

2005

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Zargon

ENERGY TRUST

Zargon Energy Trust is pleased to report continued record financial results in the second quarter of 2005. Crude oil prices reached new high levels, natural gas prices were strong and the production base remained relatively stable. For the six months ended June 30, 2005, revenues increased 19 percent and cash flow from operations increased 13 percent from the same prior year period. On these strong results, the Trust is announcing that, commencing with the August 2005 distribution payable on September 15, 2005, the Trust's monthly cash distribution rate will be increased by \$0.02 to \$0.16 per trust unit.

*Highlights from the three and six months ended June 30, 2005 are noted below:*

- The combination of historically high commodity prices and relatively stable production volumes resulted in record revenues and cash flows for the Trust. Revenues for the 2005 second quarter of \$35.87 million were 16 percent above the second quarter 2004 levels and five percent above first quarter 2005. Cash flow from operations of \$19.01 million was 15 percent higher than the 2004 second quarter and nine percent higher than the preceding quarter.
- Oil and liquids production volumes of 3,582 barrels per day in the second quarter 2005 held at the first quarter level and were 10 percent higher than the prior year's second quarter. The 2005 second quarter natural gas production volumes of 27.94 million cubic feet per day were four percent lower than the previous quarter as new production additions were offset by a sudden decline at a single prolific well (see discussion below). On an equivalent basis, second quarter 2005 production averaged 8,238 barrels of equivalent per day, up one percent from the prior year quarter and down two percent from the preceding quarter. First half production volumes averaged 8,341 barrels of equivalent per day, an increase of four percent from the first half of 2004. Production on a per million trust unit outstanding basis averaged 439 barrels of equivalent per day for the second quarter and 445 barrels of equivalent per day for the first half and is little changed from the comparable prior year period rates of 446 barrels of equivalent per day and 440 barrels of equivalent per day, respectively.
- The Trust paid six monthly cash distributions of \$0.14 per trust unit in the 2005 first half for a total of \$13.34 million. These distributions were equivalent to a payout ratio of 43 percent of the Trust's record first half cash flow of \$1.94 per diluted trust unit, or reflecting the effect of the exchangeable shares that do not receive cash distributions, a 37 percent payout of the Trust's total cash flow. With the forward price curves showing continued commodity price strength, the Trust is raising its monthly cash distribution to \$0.16 per trust unit for the August 2005 distribution payable on September 15, 2005. As a sustainable trust, Zargon will continue to fulfill its commitment to maintain a stable production base through internal exploration, exploitation and development while distributing over the long-term an average of 50 percent of the cash flow attributed to the outstanding unitholders.
- First half capital expenditures included \$20.31 million for the exploration and development program of 21.9 net wells and \$1.34 million of net property acquisitions. The Trust's balance sheet remains very strong with net debt of \$21.10 million (excluding unrealized risk management liability) at June 30, 2005, which equates to 29 percent of annualized cash flow. During the first half of 2005, the Trust financed 100 percent of its distribution and capital expenditure program from cash flows from operations.

## FINANCIAL & OPERATING HIGHLIGHTS

FOR THE THREE AND  
SIX MONTHS ENDED  
JUNE 30, 2005

(unaudited)	Three Months Ended June 30,			Six Months Ended June 30,		
	2005	2004	Percent Change	2005	2004	Percent Change
<b>FINANCIAL</b>						
<b>Income and Investments</b> (\$ million)						
Petroleum and natural gas revenue	<b>35.87</b>	30.96	16	<b>69.99</b>	58.66	19
Cash flow from operations	<b>19.01</b>	16.53	15	<b>36.50</b>	32.26	13
Cash distributions	<b>6.73</b>	–	–	<b>13.34</b>	–	–
Net earnings	<b>6.48</b>	5.54	17	<b>11.62</b>	11.08	5
Net capital expenditures	<b>10.96</b>	7.61	44	<b>21.65</b>	17.38	25
<b>Per Trust Unit, Diluted</b>						
Cash flow from operations (\$/unit)	<b>1.01</b>	0.88	15	<b>1.94</b>	1.72	13
Net earnings (\$/unit)	<b>0.41</b>	0.29	41	<b>0.73</b>	0.59	24
<b>Cash Distributions</b> (\$/trust unit)	<b>0.42</b>	–	–	<b>0.84</b>	–	–
<b>Balance Sheet at Period End</b> (\$ million)						
Property and equipment, net				<b>235.61</b>	172.88	36
Bank indebtedness				<b>15.52</b>	–	–
Unitholders' equity				<b>138.88</b>	125.19	11
<b>Total Units Outstanding at Period End</b> (million)				<b>18.77</b>	18.28	3
<b>OPERATING</b>						
<b>Average Daily Production</b>						
Oil and liquids (bbl/d)	<b>3,582</b>	3,266	10	<b>3,589</b>	3,310	8
Natural gas (mmcf/d)	<b>27.94</b>	29.30	(5)	<b>28.52</b>	28.25	1
Equivalent (boe/d)	<b>8,238</b>	8,150	1	<b>8,341</b>	8,019	4
Equivalent per million total units (boe/d)	<b>439</b>	446	(2)	<b>445</b>	440	1
<b>Average Selling Price</b> (before hedges)						
Oil and liquids (\$/bbl)	<b>54.13</b>	44.32	22	<b>52.47</b>	42.11	25
Natural gas (\$/mcf)	<b>7.17</b>	6.67	7	<b>6.96</b>	6.47	8
<b>Wells Drilled, Net</b>	<b>10.2</b>	8.4	21	<b>21.9</b>	18.3	20
<b>Undeveloped Land at Period End</b> (thousand net acres)				<b>368</b>	405	(9)

Notes: The calculation of barrels of equivalent is based on the conversion ratio that six thousand cubic feet of natural gas is equivalent to one barrel of oil (boe).

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

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

## PRODUCTION

Natural gas production volumes averaged 29.10 million cubic feet per day in the first quarter 2005 but dropped to 27.94 million cubic feet per day in the second quarter when a step-function production decline of almost two million cubic feet per day was experienced due to water influx at Zargon's previously most prolific well located at Progress in the Peace River Arch region of the West Central Alberta core area. Consequently, second quarter natural gas production volumes were down five percent from the same prior year period and four percent from the preceding quarter although the first half of 2005 volumes still remained one percent higher than the volumes reported in the first half of 2004. During the quarter, Zargon was successful in partially offsetting the Progress well's production decline and the natural occurring production declines from other properties with production additions coming from exploration and development programs at Zargon's principal gas property located at Jarrow in the Alberta Plains and from West Central Alberta exploration initiatives at Highvale, Pembina and selected properties in the Peace River Arch.

Oil and liquids production of 3,582 barrels per day in the 2005 second quarter increased 10 percent over the 2004 second quarter and was essentially unchanged from the preceding quarter. The year-over-year gains came from a 2004 Williston Basin acquisition and ongoing Williston Basin exploitation initiatives.

## CAPITAL EXPENDITURES\*

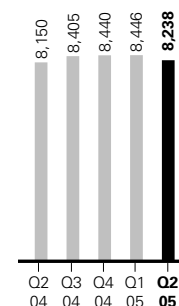
Following a prolonged spring break-up period, Zargon commenced an active Alberta drilling program in May with the result that by the end of the 2005 first half, Zargon had completed a 25 gross well (21.9 net) program that delivered 14.7 net natural gas wells, 5.3 net oil wells, 0.9 net service wells and 1.0 net dry hole for a 95 percent success ratio. During the half, natural gas drilling focused on the Alberta Plains where 12.3 net wells were drilled, primarily at the Jarrow property. The 4.4 net wells drilled in the West Central Alberta core area were also natural gas exploration focused and were approximately equally divided between the Pembina and Peace River Arch properties. During the half, 5.2 net oil exploitation wells were drilled in the Williston Basin core area with wells at Pinto, Steelman and Weyburn, Saskatchewan plus Haas, North Dakota.

The recent high level of field activity will continue throughout the remainder of the year in order to reach the 2005 budgeted program of 46 net wells, allocated 22, 10 and 14 net wells to the Alberta Plains, West Central Alberta and Williston Basin core areas respectively. Consistent with past programs, the Alberta Plains drilling program will focus on natural gas exploration and development at the Jarrow natural gas property. West Central Alberta activities will include additional Pembina natural gas locations, augmented by Highvale and Peace River Arch natural gas exploration. An expanded Williston Basin program will include seven horizontals at Steelman, Pinto, Ralph and Elswick in Southeast Saskatchewan and at Haas and Truro in North Dakota.

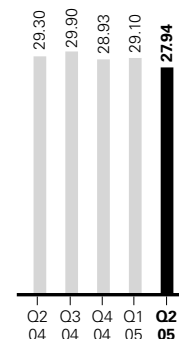
As a sustainable trust, Zargon has continued to post land and bid at Crown sales, but on an increasingly selective basis during this current period of high Crown land costs. In the six months ended June 30, 2005, Zargon spent \$1.73 million on undeveloped land, slightly less than in the prior year period. Land expiries in the first half of 2005 were partially offset by land purchases, leaving a net reduction of eight thousand net acres. Zargon's undeveloped land inventory at June 30, 2005 totalled 368 thousand net acres.

Because of the property market's current high valuation levels, Zargon's acquisitions in the first half of 2005 were limited in size with an aggregate cost of \$1.34 million, and were mostly related to Williston Basin properties in Southeast Saskatchewan.

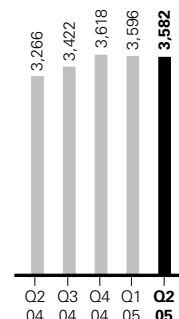
PRODUCTION  
(boe/d)



NATURAL GAS PRODUCTION  
(mmcf/d)



OIL AND LIQUID PRODUCTION  
(bbl/d)



## GUIDANCE\*

In the May 12, 2005 press release announcing the 2005 first quarter results, second quarter 2005 production guidance for the Trust was revised to 8,250 barrels of equivalent per day based on estimates of 28.50 million cubic feet per day of natural gas and 3,500 barrels per day of oil and liquids. Actual second quarter results of 8,238 barrels of equivalent per day, made up of 27.94 million cubic feet per day of natural gas and 3,582 barrels per day of oil and liquids, essentially met this target, although the actual production split had a slightly higher oil production component. In the same May 12, 2005 press release, 2005 second half production was guided to exceed 8,500 barrels of equivalent per day (29.25 million cubic feet per day of natural gas and 3,625 barrels per day of oil and liquids). The Trust was on track to exceed these levels until impacted by this spring's single well Progress area production problems. Now, third quarter 2005 rates are anticipated to roughly match second quarter levels, and growth in production volumes will be delayed until the fourth quarter when an active Williston Basin exploitation drilling program will have been completed. Based on the Trust's 2005 exploration and development \$40 million capital program, fourth quarter 2005 production volumes of 8,500 barrels of equivalent, comprised of 3,750 barrels of oil and liquids and 28.50 million cubic feet per day of natural gas, are forecasted. Further oil production gains are anticipated during the first half of calendar 2006.

The aforementioned production guidance volumes do not include an allowance for opportunistic property or corporate acquisitions that would be funded by bank debt or possibly equity issues. Zargon's acquisition initiatives will continue to be focused on acquiring underdeveloped oil properties (particularly in the Williston Basin) or undeveloped natural gas prospective lands that provide Zargon exploration and development opportunities to sustain production and reserves on a per unit basis, while distributing over the long-term an average of 50 percent of the Trust's cash flows attributed to the outstanding unitholders.

\* Please see comments on "Forward-Looking Statements" on the last page of this report.

## management's discussion and analysis

*Management's discussion and analysis (MD&A) should be read in conjunction with the unaudited interim consolidated financial statements for the three and six months ended June 30, 2005 and the audited consolidated financial statements and MD&A for the year ended December 31, 2004. All amounts are in Canadian dollars unless otherwise noted. All references to "Zargon" or the "Trust" refer to Zargon Energy Trust and all references to the "Company" refer to Zargon Oil & Gas Ltd.*

*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 (boe). Boes may be misleading, particularly if used in isolation. A boe conversion ratio of six thousand cubic feet of natural gas to one barrel of oil is based on an energy equivalent conversion method primarily applicable to the burner tip and does not represent a value equivalent at the wellhead.*

*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 Trust's financial performance. This term does not have any standardized meaning as prescribed by GAAP and therefore, the Trust's determination of cash flow from operations may not be comparable to that reported by other trusts. 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 Trust evaluates its performance based on net earnings and cash flow from operations. The Trust considers cash flow from operations to be a key measure as it demonstrates the Trust's ability to generate the cash necessary to pay distributions, repay debt and to fund future capital investment. It is also used by research analysts to value and compare oil and gas trusts, and it is frequently included in published research when providing investment recommendations. Cash flow from operations per unit is calculated using the diluted weighted average number of units for the period.*

*This MD&A has been prepared as of August 10, 2005.*

### Plan Of Arrangement

On July 15, 2004, approval was given by the shareholders to a resolution in favour of a Plan of Arrangement (the "Arrangement") reorganizing Zargon Oil & Gas Ltd. (the "Company") into Zargon Energy Trust (the "Trust" or "Zargon"). The Arrangement received court approval and also became effective on July 15, 2004. The Arrangement resulted in shareholders of the Company receiving either one trust unit or one exchangeable share for each common share held. The unitholders of the Trust are entitled to receive cash distributions paid by the Trust. Holders of exchangeable shares are not eligible to receive distributions but rather on each payment of a distribution, the number of trust units into which each exchangeable share is exchangeable is increased on a cumulative basis in respect of the distribution. The exchangeable shares are traded on the Toronto Stock Exchange and can be converted, at the option of the holder, into trust units at any time. On July 15, 2014, all the remaining outstanding exchangeable shares will be redeemed into trust units unless the Board of Directors of the Company elect to extend the redemption period. In certain circumstances, the Company has the right to require redemption of the exchangeable shares prior to July 15, 2014. Upon completion of the Arrangement, 14.87 million trust units and 3.66 million exchangeable shares were issued. The Trust is an unincorporated open-end investment trust governed by the laws of the Province of Alberta. It is the intent of the Trust to distribute over the long-term an average of 50 percent of the cash flow from operations attributable to outstanding unitholders.

The reorganization of the Company into a Trust has been accounted for using the continuity of interest method. Accordingly, the consolidated financial statements for the three and six months ended June 30, 2005 reflect the financial position, results of operations and cash flows as if the Trust had always carried on the business of the Company. The comparative figures referred to in the consolidated financial statements and this MD&A include the previous consolidated results of the Company.

## Summary Of Significant Events In The Second Quarter

- As a result of continued high commodity prices, the Trust realized record cash flow from operations of \$19.01 million in the second quarter of 2005 and declared monthly distributions of \$0.14 per trust unit with a total of \$6.73 million (\$0.42 per trust unit) paid or declared distributable to unitholders, resulting in a payout ratio of 35 percent of cash flow or 42 percent on a per diluted trust unit basis. For Canadian income tax purposes, the distributions are currently estimated to be 100 percent taxable income to unitholders.
- Average field prices for the second quarter received (before risk management losses) for oil and liquids increased to \$54.13 per barrel and for natural gas increased to \$7.17 per thousand cubic feet, a seven percent and six percent increase, respectively, from the first quarter of 2005. Production of 8,238 barrels of oil equivalent was down two percent from the previous quarter.
- During the second quarter of 2005, the Trust drilled 12 gross wells (10.2 net) with a 100 percent success rate. Total capital expenditures were \$10.96 million for the quarter.
- The Trust continues to maintain its balance sheet strength with a combined debt and working capital deficiency of \$21.10 million (excluding unrealized risk management liability), which represents under four months of the first half 2005 annualized cash flow.

## Financial Analysis

During the second quarter of 2005, commodity prices increased to record high levels and more than offset a decrease in production volumes of two percent from the previous quarter, resulting in record revenue of \$35.87 million, a five percent gain compared to the first quarter of 2005. Oil and liquids prices received averaged \$54.13 per barrel before risk management losses in second quarter 2005 compared to \$44.32 in the 2004 second quarter and \$50.79 in the preceding quarter, gains of 22 percent and seven percent respectively. West Texas Intermediate (WTI) crude oil prices were significantly higher in the second quarter due to continued world demand growth and concern over limited world spare production capacity. Reflecting industry trends, Zargon's crude oil field price differential from the Edmonton par price, increased to \$11.63 per barrel in the second quarter of 2005 compared to \$6.29 per barrel in the second quarter of 2004. Natural gas prices also averaged a very strong \$7.17 per thousand cubic feet before risk management losses in the second quarter and showed increases of seven percent and six percent, respectively, over the 2004 second quarter and the preceding quarter levels. Natural gas prices have reached historical high levels due to supply/demand concerns and the relative valuation of natural gas and crude oil prices.

### PRICING

Average For The Period	Three Months Ended June 30,			Six Months Ended June 30,		
	2005	2004	Percent Change	2005	2004	Percent Change
Natural Gas:						
NYMEX price (\$US/mmbtu)	<b>6.83</b>	5.96	15	<b>6.61</b>	5.83	13
AECO price (\$Cdn/mcf)	<b>7.37</b>	7.00	5	<b>7.13</b>	6.71	6
Realized price (\$Cdn/mcf) <i>(note 1)</i>	<b>7.17</b>	6.67	7	<b>6.96</b>	6.47	8
Crude Oil:						
WTI (\$US/bbl)	<b>53.19</b>	38.31	39	<b>51.52</b>	36.73	40
Edmonton par price (\$Cdn/bbl)	<b>65.76</b>	50.61	30	<b>63.61</b>	48.11	32
Realized price (\$Cdn/bbl) <i>(note 1)</i>	<b>54.13</b>	44.32	22	<b>52.47</b>	42.11	25

Note 1: Amounts are before risk management losses.

Natural gas production volumes of 27.94 million cubic feet per day in the 2005 second quarter decreased four percent over the preceding quarter and five percent from 2004 second quarter levels due to production losses at a significant well in the West Central Alberta core area. Oil and liquids production volumes in the second quarter of 2005 of 3,582 barrels per day were essentially unchanged from the previous quarter's production of 3,596 barrels per day. On a year-over-year basis, oil and liquids volumes increased 10 percent when compared to the second quarter of 2004 amount of 3,266 barrels per day, primarily due to the July 2004 acquisition of Southeast Saskatchewan properties and new exploitation drilling in the Williston Basin core area.

#### PRODUCTION BY CORE AREA

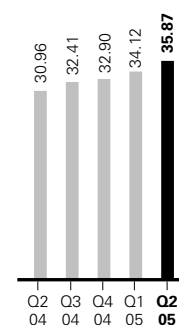
Three Months Ended June 30,	2005			2004		
	Oil and Liquids	Natural Gas	Equivalents	Oil and Liquids	Natural Gas	Equivalents
	(bbl/d)	(mmcf/d)	(boe/d)	(bbl/d)	(mmcf/d)	(boe/d)
Alberta Plains	597	19.53	3,852	606	18.81	3,742
West Central Alberta	209	8.13	1,563	226	10.26	1,937
Williston Basin	2,776	0.28	2,823	2,434	0.23	2,471
	<b>3,582</b>	<b>27.94</b>	<b>8,238</b>	3,266	29.30	8,150

Six Months Ended June 30,	2005			2004		
	Oil and Liquids	Natural Gas	Equivalents	Oil and Liquids	Natural Gas	Equivalents
	(bbl/d)	(mmcf/d)	(boe/d)	(bbl/d)	(mmcf/d)	(boe/d)
Alberta Plains	569	19.55	3,827	612	18.47	3,691
West Central Alberta	203	8.70	1,652	227	9.53	1,815
Williston Basin	2,817	0.27	2,862	2,471	0.25	2,513
	<b>3,589</b>	<b>28.52</b>	<b>8,341</b>	3,310	28.25	8,019

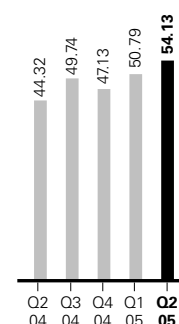
Zargon's commodity price risk management policy uses forward sales, options, puts and costless collars for, on average, 20 to 35 percent of working interest production in order to partially offset the effects of large price fluctuations. Because our risk management strategy is protective in nature and is designed to guard the Trust against extreme effects on cash flow from sudden falls in prices and revenues, upward price trends tend to produce overall losses. Risk management contracts in place as at December 31, 2004 were designated as hedges for accounting purposes and the Trust continues to monitor these contracts in determining the continuation of hedge effectiveness. For these contracts, realized gains and losses are recorded in the statement of earnings as the contracts settle and no unrealized gain or loss is recognized. For risk management contracts entered into after December 31, 2004, the Trust considers these contracts to be effective on an economic basis but has decided not to designate these contracts as hedges for accounting purposes. Accordingly, for outstanding contracts not designated as hedges as at June 30, 2005, an unrealized gain or loss is recorded on the fair value (mark-to-market) of the contracts at that time. Thus, the 2005 second quarter's continued high oil and natural gas prices brought about a realized risk management loss of \$1.23 million compared to a \$1.31 million loss in the second quarter of 2004 and \$0.79 million in the preceding quarter. The unrealized risk management loss for the second quarter of 2005 was \$1.10 million compared to \$2.26 million in the preceding quarter. The primary driver for these losses was the record high oil prices recorded in the current quarter. Zargon's commodity risk management positions are fully described in note 9 to the unaudited consolidated interim financial statements.

Royalties, inclusive of Alberta Royalty Tax Credit and Saskatchewan Resource Surcharge, totalled \$7.91 million for the second quarter of 2005, a decrease of two percent from the preceding quarter and an increase of 15 percent from \$6.89 million in the 2004 second quarter. As a percentage of gross revenue, royalty rates

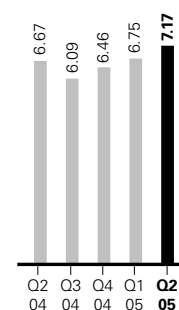
#### PETROLEUM AND NATURAL GAS REVENUE (\$ million)



#### OIL AND LIQUID PRICES (\$/bbl)



#### NATURAL GAS PRICES (\$/mcf)



have moved in a narrow range from 22.2 percent in the second quarter of 2004 to 23.5 percent in the first quarter of 2005 and 22.1 percent in the second quarter of 2005. The higher rate in the first quarter of 2005 was a result of adjustments related to prior periods.

On a unit of production basis, production costs have shown a modest decrease to \$7.67 per barrel of equivalent in second quarter 2005 compared with \$7.74 in the preceding quarter and \$8.09 in the fourth quarter 2004. During this current period of significantly increased industry-wide cost pressures, Zargon is continuing its efforts to contain increases in per unit operating costs.

#### OPERATING NETBACKS

Three Months Ended June 30,	2005		2004	
	Oil and Liquids	Natural Gas	Oil and Liquids	Natural Gas
	(\$/bbl)	(\$/mcf)	(\$/bbl)	(\$/mcf)
Production revenue	<b>54.13</b>	<b>7.17</b>	44.32	6.67
Realized risk management loss	<b>(2.84)</b>	<b>(0.12)</b>	(2.77)	(0.18)
Royalties	<b>(12.00)</b>	<b>(1.57)</b>	(9.15)	(1.56)
Production costs	<b>(9.84)</b>	<b>(1.00)</b>	(9.77)	(0.80)
Operating netbacks	<b>29.45</b>	<b>4.48</b>	22.63	4.13

Six Months Ended June 30,	2005		2004	
	Oil and Liquids	Natural Gas	Oil and Liquids	Natural Gas
	(\$/bbl)	(\$/mcf)	(\$/bbl)	(\$/mcf)
Production revenue	<b>52.47</b>	<b>6.96</b>	42.11	6.47
Realized risk management loss	<b>(2.84)</b>	<b>(0.04)</b>	(2.34)	(0.03)
Royalties	<b>(11.83)</b>	<b>(1.60)</b>	(8.72)	(1.47)
Production costs	<b>(10.09)</b>	<b>(0.98)</b>	(9.53)	(0.76)
Operating netbacks	<b>27.71</b>	<b>4.34</b>	21.52	4.21

Measured on a unit of production basis (net of recoveries), general and administrative expenses were \$1.69 per barrel of equivalent in the first half of 2005 compared to \$1.34 per barrel of equivalent in the first half of 2004 and \$1.45 for the 2004 year. The increase in costs on a per unit of production basis are primarily due to increased staff costs, increased outside advisory costs related to operating as a trust and securities regulatory compliance costs.

Expensing of unit-based compensation in the first half of 2005 was \$0.47 million, a 53 percent increase compared to the first half of 2004. The unit-based compensation expense, arising from unit rights granted upon and subsequent to the July 15, 2004 Plan of Arrangement, were originally calculated using the intrinsic value method up until December 31, 2004. In response to an emphasis by securities regulators that fair value methodologies be used, new measurement techniques were adopted for 2005 utilizing a fair value option-pricing model for such unit rights grants. Zargon has assessed the impact on 2004 unit-based compensation expense, and there is no significant impact. Prior to the effective date of the Arrangement, expensing of stock-based compensation benefits in the consolidated statement of earnings was calculated using the Black-Scholes option-pricing model.

Interest expense in the first half of 2005 was \$0.38 million, \$0.25 million higher compared to the first half of 2004. The primary reason for the increase on a year-over-year basis is the increase in average bank indebtedness due to the acquisition of Southeastern Saskatchewan properties and reorganization costs related to the trust conversion incurred in the third quarter of 2004.

Capital and current income taxes were \$0.96 million in the first half of 2005 compared to \$0.27 million in the first half of 2004. On a year-to-date basis, United States current income taxes are \$0.50 million and Canadian capital taxes are \$0.46 million. The primary reason for this increase is due to current income taxes being incurred related to the United States operations as a result of the increasing profitability of those operations due to high commodity prices.

#### TRUST NETBACKS

(\$/boe)	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2005	2004	2005	2004
Petroleum and natural gas revenue	<b>47.85</b>	41.75	<b>46.35</b>	40.20
Realized risk management loss	<b>(1.65)</b>	(1.77)	<b>(1.34)</b>	(1.09)
Royalties	<b>(10.55)</b>	(9.29)	<b>(10.57)</b>	(8.78)
Production costs	<b>(7.67)</b>	(6.79)	<b>(7.70)</b>	(6.61)
Operating netbacks	<b>27.98</b>	23.90	<b>26.74</b>	23.72
General and administrative	<b>(1.66)</b>	(1.34)	<b>(1.69)</b>	(1.34)
Interest	<b>(0.27)</b>	(0.07)	<b>(0.25)</b>	(0.09)
Capital and current income taxes	<b>(0.69)</b>	(0.21)	<b>(0.63)</b>	(0.19)
Cash flow netbacks	<b>25.36</b>	22.28	<b>24.17</b>	22.10
Depletion and depreciation	<b>(12.05)</b>	(8.66)	<b>(11.79)</b>	(8.66)
Unrealized risk management loss	<b>(1.46)</b>	–	<b>(2.22)</b>	–
Accretion of asset retirement obligations	<b>(0.40)</b>	(0.36)	<b>(0.39)</b>	(0.36)
Unit/stock-based compensation	<b>(0.20)</b>	(0.29)	<b>(0.31)</b>	(0.21)
Unrealized foreign exchange	<b>(0.13)</b>	(0.09)	<b>(0.10)</b>	(0.02)
Future income taxes	<b>(0.93)</b>	(5.41)	<b>(0.25)</b>	(5.26)
Earnings before non-controlling interest	<b>10.19</b>	7.47	<b>9.11</b>	7.59

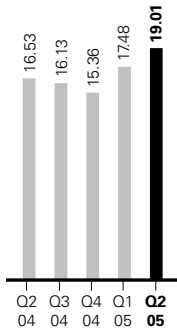
The second quarter 2005 depletion and depreciation unit expense of \$12.05 per barrel of equivalent is a five percent increase over the previous quarter expense of \$11.53 per barrel of oil equivalent and a 39 percent increase from the second quarter 2004 expense of \$8.66 per barrel of oil equivalent. The primary reason for this increase is due to the increase in the property and equipment balance from the conversion of exchangeable shares due to the application of EIC-151.

The provision for accretion of asset retirement obligations for the first half of 2005 was \$0.59 million, a 13 percent increase compared to the first half of 2004. The year-over-year change is due to changes in the estimated future liability for asset retirement obligations as a result of wells added through the drilling program and the 2004 acquisition of Southeast Saskatchewan properties in the Williston Basin core area.

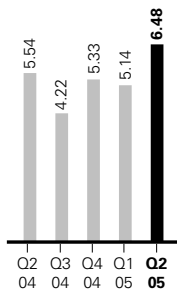
The provision for future taxes was \$0.70 million for the second quarter of 2005 compared to a recovery of future taxes of \$0.32 million in the prior quarter and an expense of \$4.01 million in the second quarter of 2004. The year-over-year reduction is due to the trust conversion since Zargon's future tax obligations are reduced as distributions are made from the Trust. Also impacting the first and second quarter of 2005 was the future tax impact of unrealized risk management losses of \$0.88 million and \$0.43 million respectively. Excluding the future tax impact of unrealized risk management losses, for the 2005 second quarter, future taxes were 11 percent of before tax earnings, which compares respectively with the 2005 first quarter and 2004 second quarter rates of six percent and 41 percent.

On January 19, 2005 the CICA issued EIC-151 "Exchangeable Securities Issued by Subsidiaries of Income Trusts" that states that exchangeable securities issued by a subsidiary of an Income Trust should be

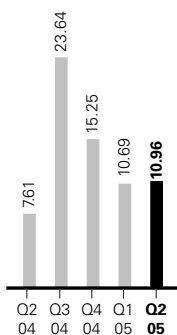
**CASH FLOW FROM OPERATIONS**  
(\$ million)



**NET EARNINGS**  
(\$ million)



**NET CAPITAL EXPENDITURES**  
(\$ million)



reflected as either a non-controlling interest or debt on the consolidated balance sheet unless they meet certain criteria. The exchangeable shares issued by Zargon Oil & Gas Ltd., a corporate subsidiary of the Trust, are publicly traded and have an expiry term, which could be extended at the option of the Board of Directors. Therefore, these securities are considered, by EIC-151, to be transferable to third parties and to have an indefinite life. EIC-151 states that if these criteria are met, the exchangeable shares should be reflected as a non-controlling interest. Previously, the exchangeable shares were reflected as a component of unitholders' equity. In accordance with the transitional provisions of EIC-151, the Trust adopted this standard as at December 31, 2004 and has retroactively restated prior periods dating back to the Plan of Arrangement dated July 15, 2004. As a result of this change in accounting policy, the Trust has reflected a non-controlling interest of \$9.20 million on the Trust's consolidated balance sheet as at June 30, 2005. Consolidated net earnings have been reduced for net earnings attributable to the non-controlling interest of \$2.13 million in the first half of 2005. In accordance with EIC-151 and given the circumstances in Zargon's case, each redemption is accounted for as a step-purchase, which to date in 2005 has resulted in an increase in property and equipment of \$21.66 million, an increase in unitholders' equity by \$18.49 million, and an increase in future income tax liability of \$5.63 million. Cash flow was not impacted by this change. The cumulative impact to date of the application of EIC-151 has been to increase property and equipment by \$32.94 million, accumulated depletion and depreciation by \$2.40 million, unitholders' equity and non-controlling interest by \$28.31 million, future income tax liability by \$8.63 million and an allocation of net earnings to exchangeable shareholders' of \$4.00 million.

Cash flow from operations in second quarter 2005 of \$19.01 million was \$1.53 million or nine percent higher than the preceding quarter and \$2.49 million or 15 percent higher than the 2004 second quarter. The 2005 first half cash flow of \$36.50 million was 13 percent higher than the prior year's comparative period primarily as a result of a nine percent increase in the cash flow netback to \$24.17 per barrel of oil equivalent and a four percent increase in production volumes to 8,341 barrels of oil equivalent. Cash flow per diluted unit showed similar gains with the 2005 second quarter cash flow of \$1.01 per diluted unit increasing nine percent over the first quarter levels and the 2005 first half cash flow of \$1.94 per diluted unit improving 13 percent over the 2004 comparable period.

Net earnings of \$6.48 million for the second quarter of 2005 increased 26 percent from the preceding quarter and 17 percent from the second quarter of 2004. The net earnings track the cash flow from operations for the respective periods modified by non-cash charges which in the 2005 period include increased depletion and depreciation, unrealized risk management losses and non-controlling interest.

**CAPITAL EXPENDITURES**

(\$ million)	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Undeveloped land	<b>0.87</b>	0.77	<b>1.73</b>	1.85
Geological and geophysical (seismic)	<b>0.64</b>	0.94	<b>1.47</b>	2.36
Drilling and completion of wells	<b>6.88</b>	4.67	<b>13.15</b>	9.73
Well equipment and facilities	<b>1.85</b>	1.14	<b>3.96</b>	2.92
Exploration and development	<b>10.24</b>	7.52	<b>20.31</b>	16.86
Property acquisitions	<b>0.72</b>	0.36	<b>1.34</b>	0.79
Property dispositions	-	(0.27)	-	(0.27)
Net property acquisitions	<b>0.72</b>	0.09	<b>1.34</b>	0.52
Total capital expenditures (net)	<b>10.96</b>	7.61	<b>21.65</b>	17.38

## Liquidity And Capital Resources

Capital expenditures of \$21.65 million in the first half of 2005 were 25 percent higher than in the first half of 2004, reflecting an active field program of 25 gross (21.9 net) wells compared to 23 gross (18.3 net) wells in the first half of 2004. Capital expenditures for the first half of 2005 were allocated to Alberta Plains \$8.45 million, West Central Alberta \$6.57 million and Williston Basin \$6.63 million. Drilling and completion expenditures increased 35 percent from the previous year to \$13.15 million and well equipping correspondingly increased 36 percent during the same period while undeveloped land purchases fell six percent as Zargon continues a more selective land acquisition program as Crown sales continue to be competitive. A modest amount of acquisitions of various properties to complement Zargon's existing asset base resulted in an increase of \$0.55 million in property acquisition costs compared to the first half of 2004. Cash flow from operations in the first half of \$36.50 million and proceeds from the exercise of trust unit rights of \$1.01 million funded the capital program, payment of distributions and a reduction of the working capital deficiency (including bank indebtedness). As at June 30, 2005, the Trust continues to maintain a strong balance sheet with a working capital deficiency balance (including bank indebtedness and excluding the unrealized risk management liability) of \$21.10 million, which is less than four months of the first half annualized cash flow.

At August 10, 2005, Zargon Energy Trust has 16.145 million trust units and 2.474 million exchangeable shares outstanding. Assuming full conversion of exchangeable shares at the effective exchange ratio of 1.06759, there would be 18.786 million trust units outstanding. Pursuant to the trust unit rights incentive plan there are currently an additional 0.671 million trust unit incentive rights issued and outstanding.

### CAPITAL SOURCES

(\$ million)	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Cash flow from operations	<b>19.01</b>	16.53	<b>36.50</b>	32.26
Changes in working capital and other	<b>1.19</b>	(5.58)	<b>(3.81)</b>	(9.23)
Change in bank indebtedness	<b>(2.70)</b>	(3.68)	<b>1.29</b>	(6.98)
Cash distributions	<b>(6.73)</b>	–	<b>(13.34)</b>	–
Issuance of trust units/shares related to exercise of trust unit rights/stock options	<b>0.19</b>	0.34	<b>1.01</b>	1.33
<b>Total capital sources</b>	<b>10.96</b>	7.61	<b>21.65</b>	17.38

### Outlook

As a result of the continuing strength of commodity prices and the demonstrated ability of the Trust to meet its objectives as a sustainable trust, distributions have been increased to \$0.16 per unit per month beginning with the August distribution payable on September 15, 2005. Zargon is well positioned with a very strong balance sheet, 368 thousand net acres of undeveloped land and a promising project inventory. Zargon intends to continue its disciplined approach with a strategy of focusing on exploration and exploitation of its existing asset base while executing value-added property acquisitions if and when they become available.

## Summary Of Quarterly Results

	2005	
	Q1	Q2
Petroleum and natural gas revenue (\$ million)	34.12	<b>35.87</b>
Net earnings (\$ million)	5.14	<b>6.48</b>
Net earnings per diluted unit (\$)	0.32	<b>0.41</b>
Cash flow (\$ million)	17.48	<b>19.01</b>
Cash flow per diluted unit (\$)	0.93	<b>1.01</b>
Cash distributions (\$ million)	6.60	<b>6.73</b>
Cash distributions paid or declared per unit (\$)	0.42	<b>0.42</b>
Net capital expenditures (\$ million)	10.69	<b>10.96</b>
Total assets (\$ million)	245.20	<b>253.75</b>
Bank debt (\$ million)	18.23	<b>15.52</b>
Daily production (boe)	8,446	<b>8,238</b>
Average realized commodity price before risk management losses (\$/boe)	44.90	<b>47.85</b>
Cash flow netback (\$/boe)	23.01	<b>25.36</b>

	2004			
	Q1	Q2	Q3	Q4
Petroleum and natural gas revenue (\$ million)	27.70	30.96	32.41	32.90
Net earnings (\$ million) <i>(note 1)</i>	5.54	5.54	4.22	5.33
Net earnings per diluted unit (\$ <i>(note 1)</i> )	0.30	0.29	0.28	0.34
Cash flow (\$ million)	15.73	16.53	16.13	15.36
Cash flow per diluted unit (\$)	0.84	0.88	0.87	0.82
Cash distributions (\$ million)	–	–	4.27	6.43
Cash distributions paid or declared per unit (\$)	–	–	0.28	0.42
Net capital expenditures (\$ million)	9.77	7.61	23.64	15.25
Total assets (\$ million) <i>(note 1)</i>	186.18	189.80	215.23	226.96
Bank debt (\$ million)	3.67	–	9.77	14.23
Daily production (boe)	7,889	8,150	8,405	8,440
Average realized commodity price before risk management losses (\$/boe)	38.59	41.75	41.91	42.36
Cash flow netback (\$/boe)	21.91	22.28	20.86	19.78

	2003			
	Q1	Q2	Q3	Q4
Petroleum and natural gas revenue (\$ million)	29.19	24.20	23.76	24.51
Net earnings (\$ million) <i>(note 1)</i>	6.65	9.17	4.44	4.10
Net earnings per diluted unit (\$ <i>(note 1)</i> )	0.36	0.50	0.24	0.22
Cash flow (\$ million)	15.23	13.53	12.34	13.24
Cash flow per diluted unit (\$)	0.84	0.74	0.67	0.72
Net capital expenditures (\$ million)	6.86	8.10	12.11	12.84
Total assets (\$ million) <i>(note 1)</i>	165.12	165.98	172.81	181.05
Bank debt (\$ million)	20.78	11.47	8.92	6.98
Daily production (boe)	7,060	7,222	7,470	8,020
Average realized commodity price before risk management losses (\$/boe)	45.94	36.82	34.57	33.22
Cash flow netback (\$/boe)	23.96	20.58	17.96	17.95

*Note 1: Certain comparative period numbers reflect retroactive restatements due to changes in accounting policies.*

### Additional Information

Additional information regarding the Trust and its business operations, including the Trust's Renewal Annual Information Form for December 31, 2004, is available on the Trust's SEDAR profile at [www.sedar.com](http://www.sedar.com).

"Signed" C.H. Hansen  
President and Chief Executive Officer

Calgary, Alberta  
August 10, 2005

# consolidated balance sheets

(unaudited) (\$ thousand)	June 30, 2005	December 31, 2004
<b>ASSETS</b>		
<b>Current</b>		
Accounts receivable	15,942	14,275
Prepaid expenses and deposits	2,197	2,953
	18,139	17,228
<b>Property and equipment, net</b> <i>(note 3)</i>	235,608	209,736
	253,747	226,964
<b>LIABILITIES</b>		
<b>Current</b>		
Bank indebtedness	15,522	14,230
Accounts payable and accrued liabilities	21,464	24,153
Cash distributions payable	2,258	2,210
Unrealized risk management liability <i>(note 9)</i>	3,351	–
	42,595	40,593
<b>Asset retirement obligations</b> <i>(note 4)</i>	15,133	14,390
<b>Future income taxes</b>	47,938	41,830
	105,666	96,813
<b>NON-CONTROLLING INTEREST</b>		
Exchangeable shares <i>(note 2)</i>	9,199	9,529
<b>UNITHOLDERS' EQUITY</b>		
Unitholders' capital/share capital <i>(note 5)</i>	65,585	45,755
Contributed surplus <i>(note 5)</i>	1,314	1,170
Accumulated earnings	96,021	84,399
Accumulated cash distributions <i>(note 10)</i>	(24,038)	(10,702)
	138,882	120,622
	253,747	226,964

See accompanying notes.

# consolidated statements of earnings and accumulated earnings

(unaudited) (\$ thousand, except per unit amounts)	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
<b>Revenue</b>				
Petroleum and natural gas revenue	35,868	30,959	69,992	58,663
Unrealized risk management loss <i>(note 9)</i>	(1,095)	–	(3,351)	–
Realized risk management loss <i>(note 9)</i>	(1,234)	(1,310)	(2,019)	(1,583)
Royalties (net of Alberta Royalty Tax Credit)	(7,911)	(6,886)	(15,946)	(12,809)
	<b>25,628</b>	22,763	<b>48,676</b>	44,271
<b>Expenses</b>				
Production	5,749	5,036	11,633	9,651
General and administrative	1,246	996	2,554	1,958
Unit/stock-based compensation <i>(note 5)</i>	147	218	473	309
Interest	200	49	384	134
Unrealized foreign exchange loss	97	65	151	24
Accretion of asset retirement obligations <i>(note 4)</i>	298	266	592	525
Depletion and depreciation	9,037	6,422	17,801	12,639
	<b>16,774</b>	13,052	<b>33,588</b>	25,240
<b>Earnings before income taxes</b>	<b>8,854</b>	9,711	<b>15,088</b>	19,031
<b>Income taxes</b>				
Future	696	4,013	377	7,680
Current	515	156	959	270
	<b>1,211</b>	4,169	<b>1,336</b>	7,950
<b>Earnings for the period before non-controlling interest</b>	<b>7,643</b>	5,542	<b>13,752</b>	11,081
Non-controlling interest – exchangeable shares <i>(note 2)</i>	(1,161)	–	(2,130)	–
<b>Net earnings for the period</b>	<b>6,482</b>	5,542	<b>11,622</b>	11,081
<b>Accumulated earnings, beginning of period</b>				
As previously reported	89,539	75,544	84,399	70,125
Retroactive application of change in accounting policy – asset retirement obligations	–	–	–	(120)
As restated	<b>89,539</b>	75,544	<b>84,399</b>	70,005
<b>Accumulated earnings, end of period</b>	<b>96,021</b>	81,086	<b>96,021</b>	81,086
<b>Net earnings per unit/per common share</b> <i>(note 6)</i>				
Basic	0.41	0.30	0.74	0.61
Diluted	0.41	0.29	0.73	0.59

See accompanying notes.

# consolidated statements of cash flows

(unaudited) (\$ thousand)	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
<b>Operating activities</b>				
Net earnings for the period	6,482	5,542	11,622	11,081
Add non-cash items:				
Non-controlling interest – exchangeable shares	1,161	–	2,130	–
Unrealized risk management loss	1,095	–	3,351	–
Depletion and depreciation	9,037	6,422	17,801	12,639
Accretion of asset retirement obligations	298	266	592	525
Unit/stock-based compensation	147	218	473	309
Unrealized foreign exchange loss	97	65	151	24
Future income taxes	696	4,013	377	7,680
	<b>19,013</b>	16,526	<b>36,497</b>	32,258
Asset retirement expenditures	(159)	(14)	(221)	(56)
Changes in non-cash working capital	1,325	(2,898)	(231)	(3,210)
	<b>20,179</b>	13,614	<b>36,045</b>	28,992
<b>Financing activities</b>				
Advances (repayment) of bank indebtedness	(2,703)	(3,675)	1,292	(6,978)
Cash distributions to unitholders	(6,732)	–	(13,336)	–
Exercise of unit rights/stock options	195	336	1,008	1,330
Changes in non-cash working capital	34	–	111	–
	<b>(9,206)</b>	(3,339)	<b>(10,925)</b>	(5,648)
<b>Investing activities</b>				
Additions to property and equipment	(10,965)	(7,883)	(21,650)	(17,651)
Proceeds on disposal of property and equipment	–	275	–	275
Changes in non-cash working capital	(8)	(1,462)	(3,470)	(4,763)
	<b>(10,973)</b>	(9,070)	<b>(25,120)</b>	(22,139)
<b>Change in cash, and cash end of period</b>	<b>–</b>	1,205	<b>–</b>	1,205

See accompanying notes.

# notes to consolidated financial statements

For the three and six months ended June 30, 2005 and 2004 (unaudited)

## 1. Nature Of The Organization And Basis Of Presentation

### ORGANIZATION

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

The Trust's principal business activity is the exploration for and development and production of petroleum and natural gas.

### BASIS OF PRESENTATION

The interim unaudited consolidated financial statements of Zargon have been prepared by management in accordance with Canadian generally accepted accounting principles. The interim unaudited consolidated financial statements have been prepared following the same accounting policies and methods in computation as the consolidated financial statements for the fiscal year ended December 31, 2004. The interim unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto in the Zargon Energy Trust annual report for the year ended December 31, 2004.

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

## 2. Non-Controlling Interest – Exchangeable Shares

Zargon Oil & Gas Ltd. is authorized to issue a maximum of 3.66 million exchangeable shares. The exchangeable shares are convertible into trust units at the option of the shareholder based on the exchange ratio, which is adjusted monthly to reflect the distribution paid on the trust units. Cash distributions are not paid on the exchangeable shares. During the six months ended June 30, 2005, a total of 702,000 exchangeable shares were converted into 732,000 trust units based on the exchange ratio at the time of conversion. At June 30, 2005, the exchange ratio was 1.06165 trust units per exchangeable share.

### NON-CONTROLLING INTEREST – EXCHANGEABLE SHARES

(thousand, except exchange ratio)	June 30, 2005	
	Number of Shares	Amount (\$)
Non-controlling interest exchangeable shares issued		
Balance, beginning of year	3,186	9,529
Earnings attributable to non-controlling interest	–	2,130
Exchanged for trust units at book value and including earnings attributed since beginning of year	(702)	(2,460)
Balance, end of period	2,484	9,199
Exchange ratio, end of period	1.06165	
Trust units issuable upon conversion of exchangeable shares, end of period	2,637	

For the year ended December 31, 2004 the Trust retroactively applied EIC-151 "Exchangeable Securities Issued by Subsidiaries of Income Trusts". Per EIC-151, if certain conditions are met, the exchangeable shares issued by a subsidiary must be reflected as non-controlling interest on the consolidated balance sheet and in turn, net earnings must be reduced by the amount of net earnings attributed to the non-controlling interest.

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

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

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

(\$ thousand)	Zargon Oil & Gas Ltd. Common Shares	Zargon Energy Trust Units	Zargon Oil & Gas Ltd. Exchangeable Shares	Total
Immediately prior to July 15, 2004 Plan of Arrangement	45,136			
Plan of Arrangement July 15, 2004	(45,136)	36,219	8,917	
	-	36,219	8,917	45,136
Issued on redemption of exchangeable shares at book value	-	1,155	(1,155)	-
Effect of EIC-151	-	8,381	1,767	10,148
<b>Balance at December 31, 2004</b>	-	45,755	9,529	55,284
Issued on redemption of exchangeable shares at book value	-	1,710	(1,710)	-
Effect of EIC-151	-	16,783	1,380	18,163
Unit-based compensation recognized	-	329	-	329
Unit rights exercised for cash	-	1,008	-	1,008
<b>Balance at June 30, 2005</b>	-	65,585	9,199	74,784

### 3. Property And Equipment

(\$ thousand)	June 30, 2005		
	Cost	Accumulated Depletion and Depreciation	Net Book Value
Petroleum, natural gas properties and other equipment	318,845	113,780	205,065
Adjustment due to conversion of exchangeable shares	32,943	2,400	30,543
	351,788	116,180	235,608

(\$ thousand)	June 30, 2004		
	Cost	Accumulated Depletion and Depreciation	Net Book Value
Petroleum, natural gas properties and other equipment	256,500	83,620	172,880

As a result of shareholders redeeming exchangeable shares, property and equipment increased \$21.66 million in the first six months of 2005 and \$11.28 million in 2004. The effect of these increases has resulted in additional depletion and depreciation expense recorded in the 2005 six months of approximately \$2.40 million.

#### 4. Asset Retirement Obligations

The following table reconciles Zargon's asset retirement obligation:

(\$ thousand)	June 30,	
	2005	2004
Balance, beginning of year	14,390	12,194
Liabilities incurred	359	255
Liabilities settled	(221)	(56)
Accretion expense	592	525
Foreign exchange	13	(69)
Balance, end of period	15,133	12,849

#### 5. Unitholders' Equity

Pursuant to the Plan of Arrangement on July 15, 2004, 14.87 million units of the Trust and 3.66 million exchangeable shares (see note 2) of the Company were issued in exchange for all of the outstanding shares of the Company on a one-for-one basis.

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

(thousand)	TRUST UNITS	
	June 30, 2005	
	Number of Units	Amount (\$)
Units issued		
Balance, beginning of year	15,341	45,755
Unit rights exercised for cash	57	1,008
Unit-based compensation recognized	–	329
Issued on conversion of exchangeable shares	732	18,493
Balance, end of period	16,130	65,585

The proforma total units outstanding at period end, including trust units outstanding, and trust units issuable upon conversion of exchangeable shares and after giving effect to the exchange ratio at the end of the period (see note 2) is 18.77 million units.

A summary of the Company's share capital account for the first six months of 2004 is as follows:

#### COMMON SHARES OF ZARGON OIL & GAS LTD.

(no par value) (thousand)	June 30, 2004	
	Number of Shares	Amount (\$)
Shares issued		
Balance, beginning of year	17,992	42,200
Stock options exercised for cash	289	1,330
Stock-based compensation recognized	–	38
Balance, end of period	18,281	43,568

## CONTRIBUTED SURPLUS

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

### CONTRIBUTED SURPLUS

(\$ thousand)	June 30,	
	2005	2004
Balance, beginning of year	<b>1,170</b>	264
Unit/stock-based compensation expense	<b>473</b>	309
Unit/stock-based compensation recognized on exercise of unit rights/stock options	<b>(329)</b>	(38)
Balance, end of period	<b>1,314</b>	535

## COMPENSATION PLANS

### TRUST UNIT RIGHTS INCENTIVE PLAN AND UNIT-BASED COMPENSATION

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

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

The assumptions made for unit rights granted for 2005 include a volatility factor of expected market price of 24 percent, a weighted average risk-free interest rate of 3.39 percent, a dividend yield of 7.64 percent and a weighted average expected life of the unit rights of four years.

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

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

	Six Months Ended June 30, 2005	
	Number of Unit Rights (thousand)	Weighted Average Exercise Price (\$)
Outstanding at beginning of year	579	17.79
Unit rights granted	163	22.00
Unit rights exercised	(57)	17.58
Unit rights cancelled	(15)	17.70
Outstanding at end of period	<b>670</b>	<b>18.82</b>
Unit rights exercisable at period end	<b>144</b>	<b>17.82</b>

#### STOCK OPTION PLAN AND STOCK-BASED COMPENSATION

Prior to the Plan of Arrangement, the Company calculated the value of stock-based compensation for its predecessor stock-option plan using a Black-Scholes option-pricing model to estimate the fair value of stock options at the date of grant. This stock-option plan ceased to exist at the July 15, 2004 Plan of Arrangement.

A summary of the Company's predecessor stock option plan prior to the Plan of Arrangement is as follows:

	Six Months Ended June 30, 2004	
	Number of Shares (thousand)	Weighted Average Exercise Price (\$)
Outstanding at beginning of year	1,297	7.05
Granted	430	16.00
Exercised	(289)	4.60
Cancelled	(9)	9.61
Outstanding at end of period	<b>1,429</b>	<b>10.22</b>
Options exercisable at period end	<b>696</b>	<b>6.94</b>

#### 6. Weighted Average Number Of Total Units/Shares

Basic per unit amounts are calculated using the weighted average number of trust units outstanding during the period. Diluted per unit amounts are calculated using the treasury stock method to determine the dilutive effect of unit-based compensation. Diluted per unit amounts also include exchangeable shares using the "if-converted" method. Comparative amounts reflect the basic and diluted calculation of the common shares of Zargon Oil & Gas Ltd.

(thousand)	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
	(units)	(shares)	(units)	(shares)
Basic	<b>15,930</b>	18,257	<b>15,776</b>	18,208
Diluted	<b>18,840</b>	18,851	<b>18,803</b>	18,797

## 7. Segmented Information

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

(\$ thousand)	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
<b>Petroleum and Natural Gas Revenue</b>				
Canada	31,173	27,379	60,630	51,748
United States	4,695	3,580	9,362	6,915
<b>Total</b>	<b>35,868</b>	<b>30,959</b>	<b>69,992</b>	<b>58,663</b>
<b>Net Capital Expenditures</b>				
Canada	9,999	5,976	20,642	15,434
United States	966	1,632	1,008	1,942
<b>Total</b>	<b>10,965</b>	<b>7,608</b>	<b>21,650</b>	<b>17,376</b>
<b>Total Assets</b>				
Canada			224,373	164,209
United States			29,374	25,594
<b>Total</b>			<b>253,747</b>	<b>189,803</b>

## 8. Supplemental Cash Flow Information

(\$ thousand)	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Cash interest paid	173	34	391	108
Cash taxes paid	420	49	864	188

## 9. Financial Instruments

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

The Trust has outstanding contracts at June 30, 2005 as follows:

	Volume	Rate	Price	Range of Terms
<b>Financial Contracts Designated as Hedges</b>				
Oil swaps	73,600 bbl	400 bbl/d	\$44.05 US/bbl	Jul. 1/05–Dec. 31/05
Oil collars	36,800 bbl	200 bbl/d	\$37.00 US/bbl Put \$44.40 US/bbl Call	Jul. 1/05–Dec. 31/05
	36,200 bbl	200 bbl/d	\$36.00 US/bbl Put \$48.40 US/bbl Call	Jan. 1/06–Jun. 30/06
Natural gas swaps	492,000 gj	4,000 gj/d	\$6.49/gj	Jul. 1/05–Oct. 31/05
Natural gas collars	246,000 gj	2,000 gj/d	\$6.00/gj Put \$8.01/gj Call	Jul. 1/05–Oct. 31/05
	453,000 gj	3,000 gj/d	\$5.90/gj Put \$10.00/gj Call	Nov. 1/05–Mar. 31/06
Natural gas put	246,000 gj	2,000 gj/d	\$5.10/gj	Jul. 1/05–Oct. 31/05

	Volume	Rate	Price	Range of Terms
<b>Financial Contracts</b>				
<b>Not Designated as Hedges</b>				
Oil swaps	55,200 bbl	300 bbl/d	\$45.70 US/bbl	Jul. 1/05–Dec. 31/05
	36,200 bbl	200 bbl/d	\$48.50 US/bbl	Jan. 1/06–Jun. 30/06
	109,500 bbl	300 bbl/d	\$51.83 US/bbl	Jan. 1/06–Dec. 31/06
	36,800 bbl	200 bbl/d	\$51.12 US/bbl	Jul. 1/06–Dec. 31/06
Oil collars	36,200 bbl	200 bbl/d	\$40.00 US/bbl Put \$49.05 US/bbl Call	Jan. 1/06–Jun. 30/06
Natural gas swaps	246,000 gj	2,000 gj/d	\$6.52/gj	Jul. 1/05–Oct. 31/05
	214,000 gj	1,000 gj/d	\$7.05/gj	Apr. 1/06–Oct. 31/06
Natural gas collars	302,000 gj	2,000 gj/d	\$6.50/gj Put \$8.80/gj Call	Nov. 1/05–Mar. 31/06
	302,000 gj	2,000 gj/d	\$7.00/gj Put \$9.35/gj Call	Nov. 1/05–Mar. 31/06
<b>Physical Contracts</b>				
Natural gas swaps	642,000 gj	3,000 gj/d	\$7.13/gj	Apr. 1/06–Oct. 31/06
Natural gas collars	151,000 gj	1,000 gj/d	\$8.47/gj Put \$9.50/gj Call	Nov. 1/05–Mar. 31/06
Natural gas put	246,000 gj	2,000 gj/d	\$6.05/gj	Jul. 1/05 – Oct. 31/05

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

Financial risk management contracts in place as at December 31, 2004 were designated as hedges for accounting purposes and the Trust continues to monitor these contracts in determining the continuation of hedge effectiveness. For these contracts, realized gains and losses are recorded in the statement of earnings as the contracts settle and no unrealized gain or loss is recognized. The realized losses for the first six months of 2005 were \$2.02 million (2004 – \$1.58 million). At June 30, 2005, an additional \$2.63 million would have been required to settle the above designated hedge contracts. Contracts settled by way of physical delivery are recognized as part of the normal revenue stream. These instruments have no book values recorded in the interim consolidated financial statements.

For financial risk management contracts entered into after December 31, 2004, the Trust does consider these contracts to be effective on an economic basis but has decided not to designate these contracts as hedges for accounting purposes and accordingly, for outstanding contracts not designated as hedges, an unrealized gain or loss is recorded based on the fair value (mark-to-market) of the contracts at that time. The unrealized losses for the first six months of 2005 were \$3.35 million (2004 – nil). These instruments have been recorded as a liability in the interim consolidated balance sheet.

## 10. Accumulated Cash Distributions

During the six month period, the Trust paid or declared distributions to the unitholders in the aggregate amount of \$13.34 million in accordance with the following schedule:

Month	Record Date	Distribution Date	Per Trust Unit
January 2005	January 31, 2005	February 15, 2005	\$0.14
February 2005	February 28, 2005	March 15, 2005	\$0.14
March 2005	March 31, 2005	April 15, 2005	\$0.14
April 2005	April 30, 2005	May 16, 2005	\$0.14
May 2005	May 31, 2005	June 15, 2005	\$0.14
June 2005	June 30, 2005	July 15, 2005	\$0.14

For Canadian income tax purposes, the distributions are currently estimated to be 100 percent taxable income to unitholders.

# corporate information

## **BOARD OF DIRECTORS**

**Craig H. Hansen**  
*Calgary, Alberta*

**K. James Harrison**  
*Oakville, Ontario*

**H. Earl Joudrie**  
*Toronto, Ontario*

**Kyle D. Kitagawa**  
*Calgary, Alberta*

**John O. McCutcheon**  
*Vancouver, British Columbia*

**Jim D. Peplinski**  
*Calgary, Alberta*

**J. Graham Weir**  
*Calgary, Alberta*

**William J. Whelan**  
*Calgary, Alberta*

**Grant A. Zawalsky**  
*Calgary, Alberta*

## **OFFICERS**

**John O. McCutcheon**  
*Chairman*

**Craig H. Hansen**  
*President and  
Chief Executive Officer*

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

**Mark I. Lake**  
*Vice President, Exploration*

**Daniel A. Roulston**  
*Executive Vice President, Operations*

**Sheila A. Wares**  
*Vice President, Accounting*

**Kenneth W. Young**  
*Vice President, Land*

## **STOCK EXCHANGE LISTING**

Toronto Stock Exchange  
Trading Symbols:  
ZAR.UN – Trust Units  
ZOG.B – Exchangeable Shares

## **TRANSFER AGENT**

Valiant Trust Company  
310, 606 – 4th Street S.W.  
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## **FORWARD-LOOKING STATEMENTS**

*This document contains statements that are forward-looking, such as those relating to results of operations and financial condition, capital spending, financing sources, commodity prices, costs of production and the magnitude of oil and natural gas reserves. By their nature, forward-looking statements are subject to numerous risks and uncertainties that could significantly affect anticipated results in the future and, accordingly actual results may differ materially from those predicted. The forward-looking statements contained in this quarterly report are as of August 10, 2005 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.*