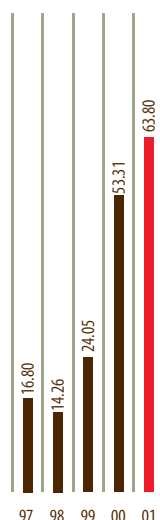
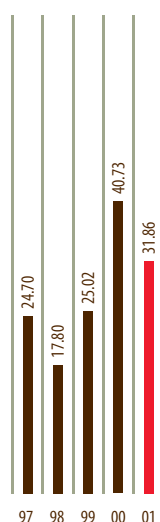


Management's Discussion and Analysis

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

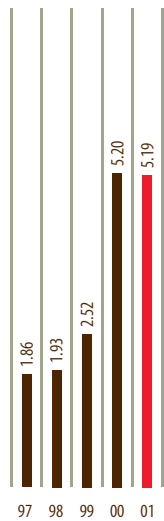
Zargon derives its revenue from the production and sale of crude oil, natural gas liquids and natural gas. Oil (inclusive of natural gas liquids) and natural gas revenue increased 20 percent to \$63.80 million in 2001 from \$53.31 million in 2000 and \$24.05 million in 1999. Production volumes (6:1) 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.

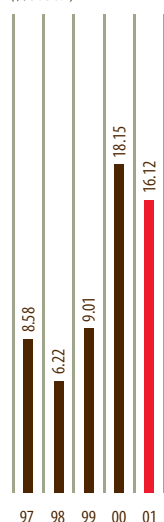
Capital and Income Tax

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.

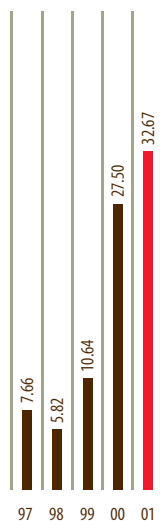
Corporate Netbacks

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

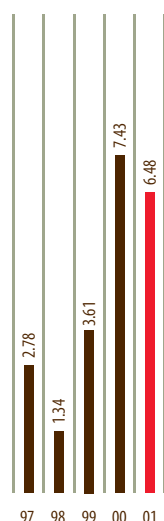
In 2001, Zargon's depletion and depreciation provision increased 15 percent to \$6.73 per barrel of equivalent (10:1), up from \$5.85 per barrel of equivalent in 2000 (\$4.96 per barrel of equivalent in 1999). Depletion, depreciation and site restoration charges calculated on a unit of production method 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.

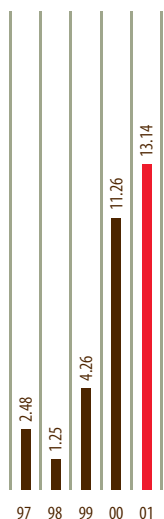
Site Restoration and Reclamation

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).

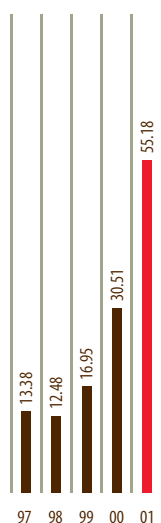
Return on Equity

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

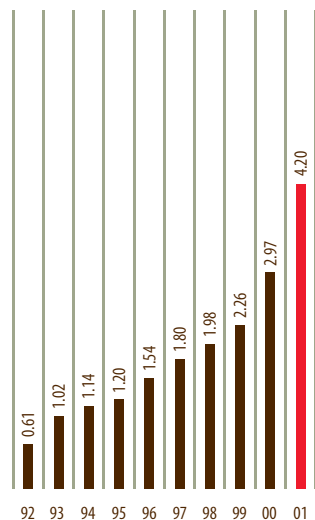
	Change in 2002 Cash Flow	
	(\$ million)	(\$/share)
Change of \$1.00 US/bbl in the price of WTI oil	1.11	0.07
Change in oil production of 100 bbl/d	0.41	0.03
Change of \$0.10 US/mcf in the price of NYMEX gas	0.71	0.05
Change in gas production of 1 mmcf/d	0.59	0.04
Change in \$0.01 in the \$US/\$Cdn exchange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