This philosophical position translates into a strategy of acquiring the paramount resource inputs of underdeveloped oil properties and undeveloped lands when commodity prices are low and industry's enthusiasm is muted. During high price periods, assets are harvested through the disposition of fully developed properties or through accelerated development drilling programs designed to maximize production coincidentally with the improved field netbacks.

2001 KEY ACHIEVEMENTS

Calendar 2001 was a solid year for Zargon with all operating and financial parameters reaching new historical levels. Our revenue increased by 20 percent, cash flow by 19 percent, earnings by 17 percent, production by 34 percent and proven reserves by 27 percent compared to 2000.

The year's most significant capital activity was the Herc corporate acquisition. The transaction brought 961 barrels per day of oil production and 3.92 million barrels of proven oil reserves to Zargon for a property and equipment cost of \$23.39 million. Additional benefits from the transaction included tax planning opportunities, substantial oil exploitation upsides and the development of a new operating platform in North Dakota that has similar geological characteristics to our adjacent Southeast Saskatchewan exploitation properties.

Industry's enthusiasm for property acquisitions provided Zargon the opportunity to streamline its asset base by selling non-strategic assets at attractive prices. In total, eight transactions were concluded, for \$4.23 million in cash.

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Southeast Saskatchewan exploitation and exploration programs were advanced, and initial interests were acquired in the Jarrow gas property in East Central Alberta. Zargon's operated gas exploration and development activity

commenced. Zargon issued 1.9 million special warrants at \$2.25 per share to raise \$4.3 million. In 1996, production averaged 1,012 bbl/d and 3.70 mmcf/d.

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Zargon increased ownership in several Southeast Saskatchewan properties and acquired the remaining interests in Hamilton Lake. Interests were acquired in 50 sections of land adjacent to Jarrow. In July 1997, Zargon purchased Oasis Energy Ltd. for

A June equity issue placed 2.0 million shares with institutional investors at a price of \$7.05 per share. The issue restored our balance sheet strength following the Herc acquisition, permitting a more aggressive capital program in 2002 when resource inputs may be more favorably priced.

Despite these very strong corporate growth achievements, the year also provided challenges. Very high oil and natural gas prices experienced in the winter of 2000-01 melted away with the inevitable cycle of commodity prices. By fourth quarter 2001, Zargon's oil and natural gas field prices had dropped 47 and 63 percent respectively from the previous year's fourth quarter prices. The robust price conditions in the first half of the year inflated the cost of the resource inputs for our business, with undeveloped land, properties and field service prices reaching unprecedented levels. Zargon and our peers were challenged by this inflated environment to provide value-added growth at reasonable cost. By year-end some were finding that capital activities that had appeared justifiable in the high price environment were showing disappointing financial returns.

Zargon, however, responded well to last year's cost challenges. Our proven finding and development cost of \$8.58 per barrel of equivalent (6:1) (or \$9.40 per barrel of equivalent (10:1)) exceeded our targets, but compared favorably with our peers. Although these costs were substantially higher than our historical average and about 20 percent higher than desired, the year's capital program provided very substantial gains in expanding our inventory of long-life exploitable oil properties.

2001 OPERATING HIGHLIGHTS

Including the Herc transaction, Zargon concluded a record \$55.18 million capital program in 2001. Operating highlights included:

- A 42 percent increase in oil production to 2,441 barrels per day with fourth quarter production averaging 2,876 barrels per day.
- A 29 percent increase in gas production to 18.67 million cubic feet per day. The majority of these gains came in the East Central Alberta Jarrow property.
- A 565 percent replacement rate of oil production with proven oil and liquid reserve additions totaling 5.03 million barrels.
- A 123 percent replacement rate of gas production with proven gas reserve additions totaling 8.40 billion cubic feet.
- A 13 percent increase in Zargon's undeveloped land inventory to 241 thousand net acres. Despite very expensive land costs during the first half of the year, costs subsided substantially by the fourth quarter and Zargon was able to commence the restocking of our undeveloped land inventory at reasonable prices.

\$3.5 million in cash and shares, gaining production, undeveloped land in West Central Alberta and tax planning opportunities. In 1997, production averaged 1,385 bbl/d and 6.36 mmcf/d.

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Jarrow's exploration, development and land purchase programs were expanded. Oil and gas assets were acquired from a private company; primarily medium gravity oil properties at Taber, for \$4.4 million. Zargon issued

1.8 million special warrants at \$2.90 per share raising \$5.2 million. New senior exploration staff were added to support gas exploration and development programs. In 1998, production averaged 1,508 bbl/d and 6.33 mmcf/d.

- To harvest benefits from the high price environment that existed during the first three quarters of the year, Zargon carried out a record drilling program drilling 47.7 net wells, an increase of 24 percent over the 38.6 net wells drilled in 2000. The program resulted in 22.7 net gas wells, 11.1 net oil wells and 13.9 net dry holes for a success ratio of 71 percent.

2001 FINANCIAL HIGHLIGHTS

Substantially higher oil production volumes and improved gas production volumes, more than offset lower oil prices to provide Zargon solid growth in revenue, cash flow and earnings. Financial highlights in 2001 include:

- Cash flow from operations increased by 19 percent to \$32.7 million, and by 9 percent to \$2.03 per diluted share.
- Earnings increased by 17 percent to \$13.1 million, and by 8 percent to \$0.82 per diluted share.
- Zargon's after tax return on equity averaged 23 percent in 2001.
- Zargon's record 2001 capital program of \$55.2 million was financed from cash flows, equity and debt. Despite this very large program, our Company's year-end debt and working capital deficiency of \$27.6 million is equivalent to only 10 months of 2001 cash flow.

OUTLOOK

Zargon enters 2002 in a strong position. The inflated input costs of 2001 have subsided, yet commodity prices are at very acceptable levels. Our strong balance sheet provides the flexibility to capture value opportunities if and when they become available.

The Company is budgeting a \$35 million capital program for 2002. The program will de-emphasize exploitation and development drilling programs focused on production growth, in order to redirect capital to gas exploration and property acquisition opportunities focused on building gas lands and oil project inventories. The capital budget provides for the drilling of 25 net wells. We anticipate that capital expenditures may well exceed cash flows in 2002, and that the balance of these expenditures will be funded from debt. This aggressive capital program comes from our conviction that in this cyclical business it is essential to capture opportunities for building resources at reasonable prices when they are available.

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Zargon increased its emphasis on gas-related projects, spending \$14.7 million or 87 percent of its capital budget on land acquisition, seismic, drilling and infrastructure. A total of 24 gross (18.8 net) wells were

drilled. Field activities were focused on the Jarrow gas property. In 1999, production averaged 1,711 bbl/d and 9.15 mmcf/d.

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Significant gains in production and reserves were obtained with capital expenditures of \$30.5 million funded primarily from cash flow. A total of 50 gross (38.6 net) wells were drilled with a focus on gas

In 1999 and 2000, Zargon focused on growing its gas business. In 2001, we had planned on a balanced oil and gas capital allocation, but relative valuations forced our attention to our oil exploitation business. In 2002, we plan to emphasize gas resource exploration opportunities in the form of Crown land purchases, industry farm-ins and possibly property purchases. Gas drilling will emphasize exploration in West Central Alberta and East Central Alberta, while corporate gas production volumes are maintained with the ongoing development of the East Central Alberta Jarrow property. Zargon's large inventory of oil exploitation projects in our Southeast Saskatchewan / North Dakota core area will provide steady production gains throughout this year and next.

As we reflect on our 10 years in operation, we are struck by the intensity and frequency of our industry's price and cost cycles. By responding to these cyclic challenges with a disciplined approach founded on the long-term goal of value appreciation, we have delivered consistent solid compounded growth rates and strong equity returns over this rather chaotic period.

We are well positioned for the future. Our substantial undeveloped gas exploration land inventory and large oil exploitation project inventory provide a broad base for growth. Over the years we have successfully expanded and enhanced our technical expertise with quality staff. Finally, our strong balance sheet provides us the financial resources to capture opportunities as they are presented. We believe that the successful combination of resource capital, intellectual capital and financial capital will power Zargon's drive for strong, efficient growth and attractive returns well into the future.

ACKNOWLEDGEMENTS

We are grateful for the confidence in Zargon by our shareholders and we will continue to do our best to reward this trust. Our overriding objective is to enhance the value of your investment while minimizing the risk to its integrity. We acknowledge with pleasure the support and counsel of our Board of Directors and we enjoy and share the commitment of our staff, consultants and advisors to Zargon's growth and prosperity.

Respectfully submitted,

(Signed)

C.H.Hansen

President and Chief Executive Officer

March 17, 2002

exploration and development. In 2000, production averaged 1,725 bbl/d and 14.49 mmcf/d, with the majority of the gas production growth occurring at Jarrow.

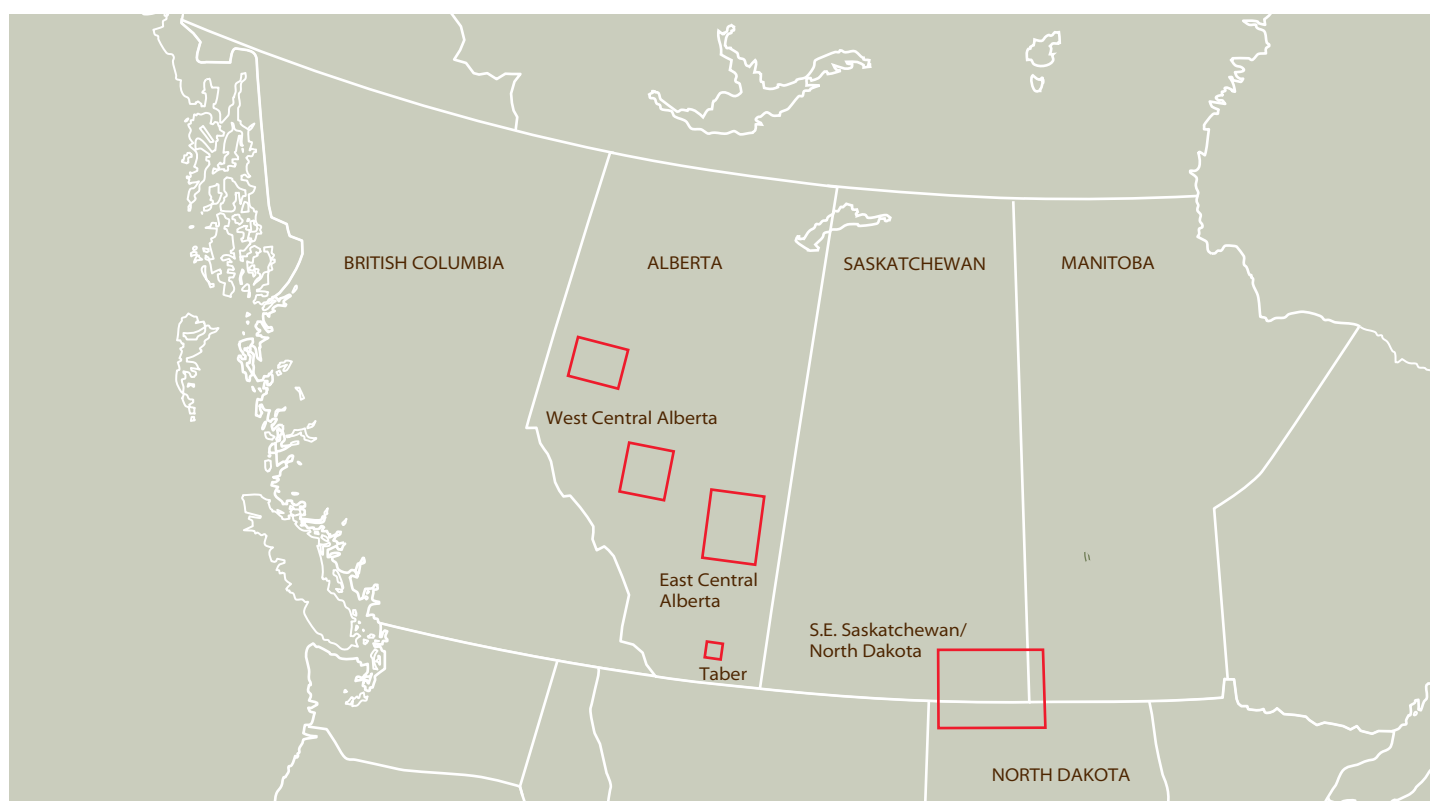
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Zargon moved its focus to oil exploitation as gas lands and properties reached excessive price levels. Zargon acquired Herc Oil Corp., a private company, for a property and equipment cost of \$23.39 million. Capital expenditures

totaled \$55.2 million. Zargon issued 2.0 million special warrants at \$7.05 per share for gross proceeds of \$14.1 million. In 2001, production averaged 2,441 bbl/d and 18.67 mmcf/d.

Looking Forward

Major Properties



Zargon's operations are divided into four main regions of exploration and development activity. The Company's gas production is located in the East Central Alberta and West Central Alberta core areas, while oil production is concentrated in the Southeast Saskatchewan / North Dakota and Taber, Alberta core areas. The diverse geology and type of hydrocarbons or reservoirs represented by these areas provide Zargon a balanced inventory of natural gas and oil projects. Despite their diversity, each area has the common characteristics of providing all-season shallow or medium depth drilling opportunities, which can be captured by employing Zargon's seismic, detailed geological analysis, reservoir engineering, and production skills.

During 2001, Zargon emphasized its oil exploitation business, allocating \$41.06 million or 74 percent of the total capital budget to oil related acquisitions and drilling. The largest expenditure totaling \$28.41 million was for corporate and property acquisitions of Southeast Saskatchewan / North Dakota long-life exploitable oil assets. Expenditures on gas exploration and exploitation operations totaled \$14.12 million and were primarily concentrated on seismic and drilling programs at the East Central Alberta property at Jarrow.

Zargon's Southeast Saskatchewan oil activities were expanded in 2001 to include two adjacent counties located in the northernmost portion of North Dakota. Although located in a different country, the geology and reservoir characteristics in this area are completely analogous to our existing properties in Southeast Saskatchewan. This expanded core area continues to be characterized by light and medium gravity oil pools with a large oil-in-place resource that frequently remains underdeveloped. Through a combination of seismic, detailed geology and reservoir engineering Zargon will continue to unlock substantial exploitation opportunities to increase oil recovery factors and ultimately increase the remaining oil reserves on these properties.

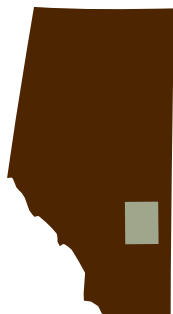
Gas activities in 2001 continued to be focused on exploration and development opportunities in East Central Alberta and to a lesser extent exploration projects in West Central Alberta. Risk is reduced on Zargon's multi-zone gas projects through the use of extensive 2-D seismic programs, reservoir engineering concepts and detailed stratigraphic geological analysis. Building large contiguous Company operated land blocks, complemented by Zargon's ownership in area gas gathering and processing facilities, enhances the gas exploration and development results.

Zargon's 2002 capital programs will focus on building or expanding gas resources and opportunities in the East Central Alberta and West Central Alberta core areas. Oil expenditures will emphasize the exploitation of Zargon's large oil-in-place asset in the Southeast Saskatchewan / North Dakota core area through waterflood implementations and vertical or horizontal drilling.

2001 CORE AREA STATISTICAL SUMMARY

	Average Production		December 31, 2001 Proven Reserves		December 31, 2001 Net Undeveloped Land			1999 – 2001 Total Capital Program	1999 – 2001 Proven Finding & Development Cost
	(boe/d 6:1)	(Annual % change)	(mboe 6:1)	(Annual % change)	(thousand acres)	(Annual % change)	(Zargon Operated %)	(\$million)	(\$/boe 6:1)
East Central Alberta	3,060	24	8,861	(4)	161.2	(2)	96	37.94	5.45
Southeast Saskatchewan	1,611	63	8,473	104	28.6	10	90	43.23	6.42
Taber, Alberta	398	112	1,154	21	12.5	212	100	12.86	16.34
West Central Alberta & Other	484	0	2,117	11	38.4	112	46	8.61	7.67
Total	5,553	34	20,605	27	240.7	13	91	102.64	6.58

EAST CENTRAL ALBERTA



The East Central Alberta core area is Zargon's most important producing region, accounting for 55 percent of total production, 43 percent of total proven reserves, and 67 percent of undeveloped lands. This core area provided 88 percent of Zargon's gas production in 2001 and will continue to provide the majority of Zargon's gas production for both the short and medium terms. The East Central Alberta properties are characterized by shallow multi-zone Cretaceous sands, located at depths from 700 to 1,200 meters, with sweet natural gas and light/medium oil reserves.

Following two very active years in East Central Alberta, Zargon reduced its 2001 capital allocation to this core area to 18 percent of its total capital budget. Essentially all the \$9.97 million of this core area's 2001 expenditures were focused on the exploration and development of gas reserves at the Jarrow property. During the year, the core area's average gas production rose by 33 percent to 16.45 million cubic feet per day. Year-end proven reserves remained steady at 49.35 billion cubic feet.

Jarrow is by far the Company's largest property in East Central Alberta and its exploration and development has been a very successful operation for Zargon. Since 1997 Zargon's net Jarrow production has increased nine-fold from 1.50 million cubic feet per day to 13.65 million cubic feet per day. Total capital spent on the property in the four year period of \$37.01 million added 42.09 billion cubic feet of natural gas reserves at an average finding and development cost of \$0.88 per thousand cubic feet. Zargon commenced this property's development with undeveloped land and property acquisitions in 1998 and 1999 followed by aggressive drilling programs in 2000 and 2001. In total more than 45 net gas wells and 12 net dry holes were drilled on this property in this four-year period. At year-end 2001, Zargon has inventoried approximately 18 gross (15 net) seismically defined exploration and development drilling locations, which will be drilled over the next 18 months. It is anticipated that these wells, along with various tie-ins and recompletions will maintain Zargon's net production from Jarrow at the current levels of 15 million cubic feet per day until mid 2003.

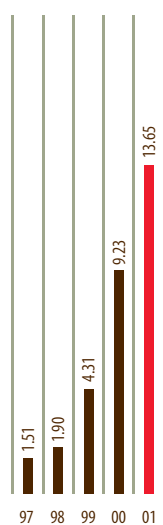
2001 ACTIVITIES

- Shot 177 kilometers of 2-D seismic in six separate programs.
- Purchased 12,410 net acres (19.4 sections) at Crown sales at an average cost of \$58 per acre.
- Drilled 35 gross wells resulting in 19.7 net gas wells and 8.9 net dry holes. Twenty three (21.4 net) of these wells were earning wells related to industry farm-ins.
- Constructed 37.8 kilometers of gathering system, tying-in 23 gross (21.1 net) gas wells into existing gathering systems.
- Added 450 horsepower of incremental compression at the 6-17-45-10 W4 Jarrow compressor station. Installed 95 horsepower of Jarrow field compression.
- During the first half of the year, sold three non-strategic, non-operated gas properties at Penhold, Hamilton Lake South and Hudson. Also, traded the operated East Central Alberta Joarcam oil property for longer-life exploitable Southeast Saskatchewan oil properties.

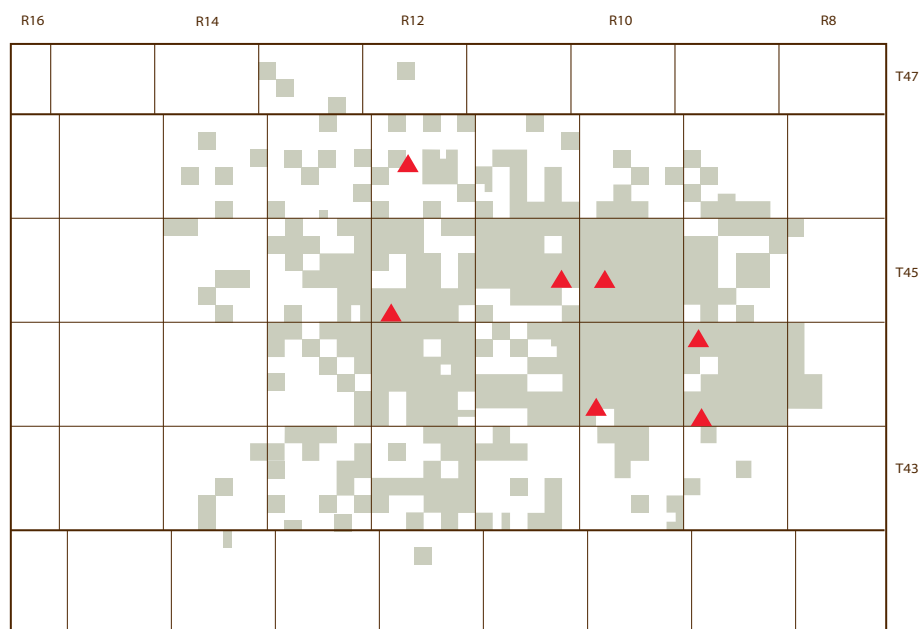
2002 PLANS

- Continue with 2-D seismic programs to identify gas exploration or development targets on existing properties.
- Drill approximately 15 gross (12 net) gas exploration or development locations, primarily at the Jarrow property.
- Continue rework, recompletion and tie-in activities to optimize the existing resource base.
- Continue an on-going program of tying-in shut-in Jarrow gas volumes pertaining to recent successful drilling programs. Enhance existing gas facilities through the addition of incremental field compression.
- Through property and undeveloped land acquisitions, expand existing Jarrow operations. Apply the successful Jarrow technical models to build and develop new East Central Alberta projects through property acquisitions.

Jarrow Net Gas Production (mmcf/d)



Jarrow Property (119.5 thousand net Zargon undeveloped acres)



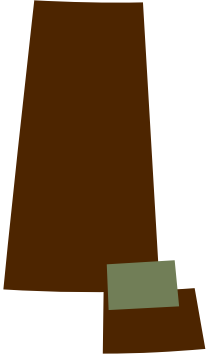
▲ Zargon Facilities
 ■ Zargon Lands

With volume additions from this winter's drilling program, Zargon's East Central Alberta production will average approximately 17.5 million cubic feet of natural gas per day and 250 barrels of oil per day in the first quarter of 2002. It is anticipated that field activities at existing properties will maintain this production rate for the next few quarters. Incremental production gains in the East Central Alberta core area will be dependent on the success of our new property acquisition initiatives.

EAST CENTRAL ALBERTA

	2001	2000	1999
AVERAGE PRODUCTION			
Oil (bbl/d)	318	406	502
Natural gas (mmcf/d)	16.45	12.41	7.54
TOTAL PROVEN RESERVES			
Oil (m bbl)	635	923	995
Natural gas (bcf)	49.35	49.57	32.52
TOTAL PROVEN & PROBABLE RESERVES			
Oil (m bbl)	793	1,185	1,235
Natural gas (bcf)	59.79	63.11	41.59
UNDEVELOPED LANDS			
Net acres (thousand)	161.2	165.1	116.7
DRILLING ACTIVITY			
Net wells	28.6	23.5	10.1
CAPITAL EXPENDITURES (\$ million)			
Net property acquisitions	(5.93)	2.08	2.08
Undeveloped land, seismic, geological	3.65	3.51	4.93
Drilling, completion, equipping and facilities	12.25	9.75	5.52
Total expenditures	9.97	15.34	12.53

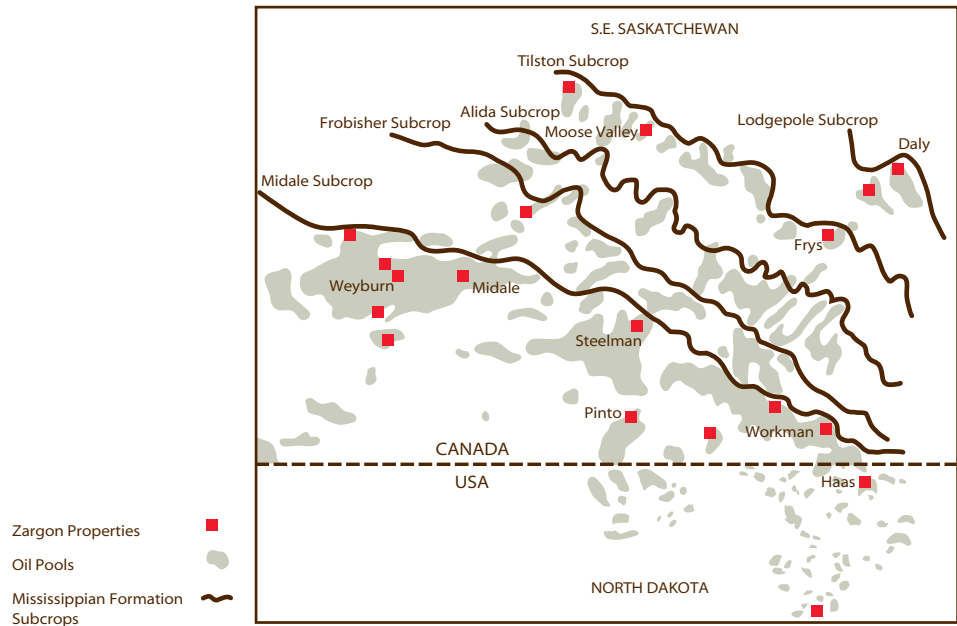
SOUTHEAST
SASKATCHEWAN /
NORTH DAKOTA



Zargon's Southeast Saskatchewan / North Dakota core area remains its most important oil region, and provides a solid base for the Company. The core area represented 72 percent of the Company's oil production in the fourth quarter of 2001 and 79 percent of the Company's year-end total proven oil reserves. This core area is situated in the southeast corner of Saskatchewan, the very northern portion of the state of North Dakota and in the adjacent extreme southwest corner of Manitoba. Although Zargon's properties are situated in two provinces and one state, all of the properties are located within a seventy mile radius and have essentially identical reservoir and geological characteristics with light and medium oil reserves produced from Mississippian carbonate reservoirs at depths ranging from 950 to 1,500 meters. The area's complex geology offers significant reservoir and/or geological related exploitation opportunities. Zargon's business plan for the area is defined by disciplined property acquisitions to establish a core position and obtain property operatorship. Then reservoir/geological related optimizations and/or modifications are implemented to increase reserves/production or improve profitability. These operations include seismic pool delineation, vertical and horizontal exploitation drilling, waterflood modifications, waterflood implementations and battery consolidations. The Company has an inventory of eleven waterflood and five exploitation projects currently in progress. These projects, which are at various stages of implementation, provide a reliable and growing reserve and production base for the Company.

In 2001, Zargon focused on this core area spending \$32.88 million, a 316 percent increase over the prior year's expenditures. Approximately 86 percent, or \$28.41 million of these expenditures related to the acquisition of exploitable oil properties. Zargon's proven reserves and average production in the Southeast Saskatchewan core area increased 105 and 61 percent respectively during the year, to 8.32 million barrels of oil and 1,569 barrels of oil per day.

Zargon is budgeting an active year in 2002 for Southeast Saskatchewan / North Dakota. Expenditures will emphasize the development of Zargon's considerable inventory of exploitation opportunities.



2001 ACTIVITIES

- Shot 15 square kilometers of 3-D and 9 kilometers of 2-D seismic to assist in the development of the Weyburn (Elswick), Saskatchewan property.
- Purchased 6,400 net acres (10 sections) at Saskatchewan Crown sales at an average cost of \$153 per acre.
- Drilled three (2.0 net) horizontal development oil wells at Weyburn (Elswick), Saskatchewan and drilled a wholly owned vertical development well at Pinto (Elcott), Saskatchewan.
- Acquired Herc Oil Corp., a private company that brought 961 barrels per day of North Dakota and Southeast Saskatchewan production for \$23.56 million (cash and the assumption of net debt). Prior to year-end disposed of three of the higher operating cost Herc acquired Saskatchewan properties for \$0.72 million.
- Concluded four property purchases or swap acquisitions, relating to the expansion of Zargon's interests in long-life, shallow-decline exploitation projects at Steelman, Weyburn and Midale.

2002 PLANS

- Expand exploitation drilling operations with wells at Pinto, Weyburn, Workman and other areas.
- Implement an expanded waterflood project at the Haas, North Dakota property.
- Enhance, initiate or modify Southeast Saskatchewan waterfloods at Steelman, Frys and Weyburn.
- Pursue Southeast Saskatchewan property acquisitions in order to continue to build our inventory of exploitable oil projects.
- Expand on the Haas, North Dakota operating platform to build exploitation drilling and waterflood opportunities.

Including the acquired Herc North Dakota properties; production from this core area is expected to average 2,100 barrels per day and 0.35 million cubic feet per day in the first quarter of 2002. It is anticipated that production will climb gradually throughout the year, as volumes from horizontal and vertical exploitation drilling more than offset the area's shallow production declines.

SOUTHEAST SASKATCHEWAN/NORTH DAKOTA

	2001	2000	1999
AVERAGE PRODUCTION			
Oil (bbl/d)	1,569	971	818
Natural gas (mmcf/d)	0.25	0.09	0.09
TOTAL PROVEN RESERVES			
Oil (mbl)	8,323	4,065	3,248
Natural gas (bcf)	0.89	0.49	0.26
TOTAL PROVEN & PROBABLE RESERVES			
Oil (mbl)	10,350	5,460	4,456
Natural gas (bcf)	1.09	0.65	0.36
UNDEVELOPED LANDS			
Net acres (thousand)	28.6	25.9	32.1
DRILLING ACTIVITY			
Net wells	3.1	4.9	4.5
CAPITAL EXPENDITURES (\$ million)			
Net property acquisitions	28.41	4.32	0.81
Undeveloped land, seismic, geological	1.49	0.83	0.23
Drilling, completion, equipping and facilities	2.98	2.77	1.39
Total expenditures	32.88	7.92	2.43

TABER, ALBERTA



In 2001 Zargon proceeded with an active exploration and exploitation program on the Taber property, drilling a total of 12 net wells. The Taber property is characterized by a complex series of relatively thick medium-gravity oil-bearing sandstones at a depth of approximately 1,000 meters. Using seismic and detailed geological models, Zargon had identified substantial exploration and exploitation potential. Although initial results were encouraging with the discovery of a new pool, follow-up drilling results were disappointing. In 2002, Zargon will proceed with a more modest exploitation and exploration program.

2001 ACTIVITIES

- Concluded one property acquisition acquiring additional interests in the Taber property.
- Shot 10 square kilometers of 3-D seismic and 43 kilometers of 2-D seismic to assist in the property's exploitation and exploration.
- Purchased 9,880 net acres (15.4 sections) at Crown sales at an average cost of \$130 per acre.
- Drilled 12 gross (12.0 net) wells resulting in eight net oil wells and four net dry holes.
- Modified one existing waterflood project.

2002 PLANS

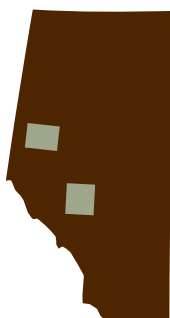
- Drill two or three net exploration and development wells.
- Modify one existing waterflood project.

First quarter 2002 production is anticipated to average about 350 barrels of oil per day. Through minor optimizations it is expected that this rate will be maintained throughout the year.

TABER, ALBERTA

	2001	2000	1999
AVERAGE PRODUCTION			
Oil (bbl/d)	398	189	150
Natural gas (mmcf/d)	-	-	0.01
TOTAL PROVEN RESERVES			
Oil (mmbbl)	1,113	953	523
Natural gas (bcf)	0.24	-	0.02
TOTAL PROVEN & PROBABLE RESERVES			
Oil (mmbbl)	1,713	1,458	803
Natural gas (bcf)	0.41	-	0.02
UNDEVELOPED LANDS			
Net acres (thousand)	12.5	4.0	0.3
DRILLING ACTIVITY			
Net wells	12.0	0.6	-
CAPITAL EXPENDITURES (\$ million)			
Net property acquisitions	1.03	3.09	0.04
Undeveloped land, seismic, geological	2.54	1.12	0.01
Drilling, completion, equipping and facilities	4.61	0.36	0.06
Total expenditures	8.18	4.58	0.11

WEST CENTRAL
ALBERTA &
OTHER
PROPERTIES



Zargon is developing a new core area in West Central Alberta that will provide meaningful gas production and gas reserve growth in the medium and longer term. The initial step in building a seismically focused gas exploration and exploitation program is to acquire a sizeable inventory of prospective undeveloped lands and/or underdeveloped properties. In 2000 and 2001, our initiatives to build a West Central Alberta core area were hampered by very competitive and expensive markets for gas related lands and properties. With the current reduced Crown land sale prices, we have expanded our efforts to build this core area.

During 2001, Zargon drilled 4.1 net wells in the West Central Alberta core area, primarily comprised of 3.0 net gas wells at Pembina, and one net dry hole in the Eaglesham area. The Pembina program is characterized by shallow, potentially gas-bearing sands at depths up to 700 meters. Production rates are varied, but can exceed 0.5 million cubic feet of natural gas per day. Further work is planned for the Pembina property in 2002. The Eaglesham abandonment relates to Zargon's initiative to build a "grass roots" gas exploration program in West Central Alberta. To accomplish this strategy, Zargon is posting Crown lands, buying seismic and has expanded our geological staffing. Production from these "grass roots" exploration initiatives is not anticipated until 2003.

2001 ACTIVITIES

- Drilled three gross (3.0 net) gas wells at Pembina exploring for shallow gas reservoirs.
- Drilled one gross (1.0 net) exploratory dry hole at Eaglesham exploring for higher risk but large upside gas accumulations.
- Purchased 539 kilometers and shot 35 kilometers of 2-D seismic.
- Purchased 19,840 net acres (31 sections) at Crown sales at an average cost of \$81 per acre.

2002 PLANS

- Pursue Pembina shallow gas development programs.
- Expand "grass roots" gas exploration programs through Crown postings and property acquisitions.

The current production for the West Central Alberta and Other Properties is approximately 2.0 million cubic feet of natural gas per day and 150 barrels of oil per day. During 2002, Zargon will be focusing on both gas acquisition and gas exploration opportunities in this core area, which should provide production gains by year-end.

WEST CENTRAL ALBERTA & OTHER PROPERTIES

	2001	2000	1999
AVERAGE PRODUCTION			
Oil (bbl/d)	156	159	241
Natural gas (mmcf/d)	1.97	1.99	1.51
TOTAL PROVEN RESERVES			
Oil (mmbbl)	409	399	444
Natural gas (bcf)	10.25	9.10	10.29
TOTAL PROVEN & PROBABLE RESERVES			
Oil (mmbbl)	567	573	595
Natural gas (bcf)	12.96	11.72	12.87
UNDEVELOPED LANDS			
Net acres (thousand)	38.4	18.1	28.1
DRILLING ACTIVITY			
Net wells	4.1	9.6	4.2
CAPITAL EXPENDITURES (\$ million)			
Net property acquisitions	0.48	(0.14)	(0.69)
Undeveloped land, seismic, geological	1.20	0.53	0.71
Drilling, completion, equipping, and facilities	2.47	2.29	1.76
Total expenditures	4.15	2.68	1.78

Looking Back Activity Review

HIGHLIGHTS

In 2001, Zargon delivered another year of strong operating results. Zargon's 2001 average daily production climbed 34 percent, to 5,553 barrels of equivalent per day (6:1); the Company's undeveloped land inventory increased 13 percent; and at year-end 2001, Zargon's total proven reserves climbed 27 percent to 20.61 million barrels of equivalent. The Company's 2001 capital investment program provided proven oil and natural gas reserve additions that replaced 2001 production volumes by 565 percent and 123 percent, respectively.

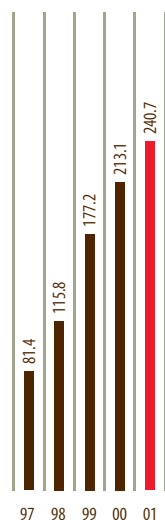
	2001	2000	Percent Change
Undeveloped land (thousand net acres)	240.7	213.1	13
Wells drilled, net	47.7	38.6	24
Natural gas production (mmcf/d)	18.67	14.49	29
Oil production (bbl/d)	2,441	1,725	42
Year-end proven gas reserves (bcf)	60.74	59.16	3
Year-end proven oil reserves (mmbbl)	10,482	6,340	65

LAND AND SEISMIC

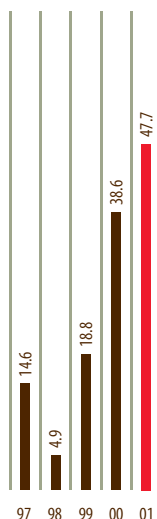
Zargon's undeveloped land inventory increased 13 percent in 2001 to 240.7 thousand net acres. During the first nine months of the year, prohibitive costs restricted additions to our undeveloped land inventory. Costs declined in the final quarter however, and Zargon was able to resume building its land inventory, primarily on West Central Alberta gas exploration concepts. During the year, Zargon's average working interest in its undeveloped lands increased to 82 percent from 79 percent recorded in 2000, furthering the Company's strategy to focus on high-interest operated properties.

During the year, the Company spent \$5.08 million on expanding and maintaining the undeveloped land inventory. Crown sale acquisitions of 48.5 thousand net acres totaled \$4.60 million for an average cost of \$95 per acre. Substantial lands were also earned through the drilling of 21.4 net farm-in wells. The independent firm Seaton Jordan & Associates Ltd. ("Seaton Jordan") has valued Zargon's undeveloped land holdings at December 31, 2001 at \$18.47 million, up 53 percent from last year's \$14.92 million appraisal. This analysis incorporates an average undeveloped acreage price of \$77 per acre, compared to the 2000 estimate of \$70 per acre.

Undeveloped Land (thousand net acres)



Drilling Activity (net wells)



As part of Zargon's continuing exploration focus, the Company shot 264 kilometers and purchased 748 kilometers of 2-D seismic in 2001. Over 25 square kilometers of 3-D seismic surveys were also conducted on oil exploitation projects in Taber, Alberta and in Southeast Saskatchewan. Total geological and geophysical costs in 2001 were \$3.80 million as compared to the prior year's expenditure of \$3.06 million. Capital expenditures for undeveloped land and seismic during the year totaled \$8.88 million, or 16 percent of the 2001 capital budget.

UNDEVELOPED LAND

As at December 31 (thousand net acres)	2001	2000	1999
Alberta	212.0	187.2	140.8
Saskatchewan	28.1	25.3	35.0
Manitoba	0.6	0.6	1.4
Total	240.7	213.1	177.2
Average Zargon working interest (%)	82	79	69

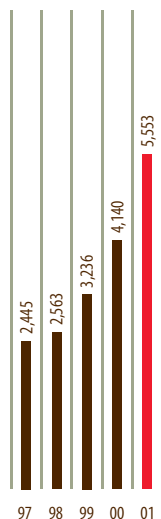
DRILLING, COMPLETION AND WORKOVERS

Zargon participated in drilling 58 wells in 2001, a 16 percent increase in activity over 2000. To capture value from the 2001 high commodity prices, Zargon expanded drilling activities. During the year, Zargon drilled 47.7 net wells, which resulted in 22.7 net gas wells, 11.1 net oil wells, and 13.9 net dry holes.

DRILLING ACTIVITY

	2001		2000		1999	
	Gross	Net	Gross	Net	Gross	Net
Oil	14	11.1	11	6.9	6	4.7
Natural gas	30	22.7	32	26.0	16	12.6
Service	0	0.0	1	0.4	2	1.5
Dry	14	13.9	6	5.3		
Total	58	47.7	50	38.6	24	18.8
Exploratory	41	37.2	31	26.1	9	8.5
Development	17	10.5	19	12.5	15	10.3
Total	58	47.7	50	38.6	24	18.8
Alberta	52	44.6	44	33.7	19	14.3
Saskatchewan	6	3.1	6	4.9	3	3.0
Manitoba	-	-	-	-	2	1.5
Total	58	47.7	50	38.6	24	18.8
Average net Zargon working interest (%)	82		77		78	

Production
(boe/d 6:1)



Zargon delivered a 71 percent success ratio for its 2001 drilling program. The Company's average working interest for the year's drilling program was 82 percent, with 48 of the 58 gross wells operated by Zargon. Approximately 60 percent of the year's drilling activities related to gas exploration and development targets in East Central Alberta. In anticipation of lower 2002 commodity prices, Zargon is scaling back its development drilling programs in 2002. During the upcoming year 25 net wells are planned emphasizing gas exploration in East and West Central Alberta and oil exploitation in Southeast Saskatchewan / North Dakota.

Expenditures for the drilling, completion and workovers of wells totaled \$17.44 million in 2001, a 55 percent increase over the \$11.28 million spent in 2000. Expenditures were 25 percent higher on a per well basis due to an increase in the average depth of the drilling program and industry-wide cost pressures. Drilling-related expenditures represented a 32 percent share of the year's total capital budget, a decrease from 37 percent in the prior year.

PRODUCTION EQUIPMENT AND FACILITIES

Zargon spent \$4.87 million on gas plant expansion and construction, oil battery modifications and construction and the installation of approximately 38 kilometers of pipelines in 2001. This is a 25 percent increase over the prior year's expenditures and these expenditures represented a 9 percent allocation of the total 2001 capital budget. The majority of the expenditures related to tie-ins and compression additions required to handle production from the exploration and development drilling at the Jarrow gas property in East Central Alberta.

PROPERTY ACQUISITIONS

Zargon's total net corporate and property acquisitions was \$23.99 million or 43 percent of Zargon's total capital expenditures in 2001. By far the largest capital commitment in 2001 was the \$23.39 million July 10, 2001 acquisition of Herc Oil Corp. The year-end evaluation by McDaniel & Associates of the Herc assets (after adjustments to include production and minor dispositions) assigned proven reserves of 3.92 million barrels of oil and 327 million cubic feet of natural gas to Herc's Southeast Saskatchewan and adjacent North Dakota oil properties. The Herc acquisition also brought substantial waterflood upside and tax planning opportunities to Zargon.

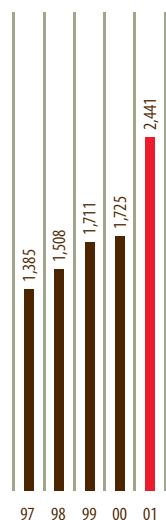
The remaining net \$0.60 million of Zargon's 2001 acquisition expenditures related to seven property acquisitions that were mostly offset by eight property disposition transactions. The acquisition transactions totaled \$4.83 million and generally related to the expansion of Zargon's waterflood interests in Southeast Saskatchewan. The disposition transactions totaled \$4.23 million and related to the sale of non-operated non-strategic gas properties in East Central Alberta during the first part of the year when gas assets were trading at premium prices. In addition to these dispositions, Zargon traded the Joarcam East Central Alberta oil property for long-life Southeast Saskatchewan oil properties.

PRODUCTION

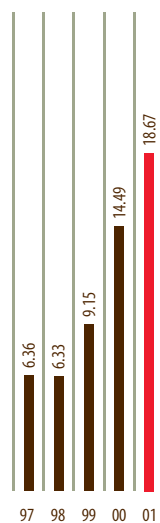
Natural gas sales volumes increased 29 percent in 2001 to average 18.67 million cubic feet per day compared to 14.49 million cubic feet per day in 2000 (1999 – 9.15 mmcf/d). Increases in natural gas production resulted primarily from successful exploration and development activity at Zargon's Jarrow property in East Central Alberta.

Crude oil and natural gas liquid sales volumes increased 42 percent to 2,441 barrels per day in 2001 compared to 1,725 barrels per day in 2000 (1999 – 1,711 bbl/d). Following a two year period focused on growing gas reserves and gas production, Zargon concentrated on building its oil business in 2001 through the Herc corporate and other Southeast Saskatchewan oil acquisitions.

Crude Oil and Liquids Production
(bbl/d)



Natural Gas Production
(mmcf/d)



On a 6:1 equivalent basis, Zargon's 2001 average daily production climbed 34 percent, to 5,553 barrels of equivalent per day compared to 4,140 barrels of equivalent per day in 2000 (1999 – 3,236 boe/d). Reflecting the 2001 oil-focused capital programs, fourth quarter 2001 oil production of 2,876 barrels per day represented 47 percent of total output, which is sharply higher than the first quarter 2001 average of 39 percent, and the 42 percent average in 2000. A renewed focus on gas opportunities in 2002 is expected to result in an increased weighting of gas production by year-end 2002.

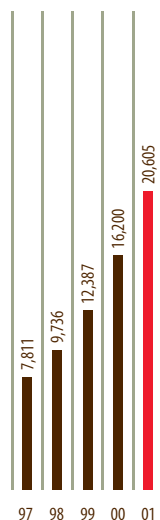
RESERVES

On an equivalent basis (6:1), Zargon's total proven reserves climbed 27 percent during 2001 to 20.61 million barrels of equivalent up from 16.20 million barrels of equivalent. Proven and probable reserves increased 21 percent to a year-end estimate of 25.79 million barrels of equivalent. The Company's proven oil and liquid reserves had increased 65 percent to 10.48 million barrels at year-end 2001, as compared to 6.34 million barrels at year-end 2000. Natural gas reserves increased 3 percent to 60.7 billion cubic feet from 59.2 billion cubic feet reported at the end of 2000.

Zargon's crude oil, liquids and natural gas reserves as of January 1, 2002 were reported by McDaniel & Associates Consultants Ltd. ("McDaniel"). McDaniel has been engaged since 1993 to conduct an annual independent review of 100 percent of the Company's reserves.

Zargon's 2001 capital investment program provided proven oil and natural gas reserve additions that replaced 2001 production volumes by 565 percent and 123 percent, respectively. Calendar 2001 net proven oil and liquid additions of 5.03 million of barrels were derived primarily from Southeast Saskatchewan and North Dakota property acquisitions. Net proven natural gas additions in 2001 of 8.40 billion cubic feet came through exploration and development drilling activities, primarily at the East Central Alberta Jarrow property.

Proven Reserves
(mboe 6:1)

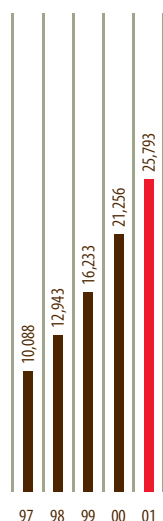


COMPANY RESERVES

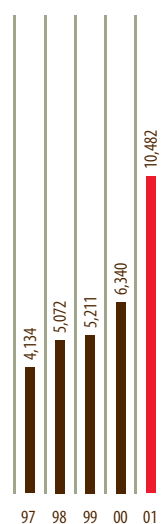
At December 31, 2001

(before royalties)	Oil and Liquids	Natural Gas	Equivalents 10:1	Equivalents 6:1
	(mdbl)	(bcf)	(mboe)	(mboe)
Proven producing	10,274	40.50	14,324	17,024
Proven non-producing	117	19.65	2,082	3,392
Proven undeveloped	92	0.58	150	189
Total proven	10,482	60.74	16,556	20,605
Probable additional	2,930	13.55	4,285	5,188
Total proven and probable	13,413	74.28	20,841	25,793
Proven reserve life index, years	9.9	8.7	9.4	9.3
Proven and probable reserve life index, years	12.7	10.6	11.9	11.6

Proven and Probable Reserves
(mboe 6:1)



Proven Oil and Liquid Reserves
(mmbbl)



Approximately 83 percent of Zargon's total proven reserves are allocated to the proven producing category. Proven non-producing reserves are comprised primarily of gas reserves from recently drilled wells at Jarrow and the more remote Sturgeon Lake property. Proven undeveloped reserves represent just over one percent of the total proven reserves. McDaniel forecasts \$5.26 million of net un-escalated future capital costs to deliver the total proven reserve estimate. Zargon's probable reserves generally reflect incremental waterflood recoveries on producing oil properties and improved gas recovery factors for currently producing gas wells. Eighty percent of the Company's reserves were classified as proven, compared to 76 percent in 2000.

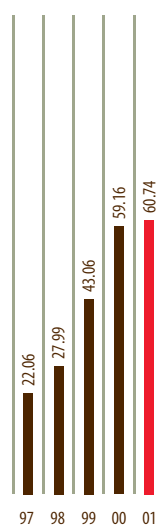
Based on year-end reserves, and the fourth quarter 2001 production rates of 19.08 million cubic feet of natural gas per day and 2,876 barrels of oil per day, Zargon's proven reserve life index is 8.7 years and 9.9 years for natural gas and oil, respectively. The corresponding proven and probable natural gas and oil reserve life indices are 10.6 and 12.7 years. The relatively high oil reserve life reflects Zargon's portfolio of long-life shallow-decline Southeast Saskatchewan / North Dakota water-flood projects.

RESERVE RECONCILIATION

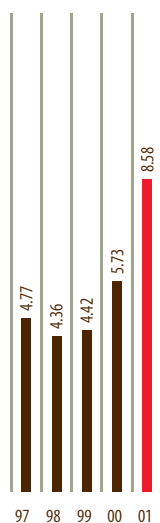
A reconciliation of Zargon's proven and probable reserves is provided below for the years 1999 through 2001:

	Oil and Liquids (mmbbl)			Natural Gas (bcf)			Equivalents (mboe 6:1)		
	Proven	Probable	Total	Proven	Probable	Total	Proven	Probable	Total
December 31, 1998	5,072	1,913	6,984	27.99	7.76	35.75	9,737	3,206	12,943
Extensions & discoveries	294	(39)	255	15.18	3.06	18.24	2,824	471	3,295
Technical revisions	436	4	440	0.90	0.57	1.47	586	99	685
Acquisitions/dispositions	34	3	37	2.33	0.40	2.73	422	70	492
Production	(625)	-	(625)	(3.34)	-	(3.34)	(1,181)	-	(1,181)
December 31, 1999	5,211	1,880	7,091	43.06	11.79	54.85	12,388	3,845	16,233
Extensions & discoveries	395	164	559	19.44	4.32	23.76	3,635	882	4,517
Technical revisions	484	47	531	0.82	0.26	1.08	620	90	710
Acquisitions/dispositions	883	246	1,128	1.13	(0.03)	1.10	1,071	241	1,312
Production	(632)	-	(632)	(5.30)	-	(5.30)	(1,515)	-	(1,515)
December 31, 2000	6,340	2,337	8,677	59.16	16.32	75.48	16,200	5,056	21,256
Extension & discoveries	492	73	565	11.39	1.12	12.51	2,390	259	2,650
Technical revisions	149	(102)	47	(1.60)	(3.40)	(5.00)	(118)	(669)	(786)
Acquisitions/dispositions	4,391	624	5,015	(1.39)	(0.49)	(1.88)	4,159	542	4,700
Production	(891)	-	(891)	(6.82)	-	(6.82)	(2,027)	-	(2,027)
December 31, 2001	10,482	2,930	13,413	60.74	13.55	74.28	20,605	5,188	25,793
Percentage change									
2001/2000	65	25	55	3	(17)	(2)	27	3	21

Proven Natural Gas Reserves (bcf)



Proven Finding and Development Costs (\$/boe 6:1)



Proven 2001 reserve additions totaled 6,431 thousand barrels of equivalent. Corporate and property acquisitions accounted for 65 percent of the total reserve additions with discoveries and extensions relating to field capital programs contributing approximately 37 percent of the reserve additions. Revisions to previous proven estimates resulted in a minor negative adjustment of 2 percent. Although Zargon's oil reserve revisions reflected a slight positive adjustment as a result of additional reserve recognition at the ongoing Southeast Saskatchewan waterflood projects, this was more than offset by a downward revision of the Company's gas reserves resulting from poor performance from selected wells located on the periphery of the Jarrow property.

During the year Zargon spent 74 percent of its capital budget on oil opportunities, primarily on the acquisition of exploitable oil properties in Southeast Saskatchewan and North Dakota and on the exploitation and exploration of the Taber property. Gas expenditures again emphasized the expansion of the Jarrow property in East Central Alberta.

FINDING AND DEVELOPMENT COSTS

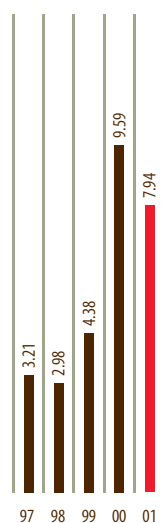
Zargon experienced higher finding and development costs in 2001. During the year Zargon spent \$41.06 million on oil projects and added 5.03 million barrels of proven oil reserves for a finding cost of \$8.16 per barrel. Disappointing results from the Taber drilling program increased the Company's oil finding and development costs. Zargon's 2001 gas capital program totaled \$14.12 million and delivered 8.40 billion cubic feet of natural gas for a proven development and finding cost of \$1.64 per thousand cubic feet. Costs increased due to a combination of negative Jarrow gas reserve revisions, West Central Alberta seismic and land acquisition pre-spending activities and generally higher industry-wide costs.

On a 6:1 equivalent basis, Zargon's proven 2001 finding and development costs were \$8.58 per barrel of equivalent or \$9.40 per barrel of equivalent on a 10:1 basis. Using proven and probable reserves, Zargon's 2001 finding and development costs were \$8.41 per barrel (6:1) and \$8.92 per barrel (10:1). The three-year cumulative proven costs are a more acceptable \$6.58 and \$8.30 per barrel of equivalent on a 6:1 and 10:1 basis, respectively.

FINDING AND DEVELOPMENT COSTS

	2001	2000	1999	Three Year Total	Five Year History	Ten Year History
Total capital expenditures (\$ million)	55.18	30.51	16.95	102.64	128.50	154.55
Reserve additions after revisions (mboe 10:1)						
Proven	5,872	3,901	2,604	12,377	16,742	22,933
Proven and probable	6,188	4,812	2,974	13,974	19,071	27,121
Reserve additions after revisions (mboe 6:1)						
Proven	6,431	5,327	3,831	15,589	22,283	28,550
Proven and probable	6,564	6,541	4,470	17,575	25,837	34,145
Finding and development costs (\$/boe 10:1)						
Proven	9.40	7.82	6.51	8.30	7.68	6.74
Proven and probable	8.92	6.34	5.70	7.35	6.74	5.70
Finding and development costs (\$/boe 6:1)						
Proven	8.58	5.73	4.42	6.58	5.77	5.41
Proven and probable	8.41	4.66	3.79	5.84	4.97	4.53

Net Asset Value
(\$/share)



NET ASSET VALUE

The following tables summarize the December 31, 2001 McDaniel forecast of cash flow derived from the production and sale of working and royalty interest reserves prior to the deduction of interest, income tax, general and administrative or other corporate costs.

DISCOUNTED CASH FLOWS

(\$ million)	Discount Factor			
	0%	10%	12%	15%
Proven producing	192.3	126.0	117.8	107.6
Proven non-producing	55.2	33.7	31.2	28.0
Proven undeveloped	1.4	0.9	0.8	0.7
Total proven	248.9	160.6	149.9	136.3
Probable (risked at 50%)	37.8	14.9	12.9	10.6
Total proven plus 50% risked probable	286.7	175.5	162.8	146.9

MCDANIEL REPORT PRICE FORECAST

	WTI Crude Oil (\$US/bbl)	Henry Hub Gas Price (\$US/mmbtu)
2002	20.00	3.10
2003	20.90	3.32
2004	21.80	3.42
2005	22.20	3.44
2006	22.60	3.51
2007	23.10	3.54
Thereafter:	Escalate at US \$0.50/bbl per year	Escalate at US \$0.07/mmbtu per year

The following estimate of Zargon's net asset value is calculated using a McDaniel 15 percent discounted pretax value for proven and risked probable reserves and a Seaton Jordan undeveloped land value estimate.

NET ASSET VALUE

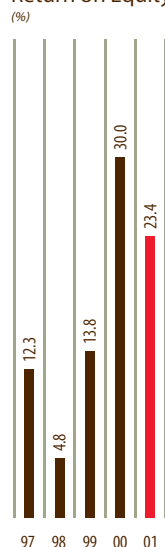
As at December 31 (\$ million)	2001	2000	1999	1998	1997
Proven reserves ⁽¹⁾	136.34	139.15	62.66	40.61	36.14
Probable reserves (risked) ⁽²⁾	10.64	11.28	6.85	4.09	3.44
Undeveloped land ⁽³⁾	18.47	14.92	9.78	6.29	6.79
Working capital	(3.51)	(2.51)	(0.14)	(0.24)	0.12
Long-term debt	(24.14)	(15.90)	(14.12)	(6.18)	(4.87)
Net asset value	137.80	146.94	65.03	44.57	41.62
Net asset value per common share					
Outstanding (\$/share)	8.27	10.28	4.50	3.01	3.32
Net asset value per diluted					
common share (\$/share)	7.94	9.59	4.38	2.98	3.21

(1) McDaniel estimate of future cash flow discounted at PV 15%.

(2) McDaniel PV 15% estimate after reduction for 50% risk.

(3) Seaton Jordan year-end estimates.

Return on Equity



As at year-end 2001, Zargon's diluted before tax net asset value was \$7.94 per share, a 17 percent decline from the 2000 year-end estimate of \$9.59 per share (1999 – \$4.38 per share). After tax analyses incorporating Zargon's year-end tax pool balances of \$72.59 million, calculate a proved and risked probable net asset value of \$6.26 per diluted share, (PV 10%), a 15 percent decline from the prior year's estimate of \$7.35 per share. These decreases in net asset values occurred despite a 10 percent increase in reserves per share, because of McDaniel's substantially reduced estimate of future commodity prices.

CORPORATE PERFORMANCE

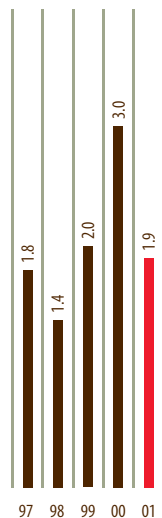
Zargon targets a sustainable 20 annual percent growth rate per share in reserves, production, cash flow and earnings as its benchmark. Over its ten-year history, Zargon has delivered an average composite growth rate of 27 percent per share for these four parameters. Since Zargon's October 1993 initial public offering, Zargon's share price has grown at a compounded 24 percent annual rate.

	2001	2000	1999	1998	1997	1992	Last Year's Growth (2000-2001)	Five Year Annual Growth (1997-2001)	Ten Year Annual Growth (1992-2001)
Proven reserves (mboe) ⁽⁴⁾	20,605	16,200	12,387	9,737	7,811	1,000	27	27	40
Boe per share ^{(1) (4)}	1.24	1.13	0.86	0.66	0.62	0.25	10	19	19
Production (boe/d) ⁽⁴⁾	5,553	4,140	3,236	2,563	2,445	362	34	23	36
Boe/d per million shares ⁽²⁾⁽⁴⁾	357	287	220	197	203	89	24	15	17
Cash flow (\$ million)	32.67	27.50	10.64	5.82	7.66	0.55	19	44	58
\$/share ⁽³⁾	2.03	1.86	0.70	0.43	0.62	0.15	9	35	34
Earnings (\$ million)	13.14	11.26	4.26	1.25	2.48	0.14	17	52	67
\$/share ⁽³⁾	0.82	0.76	0.29	0.10	0.20	0.05	8	42	37
Average shares									
outstanding (million)	15.56	14.41	14.69	13.03	12.05	4.05	8	7	16
Year end shares									
outstanding (million)	16.67	14.32	14.42	14.81	12.55	4.05	16	7	17
Year end share price (\$)	7.20	4.45	3.00	2.40	3.40	N/A	62	21	24 ⁽⁵⁾
Four parameter									
average annual growth (%) ⁽⁶⁾	24	96	92	(11)	38	–	24	36	50
Four parameter average annual									
growth per share (%) ⁽⁶⁾	13	91	72	(18)	16	–	13	28	27

Notes:

- (1) Reserves per share are calculated using year-end reserve appraisals and year-end shares outstanding.
- (2) Production per share is calculated using year average production and year average shares outstanding.
- (3) Cash flow and earnings per share are presented on a year average diluted basis.
- (4) Assumes 6 thousand cubic feet of natural gas is equivalent to 1 barrel of oil.
- (5) Share price growth rate since the October 1993 initial public offering at \$1.50 per share.
- (6) Four parameters include proven reserves, production, cash flow and earnings.

Corporate
Recycle Ratio
(\$/boe 6:1)



In addition to providing a sustainable 20 percent per share growth rate, Zargon is committed to providing profitable growth as measured by corporate recycle ratios and the return on book equity. Throughout its ten year history, Zargon has delivered an average rate of return on equity in excess of 17 percent per year, and an average proven historical corporate recycle ratio of 2.1 times.

CORPORATE PERFORMANCE

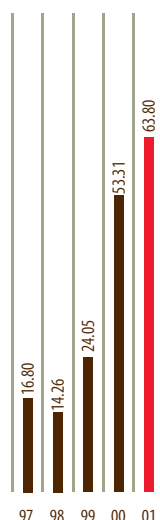
	2001	2000	1999	1998	1997	Three Year Average (1999- 2001)	Five Year Average (1997- 2001)	Ten Year Average (1992- 2001)
Corporate recycle ratio ⁽¹⁾	1.9	3.0	2.0	1.4	1.8	2.3	2.2	2.1
Return on equity (%) ⁽²⁾	23.4	30.0	13.8	4.8	12.3	23.0	15.1	17.3

Notes:

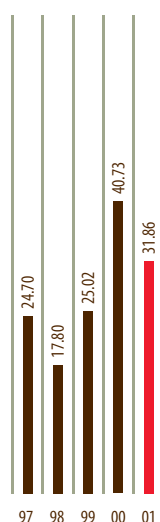
- (1) Corporate Recycle Ratio is defined as the corporate cash flow including allowances for taxes, interest charges and general and administrative costs on a barrel of oil equivalent production basis (6:1) divided by Proven Finding and Development Costs.
- (2) Return on equity is defined as the net after tax annual earnings divided by the year average shareholders' equity. Multi year averages are dollar weighted.

Management's Discussion and Analysis

Revenue
(\$ million)



Oil and Liquid Prices
(\$/bbl)



HIGHLIGHTS

Zargon reported record levels of revenue, cash flow, earnings and capital expenditures in 2001.

(\$ million, except per share amounts)	2001	2000	Percent Change
Production revenue	63.80	53.31	20
Cash flow from operations	32.67	27.50	19
Per diluted share (\$)	2.03	1.86*	9
Earnings	13.14	11.26	17
Per diluted share (\$)	0.82	0.76*	8
Net capital expenditures	55.18	30.51	81

*Restated using the treasury stock method

DETAILED FINANCIAL ANALYSIS

Production Revenue

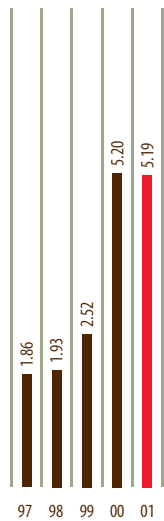
Zargon derives its revenue from the production and sale of crude oil, natural gas liquids and natural gas. Oil (inclusive of natural gas liquids) and natural gas revenue increased 20 percent to \$63.80 million in 2001 from \$53.31 million in 2000 and \$24.05 million in 1999. Production volumes (6:1) in 2001 increased 34 percent from the prior year and were the major contributor to higher revenue. The production volume gains were offset by a 22 percent decline from 2000 in the average oil price received by Zargon. Although the 2001 natural gas prices fluctuated from a very high first quarter to a low second half, the year's average field price was unchanged from the prior year.

Production revenue in 2001 was allocated 55 percent to the sale of natural gas and 45 percent to the sale of oil and liquids. For the last four years, natural gas revenue allocations have trended up from a 31 percent weighting in 1998, 35 percent in 1999 and 52 percent in 2000, reflecting Zargon's 1998 strategic decision to build a balanced revenue base.

Crude Oil Pricing

Canadian crude oil prices are referenced to an Edmonton light sweet reference price that is negatively adjusted for transportation charges and oil quality differentials to arrive at Zargon field prices. In 2001, Zargon's average oil field prices, exclusive of price hedges, dropped \$8.87 per barrel or 22 percent to \$31.86 per barrel, reflecting corresponding changes in global commodity prices. Zargon's blended average crude density is 30 degrees API (31 degrees API in 2000). The Zargon average field price differential to the Edmonton reference price in 2001 was \$7.32 per barrel, which compares to the 2000 differential of \$3.60 per barrel (\$2.33 per barrel in 1999). This much higher price differential partially reflected the slightly reduced quality of the average Zargon crude blend due to the addition of Taber, Alberta and Haas, North Dakota medium gravity production volumes, but was primarily due to the significant widening of medium gravity oil price differentials in 2001, a trend which has reversed in early 2002.

Natural Gas Prices
(\$/mcf)



Natural Gas Pricing

During 2001, Zargon's field natural gas price exclusive of price hedges showed extreme variation over the year from an average of \$8.92 per thousand cubic feet in the first quarter to an average of \$2.95 per thousand cubic feet in the fourth quarter. The year's average of \$5.19 per thousand cubic feet was however virtually unchanged from the \$5.20 reported in 2000. Approximately 56 percent of Zargon's gas production was sold under aggregator contracts pursuant to long-term contracts with Mirant Canada Gas Marketing, Ltd. (Jarrow-45 percent) and ProGas Limited (Hamilton Lake-9 percent). The remainder of Zargon's gas production was sold by spot sale contracts and received Alberta index prices. When and as Zargon develops new gas reserves outside of the original Jarrow and Hamilton Lake aggregator contract areas, it is anticipated that the aggregator share of total production will continue to decline.

Hedging Activities

Crude oil and natural gas prices moved in unusually large ranges in 2001 and our hedging program functioned much as intended. During the first half of the year both oil and gas prices exceeded expectations and cash flow was very strong. Cumulative hedge losses reached a maximum of approximately \$1.60 million in mid-summer but were readily absorbed by the high cash flows. In the second half of the year both oil and gas prices fell sharply. Cash flow was much reduced but was given useful support by hedge receipts aggregating \$1.03 million. Using a combination of put options, collars and forward sales, the overall hedge loss for the year was \$0.57 million. While a similar level of risk management was maintained, this was significantly less than the hedging losses experienced of \$2.73 million in 2000 and \$1.09 million in 1999, due in part to the use of put options in 2001 and in part to a less adverse pricing curve.

During the year, crude oil and currency hedges resulted in a \$0.30 million reduction of 2001 oil and liquid revenues, which is equivalent to a \$0.33 per barrel charge against the year's total oil and liquid production. Natural gas hedges reduced Zargon's 2001 revenues by \$0.27 million, which is equivalent to a \$0.04 per thousand cubic feet charge against the year's total natural gas production. For 2002, to reduce commodity price risk, Zargon will maintain a similar hedging program for about 30 percent of our production base.

Royalties

Royalties include payments made to the Crown, freehold owners and third parties. Reported royalties include credits received through the Alberta Royalty Tax Credit (ARTC) program, the cost of the Saskatchewan Resource Surcharge (SRC) and the cost of the North Dakota state and county taxes. During 2001, total royalties were \$14.22 million, up 33 percent from the \$10.72 million reported in 2000 (\$4.03 million in 1999). Royalties as a percentage of gross revenue (before hedging adjustments) increased to 22.3 percent, up from 20.1 percent in 2000 and 16.8 percent in 1999. On a commodity basis, oil royalties averaged 19.8 percent (before hedging), which was a slight decline from the previous year's average of 21.0 percent. Gas royalties averaged 24.3 percent, up from 19.2 percent in 2000. The increasing trend in gas royalty rates reflects the increased production volumes from the more highly encumbered Jarrow, Alberta gas property.

During the year, 61 percent of the total royalties were paid to provincial governments with the remainder paid to freehold owners and other third parties. Royalties payable to the Province of Alberta on qualifying properties are reduced through the ARTC program. Zargon received a \$0.50 million ARTC rebate in 2001 and a \$0.52 million rebate in 2000. Due to higher crude volumes the SRC charges increased to \$0.34 million in 2001, up from the prior year's charge of \$0.30 million. North Dakota state and county taxes for the recently acquired Herc properties totaled \$0.20 (Cdn.) million in 2001.

Production Expenses

Zargon's production expenses increased 38 percent to \$11.93 million in 2001. On a unit of production basis however, expenses increased 3 percent to \$5.89 per barrel of equivalent (6:1) from \$5.68 per barrel of equivalent in 2000 (\$5.18 per barrel of equivalent in 1999).

Production expenses for natural gas held steady at \$0.59 per thousand cubic feet in both 2000 and 2001 (\$0.57 per thousand cubic feet in 1999).

The acquisition of Herc Oil Corp. in mid-2001 increased oil production by 42 percent with largely long-life, flat decline properties with relatively high production costs. Three of Herc's highest cost Saskatchewan properties were subsequently sold and others are being upgraded to improve efficiencies. The overall effect however was to place upward pressure on unit production costs. In 2001 oil production expenses of \$8.85 per barrel were 2 percent higher than the prior year's \$8.69 per barrel but well above \$6.74 per barrel in 1999. In 2002, Zargon is focusing significant engineering effort on reversing this upward trend in oil production expenses.

Operating Netbacks

The very high oil and gas prices received in the first quarter declined throughout 2001. The average oil price received after hedges in 2001 was \$31.53 per barrel, 17 percent below the \$38.17 per barrel in 2000 while the average gas price received after hedges in 2001 was \$5.15 per thousand cubic feet, 3 percent higher than \$5.02 per thousand cubic feet in 2000. During 2001, Zargon's oil netbacks declined 22 percent to \$16.37 per barrel from \$20.92 per barrel in 2000 (\$13.15 per barrel in 1999) while natural gas netbacks eased 4 percent to \$3.30 per thousand cubic feet from \$3.43 per thousand cubic feet in 2000 (\$1.36 per thousand cubic feet in 1999). On an equivalent basis, 2001 operating netbacks fell 11 percent to \$18.29 per barrel of equivalent from \$20.62 per barrel of equivalent in 2000 (\$10.84 per barrel of equivalent in 1999).

OPERATING NETBACKS

	2001			2000		
	Oil & Liquids (\$/bbl)	Natural Gas (\$/mcf)	Equivalents (\$/boe 6:1)	Oil & Liquids (\$/bbl)	Natural Gas (\$/mcf)	Equivalents (\$/boe 6:1)
Revenues (adjusted for oil, gas and currency hedges)	31.53	5.15	31.19	38.17	5.02	33.37
Royalties (net of ARTC and SRC)	(6.31)	(1.26)	(7.01)	(8.56)	(1.00)	(7.07)
Operating costs	(8.85)	(0.59)	(5.89)	(8.69)	(0.59)	(5.68)
Operating netbacks	16.37	3.30	18.29	20.92	3.43	20.62

General and Administration Expenses

Gross general and administration costs increased 27 percent in 2001 to \$4.50 million as activity levels increased and new staff members and consultants were added to handle the load. Zargon continues to base its growth on the exploitation of oil properties with high operational, reservoir and engineering requirements and on the exploration/exploitation of gas properties using an intense geophysical and geological focus. Each of these initiatives requires substantial inputs from professional and technical staff. Costs associated with the acquisition of Herc Oil Corp. and office space requirements have also added to general and administration expenses. Since 1995, Zargon has maintained a policy of not capitalizing any portion of its general and administrative costs.

GENERAL AND ADMINISTRATION COSTS

(\$ million, except as noted)	2001	2000	1999
Gross general and administration expense	4.50	3.53	2.68
Overhead recoveries	(1.42)	(1.34)	(1.22)
Net general and administration expense	3.08	2.19	1.46
Net expense after recoveries (\$/boe 6:1)	1.52	1.44	1.24
Net expense after recoveries (\$/boe 10:1)	1.96	1.88	1.53
Number of employees at year-end	30	24	21

General and administration expenses on a unit of production basis increased 6 percent in 2001 to \$1.52 per barrel of equivalent or \$1.96 per barrel of equivalent (10:1). Future unit general and administrative costs are expected to trend lower as production volumes are added with less than a commensurate increase in staff and related costs.

Interest Expense

Zargon's primary borrowings are through its bank line of credit. In 2001, interest expense decreased 24 percent to \$0.96 million from \$1.27 million in 2000 (\$0.59 million in 1999) as Canadian and US short-term rates fell to record low levels. Zargon's effective interest rate was 4.9 percent on an average bank debt of \$19.5 million in 2001, compared to a 7.1 percent effective interest rate on an average bank debt of \$18.0 million in 2000 (6.0 percent on \$9.8 million in 1999). Bank debt rose moderately during the year as the Herc acquisition was completed, much of which was offset by a new equity issue. At year-end 2001 Zargon's bank debt totaled \$24.14 million, up \$8.24 million from the \$15.90 million reported at December 31, 2000.

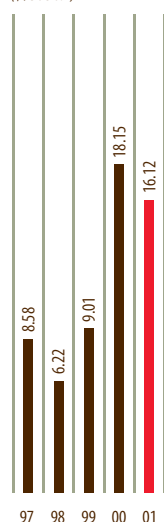
Capital and Income Tax

Zargon did not pay current income taxes in 2001, but did remit \$0.36 million of federal and provincial capital taxes (\$0.29 million remitted in 2000). The acquisition of Herc Oil Corp. facilitated Zargon in moving its operations to a partnership structure effective July 10, 2001. Herc also came with significant tax pools and as of December 31, 2001 the Company has \$72.59 million in resource tax pools, a 58 percent improvement over the 2000 year-end balance of \$45.92 million. It is expected that Zargon will have sufficient tax pools to shelter Zargon's 2002 taxable income.

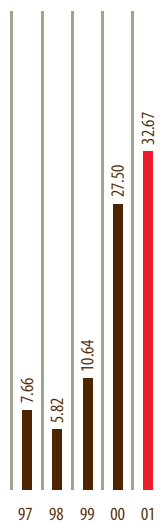
Corporate Netbacks

Lower oil prices and slightly higher costs had a negative impact on corporate netbacks in 2001. Corporate netbacks, defined as operating netbacks less general and administration costs, financial costs and cash taxes, were \$16.12 per barrel of equivalent in 2001, down 11 percent from \$18.15 per barrel of equivalent in 2000 (\$9.01 per barrel of equivalent in 1999).

Corporate
Cash Flow Netback
(\$/boe 6:1)



Cash Flow From Operations
(\$ million)



CORPORATE NETBACKS

(\$/boe 6:1)	2001	2000	1999
Operating netbacks	18.29	20.62	10.84
General and administration	(1.52)	(1.44)	(1.24)
Financial charges	(0.47)	(0.84)	(0.50)
Capital and current income taxes	(0.18)	(0.19)	(0.09)
Corporate netbacks	16.12	18.15	9.01

Cash Flow From Operations

Despite large variances over the year, average prices for both oil and gas in 2001 were strong and, combined with materially higher production volumes, brought 2001 cash flow from operations to \$32.67 million, a 19 percent increase from \$27.50 million in 2000 (\$10.64 million in 1999). The corresponding cash flow per share (diluted) rose 9 percent to \$2.03, up from \$1.86 (restated) in 2000 and \$0.70 in 1999.

Depletion and Depreciation

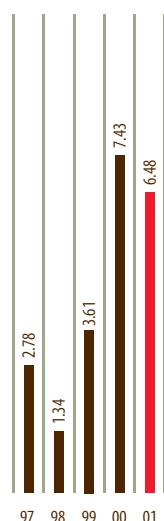
In 2001, Zargon's depletion and depreciation provision increased 15 percent to \$6.73 per barrel of equivalent (10:1), up from \$5.85 per barrel of equivalent in 2000 (\$4.96 per barrel of equivalent in 1999). Depletion, depreciation and site restoration charges calculated on a unit of production method are based on total proven reserves with a conversion of 10 thousand cubic feet of natural gas being equivalent to 1 barrel of oil. The 2001 depletion calculation includes \$5.26 million of future capital expenditures to develop the Company's reserves but excludes \$9.44 million of unproven properties relating to undeveloped land. The 2001 depletion and depreciation charges calculated assuming a 6:1 gas/oil equivalency ratio equate to \$5.22 per barrel of equivalent, up from \$4.49 in 2000 and \$4.02 in 1999. Zargon's relatively low per unit depletion and depreciation charges are a result of the Company's historically low finding and development costs.

Zargon's corporate depletion and depreciation provision increased 56 percent to \$10.58 million in 2001 compared to \$6.80 million in 2000 (\$4.75 million in 1999). The higher charges reflected increased production volumes and higher per unit charges relating to both Zargon's and the industry's trend in 2000 and 2001 towards higher finding and development costs.

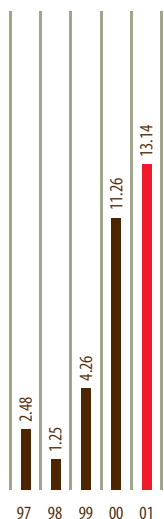
Site Restoration and Reclamation

In 2001 Zargon provided for \$1.05 million of site restoration and reclamation charges compared to a \$0.72 million provision in 2000 (\$0.59 million in 1999). This charge of \$0.66 per barrel of equivalent (10:1) is 6 percent higher than the 2000 and 1999 charges of \$0.62 and \$0.61 per barrel of equivalent respectively, reflecting an increased abandonment liability stemming from the Herc acquisition. Zargon accrues the estimated future restoration and reclamation charges on a unit of production basis assuming a \$25,000 net after salvage abandonment charge for each net working interest well. By using the assumption that 6 thousand cubic feet of natural gas is equivalent to 1 barrel of oil, the 2001 site restoration and reclamation charge would be \$0.52 per barrel of equivalent compared to \$0.48 in 2000 and \$0.49 in 1999. As part of the 2001 Herc corporate transaction, Zargon increased its site restoration and reclamation provision by \$0.83 million to recognize the future liabilities associated with the acquired Herc assets. Actual site restoration and reclamation costs incurred in 2001 were \$0.34 million compared to the 2000 expenditures of \$0.38 million (\$0.18 million in 1999).

Corporate Earnings
Netback
(\$/boe 6:1)



Earnings
(\$ million)



Future Income Taxes

Zargon's 2001 future taxes decreased 10 percent to \$7.81 million from \$8.71 million in 2000 (\$1.05 million in 1999). On a unit of production basis, future income taxes were \$3.85 per barrel of equivalent in 2001, a decrease of 33 percent from the prior year's future income taxes of \$5.75 per barrel of equivalent (\$0.89 per barrel of equivalent in 1999). The 2001 effective tax rate (current and future) declined to 38 percent from 44 percent in 2000 (21 percent in 1999). The reduction in the 2001 effective tax rate relates to lower federal and provincial tax rates and the benefit of the additional tax shelter acquired in the Herc corporate transaction.

Net Earnings

Zargon's 2001 net earnings were \$13.14 million, a 17 percent increase from the \$11.26 million recorded in 2000 (\$4.26 million in 1999). On a per share basis, 2001 net earnings increased 8 percent to \$0.82 (diluted) from \$0.76 (restated) in the prior year (\$0.29 in 1999). The per share increase in earnings over 2000 was derived from higher production volumes offset in part by the additional shares outstanding.

NET EARNINGS

(\$/boe 6:1)	2001	2000	1999
Corporate netbacks	16.12	18.15	9.01
Depletion, depreciation and foreign exchange	(5.27)	(4.49)	(4.02)
Site restoration and reclamation	(0.52)	(0.48)	(0.49)
Future income taxes	(3.85)	(5.75)	(0.89)
Net earnings	6.48	7.43	3.61

On a unit of production basis, the 2001 net earnings were \$6.48 per barrel of equivalent, which represented a 13 percent decline from the prior year's earnings of \$7.43 per barrel of equivalent (\$3.61 per barrel of equivalent in 1999). In 2001, net earnings represented 40 percent of cash flow, essentially unchanged from a 42 percent ratio in 2000 (40 percent in 1999).

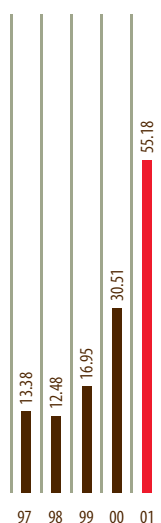
Return on Equity

The after-tax return on shareholders' equity in 2001 declined to 23.4 percent from 30.0 percent in the prior year (13.8 percent in 1999). Zargon's after tax rates of return on equity have averaged 23.0 percent over the past three years and 17.3 percent over the Company's ten-year corporate history.

Capital Expenditures

Net capital expenditures in 2001 increased 81 percent to \$55.18 million from the prior year's \$30.51 million (\$16.95 million in 1999). During the year, Zargon supported an active exploration program by spending \$8.88 million or 16 percent of the total budget on geological, geophysical and undeveloped land acquisition activities. Field activities in 2001 attained new high levels with an expenditure of \$22.31 million or 40 percent of the year's capital allocation in the drilling and completion of wells and the construction of related facilities.

Net Capital Expenditures
(\$ million)



On July 10, 2001 Zargon acquired Herc Oil Corp., a private company, for \$19.83 million cash plus the assumption of long-term debt of \$ 5.70 million. Working capital acquired was \$1.97 million and there was a net non-cash adjustment of \$0.16 million for future taxes and site restoration liabilities. Also during the year, Zargon made property acquisitions of \$4.83 million and dispositions of \$4.23 million for a net increase of \$0.60 million. The majority of the property acquisitions related to oil exploitation opportunities while the dispositions were opportunity-driven dispositions of non-core, non-operated gas assets at the high point of the gas commodity price cycle. In 2002, Zargon is projecting to spend \$35 million of capital expenditures.

CAPITAL EXPENDITURES

(\$ million)	2001	2000	1999
Property, plant and equipment assets			
Undeveloped land	5.08	2.93	3.98
Geological and geophysical (seismic)	3.80	3.06	1.91
Drilling and completion of wells	17.44	11.28	6.20
Well equipment and facilities	4.87	3.89	2.61
Exploration and development	31.19	21.16	14.70
Property acquisitions	4.83	10.09	3.70
Property dispositions	(4.23)	(0.74)	(1.45)
Net property acquisitions	0.60	9.35	2.25
Herc acquisition assigned to property, plant and equipment	23.39	0.00	0.00
Total capital expenditures (net)	55.18	30.51	16.95

LIQUIDITY AND CAPITAL RESOURCES

Zargon relies on three sources of funding to support its capital expenditure programs:

- Internally generated cash flow provides the basic level of funding for the Company's annual capital expenditures program.
- Debt may be utilized to expand capital programs when it is deemed appropriate. The Company has followed and intends to maintain a conservative debt policy.
- New equity, if available and if on favourable terms, will be utilized to expand further capital programs. Conversely, if Zargon's equity is valued by the stock market at levels perceived to be at a substantial discount to the underlying net asset value, Zargon will consider the repurchase of Zargon shares through an issuer bid.

In 2001, Zargon's capital program was funded 60 percent by cash flow, 25 percent by the issue of equity and 15 percent by the increase of long-term debt.

During the first quarter of 2001, Zargon repurchased 23 thousand common shares pursuant to the November 2000 issuer bid. Including commissions the total cost for these shares was \$0.11 million, which equates to an average cost of \$4.57 per share. In 2000 the Company had repurchased 340 thousand common shares at an average cost of \$3.50 per share.

Pursuant to the Company's stock option plan, Zargon issued 374 thousand shares for \$0.89 million, to employees and directors of the Company in 2001, at an average exercise price of \$2.37 per share. In the prior year, 235 thousand shares were issued pursuant to the plan at an average exercise price of \$1.84 per share.

CAPITAL SOURCES

(\$ million)	2001	2000	1999
Cash flow from operations	32.67	27.50	10.64
Changes in working capital	(3.34)	1.98	(0.57)
Bank debt	8.23	1.79	7.94
Assumption of Herc debt	5.70	0.00	0.00
Assumption of Herc working capital	(1.97)	0.00	0.00
Issuance (buyback) of common shares	13.89	(0.76)	(1.06)
Total capital sources	55.18	30.51	16.95

Cash Flow

It is anticipated that the majority of Zargon's 2002 capital budget will be financed through the reinvestment of the Company's cash flow from operations. Cash flow is influenced by factors that the Company cannot control such as commodity prices, the US/Canadian dollar exchange rates and interest rates. Zargon's 2002 sensitivity to moderate fluctuations in these key business parameters is shown in the accompanying table.

CASH FLOW SENSITIVITY SUMMARY

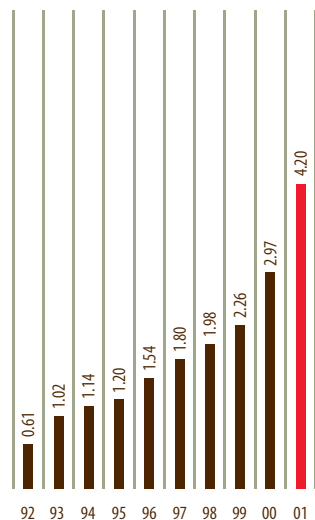
	Change in 2002 Cash Flow	
	(\$ million)	(\$/share)
Change of \$1.00 US/bbl in the price of WTI oil	1.11	0.07
Change in oil production of 100 bbl/d	0.41	0.03
Change of \$0.10 US/mcf in the price of NYMEX gas	0.71	0.05
Change in gas production of 1 mmcf/d	0.59	0.04
Change in \$0.01 in the \$US/\$Cdn exchange rate	0.31	0.02

Bank Debt and Liability

The Company has lines of credit totalling approximately \$57 million: \$50 million with a Canadian bank and \$4.3 million US with an American bank. At December 31, 2001, total debt outstanding was \$24.14 million, a 52 percent increase from the prior year-end amount of \$15.90 million. The Company's working capital deficiency increased to \$3.51 million at December 31, 2001, which compares to the prior year-end's \$2.51 million working capital deficiency.

Zargon's combined debt and working capital deficiency of \$27.65 million at December 31, 2001, represented a relatively low 0.85 year multiple of Zargon's 2001 corporate cash flow of \$32.67 million. At December 31, 2000, Zargon's combined debt and working capital deficiency was \$19.40 million, equivalent to a 0.61 year multiple of 2000 cash flow.

Shareholders' Equity
(\$/share)



Equity

On June 26, 2001 Zargon issued 2 million special warrants by way of private placement at a price of \$7.05 per special warrant for gross proceeds of \$14.10 million. The special warrants were converted to 2 million common shares on August 20, 2001.

At year-end 2001, Zargon had 16.67 million shares outstanding. Including the 1.20 million options outstanding (0.92 million vested at December 31, 2001) under the Company stock option plan; Zargon's fully diluted year-end balance of shares outstanding is 17.87 million.

During 2001, 7.41 million Zargon shares traded on The Toronto Stock Exchange with a high of \$7.70 per share, a low of \$4.10 per share and a close of \$7.20 per share. The 2001 trading statistics represent a 52 percent year over year increase in trading volume, and a 62 percent increase in the closing stock price. Zargon's market capitalization at year-end 2001 was approximately \$120 million.

Changes in Accounting Standards

During 2001, the Canadian Institute of Chartered Accountants (CICA) issued several new standards that are noted below together with comments as to their applicability to Zargon's current practices.

The new standards require business combinations initiated after June 30, 2001 to be accounted for using the purchase method of accounting. They specify the types of acquired intangible assets that are required to be recognized and reported separately from goodwill, and set out the amortization requirements for goodwill and intangible assets. Zargon does not anticipate that these standards will impact its financial statements.

There is also a new Canadian standard on stock-based compensation. Zargon currently does not use stock-based compensation that would require the use of the new fair value-base method of accounting. Zargon will adopt the intrinsic value method of accounting for its stock options.

The CICA has also issued an accounting guideline on hedging relationships effective for years beginning on or after July 1, 2002. Zargon believes that its current hedging practices will meet the criteria for hedging relationships.

An amended CICA standard on foreign currency relationships became effective on January 1, 2002 and requires that translation gains and losses arising on long-term foreign currency denominated monetary items be included in income in the current period. Zargon currently does not hold any such monetary items.

Segmented Geographic Information

Since July 10, 2001 Zargon has produced and marketed approximately 10 percent of its combined oil and natural gas production from properties located in the state of North Dakota, representing about 11 percent of Zargon's gross revenue.

BUSINESS RISKS AND OUTLOOK

Business Risks

Zargon's external business risks arise from the uncertainty of crude oil and natural gas pricing, the uncertainty of interest and exchange rates, environmental and safety issues, and financial and liquidity considerations. Additional risk exists regarding the production performance of existing properties and regarding the uncertain results from capital expenditure programs.

Zargon attempts to minimize pricing and currency exchange uncertainty with a risk management program that encompasses a variety of financial instruments. These include forward sales of crude oil and natural gas production, put options on both oil and gas, costless collars (in which some potential high price gain is given up in return for potential low price support) and U.S. dollar currency hedges in different forms for up to 30 percent of its oil and gas volumes. In general the Company seeks to use strategies that allow minimum price expectations to be met while preserving most of the Company's exposure to higher prices. Environmental and safety risks are mitigated through compliance with provincial and federal environmental and safety regulations, by maintaining adequate insurance, and by adopting appropriate emergency response and employee safety procedures.

Financial and liquidity risks are reduced by limiting debt financing to conservative self-imposed debt to cash flow guidelines. Zargon actively manages the risks of its capital programs by concentrating drilling and subsequent development activities in areas where Zargon has demonstrated proven technical capabilities. Finally, Zargon's capital budget is managed so as to limit Zargon's capital exposure to any one project or concept to a non-material amount.

Corporate Outlook

Zargon remains confident of its ability to maintain its record of consistent and sustainable profitable growth. For 2002, Zargon has budgeted \$35 million of capital expenditures allocated to gas exploration, oil exploitation and property acquisition opportunities.

FOURTH QUARTER 2001 – MANAGEMENT'S DISCUSSION AND ANALYSIS

Zargon's production averaged 6,057 barrels of equivalent per day (6:1) in fourth quarter 2001, up one percent from the third quarter 2001 rate of 5,995 barrels of equivalent per day and 33 percent higher than the 4,543 barrels of equivalent per day reported in fourth quarter 2000. Fourth quarter 2001 oil production averaged 2,876 barrels per day, essentially unchanged from the 2,851 barrels per day reported in third quarter 2001, but 69 percent higher than the 1,703 barrels per day reported in fourth quarter 2000. The year over year oil production gains came primarily from the integration of the oil properties acquired in the July 10, 2001 Herc corporate transaction. Fourth quarter 2001 natural gas production averaged 19.08 million cubic feet per day, compared to 18.86 million cubic feet per day in third quarter 2001 and 17.05 million cubic feet per day in fourth quarter 2000. The increased natural gas production volumes were primarily generated from Zargon's ongoing exploration and development activities in the Jarrow property of East Central Alberta.

Despite a 33 percent year over year improvement in fourth quarter 2001 production volumes, severe declines in natural gas and oil prices reduced fourth quarter 2001 revenues to \$11.18 million, a 42 percent decrease from fourth quarter 2000 revenues of \$19.32 million. Third quarter 2001 revenues of \$14.67 million were also substantially higher than the fourth quarter 2001 revenues. These lower revenues were a direct result of declining field natural gas prices throughout 2001 to an average of \$2.95 per thousand cubic feet (\$3.36 after hedging) in the 2001 fourth quarter, 9 percent less than the \$3.25 per thousand cubic feet received in third quarter 2001, but 63 percent less than the very strong gas prices of \$8.00 per thousand cubic feet received in fourth quarter 2000. Zargon's oil prices also declined substantially throughout the year to an average of \$22.72 per barrel (\$23.32 after hedging) in the fourth quarter, 34 percent and 47 percent below third quarter 2001 and fourth quarter 2000 prices of \$34.33 per barrel and \$43.21 per barrel, respectively. The Corporation's hedging policy, which is designed to provide floor prices for a component of production to help stabilize cash flows during lower price periods, functioned well during the fourth quarter, providing hedging income of \$0.88 million in the quarter, 15 percent of reported cash flow.

Royalties, inclusive of Alberta Royalty Tax Credit and Saskatchewan Resource Surcharge, were \$2.31 million for fourth quarter 2001, down 36 percent from \$3.59 million reported in the 2000 fourth quarter as production revenues fell with much lower prices. As a percentage of gross revenue, fourth quarter 2001 royalties were 20.6 percent of revenue, somewhat higher than the fourth quarter of 2000 rate of 18.5 percent, but lower than the 23.5 percent reported in the third quarter 2001.

Higher production volumes in the 2001 fourth quarter were the primary reason for operating cost increases to \$3.49 million from \$3.23 million in the 2001 third quarter and \$2.66 million in the 2000 fourth quarter. On a unit of production basis operating costs were approximately consistent at \$6.27, \$5.85 and \$6.36 per barrel of equivalent per day (6:1) for the fourth quarter 2001, third quarter 2001 and fourth quarter 2000 periods, respectively.

General and administrative expenses were \$0.83 million for fourth quarter 2001 compared to \$0.61 million in the corresponding period of 2000 and \$0.77 million in third quarter 2001. The higher costs reflect increased salaries and related staffing costs as Zargon continued to expand and upgrade its intellectual resources in preparation for further growth. On a unit of production basis, general and administrative costs were approximately consistent at \$1.49, \$1.39 and \$1.46 per barrel of equivalent for the fourth quarter 2001, third quarter 2001 and fourth quarter 2000 periods, respectively. Interest expense of \$0.24 million in fourth quarter 2001 was 31 percent less than for the 2000 period as short-term interest rates dropped dramatically in the second half of 2001.

Depletion and depreciation expense for fourth quarter 2001 of \$3.10 million was 38 percent higher than the \$2.24 million reported in the same period of 2000. While the 33 percent year over year gain in quarterly production volumes was the major factor in this increase, unit of production charges were also higher arising from the industry-wide and Zargon trend to higher finding and development costs in 2001. On a unit of production basis, depletion and depreciation expenses were \$5.57, \$5.22 and \$5.36 per barrel of equivalent for the fourth quarter 2001, third quarter 2001 and fourth quarter 2000 periods, respectively.

In the 2001 first quarter, Zargon booked a \$1.50 million provision for capital and cash taxes. The Herc transaction provided tax-planning opportunities that were able to reduce the expected cash tax payments in 2001. The third quarter 2001 results included a \$0.65 million reversal of a portion of the first quarter capital and cash tax accrual and an additional recovery of \$0.57 million was booked in the fourth quarter.

Zargon's cash flow for fourth quarter 2001 of \$5.81 million was 24 percent below third quarter 2001 cash flow of \$7.66 million and 47 percent below fourth quarter 2000 cash flow of \$10.93 million. These reduced results are directly related to the steady decline in oil and natural gas prices over the last few quarters from the extraordinarily high prices received in the previous winter. On a per diluted share basis, fourth quarter 2001 cash flow was \$0.34 as compared to \$0.44 in third quarter 2001 and \$0.74 in fourth quarter 2000.

Fourth quarter 2001 earnings of \$1.77 million show a similar trend dropping from \$2.60 million in the 2001 third quarter and \$4.76 million in the 2000 fourth quarter. On a per diluted share basis, fourth quarter cash flow was \$0.10 as compared to \$0.15 in the 2001 third quarter and \$0.32 in the 2000 fourth quarter.

In the fourth quarter of 2001, capital expenditures continued at a high level of \$9.28 million, funded 62 percent by cash flows from operations and 38 percent from draws of existing bank lines and working capital. The expenditures included \$8.91 million to fund field exploration and development activity and a net \$0.36 million of property acquisitions. The comparative capital expenditures in third quarter 2001 and fourth quarter 2000 were \$29.82 million (inclusive of the Herc corporate acquisition) and \$10.90 million, respectively.

SELECTED QUARTERLY INFORMATION

(\$ million, except per share amounts)	2001				2000			
	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
Production revenue	11.18	14.67	16.90	21.04	19.32	14.24	10.62	9.13
Cash flow from operations	5.81	7.66	8.59	10.61	10.93	7.17	5.04	4.36
Per diluted share (\$/share) *	0.34	0.44	0.57	0.71	0.74	0.48	0.35	0.29
Earnings	1.77	2.60	3.49	5.28	4.76	2.88	1.85	1.77
Per diluted share (\$/share) *	0.10	0.15	0.22	0.36	0.32	0.19	0.13	0.12
Total assets	127.93	119.06	108.27	90.91	86.88	74.61	68.53	62.42
Long-term debt	24.14	19.27	13.19	10.09	15.90	17.63	19.44	19.30

* 2000 data, restated using the treasury stock method

MANAGEMENT'S
REPORT

The financial statements of Zargon Oil & Gas Ltd. were prepared by management in accordance with accounting principles generally accepted in Canada. The financial and operating information presented in this annual report is consistent with that shown in the financial statements.

Management has designed and maintains a system of internal controls to provide reasonable assurance that all assets are safeguarded and to facilitate the preparation of financial statements for reporting purposes. 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 judgements made by management.

External auditors appointed by the shareholders have conducted an independent examination of the corporate and accounting records in order to express their opinion on the financial statements.

The Board of Directors is responsible for ensuring that management fulfils 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 the external auditors and management in order to determine that management has fulfilled its responsibilities in the preparation of the financial statements. The Audit Committee has reported its findings to the Board of Directors who have approved the financial statements.

(Signed)

J.O. McCutcheon
Chairman

Calgary, Canada
February 27, 2002

(Signed)

C.H. Hansen
President and Chief Executive Officer

AUDITORS'
REPORT

TO THE SHAREHOLDERS OF ZARGON OIL & GAS LTD.

We have audited the consolidated balance sheets of Zargon Oil & Gas Ltd. as at December 31, 2001 and 2000 and the consolidated statements of income and retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Corporation'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 Corporation as at December 31, 2001 and 2000 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

(Signed)

Calgary, Canada
February 27, 2002

Chartered Accountants

CONSOLIDATED
BALANCE
SHEETS

As at December 31

(\$ thousand)

	2001	2000
ASSETS <small>[note 4]</small>		
Current		
Cash	201	159
Accounts receivable	7,990	11,483
Prepaid expenses and deposits	741	848
	8,932	12,490
Property and equipment <small>[note 3]</small>	118,994	74,394
	127,926	86,884
LIABILITIES		
Current		
Accounts payable and accrued liabilities	12,440	15,003
Long-term debt <small>[note 4]</small>	24,137	15,902
Future site restoration costs	3,141	1,606
Future income taxes <small>[note 6]</small>	18,223	11,851
	57,941	44,362
Commitments <small>[note 8]</small>		
SHAREHOLDERS' EQUITY		
Share capital <small>[note 5]</small>	35,066	20,667
Retained earnings	34,919	21,855
	69,985	42,522
	127,926	86,884

See accompanying notes

On behalf of the Board:

(Signed)

J.O. McCutcheon
Director

(Signed)

C.H. Hansen
Director

CONSOLIDATED
STATEMENTS OF
INCOME AND
RETAINED
EARNINGS

For the years ended December 31

(\$ thousand, except per share amounts)

	2001	2000
Income		
Oil and gas sales	63,795	53,306
Hedging loss [note 8]	(573)	(2,733)
Royalties (net of Alberta Royalty Tax Credit)	(14,222)	(10,716)
	49,000	39,857
Expenses		
Production	11,933	8,615
Administration	3,083	2,189
Interest on long-term debt	957	1,269
Foreign exchange	107	-
Site restoration	1,045	720
Depreciation and depletion	10,576	6,801
	27,701	19,594
Income before income taxes	21,299	20,263
Income taxes [note 6]		
Future	7,806	8,713
Current	358	288
	8,164	9,001
Net income for the year	13,135	11,262
Retained earnings, beginning of year	21,855	11,781
Repurchase of common shares [note 5]	(71)	(682)
Change in accounting policy [note 1]	-	(506)
Retained earnings, end of year	34,919	21,855
Earnings per common share [note 7]		
Basic	0.84	0.78
Diluted [note 1]	0.82	0.76

See accompanying notes

CONSOLIDATED
STATEMENTS OF
CASH FLOWS

For the years ended December 31

(\$ thousand, except per share amounts)

	2001	2000
Operating activities		
Net income for the year	13,135	11,262
Add non-cash items:		
Depreciation and depletion	10,576	6,801
Site restoration	1,045	720
Foreign exchange	107	-
Future income taxes	7,806	8,713
Cash flow from operations	32,669	27,496
Change in non-cash working capital	(1,189)	(899)
	31,480	26,597
Financing activities		
Long-term debt	8,235	1,786
Issuance of common shares	13,992	434
Repurchase of common shares	(105)	(1,191)
	22,122	1,029
Investing activities		
Acquisition of property and equipment	(36,014)	(31,254)
Disposal of property and equipment	4,230	740
Acquisition of Herc Oil Corp. [note 2]	(19,831)	-
Site restoration expenditures	(340)	(379)
Change in non-cash working capital	(1,605)	3,310
	(53,560)	(27,583)
Increase in cash	42	43
Cash, beginning of year	159	116
Cash, end of year	201	159
Cash interest paid	956	1,237
Cash taxes paid	218	128
Cash flow from operations per share [note 7]		
Basic	2.10	1.91
Diluted [note 1]	2.03	1.86

See accompanying notes

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of Business

Zargon Oil & Gas Ltd. (the "Corporation") is a public company that trades on the Toronto Stock Exchange, is incorporated under the Business Corporations Act (Alberta) and is engaged in the exploration for and the development and production of oil and gas in Canada and the United States.

Consolidation

All subsidiaries and a partnership are directly or indirectly wholly owned and their operations are fully reflected in the consolidated financial statements.

Joint Operations

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

Property and Equipment

The Corporation follows the full cost method of accounting for its oil and gas operations in accordance with the guideline issued by the Canadian Institute of Chartered Accountants whereby all costs relating to the acquisition, exploration and development of petroleum and natural gas reserves are capitalized. Such costs include land acquisition costs, annual carrying charges of non-producing properties, geological and geophysical costs, and costs of drilling and equipping both productive and non-productive wells. General and administrative costs related to these activities are not capitalized.

Depreciation and depletion of capitalized costs is computed using the unit-of-production method based on the estimated proven reserves of oil and gas determined by independent consultants. Reserves are converted to common units on the basis that ten thousand cubic feet of gas is equivalent to one barrel of oil and liquids.

The Corporation applies a ceiling test to capitalized costs on an annual basis to ensure that such costs do not exceed the estimated undiscounted future net revenues from production of gross proven reserves using year end market prices, plus the cost of undeveloped properties, net of impairment, less amounts associated with future production costs, general and administrative, financing, site restoration, and income tax costs.

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% or more.

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

Future Site Restoration and Abandonment Costs

Estimated future site restoration and abandonment costs, including the removal of production facilities at the end of their useful lives, and net of salvage values, are provided for using the unit-of-production method. This estimate is based on current costs, existing legislation and industry standards. The annual charge is accounted for as an expense and the accumulated provision is reflected as a deferred liability. Actual site restoration costs are deducted from the accumulated provision in the year incurred.

Financial Instruments

Financial instruments of the Corporation consist of cash, accounts receivable, accounts payable and accrued liabilities, and long-term debt. As at December 31, 2001 and 2000, there are no significant differences between the carrying values of these amounts and their estimated market values.

The Corporation enters into swap contracts, as described in note 8, that are designed to be effective as a hedge against changes in commodity prices and foreign exchange rates. Gains and losses on the hedging contracts are deferred and are recognized when the hedged transaction occurs.

Income Taxes

The Corporation follows the liability method of tax allocation in accounting for income taxes. Under this method, the Corporation records future income taxes for the effect of any differences between the accounting and income tax basis of an asset or liability (temporary differences). Future income tax assets and liabilities are measured using income tax rates expected to apply in the years in which 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 income in the period in which the change is substantially enacted.

The Corporation retroactively, without restatement of prior periods, adopted the liability method on January 1, 2000. At December 31, 2000 the effect of this was to increase future income tax liability and property and equipment by \$804,000 and \$298,000 respectively and to decrease retained earnings by \$506,000.

Foreign Currency Translation

The Corporation 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 statement of income.

Stock Options

The Corporation has a stock option plan available to employees and directors with grants under the Plan approved from time to time by the Board of Directors. Under the Plan, the Corporation is authorized to issue options to purchase, in aggregate, up to 10% of the issued and outstanding common shares. The options vest after one year, expire not more than five years from the date of grant, and each option can be exercised for one common share of the Corporation.

Earnings Per Common Share

In accordance with the recommendations of the Canadian Institute of Chartered Accountants, the Corporation retroactively adopted the treasury stock method for the computation and disclosure of diluted per share amounts effective January 1, 2001. Under this method, the diluted weighted average number of common shares is calculated assuming the proceeds from the exercise of dilutive options are used to purchase common shares at the average market price.

If the imputed interest method had been used for the year ended December 31, 2001, fully diluted earnings per common share would have been \$0.83 (2000 – \$0.73) and fully diluted funds from operations per common share would have been \$2.06 (2000 – \$1.77).

Measurement Uncertainty

The amounts recorded for depreciation and depletion of property and equipment and the provision for future site restoration are based on estimates. The ceiling test calculation is based on estimates of proven reserves production rates, oil 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 financial statements of changes in such estimates in future periods could be material.

2. ACQUISITION

On July 10, 2001, the Corporation acquired all of the outstanding shares of Herc Oil Corp. ("Herc"), a private oil and gas company, for cash consideration of \$19.83 million. The acquisition was accounted for by the purchase method and the purchase price has been allocated as follows:

(\$ thousand)		
Working capital		1,972
Property and equipment		23,392
Future tax asset		993
Long-term debt		(5,696)
Future-site restoration		(830)
Cash consideration		<u>19,831</u>

3. PROPERTY AND EQUIPMENT

(\$ thousand)	2001		
	Cost	Accumulated Depreciation and Depletion	Net Book Value
Petroleum and natural gas rights	128,066	27,990	100,076
Production equipment and facilities	25,914	7,362	18,552
Office equipment	739	373	366
	<u>154,719</u>	<u>35,725</u>	<u>118,994</u>

(\$ thousand)	2000		
	Cost	Accumulated Depreciation and Depletion	Net Book Value
Petroleum and natural gas rights	79,103	19,524	59,579
Production equipment and facilities	19,787	5,316	14,471
Office equipment	653	309	344
	<u>99,543</u>	<u>25,149</u>	<u>74,394</u>

At December 31, 2001, petroleum and natural gas rights include \$9,437,099 (2000 – \$6,698,621) relating to undeveloped properties which have been excluded from the depletion calculation.

4. LONG-TERM DEBT

The Corporation has a revolving demand credit facility which provides for a line of credit of \$50,000,000 bearing interest at prime (December 31, 2001 – 4%; 2000 – 7.5%) and has 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. As at December 31, 2001 \$22,530,000 (2000 – \$15,475,000) was drawn on this credit facility.

The Corporation also has a revolving demand credit facility in the United States for \$4,300,000 (U.S.) bearing interest at U.S. prime plus $\frac{3}{4}\%$ (December 31, 2001 – 5.5%) and has pledged a first floating charge on all of the U.S. assets and a fixed charge over certain U.S. property and equipment as collateral. As at December 31, 2001, \$725,668 (U.S.) was drawn on this facility.

While the credit facilities are of a demand nature, the banks have stated that it is not their present intention to demand repayment nor do they have information that would lead them to anticipate that the loans would be called before January 1, 2003. Accordingly, the loans are classified as long-term.

5. SHARE CAPITAL

The Corporation is authorized to issue an unlimited number of common shares and an unlimited number of first preferred and second preferred shares.

Common shares

	2001		2000	
	Number of Shares	Amount \$	Number of Shares	Amount \$
(thousand)				
Shares issued				
Balance, beginning of year	14,315	20,667	14,420	20,742
Issuance of common shares	2,000	13,547	–	–
Normal course issuer bid	(23)	(34)	(340)	(509)
Stock options exercised	374	886	235	434
Balance, end of year	16,666	35,066	14,315	20,667

On August 20, 2001 the Corporation issued 2,000,000 common shares for gross proceeds of \$14,100,000. Share issue costs of \$993,916 have been recorded net of tax of \$441,163.

Normal Course Issuer Bids were filed with the Toronto Stock Exchange on June 22, 1999 and November 22, 2000 whereby the Corporation was permitted to purchase and cancel up to 970,000 of its common shares prior to June 23, 2000 and 1,150,000 of its common shares prior to November 23, 2001, respectively.

Shares purchased and cancelled under these Issuer Bids are summarized as follows:

	Average Number of Shares (thousand)	Cost Per Share \$	Aggregate Cost of Shares Purchased (\$ thousand)	Charged to Share Capital (\$ thousand)	Charged to Retained Earnings (\$ thousand)
June 22, 1999 Issuer Bid:					
June to December, 1999	388	2.71	1,058	574	484
January to June, 2000	161	3.00	487	241	246
	549	2.81	1,545	815	730
November 22, 2000 Issuer Bid:					
November and December, 2000	179	3.93	704	268	436
January to March, 2001	23	4.57	105	34	71
	202	3.99	809	302	507
	751	3.13	2,354	1,117	1,237

Stock options

Stock options to acquire common shares are granted to employees and directors from time to time at exercise prices equal to the market value of the shares at the date of the grant. No compensation expense is recognized for grants under this Plan when stock or stock options are issued. Any consideration paid on exercise of stock options is credited to share capital.

The Corporation has reserved 1,260,000 shares at December 31, 2001 (December 31, 2000 – 1,245,000) for issuance under the stock option plan.

A summary of the status of the Corporation's stock option plans as at December 31, 2001 and 2000, and changes during the years ended on those dates is presented below:

	2001		2000	
	Shares (thousand)	Weighted Average Exercise Price \$	Shares (thousand)	Weighted Average Exercise Price \$
Outstanding at beginning of year	1,290	2.71	1,450	2.51
Granted	298	4.94	75	3.96
Exercised	(374)	2.37	(235)	1.84
Cancelled	(15)	4.28	–	–
Outstanding at end of year	1,199	3.36	1,290	2.71
Options exercisable at year end	916	2.85	842	2.67

The following table summarizes information about stock options outstanding at December 31, 2001:

Range of Exercise Prices (\$)	Options Outstanding			Options Exercisable	
	Number Outstanding at 12/31/01 (thousand)	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price \$	Number Exercisable at 12/31/01 (thousand)	Weighted Average Exercise Price \$
2.14 to 2.59	84	0.7 years	2.35	84	2.35
2.60	338	2.3 years	2.60	338	2.60
2.90 to 3.10	438	1.0 years	3.00	438	3.00
3.90 to 4.57	194	4.0 years	4.19	56	3.98
5.40 to 7.20	145	4.3 years	5.65	–	–
	1,199		3.36	916	2.85

6. INCOME TAXES

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

(\$ thousand)	2001	2000
Statutory income tax rate	43.33%	44.99%
Computed income taxes	9,229	9,053
Add (deduct) income tax effect of:		
Non-deductible crown charges, net of Alberta Royalty Tax Credit	3,756	3,366
Resource allowance	(4,394)	(3,726)
Rate adjustment	(440)	5
Large corporation and capital taxes	358	288
Other	(345)	15
	8,164	9,001

As at December 31, 2001, the Corporation has exploration and developments costs, unamortized oil and gas property expenditures, undepreciated capital costs, unamortized share issue costs and non-capital loss carry forwards available for deduction against future taxable income in aggregate of approximately \$72,591,000 (December 31, 2000 – \$45,923,000).

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 the Corporation's future income tax liability are as follows:

(\$ thousand)	2001	2000
Net book value of capital assets in excess of tax pools	21,140	12,703
Site restoration	(1,359)	(723)
Non-capital loss carryforwards	(1,136)	-
Share issue costs	(379)	(79)
Attributed royalty income	(43)	(50)
	18,223	11,851

7. WEIGHTED AVERAGE NUMBER OF COMMON SHARES

(thousand)	2001	2000
Weighted average number of common shares outstanding during the year	15,558	14,408
Diluted weighted average number of common shares outstanding during the year	16,114	14,771

Diluted earnings and cash flow from operations per share reflect the dilutive effect of the exercise of the vested stock options outstanding.

8. FINANCIAL INSTRUMENTS

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

The Corporation enters into currency contracts for hedging purposes because the price received for its products varies in close relationship to the U.S. dollar currency exchange rate.

The Corporation enters into interest rate swaps in order to fix the rate of a portion of its long term debt.

The Corporation has outstanding contracts at December 31, 2001 and 2000 as follows:

	Volume	Average Fixed Price Range	Range of Terms
At December 31, 2001			
Oil collar	109,500 bbl	\$23.00 US/bbl Put \$28.15 US/bbl Call	Jan. 1/02 – Dec. 31/02
Oil swap	73,000 bbl	\$25.85US/bbl	Jan. 1/02 – Dec. 31/02
Natural gas swaps	856,000 gj	\$3.48 – \$4.11/gj	Apr. 1/02 – Oct. 31/02
	608,000 gj	\$3.65 – \$3.77/gj	Jan. 1/02 – Oct. 31/02
Gas collars	604,000 gj	\$5.00/gj Put \$7.05 – \$9.15/gj Call	Jan. 1/02 – Mar. 31/02
Interest rate swap	5.35% int.	\$5,000,000 CDN	Jan. 1/02 – Apr. 30/02
At December 31, 2000			
Oil collar	54,750 bbl	\$20.00 US/bbl Put \$23.65 US/bbl Call	Jan. 1/01 – Dec. 31/01
Oil put options	146,000 bbl	\$25.00 US/bbl Put	Jan. 1/01 – Dec. 31/01
Natural gas swaps	456,000 gj	\$3.615 – \$5.17/gj	Jan. 1/01 – Oct. 31/01
Gas put options	1,644,000 gj	\$3.50 – \$5.00/gj	Jan. 1/01 – Oct. 31/01
Currency swaps	\$180,000 US/mo.	1.5165 exch.	Jan. 1/01 – Dec. 31/01
Interest rate swap	5.35% int.	\$5,000,000 CDN	Jan. 1/01 – Apr. 30/02

At December 31, 2001, \$1,447,000 would have been received to settle the above swap transactions and as at December 31, 2000, the cost to settle the swaps would have been \$1,915,000. These instruments have no book values recorded in the financial statements.

9. SEGMENTED INFORMATION

Oil and Gas Sales

(\$ thousand)	2001	2000
Canada	60,999	53,306
United States	2,796	–
	63,795	53,306

Total Assets

(\$ thousand)	2001	2000
Canada	123,262	86,884
United States	4,664	–
	127,926	86,884

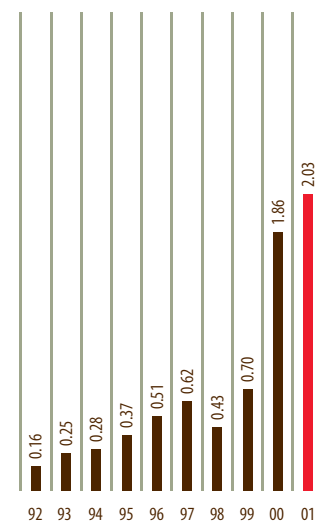
TEN YEAR
FINANCIAL AND
OPERATING
SUMMARY

	2001	2000	1999	1998
FINANCIAL (\$ thousand, except per share amounts)				
Production Revenue	63,795	53,306	24,048	14,264
Less expenses – cash items				
Royalty expenses	14,222	10,716	4,033	1,837
Field operating expenses	11,933	8,615	6,120	5,080
General and administrative expenses (net)	3,083	2,189	1,463	1,252
Hedging (gain) loss	573	2,733	1,095	(180)
Bank and other interest	957	1,269	592	377
Current and capital taxes	358	288	103	77
Net Corporate Cash Flow	32,669	27,496	10,642	5,821
Less expenses – non-cash items				
Depletion, depreciation and foreign exchange	10,683	6,801	4,750	3,659
Future income tax	7,806	8,713	1,046	430
Site restoration and reclamation	1,045	720	585	482
Net Corporate Earnings	13,135	11,262	4,261	1,250
Per Share, diluted				
Cash flow (\$/share)	2.03	1.86*	0.70	0.43
Earnings (\$/share)	0.82	0.76*	0.29	0.10
Net capital expenditures	55,176	30,514	16,945	12,477
Balance Sheet At Year End				
Total property and equipment	118,994	74,394	50,383	38,189
Bank and other debt	24,137	15,902	14,116	6,178
Shareholders' equity	69,985	42,522	32,523	29,320
Shareholders' equity (\$/share)	4.20	2.97	2.26	1.98
Average common shares outstanding (thousand)	15,558	14,408	14,686	13,025
Period end common shares outstanding (thousand)	16,666	14,315	14,420	14,810
OPERATIONS				
Total production (boe/d 6:1)	5,553	4,140	3,236	2,563
Total production (boe/d 10:1)	4,308	3,174	2,626	2,141
Crude oil and liquids (bbl/d)	2,441	1,725	1,711	1,508
Natural gas (mmcf/d)	18.67	14.49	9.15	6.33
Boe/d per million shares (6:1)	357	287	224	196
Total proven reserves (mboe 6:1)	20,605	16,200	12,387	9,736
Total proven reserves (mboe 10:1)	16,556	12,256	9,516	7,871
Proven crude oil and liquids (mmbbl)	10,482	6,340	5,210	5,072
Proven natural gas (bcf)	60.74	59.16	43.06	27.99
Boe per share (year-end @ 6:1)	1.24	1.13	0.86	0.66
Total proven and probable reserves (mboe 6:1)	25,793	21,256	16,233	12,942
Total proven and probable reserves (mboe 10:1)	20,841	16,215	12,575	10,559
Proven and probable crude oil and liquids (mmbbl)	13,413	8,676	7,090	6,984
Proven and probable natural gas (bcf)	74.28	75.39	54.85	35.75
Average selling prices (before hedges)				
WTI crude price (\$US/bbl)	25.90	30.20	19.24	14.42
FOB Edmonton crude price (\$/bbl)	39.18	44.33	27.35	20.08
Zargon field crude price (\$/bbl)	31.86	40.73	25.02	17.80
NYMEX Henry Hub Price (\$US/mmbtu)	3.94	4.31	2.27	2.09
Alberta AECO gas price (\$/mmbtu)	5.43	5.60	2.92	2.07
Zargon field gas price (\$/mcf)	5.19	5.20	2.52	1.93
Other Data				
Net wells drilled	47.7	38.6	18.8	4.9
Net undeveloped land (acres)	240.7	213.1	177.2	115.8
Closing share price (\$/share)	7.20	4.45	3.00	2.40

*Restated using the treasury stock method

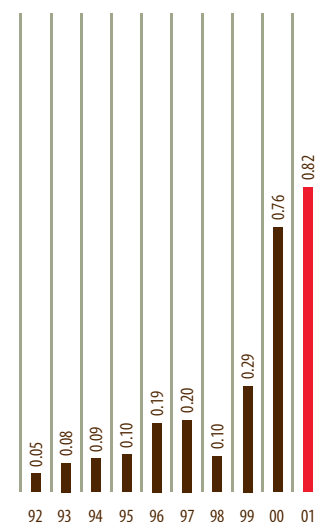
1997	1996	1995	1994	1993	1992
16,800	12,150	8,244	5,748	4,016	2,130
2,652	2,075	1,293	997	751	529
5,081	3,324	2,875	2,095	1,474	685
1,035	741	508	416	277	205
44	434	-	-	-	-
142	232	313	122	196	134
181	236	-	-	(39)	59
7,665	5,108	3,255	2,118	1,357	545
3,276	2,028	1,733	1,179	830	382
1,421	910	507	20	40	5
490	267	215	194	128	21
2,478	1,903	800	723	359	137
0.62	0.51	0.37	0.28	0.25	0.16
0.20	0.19	0.10	0.09	0.08	0.05
13,371	7,821	5,526	4,730	6,017	1,972
29,371	20,776	14,983	11,604	8,146	3,021
4,872	491	2,864	2,040	400	1,393
22,364	18,060	11,127	9,048	7,696	1,575
1.80	1.54	1.20	1.12	1.02	0.61
12,051	9,659	8,441	7,595	5,781	4,050
12,553	10,486	9,261	8,061	7,510	4,050

Cash Flow Per Share
(\$/share - diluted)



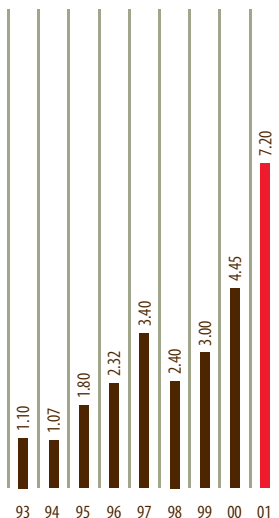
2,445	1,629	1,347	993	771	362
2,021	1,382	1,162	842	633	319
1,385	1,012	885	616	426	256
6.36	3.70	2.77	2.26	2.07	0.63
203	169	159	131	133	89
7,811	5,903	4,213	3,499	2,743	1,000
6,340	5,024	3,625	2,939	2,194	888
4,134	3,706	2,744	2,099	1,371	720
22.06	13.18	8.82	8.40	8.23	1.68
0.62	0.50	0.46	0.43	0.34	0.25
10,088	8,483	6,595	5,886	4,743	1,506
8,333	6,980	5,551	4,962	3,970	1,306
5,700	4,728	3,986	3,576	2,643	1,006
26.33	22.53	15.66	13.86	13.27	3.00
20.61	22.01	18.40	17.17	18.48	20.55
27.64	29.23	24.04	21.86	21.90	23.52
24.70	26.91	21.79	19.41	18.53	20.25
2.48	2.72	1.69	1.92	2.12	-
1.80	1.47	1.19	1.96	1.93	1.36
1.86	1.62	1.19	1.67	1.49	0.93
14.6	8.5	6.5	6.9	0.1	-
81.4	63.5	44.5	23.6	18.1	9.5
3.40	2.32	1.80	1.07	1.10	-

Earnings Per Share
(\$/share - diluted)



CORPORATE
INFORMATION

Zargon Year End Share Price



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

James D. Peplinski
Calgary, Alberta

Byron J. Seaman
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

KEY PERSONNEL

J. Yves Gauthier
Manager, Exploitation

John D. Sorkilmo
Senior Geologist

Neil D. Watson
Senior Geologist

Stuart A. Wilson
Production Manager, North

STOCK EXCHANGE LISTING

The Toronto Stock Exchange
Trading Symbol: ZAR

TRANSFER AGENT

Computershare Trust Company of Canada
600, 530 8th Avenue S.W.
Calgary, Alberta T2P 3S8

BANKER

The Toronto Dominion Bank
2 Calgary Place, 340 5th Avenue S.W.
Calgary, Alberta T2P 3N9

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

ABBREVIATIONS

bbl	Barrel
bbl/d	Barrels of oil per day
bcf	Billion cubic feet
boe	Barrel of oil equivalent
boe/d	Barrel of oil equivalent per day
btu	British thermal units
gj	Gigajoules
m	Thousand
mm	Million
mcf	Thousand cubic feet
mcf/d	Thousand cubic feet per day

Zargon Oil & Gas Ltd.

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