Management's discussion and analysis ("MD&A") is a review of Zargon Oil & Gas Ltd.'s ("Zargon" or the "Company") 2003 financial results and should be read in conjunction with the audited consolidated financial statements and related notes for the years ended December 31, 2003 and 2002. The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP"). In the MD&A, reserves and production are commonly stated in barrels of equivalent (boe) on the basis that six thousand cubic feet of natural gas is equivalent to one barrel of oil.

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

HIGHLIGHTS

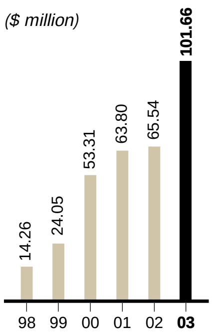
The combination of high oil and natural gas prices and strong production volume gains enabled Zargon to achieve record revenues, cash flow from operations and net earnings in 2003, showing gains of 55 percent, 69 percent and 130 percent, respectively, over the prior year. Approximately 80 percent of these annual revenue and cash flow gains came from our natural gas operations, as Zargon's 2003 natural gas production volumes grew 23 percent and natural gas prices increased 66 percent over 2002 levels. Net earnings benefited similarly from these natural gas gains, but in addition were enhanced significantly by the mid-year announcement of future federal tax rate reductions that produced a large one-time reduction in future tax provisions.

Net capital expenditures for 2003 totalled $39.91 million with $37.30 million allocated to field-related activities, showing a 12 percent increase in overall net expenditures, but a 56 percent increase in field-related expenditures. The significant expansion in 2003 fieldwork came from an active second half 2003 exploration program. The purchase of the Truro Unit in North Dakota was the largest acquisition made in 2003. Over the year, Zargon increased its undeveloped land base by 20 percent at a cost of $6.98 million; shot or acquired seismic at a cost of $5.69 million; drilled, equipped and tied-in wells for $24.63 million and made property acquisitions of $7.83 million. All of these activities were funded by the high cash flows received throughout the year plus non-core property dispositions of $5.22 million. The combined operation and disposition cash flows along with minor stock-option-related equity issuances exceeded the year's capital expenditures, and debt net of working capital was reduced by $15.65 million to $13.09 million at December 31, 2003.

($ million, except per share amounts)	**2003**	2002	2001
Petroleum and natural gas revenue	**101.66**	65.54	63.80
Cash flow from operations	**54.35**	32.12	32.67
Per diluted share ($)	**2.96**	1.81	2.03
Net earnings	**24.53**	10.68	13.14
Per diluted share ($)	**1.33**	0.60	0.82
Net capital expenditures	**39.91**	35.55	55.18

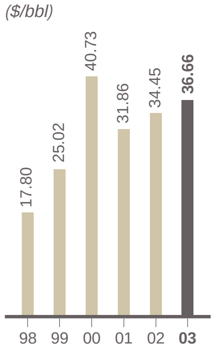
PETROLEUM AND NATURAL GAS REVENUE

($ million)



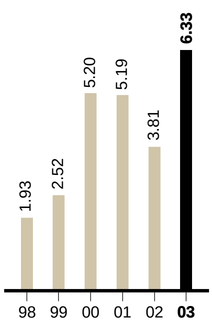
OIL AND LIQUID PRICES

($/bbl)



NATURAL GAS PRICES

($/mcf)



DETAILED FINANCIAL ANALYSIS

PETROLEUM AND NATURAL GAS REVENUE

Zargon derives its revenue from the production and sale of petroleum (crude oil and natural gas liquids) and natural gas. Petroleum and natural gas revenue exclusive of hedges increased 55 percent to $101.66 million in 2003 from $65.54 million in 2002 due to increased production and higher prices. Production volumes in 2003 increased 17 percent from the prior year, made up of a natural gas production increase of 23 percent and an oil and liquids production increase of 11 percent. The average price of oil and liquids received by Zargon rose to $36.66 per barrel in 2003, up six percent from 2002; however, the major impact came from a 66 percent gain in the average field price of natural gas to $6.33 per thousand cubic feet in 2003.

Because of the large gains in both natural gas production volumes and prices received, the allocation of production revenue in 2003 increased to 57 percent from the sale of natural gas and 43 percent from the sale of oil and liquids, a reversal from the 43 percent from natural gas and 57 percent from oil and liquids in the preceding year.

PETROLEUM (OIL AND NATURAL GAS LIQUIDS) PRICING

Zargon's field oil and liquid prices are adjusted for transportation charges and oil quality differentials from an Edmonton light sweet crude price that varies with world commodity prices. In 2003, Zargon's average oil and liquids field price, exclusive of hedges, rose six percent to $36.66 per barrel from $34.45 per barrel in 2002 and $31.86 per barrel in 2001. The field price differential for Zargon's average blended 30 degree API crude stream was $6.48 per barrel less than the 2003 Edmonton reference crude price, which compares to the 2002 differential of $5.49 per barrel and the 2001 differential of $7.32 per barrel. As the quality and weight of Zargon's crude stream have remained relatively consistent for several years, the movements in the Zargon's price differential is derived from the North American refinery supply and demand factors for sour medium crudes.

NATURAL GAS PRICING

After peaking in March 2003 at $8.90 per thousand cubic feet, Zargon's field natural gas price exclusive of hedges stayed at historically strong levels between $5.00 and $6.70 per thousand cubic feet for the balance of the year. The average natural gas price for 2003 of $6.33 per thousand cubic feet was 66 percent above 2002, 22 percent above both 2001 and 2000, and far above all previous years. The apparent trend to higher Alberta natural gas prices is based on North American supply and demand fundamentals modified by shorter term climatic and storage inventory factors.

Approximately 35 percent of Zargon's 2003 natural gas production was sold under aggregator contracts pursuant to long-term contracts with Cargill Gas Marketing Ltd. (Jarrow—29 percent) and ProGas Limited (Hamilton Lake—six percent), compared to 41 percent in the prior year. The remainder of Zargon's natural gas production was sold by spot sale contracts and Alberta index prices were received. In 2003, Zargon continued with an ongoing trend to develop new West Central Alberta natural gas production, which receives spot sale natural gas prices and is not subject to aggregator contract prices.

HEDGING ACTIVITIES

Zargon's commodity price risk management policy uses forward sales, options, puts and costless collars for, on average, 20 to 30 percent of our net petroleum and natural gas production in order to partially offset the effects of large price fluctuations. As both Canadian oil and natural gas field prices are closely correlated to US dollar denominated markets, Zargon will also place US/Cdn currency exchange hedges when considered prudent.

Because our hedging strategy is protective in nature and is designed to guard the Company against extreme effects from sudden falls in prices and revenues, upward price spikes and trends tend to produce overall losses. Oil and natural gas prices moved to very high levels in first quarter 2003 and then trended to lower, although still historically high levels, as the year progressed. As a consequence, hedging activities produced a loss of $2.22 million in the first quarter and smaller losses of $0.47 million and $0.35 million in the second and third quarters respectively. The currency exchange collar in place throughout 2003 was positive all year and provided an overall gain of $1.22 million, partially offsetting the commodity hedge losses. Lower natural gas prices in the fourth quarter, plus increased strength in the Canadian dollar, produced a quarterly hedge gain of $0.17 million. For the full year 2003, the hedge loss was $2.88 million, which compares to a gain of $0.67 million in 2002 and hedge losses of $0.57 million in 2001 and $2.73 million in 2000. A similar level of risk management was employed in all four years.

During the year, oil and currency hedges resulted in a $1.04 million reduction of 2003 oil and liquid revenues, which is equivalent to a $0.87 per barrel charge against the year's total oil and liquid production. Natural gas hedges reduced Zargon's 2003 gas revenues by $1.84 million, equivalent to a $0.20 per thousand cubic feet charge on the year's total natural gas production.

ROYALTIES

Royalties include payments made to the Crown, freehold owners and third parties. Reported royalties also 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 taxes. During 2003, total royalties were $22.51 million, an increase of 67 percent from $13.51 million in 2002. Royalties as a percentage of gross revenue (before hedging adjustments) were 22.1 percent in 2003 compared to 20.6 percent in 2002 and 22.3 percent in 2001. On a commodity basis, oil royalties averaged 20.2 percent (before hedging) in 2003, a small increase from the previous year's average of 19.9 percent. Natural gas royalties averaged 23.5 percent, up from 21.5 percent in the prior year, as a result of the addition of several higher production natural gas wells in 2003 that carry a higher effective royalty rate.

During 2003, 56 percent of the total royalties were paid to provincial and state 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 earned a $0.50 million ARTC rebate in 2003 compared to a $0.32 million rebate in 2002. The SRC charges were $0.53 million in 2003, up from $0.52 million in the prior year and $0.34 million in 2001. North Dakota state taxes increased to $0.85 million Cdn in 2003 from $0.52 million in the prior year, reflecting increased production from Haas and the addition of the Truro Unit.

PRODUCTION EXPENSES

Zargon's production expenses increased 10 percent to $17.20 million in 2003 from $15.65 million in 2002; less than the 17 percent gain in 2003 production volumes. On a unit of production basis, production expenses decreased six percent to $6.33 per barrel of equivalent from $6.75 in 2002 ($5.89 in 2001) as the Company made a concerted effort to reverse an increasing cost trend.

Natural gas production expenses in 2003 rose three percent to $0.71 per thousand cubic feet from $0.69 per thousand cubic feet in 2002. The increase in the 2003 natural gas costs reflects the industry-wide trend to higher operating costs.

Oil production expenses in 2003 of $8.95 per barrel showed a reduction of eight percent from the prior year charge of $9.72 per barrel in 2002 ($8.85 per barrel in 2001). The corporate acquisition of Herc Oil Corp. in mid-2001 added largely long-life, low-decline exploitable oil properties with relatively high production costs. To contain these costs, a number of the smaller, less desirable oil properties were sold in 2002 and 2003, taking advantage of robust property markets. These dispositions of the higher cost components of our property base were the primary source of the 2003 oil production cost improvements.

OPERATING NETBACKS

The average oil price received after hedges in 2003 of $35.79 per barrel was five percent higher than $34.12 per barrel in 2002, while the average natural gas price received after hedges in 2003 of $6.13 per thousand cubic feet rose sharply, 55 percent above $3.95 per thousand cubic feet in 2002. Operating netbacks increased commensurately; oil and liquids netbacks rose 11 percent to $19.42 per barrel from $17.54 per barrel in 2002 and were helped by lower production costs. Natural gas netbacks increased 61 percent to $3.93 per thousand cubic feet from $2.44 per thousand cubic feet in 2002. On an equivalent basis, 2003 operating netbacks rose 36 percent to $21.73 from $15.99 in 2002.

OPERATING NETBACKS

	2003		2002	
	Oil and Liquids ($/bbl)	**Natural Gas ($/mcf)**	Oil and Liquids ($/bbl)	Natural Gas ($/mcf)
Production revenue	**36.66**	**6.33**	34.45	3.81
Hedging	**(0.87)**	**(0.20)**	(0.33)	0.14
Royalties	**(7.42)**	**(1.49)**	(6.86)	(0.82)
Production costs	**(8.95)**	**(0.71)**	(9.72)	(0.69)
Operating netbacks	**19.42**	**3.93**	17.54	2.44

GENERAL AND ADMINISTRATIVE EXPENSES

Gross general and administrative costs increased 17 percent in 2003 to $5.94 million from $5.06 million in 2002 due mainly to an increase in the number of employees and office space as the Company expanded. On a unit of production basis, general and administrative costs decreased 13 percent to $1.30 per barrel of equivalent. This improvement was derived from a 17 percent increase in production volumes and a 49 percent increase in capital program overhead recoveries pertaining to Zargon's 2003 expanded field exploration and operations program.

GENERAL AND ADMINISTRATIVE EXPENSES

($ million, except as noted)	**2003**	2002	2001
Gross general and administrative expense	**5.94**	5.06	4.50
Overhead recoveries	**(2.40)**	(1.61)	(1.42)
Net general and administrative expense	**3.54**	3.45	3.08
Net expense after recoveries ($/boe)	**1.30**	1.49	1.52
Number of office employees at year end	**34**	30	30

INTEREST EXPENSE

Zargon's primary borrowings are through its bank line of credit. Strong cash flows from operations throughout 2003 were sufficient to cover capital expenditures and, coupled with the proceeds from non-core dispositions, reduce bank indebtedness to $6.98 million at December 31, 2003. Short-term interest rates remained at historically low levels throughout the year. Interest charges for 2003 were $0.77 million, their lowest level since 1999. Zargon's effective interest rate was 4.5 percent on an average bank debt of $17.19 million in 2003 compared to 4.1 percent on an average bank debt of $26.72 million in 2002 and 4.9 percent on an average bank debt of $19.50 million in 2001. At year end 2003 Zargon's bank debt, net of working capital, totalled $13.09 million, down 54 percent from $28.74 million at December 31, 2002.

CAPITAL AND CURRENT INCOME TAX

Zargon did not pay current income taxes in 2003, but incurred $0.41 million of federal and provincial capital taxes compared to the $0.38 million incurred in 2002. Zargon reorganized its operations into a partnership structure effective July 10, 2001 and acquired significant excess tax pools with both the 2001 Herc Oil Corp. and 2002 Hadrian Energy Corp. acquisitions. These transactions helped increase the 2002 year-end tax pools to approximately $87 million and sheltered 2003 taxable income. Tax pools at December 31, 2003 were approximately $79 million and it is expected that they will shelter most of the budgeted 2004 taxable income.

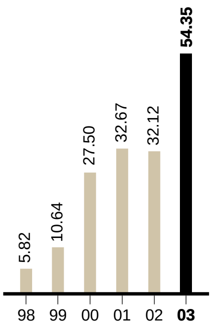
CORPORATE NETBACKS

Historically high oil and natural gas commodity prices were experienced in 2003 and resulted in much higher revenue and operating netbacks. Driven by a 32 percent increase in revenue on a barrel of equivalent basis, cash flow netbacks increased 44 percent over the prior year to $20.00 per barrel of equivalent.

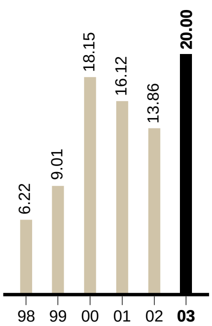
CORPORATE NETBACKS

($/boe)	**2003**	2002	2001
Petroleum and natural gas revenue	**37.40**	28.28	31.48
Hedging	**(1.06)**	0.29	(0.29)
Royalties	**(8.28)**	(5.83)	(7.01)
Production costs	**(6.33)**	(6.75)	(5.89)
Operating netbacks	**21.73**	15.99	18.29
General and administrative	**(1.30)**	(1.49)	(1.52)
Interest	**(0.28)**	(0.47)	(0.47)
Capital and current income taxes	**(0.15)**	(0.17)	(0.18)
Cash flow netbacks	**20.00**	13.86	16.12
Depletion and depreciation	**(6.99)**	(5.84)	(5.22)
Site restoration	**(0.58)**	(0.55)	(0.52)
Stock-based compensation	**(0.10)**	–	–
Unrealized foreign exchange	**0.11**	(0.03)	(0.05)
Future income taxes	**(3.41)**	(2.83)	(3.85)
Net earnings	**9.03**	4.61	6.48

CASH FLOW FROM OPERATIONS
($ million)



CASH FLOW NETBACKS
($/boe)



CASH FLOW FROM OPERATIONS

In 2003, a 17 percent gain in production volumes, in addition to increases of six percent in oil and liquids prices and 66 percent in natural gas prices, produced a 69 percent gain in cash flow from operations to $54.35 million, compared to $32.12 million in 2002 and $32.67 million in 2001. The corresponding cash flow per diluted share was $2.96 in 2003 and was a 64 percent gain from $1.81 per diluted share in 2002 and compares to $2.03 in 2001. The per share statistics reflected a three percent increase in the average number of outstanding shares to 17.82 million in 2003 from 17.23 million in 2002.

DEPLETION AND DEPRECIATION

In 2003, Zargon's depletion and depreciation provision increased 40 percent to $19.01 million compared to $13.54 million in 2002 and $10.58 million in 2001. The higher charges reflect an increase of 17 percent in production volumes and a 20 percent increase in per unit charges. This large increase in per unit depletion and depreciation expense is primarily due to a December 31, 2003 year-over-year 14 percent reduction in the Company's proved reserves as calculated under the new policies of NI 51-101.

Depletion, depreciation and site restoration charges calculated on a unit of production method are based on total proved reserves with a conversion of six thousand cubic feet of natural gas being equivalent to one barrel of oil. The 2003 depletion calculation includes $4.73 million of future capital expenditures to develop the Company's reserves, but excludes $14.50 million of unproven properties relating to undeveloped land.

Zargon's depletion and depreciation, on a barrel of equivalent basis, increased 20 percent in 2003 to $6.99 from $5.84 in 2002 and $5.22 in 2001. Depletion and depreciation rates continue to climb as evidenced by Zargon's depletion and depreciation rate per barrel of equivalent in fourth quarter 2003 of $8.47 compared to a first half 2003 rate of $6.26.

SITE RESTORATION

Zargon provided for $1.57 million of site restoration charges in 2003 compared to $1.27 million in 2002 and $1.05 million in 2001. In fourth quarter 2003, Zargon increased the estimated future site restoration charges to $30,000 for each net working interest well from $25,000 per net well used in the past. The impact of this change and the year-over-year 14 percent reduction in proven reserves resulted in a fourth quarter charge of $0.78 per barrel of equivalent as compared to the first half 2003 rate of $0.50. In 2004 site restoration costs will be calculated using the new Asset Retirement Obligation rules as outlined under the "Recent Canadian Accounting Pronouncements" section.

STOCK-BASED COMPENSATION

Stock-based compensation of $0.26 million is recorded for the first time in the 2003 income statement in response to prospective adoption of a new CICA accounting standard. The non-cash expense was calculated using the Black-Scholes option-pricing model and covers all employee and director stock options granted by Zargon in 2003. The introduction of stock-based compensation expense added $0.10 per barrel of equivalent to the unit cost. These non-cash expenses will be recurring charges in future years if Zargon continues to grant employee and director stock options.

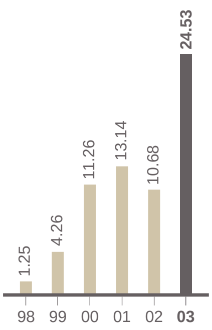
FUTURE INCOME TAXES

Zargon's 2003 future tax expense increased 42 percent to $9.28 million from $6.55 million in 2002, because of a 69 percent gain in cash flow from operations that was partially offset by a mid-year recognition of changes in federal tax legislation. The changes, which were contained in Bill C-48 and introduced into the House of Commons in June 2003, will be implemented over a five-year period and encompass the following:

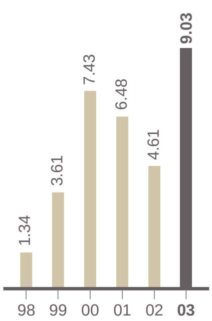
- The federal Large Corporations Tax of 0.225 percent will be eliminated;
- The corporate income tax rate on income from resource activities will be gradually reduced from 28 percent to 21 percent;
- The existing 25 percent resource allowance will be eliminated and a deduction for actual provincial and other Crown royalties paid will be introduced.

The effect of these one-time changes, which are considered to be "substantively enacted" for GAAP purposes, and a reduction in the Alberta corporate income tax rate from 13 percent to 12.5 percent, created a large one-time recovery in Zargon's future income tax expense of $4.31 million. On a barrel of equivalent basis, future income taxes were $3.41 in 2003, an increase of 20 percent from the prior year's future income taxes of $2.83. Without the tax rate adjustment, 2003 future taxes would have been approximately $13.59 million or $5.00 per barrel of equivalent. The 2003 effective tax rate (current and future) was 28 percent compared to 39 percent in 2002 and 38 percent in 2001.

NET EARNINGS
($ million)



NET EARNINGS NETBACKS
($/boe)



NET EARNINGS

Zargon's 2003 net earnings of $24.53 million jumped 130 percent from $10.68 million in 2002 and compare to $13.14 million recorded in 2001. The very strong 2003 increase was due primarily to the 69 percent increase in cash flow from operations and secondarily to the downward adjustment made in the 2003 future tax provision, which effectively added about $4.31 million to net earnings. On a per diluted share basis, 2003 net earnings increased 122 percent to $1.33 from $0.60 in 2002 and $0.82 in 2001.

On a barrel of equivalent basis, the 2003 net earnings were $9.03 compared to $4.61 in 2002 and $6.48 in 2001. Reflecting primarily the adjustment in future tax calculations, the 2003 net earnings represented 45 percent of cash flow, a strong gain from 33 percent of cash flow in 2002 and 40 percent in 2001.

RETURN ON EQUITY

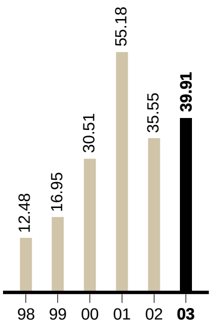
Zargon's pre-tax return on shareholders' equity in 2003 increased to 34 percent, compared to 22 percent in the previous year and 38 percent in 2001. The after-tax return on shareholders' equity in 2003 increased to 25 percent from 14 percent in the prior year (23 percent in 2001). Zargon's after-tax rates of return on equity have averaged 21 percent over the past three years and 18 percent over the Company's twelve-year corporate history.

CAPITAL EXPENDITURES

Net capital expenditures in 2003 of $39.91 million increased 12 percent over $35.55 million in 2002, although remained well below the $55.18 million expended in 2001, which included the relatively large Herc Oil Corp. acquisition. During the year, Zargon supported and internally funded an aggressive land acquisition program and a strong exploration effort. Total undeveloped land expenditures were $6.98 million, including $6.20 million of Crown land purchases at an average cost of $81 per acre, a significant increase in both amount and unit price from prior years and reflecting the very competitive current environment. Seismic work, drilling, completions and other field activities in 2003 were focused on gas exploration in the Alberta Plains and West Central Alberta core areas, plus a strong component of Williston Basin oil exploitation and totalled $30.32 million, a 56 percent increase from the prior year.

NET CAPITAL EXPENDITURES

($ million)



During 2003, Zargon made additional property acquisitions of $7.83 million and a series of dispositions aggregating $5.22 million for a net amount of property acquisitions of $2.61 million. The largest property acquisition in 2003 was the purchase of a 92.5 percent interest in the Truro Unit in North Dakota for $4.95 million Cdn The dispositions were opportunity-driven and were offered in packages of non-core, higher-cost property interests sold at premium prices. In 2004, Zargon is projecting to spend $45 million on capital expenditures.

CAPITAL EXPENDITURES

($ million)	**2003**	2002	2001
Undeveloped land	**6.98**	4.46	5.08
Geological and geophysical (seismic)	**5.69**	2.47	3.80
Drilling and completion of wells	**17.30**	12.49	17.44
Well equipment and facilities	**7.33**	4.48	4.87
Exploration and development	**37.30**	23.90	31.19
Property acquisitions	**7.83**	7.39	4.83
Property dispositions	**(5.22)**	(3.13)	(4.23)
Net property acquisitions	**2.61**	4.26	0.60
Corporate acquisitions assigned to property and equipment	**–**	7.39	23.39
Total net capital expenditures	**39.91**	35.55	55.18

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.
- When debt is considered to be at reasonable upper levels, new equity, if available and if on favourable terms, will be utilized to expand capital programs further. Conversely, on occasions when Zargon's equity may be valued by the stock market at levels perceived to be at a substantial discount to the underlying net asset value, the Company will consider the repurchase of its shares through an issuer bid.

In 2003, Zargon's net capital expenditure program of $39.91 million was fully funded from cash flow from operations, while the remaining cash flow of $14.44 million was used to pay down debt.

CAPITAL SOURCES

($ million)	**2003**	2002	2001
Cash flow from operations	**54.35**	32.12	32.67
Changes in working capital and other	**2.66**	(3.58)	0.39
Change in bank indebtedness	**(18.30)**	1.14	8.23
Issuance of common shares	**1.20**	5.87	13.89
Total capital sources	**39.91**	35.55	55.18

CASH FLOW FROM OPERATIONS

It is anticipated that the majority, if not Zargon's entire 2004 capital budget, will be financed through the reinvestment of the Company's cash flow from operations. Cash flow is partially influenced by factors that the Company cannot control such as commodity prices, the US/Cdn dollar exchange rates and interest rates. Zargon's 2004 sensitivity to moderate fluctuations in these key business parameters is shown in the accompanying table.

CASH FLOW SENSITIVITY SUMMARY

	Change in 2004 Cash Flow	
	($ million)	($/share)
Change of $1.00 US/bbl in the price of WTI oil	1.40	0.07
Change in oil production of 100 bbl/d	0.60	0.03
Change of $0.10 US/mcf in the price of NYMEX natural gas	1.00	0.05
Change in natural gas production of one mmcf/d	1.30	0.07
Change in $0.01 in the $US/$Cdn exchange rate	1.20	0.06

BANK INDEBTEDNESS

The Company has authorized lines of credit totalling $50 million with a Canadian bank. At December 31, 2003, bank debt was $6.98 million, a decrease of 72 percent from the prior year-end amount of $25.28 million. Effective January 1, 2002 the Company adopted the CICA recommendation that treats revolving demand bank debt as a current liability.

Zargon's combined debt and working capital deficiency of $13.09 million at December 31, 2003 was equivalent to 24 percent of the 2003 cash flow from operations of $54.35 million and slightly less than the fourth quarter cash flow from operations of $13.24 million. At December 31, 2002 the combined debt and working capital deficiency was $28.74 million, equivalent to 89 percent of 2002 cash flow from operations.

EQUITY

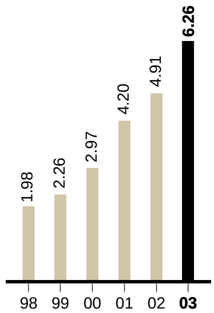
At year end 2003, Zargon had 17.99 million shares outstanding. Including the 1.30 million options outstanding (0.99 million vested at December 31, 2003) under the Company stock option plan, Zargon's fully diluted year-end balance of shares outstanding was 19.29 million.

Pursuant to the Company's stock option plan, Zargon issued 355 thousand shares for $1.20 million to employees and directors of the Company in 2003, at an average exercise price of $3.39 per share. In the prior year, 429 thousand shares were issued pursuant to the plan at an average exercise price of $2.94 per share.

On June 17, 2002 Zargon issued 542 thousand common shares as partial consideration for Hadrian Energy Corp. The shares issued were valued at $8.75 per share.

During 2003, 4.77 million Zargon shares traded on The Toronto Stock Exchange with a high of $13.75 per share, a low of $8.26 per share and a close of $13.50 per share. The 2003 trading statistics show a 25 percent year-over-year decrease in trading volume, and a 50 percent increase in the closing stock price. Zargon's market capitalization at year end 2003 was approximately $243 million.

SHAREHOLDERS' EQUITY
($/share)



SEGMENTED GEOGRAPHIC INFORMATION

In calendar 2003 and 2002, approximately 89 percent of Zargon's combined petroleum and natural gas revenue came from Western Canada properties (Alberta, Saskatchewan and Manitoba), with the remaining 11 percent of revenues generated in the United States (North Dakota and Montana).

CONTRACTUAL OBLIGATIONS

Zargon has certain contractual obligations relating to the lease of head office space, field operating leases and transportation contracts that extend over future years as set out in the table below:

CONTRACTUAL OBLIGATIONS

($ million)	Total	2004	2005	2006	Thereafter
Head office lease and other	2.15	0.62	0.60	0.59	0.34
Field operating leases	1.06	0.85	0.21	–	–
Transportation contracts	0.79	0.47	0.22	0.04	0.06
	4.00	1.94	1.03	0.63	0.40

CRITICAL ACCOUNTING POLICIES

The preparation of the consolidated financial statements in accordance with Canadian generally accepted accounting principles requires management to make judgments and estimates that affect the financial results of the Company. The critical estimates are discussed below.

FULL COST ACCOUNTING

Zargon follows the full cost method of accounting for petroleum and natural gas operations as outlined in Canadian Institute of Chartered Accountants ("CICA") accounting guideline "Oil and Gas Accounting—Full Cost" (AcG-5). Under this accounting method, all costs related to the exploration and development of petroleum and natural gas reserves are capitalized. Capitalized costs, as well as the estimated future expenditures to develop proved reserves, are depleted using the unit of production method based on estimated proved petroleum and natural gas reserves.

PETROLEUM AND NATURAL GAS RESERVES

All of Zargon's petroleum and natural gas reserves are evaluated and reported on by independent petroleum engineering consultants. The estimation of reserves is a subjective process. Forecasts are based on engineering data, projected future rates of production, and the timing of future expenditures, all of which are subject to numerous uncertainties and various interpretations. The Company expects that its estimates of reserves will change to reflect updated information. Reserve estimates can be revised upward or downward based on the results of future drilling, testing or production levels.

CEILING TEST

In applying the full cost method, Zargon calculates a ceiling test on a quarterly basis to ensure that the net carrying value of petroleum and natural gas assets does not exceed the estimated undiscounted future net revenues from production of proved reserves before royalties, 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. The calculation of future net revenue is based on sales prices, costs and regulations in effect at the period end.

RECENT CANADIAN ACCOUNTING PRONOUNCEMENTS

ASSET RETIREMENT OBLIGATIONS

In March 2003, the CICA approved Section 3110, "Asset Retirement Obligations," which requires liability recognition for retirement obligations associated with the Company's property, plant and equipment. The obligations are initially measured at fair value, which is the discounted future value of the liability. The fair value is capitalized as part of the cost of the related assets and amortized to expense over their useful lives. The liability accretes until the retirement obligations are settled. Section 3110 is effective for fiscal years beginning on or after January 1, 2004. The site restoration liability currently on the balance sheet, which has been calculated using the unit of production method, will be reversed on January 1, 2004. The Company is currently evaluating the impact of this standard on its consolidated financial statements.

PETROLEUM AND NATURAL GAS ASSETS—FULL COST ACCOUNTING

In September 2003, the CICA issued Accounting Guideline 16, "Oil and Gas Accounting—Full Cost" (AcG-16), to replace AcG-5. The new guideline is effective for fiscal years beginning on or after January 1, 2004. The most significant change between AcG-16 and AcG-5 is that AcG-16 limits the carrying value of petroleum and natural gas properties to their fair value. The fair value is equal to estimated future cash flows from proved and probable reserves using future price forecasts and costs discounted at a risk-free rate. This differs from the current cost recovery ceiling test under AcG-5 that uses undiscounted cash flows, constant prices and costs, less general and administrative and financing costs. Zargon is following AcG-5 at December 31, 2003. No write-down of the Company's petroleum and natural gas properties would be required under either method at December 31, 2003. AcG-16 also adopted the reserve evaluation and disclosure requirements of NI 51-101, which have been followed in the preparation of this report.

VARIABLE INTEREST ENTITIES

In June 2003, the CICA issued Accounting Guideline 15, "Consolidation of Variable Interest Entities" (AcG-15), which deals with the consolidation of entities that are subject to control on a basis other than ownership of voting interests. This guideline is effective for annual and interim periods beginning on or after November 1, 2004. Zargon has assessed that this new guideline is not applicable based on the current structure of the Company and therefore has no impact on the consolidated financial statements of the Company.

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 arises from the production performance of existing properties, the changes in regulatory standards and 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 oil and natural gas production, put options on both oil and natural gas, costless collars (in which some potential high price gain is given up in return for potential low price support) and US dollar currency hedges in different forms for up to 30 percent of its net oil and natural gas production 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. This strategy is designed mainly to protect the Company against periods of unusually low commodity prices and by its nature is likely to produce significant hedging losses when prices are unusually high.

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 it has demonstrated proven technical capabilities and understanding. Finally, Zargon's capital budget is managed so as to limit 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, sustainable and profitable growth. For calendar 2004, Zargon has budgeted $45 million of capital expenditures allocated to natural gas exploration, oil exploitation and property acquisition opportunities. In addition, its balance sheet strength will permit Zargon to make a relatively large property or corporate acquisition as value-added opportunities become available.

SELECTED QUARTERLY INFORMATION

				2003				2002
($ million, except per share amounts)	**Q4**	**Q3**	**Q2**	**Q1**	Q4	Q3	Q2	Q1
Petroleum and natural gas revenue	**24.51**	**23.76**	**24.20**	**29.19**	20.67	16.65	15.50	12.73
Cash flow from operations	**13.24**	**12.34**	**13.53**	**15.23**	10.71	7.75	7.47	6.19
Per diluted share ($)	**0.72**	**0.67**	**0.74**	**0.84**	0.59	0.43	0.42	0.36
Net earnings	**4.03**	**4.51**	**9.25**	**6.74**	4.28	2.27	2.55	1.58
Per diluted share ($)	**0.22**	**0.24**	**0.51**	**0.37**	0.24	0.13	0.14	0.09
Total assets	**175.07**	**166.89**	**160.05**	**159.34**	153.66	146.00	137.76	128.97
Bank indebtedness	**6.98**	**8.92**	**11.47**	**20.78**	25.28	28.71	28.00	25.26

Forward-Looking Statements: This document contains statements that are forward-looking, such as those relating to results of operations and financial condition, capital spending, financing sources, commodity prices, costs of production and the magnitude of oil and natural gas reserves. By their nature, forward-looking statements are subject to numerous risks and uncertainties that could significantly affect anticipated results in the future and, accordingly, actual results may differ materially from those predicted. The forward-looking statements contained in this annual report are as of March 23, 2004 and are subject to change after this date. Readers are cautioned that the assumptions used in the preparation of such information, although considered reasonable at the time of preparation, may prove to be imprecise and, as such, undue reliance should not be placed on forward-looking statements. Zargon disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.