



# MIDNIGHT

Oil Exploration Ltd.



ANNUAL REPORT | 2004

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## ANNUAL GENERAL MEETING

Midnight Oil Exploration's Annual General Meeting for its shareholders is scheduled for 2:00 p.m. on Thursday, May 5, 2005 at Sunlife Conference Centre, 2nd Level Sunlife Plaza, 140 – 4th Avenue SW, Calgary, Alberta



# MIDNIGHT

Oil Exploration Ltd.

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## **PRESIDENT'S MESSAGE**

Midnight Oil Exploration Ltd. ("Midnight") has enjoyed a successful commencement to its operations as a new junior oil and gas exploration company. From the re-start of Midnight on November 30th 2004, we have pursued an aggressive drilling program while growing our production base and expanding our land base and play prospect portfolio. Midnight has continued its solid record of drilling successes resulting in 16 gross (3.9 net) gas wells, - for a 100% success rate. This program has resulted in current production increasing to over 1,000 boe/d from an average of 723 boe/d in December, with an additional 300 boe/d behind pipe expected to be brought on production in the second quarter. In addition, through farm-in activities and crown sale acquisitions, we have grown our net undeveloped land base to more than 144,000 acres.

Our formula for growth and success at Midnight Oil Exploration Ltd. will be the same proven formula that we employed at Midnight Oil & Gas Ltd. We have a high-end team with proven technical expertise and strong business execution skills. We continue to be focused in the high potential multi-zone areas of West Central Alberta and the Peace River Arch. We have started with an excellent foundation of properties to pursue a risk balanced portfolio of prospects from our development activities in the West Central area as well as a large exploratory prospect inventory in the Peace River Arch area. Our existing property and prospect portfolio offers excellent potential and we have the experience and expertise in these areas to develop and grow our base. We will strive to own and operate the drilling and facilities related to our activities in order to maintain operational control for timing and costs. As a result of our transaction which established Daylight Energy Trust ("Daylight") and the new Midnight, we have ownership in strategic facilities in our core areas that will provide Midnight with timely access and a competitive edge in these multi-zone high potential areas. In addition, our ongoing relationship with Daylight through joint holdings and a technical services agreement provides for the entities to share certain personnel and services. This gives Midnight greater technical breadth specifically in drilling, completions and operations and provides Midnight, through Daylight, access to the services and equipment that a new junior exploration company would normally not have.

### **Drilling Activity**

Midnight's drilling success continues as we enjoyed a 100% drilling success rate since inception with 16 gross (3.9 net) gas wells including five (1.4 net) gas wells in 2004.

In December 2004, our first month of operation, the Company drilled three gross (0.8 net) natural gas wells in the West Central area. Two of these wells were located in our core area of Fir/Pine and are part of the large joint venture with Daylight. The Fir/Pine area holds tremendous development potential for the Company and is the core producing property within Midnight. Midnight has access to a large (193,000 gross acres) land base through its relationship with Daylight including over 69,000 net undeveloped acres. In the West Central area, the Company is in the process of conducting a detailed geologic review and evaluation of the potential within this multi-zone area and plans an aggressive exploration program including a planned 30 gross (8 net) well drilling program.

In the Peace River Arch area, the Company drilled two gross (0.6 net) natural gas wells with a 100 percent success rate. The Company continues to focus its activities in the Deep Basin area at Wapiti, Red Rock and Elmworth. On the Company's Deep Basin Cadomin play, drilling success continues and two new multi-zone prospect areas have already been identified. Midnight has ownership in over (71,000 gross) 52,000 net undeveloped acres and has planned a 20 gross (12 net) well drilling program.

Substantially all of our December production (723 boe/d) was from our joint production with Daylight in our West Central area. Our recent drilling program and tie-ins has grown current production to over 1,000 boe/d with an additional 300 boe/d tested and behind pipe that is expected to brought on production during the second quarter.

The early results of our drilling program indicate the tremendous potential we believe these areas and our lands hold. We are very pleased with these results and are confident in our ability to continue with these successes and to deliver production growth through our drilling program.

## **2005 Outlook**

Midnight Oil Exploration Ltd. effectively commenced operations on November 30, 2004 with the closing of the Plan of Arrangement creating our company and Daylight Energy Trust. There was an initial transition phase as we exchanged and allocated the properties between the respective parties and put in action our plans and our program. Strong commodity prices have fuelled the industry to record drilling and activity levels. Industry wide, costs continue to increase and services are in high demand causing delays and interruptions to programs.

As previously stated, Midnight has in place the key elements to deliver excellent returns to our shareholders. Thanks to our high-end technical team and to our large prospect inventory and undeveloped land base, Midnight continues to produce a highly successful drilling program. From the early success of our exploration activities and the exploitation opportunities provided from our West Central asset base, we have already expanded and broadened our large high potential play and prospect inventory with additional farm-ins and crown sale acquisitions.

The Board of Directors of Midnight has set our 2005 capital budget at \$30 million. This budget will allow Midnight to drill approximately 50 gross (20 net) wells resulting in an anticipated forecast production increase of over 235% to the 1,700 boe/d range.

Notwithstanding the short time since starting Midnight, we have quickly shown the quality of our people and our prospects. Looking forward we are very optimistic about Midnight's ability to continue to repeat its success, based on our core strengths, our high-end technical team and a highly prospective asset base. We are excited about the potential of the new Midnight and we look forward to the next year and the next steps we take in the growth of Midnight.



Signed: "Fred Woods"

**Fred Woods**  
**President and Chief Executive Officer**

March 21, 2005

## MANAGEMENT'S DISCUSSION AND ANALYSIS

Midnight Oil Exploration Ltd. ("Midnight" or the "Company") was incorporated on September 10, 2004, capitalized by way of a private placement on November 29, 2004 and commenced operations on November 30, 2004 under a Plan of Arrangement entered into by Midnight Oil & Gas Ltd. ("MOG") Daylight Energy Trust, Daylight Acquisition Corp. and Midnight (the "Plan of Arrangement"). Under the Plan of Arrangement, Daylight Acquisition Corp., a subsidiary of Daylight Energy Trust, acquired all the issued and outstanding shares of Vintage Petroleum Canada, Inc ("Vintage") along with the shares of MOG. As a part of the Plan of Arrangement certain assets of MOG and Vintage were transferred to Midnight, and in return the shareholders of MOG and the Series U subscription holders of Daylight Energy Trust received voting common shares of Midnight.

The financial information presented includes the operating results of Midnight from the effective date of the Plan of Arrangement, November 30, 2004 to December 31, 2004. As a result, there is no comparative information.

The Management Discussion and Analysis for Midnight should be read in conjunction with the audited Financial Statements and accompanying notes for the period ended December 31, 2004. Additional information relating to Midnight, including a detailed reserve analysis, will be included in our Initial Annual Information Form, which may be found on SEDAR at [www.sedar.com](http://www.sedar.com).

*Basis of Presentation – The financial data presented below has been prepared in accordance with Canadian Generally Accepted Accounting Principles ("GAAP"). The reporting and the measurement currency is the Canadian dollar. For the purpose of calculating unit costs, natural gas is converted to a barrel equivalent ("boe") using six thousand cubic feet of natural gas equal to one barrel of oil unless otherwise stated.*

*Non-GAAP Measurements - Within the Management Discussion and Analysis references are made to terms commonly used in the oil and gas industry. Cash flow and cash flow per share are not defined by GAAP in Canada and are referred to as non-GAAP measures. Cash flow represents funds from operations as detailed on the Statement of Cash Flows. Cash flow per share is calculated based on the weighted average number of common shares outstanding consistent with the calculation of net income per share. Netbacks equal total revenue less royalties and operating costs calculated on a boe basis. Total boes are calculated by multiplying the daily production by the number of days in the period.*

*Forward Looking Statements - Certain information regarding Midnight Oil Exploration Ltd. set forth in this document, including management's assessment of the Company's future plans and operations, contains forward looking statements that involve substantial known and unknown risks and uncertainties. By their very nature, these forward looking statements are subject to numerous risks and uncertainties, certain of which are beyond Midnight's control. Actual results could differ materially from those currently anticipated due to any number of factors including such variables as new information regarding recoverable reserves, volatility of commodity prices, competition from other producers, environmental, legislative, regulatory and political changes along with other factors discussed in our annual information form. Accordingly, no assurance can be given that any events anticipated by the forward looking statements will transpire or occur, or if any of them do, what the impact to Midnight will be.*

This Management Discussion and Analysis is dated as of March 15, 2005.

### **Business Objectives**

Midnight targets to deliver above average growth and share price appreciation through execution of a well defined business strategy. To accomplish this, Midnight focuses on growing its production and reserves through a program of exploratory and development drilling and strategic acquisitions within its core project areas in the Western Canadian Sedimentary Basin.

The Company is focusing on exploration and development drilling of prospects in its core areas in West Central Alberta and Peace River Arch. Midnight will also pursue strategic acquisitions that meet its business objectives.

Midnight is a grass roots exploration and development company that internally generates opportunities in certain high potential multi-zone areas in the deeper part of the Western Canadian Sedimentary Basin. The Company strives to maintain a risk balance between exploration, development and exploitation projects combined with strategic acquisition opportunities that meet Midnight's business parameters. Midnight has an Administrative and Technical Services Agreement with Daylight Energy that provides for the sharing of certain personnel and services including drilling and field operations. Midnight, or Daylight on its behalf, aims to operate its activities as it believes that controlling the timing and costs of its projects wherever possible is essential to achieve its objectives. In the Pine Creek Block of West Central Alberta although Midnight initially has a relatively small interest, the Company will seek to become the operator of its properties in this area, either on its own or through Daylight. In its higher working interest areas, either in the West Central area or on the Peace River Arch Midnight generally is the operator of these properties. Further, to maintain cost control and reasonable access to facilities within its geographic areas of interest, Midnight strives to establish and optimize its working interest ownership in facilities and infrastructure where reasonably possible.

In reviewing potential drilling or acquisition opportunities, Midnight uses a similar methodology previously employed by MOG giving consideration to the following criteria including a ranking or prioritizing of opportunities based on available capital, resources and timing:

- risk capital required to secure or evaluate the investment opportunity;
- potential return on the project, if successful;
- likelihood of success; and
- risked return versus cost of capital.

In general, Midnight uses a portfolio approach in developing a large number of opportunities with a balance of risk profiles in an attempt to generate sustainable high levels of profitable production and financial growth.

#### **Creation of Midnight Oil Exploration Ltd.**

Under the Plan of Arrangement, made effective on November 30, 2004, certain assets of MOG and Vintage were transferred to Midnight. The MOG shareholders along with the Daylight Energy Trust Series U subscription receipt holders effectively received 0.50 of a voting share of Midnight for every common share of MOG and for every Series U subscription receipt of Daylight Energy Trust.

The conveyed assets included petroleum and natural gas properties that produced approximately 700 boe/d at closing comprised of 15% percent of Vintage's interest in its properties in West Central Alberta (the "Pine Creek Block"), and 142,000 acres of undeveloped land in West Central Alberta and Peace River Arch areas. In addition, Midnight has an option to farm-in on approximately 20,000 net acres of former Vintage exploratory lands retained by Daylight on standard industry terms, thereby providing Midnight with an additional portfolio of opportunities.

#### **Relationship with Daylight**

In conjunction with the Plan of Arrangement, Midnight and Daylight entered into an Administrative and Technical Services Agreement which provides for the sharing of services required to manage Midnight's activities and govern the allocation of general and administration expenses between the entities. The Administrative and Technical Services Agreement has no set termination date and will continue until terminated by either party with three months prior written notice. Under this agreement, Daylight receives payment for certain technical and administration services provided to Midnight on a cost recovery basis

as well as reimbursement for any costs incurred on Midnight's behalf. Pursuant to the Administrative and Technical Services Agreement, from November 30, 2004 to December 31, 2004, \$110,000 of fees were charged relating to general and administration activities and \$99,000 of fees were charged relating to capital expenditures for the period.

As a result of this technical services arrangement, the majority of the Company's accounts receivable and accounts payable as at December 31, 2004 are due from (to) Daylight.

## Highlights

The financial and operational highlights are provided for one month of operations.

<b>Financial</b> (000's, except for share amounts)	<b>Period from November 30 to December 31, 2004</b>
Petroleum and natural gas sales (net of transportation)	\$ 976
Royalties	211
Operating expenses	249
Net backs	\$ 516
Cash flow from operations	397
Per share – Basic	.02
– Diluted	.02
Net income	\$ 15
Per share – Basic	.00
– Diluted	.00
Additions to capital assets	\$ 2,680
Working capital surplus	2,902
Total assets	42,120
Total long-term obligations	0
Shares outstanding	
Basic	26,328
Diluted	28,661
<b>Operations</b>	
Average daily production	
Natural gas (mcf/d)	3,549
NGLs & crude oil (bbls/d)	132
Combined (boe/d)	723
Average prices received	
Natural gas (\$/mcf)	\$ 7.00
NGLs & crude oil (\$/bbl)	50.75
Combined (\$/boe)	\$ 43.58
Royalties (\$/boe)	9.40
Operating expenses (\$/boe)	11.14
Netback received (\$/boe)	\$ 23.04

## Historical Information

The following table sets forth certain information in respect of production, product prices received, royalties, operating costs and netbacks received by Vintage in respect of the Midnight assets for each of the periods indicated in order to provide a historical basis for the current producing properties.

	3 Months ended 2004				3 Months Ended 2003		
	Sept 30	June 30	March 31	Dec. 31	Sept. 30	June 30	Mar. 31
Average Daily Production <sup>(1)</sup>							
Light Crude Oil (bbls/d)	62	56	48	45	47	52	57
NGL (bbls/d)	86	83	89	120	139	126	120
Gas (mcf/d)	2,936	3,186	3,058	3,858	3,724	3,438	3,250
Total (boe/d)	630	670	647	807	806	753	718
Oil & NGL Netbacks <sup>(4)</sup> (\$/bbls)							
Revenue	45.58	48.16	42.98	48.10	40.71	39.12	39.30
Royalties	9.06	11.08	10.73	13.26	11.90	10.38	9.69
Operating costs <sup>(2)(3)</sup>	16.60	13.09	12.57	13.63	11.11	10.57	9.37
Netback	19.92	23.99	19.68	21.21	17.70	18.17	20.24
Natural Gas Netbacks <sup>(4)</sup> (\$/mcf)							
Revenue	6.78	7.16	6.78	8.45	7.02	6.16	5.86
Royalties	1.12	1.38	1.25	1.89	1.49	1.31	1.26
Operating costs <sup>(2)(3)</sup>	2.77	2.18	2.10	2.27	1.85	1.76	1.56
Netback	2.89	3.60	3.43	4.29	3.68	3.09	3.04
Combined Netback <sup>(4)</sup> (\$/boe)							
Revenue	42.65	44.36	41.53	50.33	42.09	37.70	36.39
Royalties	7.25	8.85	8.19	11.74	9.63	8.49	8.11
Operating costs <sup>(2)(3)</sup>	16.60	13.09	12.57	13.63	11.11	10.57	9.37
Netback	18.80	22.42	20.77	24.96	21.35	18.64	18.91

### Notes:

- (1) Before deduction of royalties.
- (2) Operating costs have been allocated to the primary product for the expense. A number of assumptions have been made in allocating these costs between oil and natural gas.
- (3) Operating recoveries associated with operated properties were excluded from operating costs and accounted for as a reduction to general and administrative costs.
- (4) Netbacks are calculated by subtracting royalties and operating costs from revenues.

## Petroleum and Natural Gas Sales

For the period November 30, 2004 to December 31, 2004, petroleum and natural gas sales totalled \$977,000 comprised of natural gas sales of \$770,000, natural gas liquid sales of \$118,000 and crude oil sales of \$89,000.

Production for the month of December was 723 boe/d comprised of 3,549 mcf/d and 77 bbls/d of natural gas liquids and 55 bbls/d of oil. The production mix was 81% natural gas, 11% Natural gas liquids and 8% light quality crude oil.

The following table indicates the average daily production from the important fields comprising the Company's assets for the one month ended December 31, 2004.

	<b>Light Crude Oil and NGLs</b>	<b>Gas</b>	<b>Boe</b>
	(bbls/d)	(mcf/d)	(boe/d)
Pine Creek	22	990	187
Oldman	38	816	174
Other – Minor	72	1,743	362
<b>Total</b>	<b>132</b>	<b>3,549</b>	<b>723</b>

The following table outlines Midnight's achieved pricing comparable to Industry benchmark pricing:

<b>Prices and Marketing</b>	<b>December 2004</b>	
<b>Benchmark Prices</b>		
AECO gas (\$/mcf)	\$	6.87
WTI oil (\$US/bbl)		43.23
Cdn/US average exchange rate		0.821
Edmonton Par (\$Cdn/bbl)		51.48
<b>Midnight's Average Selling Price</b>		
Natural gas (\$/mcf)	\$	7.00
NGLs & Oil (\$/bbl)		50.75
Total (\$/boe)	\$	43.58

Midnight markets its natural gas on a daily spot market basis at various delivery points in Alberta and therefore the average AECO spot market price in Canadian dollars per mcf is an appropriate benchmark for our gas.

Midnight did not buy or sell any commodity or currency hedges in 2004.

### **Royalties**

For the period November 30 to December 31, 2004, Midnight had an average royalty rate of 21.6% of revenues or \$9.40 per boe. Since all of Midnight's production was derived from original Vintage properties, all the production was obtained from "over-the-limit" corporations, and therefore Midnight's production does not qualify for the Alberta Royalty Tax Credit for this time period.

By product, gas royalties averaged 21%, associated liquids averaged 28% and oil averaged 18%. In 2005, the Company expects the overall royalty rate to remain substantially the same.

### **Operating Expenses**

Operating costs for the period totalled \$249,000 or \$11.14 per boe. The operating costs for November 30 to December 31, 2004 are lower than the historical operating costs as illustrated in the Historical Information table due to lower turnaround expenses and reduced processing fees resulting from a new operating agreement with the operator of one of our major non-operated facilities. As gas production is brought on stream at a lower cost, we expect the 2005 operating costs to decrease to \$9 to \$10 per boe.

## Other Income

Other income is comprised of interest income of \$12,000. At December 31, 2004, Midnight had a cash balance totalling \$5,031,000 from the proceeds of the private placements, net of the \$2 million debt settlement on the conveyance of assets. Midnight expects to utilize this cash and be in a net debt position by the end of the first quarter of 2005.

## General and Administration Expenses

During the period, net general and administration (“G&A”) expenses totalled \$126,000 or \$5.63 per boe. For 2004, the G&A costs on a per boe basis are higher than our expected G & A costs on a normalized basis as certain costs such as the year end audit, reserve report and annual report which accounts for approximately 63% of our general and administration expenses were incurred during the period. Annualizing these costs our general and administration expenses would have averaged \$2.35 per boe for this period. In 2005, we anticipate our net G&A expenses to decrease to \$2 to \$3 per boe.

Midnight’s general and administration expenses have been allocated based on the Administrative and Technical Service Agreement with Daylight and are comprised of the following components:

<b>General and Administration Expenses</b> (\$000's)	<b>Period from November 30 to December 31, 2004</b>
Direct general and administration	\$ 106
Technical service fee from Daylight	119
Capitalized general and administration	(99)
Net general and administrative	\$ 126
\$/boe	\$ 5.63

## Depletion, Depreciation and Accretion

For the reported period, depletion and depreciation of the petroleum and natural gas assets and the accretion of the asset retirement obligation was \$329,000. On a per boe basis, depletion, depreciation and accretion was \$14.70 per boe. The assets allocated to Midnight in connection with the Plan of Arrangement were transferred at fair market value establishing the starting point for the depletable base. We expect to be able to maintain the depletion rate on a per boe basis in 2005.

Additional reserves data will be disclosed in our Initial Annual Information Form filed on SEDAR.

## Stock Based Compensation

The Company applies the fair value method for valuing stock option grants and warrants. Under this method, compensation cost attributable to all share options granted and warrants issued are measured at fair value at the grant and issuance date and expensed over the vesting period with a corresponding increase to contributed surplus. For the period November 30, 2004 to December 31, 2004 Midnight recognized a stock based compensation expense of \$15,000 on its outstanding warrants. Midnight’s unamortized portion of stock-based compensation totalled \$522,000 at December 31, 2004.

## Taxes

Midnight’s future tax asset was acquired on the Plan of Arrangement and relates to a temporary difference on asset retirement obligations. The petroleum and natural gas assets conveyed were acquired at fair market value with full tax basis. The future tax expense for the period November 30, 2004 to December 31, 2004 was \$43,000 resulting in an effective tax rate of 74.1%. The difference in the

expected rate of 38.6% and the effective rate is from permanent differences relating to stock based compensation and the difference between non-deductible crown royalties and the resource allowance.

Midnight had no current income taxes payable in 2004 and was under the corporate exemption level for Large Corporation's Tax. Midnight does not expect to become taxable on an income tax basis in 2005. The Company has approximately \$36 million in tax pools to shelter taxable income in future years. The estimated tax pools are as follows:

<b>Tax Pools</b> (\$000's)	<b>2004</b>
Canadian exploration expense	\$ 3,300
Canadian development expense	1,179
Canadian oil and gas property expense	27,477
Undepreciated capital cost	3,753
<b>Total</b>	<b>\$ 35,709</b>

### Cash Flow and Net Income

Cash flow from operations totalled \$402,000, before abandonment expenditures of \$5,000, for the period November 30, 2004 to December 31, 2004. Cash flow per basic and diluted share averaged \$0.02 for 2004. Net income for the period totalled \$15,000. Net income per share on a basic and diluted basis was \$0.00.

The following table summarizes the netbacks on a barrel of oil equivalent basis for the period November 30 to December 31, 2004.

<b>(\$/boe)</b>	<b>Period from November 30 to December 31, 2004</b>
Sales price	\$ 43.58
Royalties	9.40
Operating expenses	11.14
Operating netback	\$ 23.04
General and administration	5.63
Interest (income)	(0.53)
Cash flow netback	\$ 17.94
Depletion, depreciation and accretion	14.70
Stock-based compensation	0.68
Future tax	1.89
Net income	\$ 0.67

### Netbacks

As the Company reported only one month of operations, certain expenditures on an annualized basis may produce different results from the table illustrated above.

### Equity

On November 29, 2004, prior to the completion of the Plan of Arrangement, Midnight completed a private placement of 4,666,666 common shares for gross proceeds of \$7 million. In a separate private placement, Midnight issued 2,333,333 warrants for proceeds of \$47,000. Each warrant is exercisable into one common share of the Company at a price of \$3.00 per share. The warrants vest over three years providing specific performance conditions are met (see note 6(e) to the audited financial statements).

On November 30, 2004, 21,661,162 shares were issued under the Plan of Arrangement to shareholders and stock option holders of Midnight Oil & Gas Ltd. and to holders of the Series U subscription receipts of Daylight Energy Trust.

The Company had no stock options outstanding as at December 31, 2004. Midnight intends to limit option grants under its Stock Option Plan to 5% of the number of outstanding Midnight shares until December 1, 2005 and to 7.5% of the number of outstanding Midnight shares until December 1, 2006. On February 14, 2005, stock options were granted to non-executive service providers to acquire 160,000 common shares at the market price of \$3.75. The stock options vest equally over three years from the date of grant and expire on February 14, 2010.

<b>Share Information</b> (000's)	<b>2004</b>
Shares outstanding	
Basic	26,328
Diluted	28,661
Weighted average shares outstanding	
Basic	25,651
Diluted	25,804

As at March 15, 2005 the Company had outstanding 26,327,829 common shares, 160,000 stock options and 2,333,333 warrants.

### Capital Expenditures

The Company commenced its operations on November 30, 2004 and conducted a successful five well drilling program prior to year end. By December 31, 2004 Midnight had incurred \$2,680,000 of expenditures as follows:

<b>Capital Expenditures</b> (\$000's)	<b>2004</b>
Land	\$ 72
Geological and geophysical	99
Drilling	1,594
Completions	261
Facilities pipelines and equipment	654
Petroleum and natural gas expenditures	\$ 2,680

During the period, the Company incurred \$1.6 million to drill five (1.4 net) gas wells for a 100 % success rate. The Plan of Arrangement contemplated \$3.5 million of capital expenditures to be spent on the Midnight lands between July 1 and November 30, 2004, the closing of the transaction. Actual expenditures totaled \$4.1 million offset by operating cash flow left in Daylight Energy Trust of \$1.8 million.

For 2005, the Company anticipates drilling 20 to 25 net wells of which 10 are planned for the West Central Alberta and 10 to 15 wells are planned for the Peace River Arch area.

## Liquidity and Capital Resources

Midnight Oil Exploration Ltd. was listed as a senior producer on the Toronto Stock Exchange on December 2, 2004 trading under the symbol "MOX". The Company's market capitalization at December 31, 2004 was \$89.5 million.

<b>Trading History on the TSX</b>	<b>Q4 2004</b>
High	\$4.20
Low	\$3.20
Close	\$3.40
Volume (000's)	6,559

At December 31, 2004, Midnight had \$2.9 million in cash and working capital and an undrawn credit facility of \$8 million. Midnight expects to be in a net debt position by the end of the first quarter of 2005. Midnight has no off balance sheet arrangements.

The credit facility is available by way of Canadian and US dollar prime rate based loans, bankers' acceptances, Libor borrowings and letters of credit. The facility is available on a revolving basis until June 30, 2005. On this date and at the Company's discretion, the facility is available on a non-revolving basis for a period of 366 days, at which time the facility would be due and payable. Alternatively, the facility may be extended for a further 364-day period at the request of the Company and subject to approval by the bank. The credit facility bears interest at the bank prime rate and is secured by a \$50 million first floating charge debenture and a general securities agreement.

Midnight anticipates that it will make substantial capital expenditures for the acquisition, exploration, development and production of petroleum and natural gas reserves in the future. To execute its 2005 capital of program of \$30 million, the Company will require additional debt or equity financing. Failure to obtain such financing on a timely basis could cause Midnight to delay its capital program and as a result potentially forfeit its interest in certain properties or miss certain acquisition opportunities. If Midnight's revenues from its production decrease as a result of lower oil and natural gas prices or otherwise, it will affect Midnight's ability to expend the necessary capital to replace its reserves or to maintain its production. If Midnight's cash flow from operations is not sufficient to satisfy its capital expenditure requirements, there can be no assurance that additional debt or equity financing will be available to meet these requirements or available on terms acceptable to Midnight.

## Contractual Obligations

The contractual obligations for which the Company is responsible are as follows:

<b>Contractual Obligations (\$000's)</b>	<b>Total</b>	<b>Less than 1 Year</b>	<b>1-3 Years</b>	<b>4-5 Years</b>	<b>After 5 Years</b>
Technical Service Agreement	\$ 1,100	1,100	-	-	-
<b>Total Contractual Obligations</b>	<b>\$ 1,100</b>	<b>1,100</b>	<b>-</b>	<b>-</b>	<b>-</b>

Midnight enters into many contractual obligations in the course of conducting its day to day business. Material contract obligations consist only of our Administrative and Technical Service Agreement. As the Company continues to spend money as part of its capital program, we will draw on our bank facility and will have the related contractual obligation. Midnight has not entered into any firm transportation commitments to date.

## **Application of Critical Accounting Estimates**

The significant accounting policies used by Midnight are disclosed in note 1 to the Financial Statements. Certain accounting policies require that management make appropriate decisions with respect to the formulation of estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. Management reviews its estimates on a regular basis. The emergence of new information and changed circumstance may result in actual results or changes to estimated amounts that differ materially from current estimates. The following discussion identifies the critical accounting policies and practices of the Company and helps assess the likelihood of materially different results being reported.

### ***Proved Reserves***

Under the National Instrument 51-101 (NI 51-101) "Proved" reserves are defined as those reserves that can be estimated with a high degree of certainty to be recoverable. The level of certainty should result in at least a 90 percent probability that the quantities actually recovered will equal or exceed the estimated Proved reserves. It does not mean that there is a 90% probability that the Proved reserves will be recovered; it means there must be at least a 90% probability that the given amount or more will be recovered.

"Proved plus Probable" reserves are the most likely case and are based on a 50 percent certainty that they will equal or exceed the reserves estimated.

These oil and gas reserve estimates are made using all available geological and reservoir data, as well as historical production data. All of the Company's reserves were evaluated and reported on by an independent qualified reserves evaluator. However, revisions can occur as a result of various factors including: actual reservoir performance, changes in price and cost forecasts or a change in the Company's plans. Reserve changes will impact the financial results as reserves are used in the calculation of depletion and are used to assess whether asset impairment occurs. Reserve changes also affect other Non-GAAP measurements such as finding and development costs, recycle ratios and net asset value calculations.

### ***Depletion***

The Company follows the full cost method of accounting for oil and natural gas properties. Under this method, all costs related to the acquisition of, exploration for and development of oil and natural gas reserves are capitalized whether successful or not. Depletion of the capitalized oil and natural gas properties and depreciation of production equipment which includes estimated future development costs less estimated salvage values are calculated using the unit-of-production method, based on production volumes in relation to estimated proven reserves.

An increase in estimated proved reserves would result in a reduction in depletion expense. A decrease in estimated future development costs would also result in a reduction in depletion expense.

### ***Unproved Properties***

The cost of acquisition and evaluation of unproved properties are initially excluded from the depletion calculation. An impairment test is performed on these assets to determine whether the carrying value exceeds the fair value. Any excess in carrying value over fair value is an impairment. When proved reserves are assigned or a property is considered to be impaired, the cost of the property or the amount of the impairment will be added to the capitalized costs for the calculation of depletion.

### ***Ceiling Test***

The ceiling test is a cost recovery test intended to identify and measure potential impairment of assets. An impairment loss is recorded if the sum of the undiscounted cash flows expected from the production of the proved reserves and the lower of cost and market of unproved properties does not exceed the carrying values of the petroleum and natural gas assets. An impairment loss is recognized to the extent that the carrying value exceeds the sum of the discounted cash flows expected from the production of proved and probable reserves and the lower of cost and market of unproved properties. The cash flows are estimated using the future product prices and costs and are discounted using the risk free rate. By their nature, these estimates are subject to measurement uncertainty and the impact on the financial statements could be material. Any impairment as a result of this ceiling test will be charged to operations as additional depletion and depreciation expense.

### ***Asset Retirement Obligations***

The Company records a liability for the fair value of legal obligations associated with the retirement of petroleum and natural gas assets. The liability is equal to the discounted fair value of the obligation in the period in which the asset is recorded with an equal offset to the carrying amount of the asset. The liability then accretes to its fair value with the passage of time and the accretion is recognized as an expense in the financial statements. The total amount of the asset retirement obligation is an estimate based on the Company's net ownership interest in all wells and facilities, the estimated costs to abandon and reclaim the wells and facilities and the estimated timing of the costs to be incurred in future periods. The total amount of the estimated cash flows required to settle the asset retirement obligation, the timing of those cash flows and the discount rate used to calculate the present value of those cash flows are all estimates subject to measurement uncertainty. Any change in these estimates would impact the asset retirement liability and the accretion expense.

### ***Plan of Arrangement***

As disclosed in Note 2 to the Financial Statements, Midnight acquired assets from Vintage Petroleum Canada, Inc and Midnight Oil & Gas Ltd and accounted for these acquisitions using the purchase method based on fair values. The determination of fair value involves numerous estimates. The valuation of petroleum and natural gas assets is based on Midnight's estimate of proved plus probable reserves using estimated forecasted prices at the time of acquisition, plus an estimation of unproved properties. Management also estimates the fair value of other assets and liabilities acquired on the acquisition. This valuation could differ materially by altering the various assumptions which would have impacted the composition of the balance sheet.

### ***Income Taxes***

The determination of income and other tax liabilities requires interpretation of complex laws and regulations. All tax filings are subject to audit and potential reassessment after the lapse of considerable time. Accordingly, the actual income tax liability may differ significantly from that estimated and recorded by management.

### ***Other Estimates***

The accrual method of accounting requires management to incorporate certain estimates including estimates of revenues, royalties and operating costs as at a specific reporting date but for which actual revenues and costs have not yet been received. In addition, estimates are made on capital projects which are in progress or recently completed where actual costs have not been received by the reporting date. The Company obtains the estimates from the individuals with the most knowledge of the activity and from all project documentation received. The estimates are reviewed for reasonableness and compared to past performance to assess the reliability of the estimates. Past estimates are compared to actual results in order to make informed decisions on future estimates.

## **New Accounting Standards to be Adopted in 2005**

All policies adopted on commencement of our operations are compliant with all new applicable accounting standards.

## **Risks and Uncertainties**

### ***Exploration, Development and Production Risks***

Oil and natural gas exploration involves a high degree of risk, for which even a combination of experience, knowledge and careful evaluation may not be able to overcome. There is no assurance that expenditures made on future exploration by Midnight will result in new discoveries of oil or natural gas in commercial quantities. It is difficult to project the costs of implementing an exploratory drilling program due to the inherent uncertainties of drilling in unknown formations, the costs associated with encountering various drilling conditions such as over pressured zones, tools lost in the hole and changes in drilling plans and locations as a result of prior exploratory wells or additional seismic data and interpretations thereof.

The long-term commercial success of Midnight will depend on its ability to find, acquire, develop and commercially produce oil and natural gas reserves. No assurance can be given that Midnight will be able to locate satisfactory properties for acquisition or participation. Moreover, if such acquisitions or participations are identified, Midnight may determine that current markets, terms of acquisition and participation or pricing conditions make such acquisitions or participations uneconomic.

Future oil and gas exploration may involve unprofitable efforts, not only from dry wells, but from wells that are productive but do not produce sufficient net revenues to return a profit after drilling, operating and other costs. Completion of a well does not assure a profit on the investment or recovery of drilling, completion and operating costs. In addition, drilling hazards or environmental damage could greatly increase the cost of operations, and various field operating conditions may adversely affect the production from successful wells. These conditions include delays in obtaining governmental approvals or consents, shut-ins of connected wells resulting from extreme weather conditions, insufficient storage or transportation capacity or other geological and mechanical conditions. While diligent well supervision and effective maintenance operations can contribute to maximizing production rates over time, production delays and declines from normal field operating conditions cannot be eliminated and can be expected to adversely affect revenue and cash flow levels to varying degrees.

In addition, oil and gas operations are subject to the risks of exploration, development and production of oil and natural gas properties, including encountering unexpected formations or pressures, premature declines of reservoirs, blow-outs, cratering, sour gas releases, fires and spills. Losses resulting from the occurrence of any of these risks could have a materially adverse effect on future results of operations, liquidity and financial condition.

### ***Prices, Markets and Marketing of Crude Oil and Natural Gas***

Oil and natural gas are commodities whose prices are determined based on world demand, supply and other factors, all of which are beyond the control of Midnight. World prices for oil and natural gas have fluctuated widely in recent years. Any material decline in prices could result in a reduction of net production revenue. Certain wells or other projects may become uneconomic as a result of a decline in world oil prices and natural gas prices, leading to a reduction in the volume of Midnight's oil and gas reserves. Midnight might also elect not to produce from certain wells at lower prices. All of these factors could result in a material decrease in Midnight's future net production revenue, causing a reduction in its oil and gas acquisition and development activities. In addition, bank borrowings available to Midnight are expected to be determined in part by the borrowing base of Midnight. A sustained material decline in

prices from historical average prices could limit Midnight's borrowing base, therefore reducing the bank credit available to Midnight, and could require that a portion of any existing bank debt of Midnight be repaid.

In addition to establishing markets for its oil and natural gas, Midnight must also successfully market its oil and natural gas to prospective buyers. The marketability and price of oil and natural gas which may be acquired or discovered by Midnight will be affected by numerous factors beyond its control. Midnight will be affected by the differential between the price paid by refiners for light quality oil and the grades of oil produced by Midnight. The ability of Midnight to market its natural gas may depend upon its ability to acquire space on pipelines which deliver natural gas to commercial markets. Midnight will also likely be affected by deliverability uncertainties related to the proximity of its reserves to pipelines and processing facilities and related to operational problems with such pipelines and facilities and extensive government regulation relating to price, taxes, royalties, land tenure, allowable production, the export of oil and natural gas and many other aspects of the oil and natural gas business. Midnight has limited direct experience in the marketing of oil and natural gas.

### ***Substantial Capital Requirements; Liquidity***

Midnight's cash flow from its reserves may not be sufficient to fund its ongoing activities at all times. From time to time, Midnight may require additional financing in order to carry out its oil and gas acquisition, exploration and development activities. Failure to obtain such financing on a timely basis could cause Midnight to forfeit its interest in certain properties, miss certain acquisition opportunities and reduce or terminate its operations. If Midnight's revenues from its reserves decrease as a result of lower oil and natural gas prices or otherwise, it will affect Midnight's ability to expend the necessary capital to replace its reserves or to maintain its production. If Midnight's cash flow from operations is not sufficient to satisfy its capital expenditure requirements, there can be no assurance that additional debt or equity financing will be available to meet these requirements or available on terms acceptable to Midnight.

Midnight's lenders will be provided with security over substantially all of the assets of Midnight. If Midnight becomes unable to pay its debt service charges or otherwise commits an event of default, such as bankruptcy, these lenders may foreclose on or sell Midnight's properties. The proceeds of any such sale would be applied to satisfy amounts owed to Midnight's lenders and other creditors and only the remainder, if any, would be available to Midnight.

### ***Insurance***

Midnight's involvement in the exploration for and development of oil and gas properties may result in Midnight becoming subject to liability for pollution, blow-outs, property damage, personal injury or other hazards. Although Midnight has insurance in accordance with industry standards to address such risks, such insurance has limitations on liability that may not be sufficient to cover the full extent of such liabilities. In addition, such risks may not, in all circumstances be insurable or, in certain circumstances, Midnight may elect not to obtain insurance to deal with specific risks due to the high premiums associated with such insurance or other reasons. The payment of such uninsured liabilities would reduce the funds available to Midnight. The occurrence of a significant event that Midnight is not fully insured against, or the insolvency of the insurer of such event, could have a material adverse effect on Midnight's financial position, results of operations or prospects.

### ***Competition***

Midnight actively competes for reserve acquisitions, exploration leases, licences and concessions and skilled industry personnel with a substantial number of other oil and gas companies, many of which have significantly greater financial resources than Midnight. Midnight's competitors include major integrated oil and natural gas companies and numerous other independent oil and natural gas companies and individual producers and operators.

The oil and gas industry is highly competitive. Midnight's competitors for the acquisition, exploration, production and development of oil and natural gas properties, and for capital to finance such activities, include companies that have greater financial and personnel resources available to them than Midnight.

Certain of Midnight's customers and potential customers are themselves exploring for oil and natural gas, and the results of such exploration efforts could affect Midnight's ability to sell or supply oil or gas to these customers in the future. Midnight's ability to successfully bid on and acquire additional property rights, to discover reserves, to participate in drilling opportunities and to identify and enter into commercial arrangements with customers will be dependent upon developing and maintaining close working relationships with its future industry partners and joint operators and its ability to select and evaluate suitable properties and to consummate transactions in a highly competitive environment.

### ***Environmental Risks***

All phases of the oil and natural gas business present environmental risks and hazards and are subject to environmental regulation pursuant to a variety of international conventions and state and/or provincial and municipal laws and regulations. Environmental legislation provides for, among other things, restrictions and prohibitions on spills, releases or emissions of various substances produced in association with oil and gas operations. The legislation also requires that wells and facility sites be operated, maintained, abandoned and reclaimed to the satisfaction of applicable regulatory authorities. Compliance with such legislation can require significant expenditures and a breach may result in the imposition of fines and penalties, some of which may be material. Environmental legislation is evolving in a manner expected to result in stricter standards and enforcement, larger fines and liability and potentially increased capital expenditures and operating costs. The discharge of oil, natural gas or other pollutants into the air, soil or water may give rise to liabilities to foreign governments and third parties and may require Midnight to incur costs to remedy such discharge. No assurance can be given that environmental laws will not result in a curtailment of production or a material increase in the costs of production, development or exploration activities or otherwise adversely affect Midnight's financial condition, results of operations or prospects.

### ***Reserve Replacement***

Midnight's future oil and natural gas reserves, production, and cash flows to be derived therefrom are highly dependent on Midnight successfully acquiring or discovering new reserves. Without the continual addition of new reserves, any existing reserves Midnight may have at any particular time and the production therefrom will decline over time as such existing reserves are exploited. A future increase in Midnight's reserves will depend not only on Midnight's ability to develop any properties it may have from time to time, but also on its ability to select and acquire suitable producing properties or prospects. There can be no assurance that Midnight's future exploration and development efforts will result in the discovery and development of additional commercial accumulations of oil and natural gas.

### ***Reliance on Operators and Key Employees***

Pursuant to the terms of the Administrative and Technical Services Agreement between Midnight and Daylight the Company relies significantly on Daylight and its employees in the conduct of its day-to-day business. To the extent Midnight or Daylight is not the operator of Midnight's oil and gas properties, Midnight will be dependent on such third party operators for the timing of activities related to such properties and will largely be unable to direct or control the activities of the operators. In addition, the success of Midnight will be largely dependent upon the performance of its management and key employees. Midnight does not have any key man insurance policies, and therefore there is a risk that the death or departure of any member of management or any key employee could have a material adverse effect on Midnight.

### ***Changes in Legislation***

The return on an investment in securities of Midnight is subject to changes in Canadian federal and provincial tax laws and government incentive programs and there can be no assurance that such laws or programs will not be changed in a manner that adversely affects Midnight or the holding and disposing of the securities of Midnight.

### ***Seasonality***

The level of activity in the Canadian oil and gas industry is influenced by seasonal weather patterns. Wet weather and spring thaw may make the ground unstable. Consequently, municipalities and provincial transportation departments enforce road bans that restrict the movement of rigs and other heavy equipment, thereby reducing activity levels. Also, certain oil and gas producing areas are located in areas that are inaccessible other than during the winter months because the ground surrounding the sites in these areas consists of swampy terrain. Seasonal factors and unexpected weather patterns may lead to declines in exploration and production activity and corresponding declines in the demand for the goods and services of Midnight.

### ***Assessments of Value of Acquisitions***

Acquisitions of oil and gas issuers and oil and gas assets are typically based on engineering and economic assessments made by independent engineers and Midnight's own assessments. These assessments both will include a series of assumptions regarding such factors as recoverability and marketability of oil and gas, future prices of oil and gas and operating costs, future capital expenditures and royalties and other government levies which will be imposed over the producing life of the reserves. Many of these factors are subject to change and are beyond Midnight's control. In particular, the prices of and markets for oil and natural gas products may change from those anticipated at the time of making such assessment. In addition, all such assessments involve a measure of geologic and engineering uncertainty which could result in lower production and reserves than anticipated. Initial assessments of acquisitions may be based on reports by a firm of independent engineers that are not the same as the firm that Midnight uses for its year end reserve evaluations. Because each of these firms may have different evaluation methods and approaches, these initial assessments may differ significantly from the assessments of the firm used by Midnight. Any such instance may offset the return on and value of the Midnight Shares.

### ***Third Party Credit Risk***

Midnight is or may be exposed to third party credit risk through its contractual arrangements with its current or future joint venture partners, marketers of its petroleum and natural gas production and other parties. In the event such entities fail to meet their contractual obligations to Midnight, such failures could have a material adverse effect on Midnight and its cash flow from operations.

### ***Outlook***

The one month of operations prior to the December 31, 2004 year end and large undeveloped land base has provided Midnight a platform for multi-year exploration and development opportunities in its core areas of West Central Alberta and the Peace River Arch.

Midnight has a 2005 capital budget of \$30 million which provides for the drilling of over 20 net wells. Production for the year should average between 1,650 and 1,750 boe/d to generate cash flow of \$11 to \$14 million or \$0.38 to \$0.50 per diluted share. Forecasts are based on a gas price of \$6.60/mcf and a WTI oil price of \$42 US/bbl with an exchange rate of \$0.82. Midnight expects to decrease operating costs near \$9.00/boe while decreasing general and administrative expenses to the \$2 to \$3 per boe range.

## SUPPLEMENTARY INFORMATION

### Drilling History

The following table sets forth the gross and net wells in which Midnight participated for the period November 30, 2004 to December 31, 2004:

	West Central		Peace River Arch	
	Gross	Net	Gross	Net
Natural gas	3	0.8	2	0.6
Oil	-	-	-	-
Total	3	0.8	2	0.6
Success rate	100%		100%	

### Land Holdings

The following table sets out Midnight's land holdings as at December 31, 2004:

(acres)	Developed		Undeveloped		Total	
	Gross	Net	Gross	Net	Gross	Net
Alberta	156,763	7,100	268,586	126,343	425,349	133,443
British Columbia	-	-	22,027	17,858	22,027	17,858
Total December 31, 2004	156,763	7,100	290,613	144,201	447,376	151,301

### Reserves

The reserves data set forth below (the "Reserves Data") is based upon an evaluation by Gilbert Laustsen Jung Associates Ltd ("GLJ") with an effective date of December 31, 2004 contained in a report of March 11, 2005 (the "GLJ Report"). The Reserves Data summarizes the oil, liquids and natural gas reserves of the Company and the net present values of future net revenue for these reserves using constant prices and costs and forecast prices and costs. The Reserves Data conforms with the requirements of National Instrument 51-101 Standards of Disclosure for Oil and Gas Activities ("NI 51-101"). Midnight engaged GLJ to provide an evaluation of proved and proved plus probable reserves and no attempt was made to evaluate possible reserves.

All of the Company's reserves are in Canada and, specifically, in the provinces of Alberta and British Columbia.

It should not be assumed that the estimates of future net revenues presented in the tables below represent the fair market value of the reserves. There is no assurance that the constant prices and costs assumptions and forecast prices and costs assumptions will be attained and variances could be material. The recovery and reserve estimates of crude oil, natural gas liquids and natural gas reserves provided herein are estimates only and there is no guarantee that the estimated reserves will be recovered. Actual crude oil, natural gas and natural gas liquid reserves may be greater than or less than the estimates provided herein.

The following reserve tables may not add due to rounding.

### Forecast Prices and Costs

Reserves Category	Company Reserves			
	Light and Medium Oil	Natural Gas	Natural Gas Liquids	Total Boe
	Gross (mdbl)	Gross (mmcf)	Gross (mdbl)	Gross (mboe)
Proved				
Developed Producing	55	6,165	173	1,256
Developed Non-Producing	-	634	8	114
Undeveloped	-	1,512	6	258
Total Proved	55	8,311	187	1,627
Probable	16	2,540	48	488
Total Proved Plus Probable	71	10,850	236	2,115

(\$000's)	Net Present Values of Future Net Revenue							
	Before Income Taxes Discounted at %/year				After Income Taxes Discounted at %/year			
	0%	5%	10%	15%	0%	5%	10%	15%
Proved								
Developed Producing	24,673	20,529	17,839	15,926	24,409	20,283	17,610	15,712
Developed Non-Producing	2,070	1,677	1,450	1,301	1,634	1,271	1,056	913
Undeveloped	2,892	2,251	1,769	1,396	2,283	1,705	1,289	980
Total Proved	29,635	24,457	21,057	18,623	28,326	23,259	19,955	17,605
Probable	9,219	6,357	4,917	4,041	7,858	5,123	3,790	3,004
Total Proved Plus Probable	38,854	30,814	25,975	22,665	36,184	28,382	23,745	20,609

## Constant Prices and Costs

Reserves Category	Company Reserves			
	Light and Medium Oil	Natural Gas	Natural Gas Liquids	Total Boe
	Gross (mdbl)	Gross (mmcf)	Gross (mdbl)	Gross (mboe)
Proved				
Developed Producing	56	6,406	177	1,301
Developed Non-Producing	-	658	8	118
Undeveloped	-	1,529	6	261
Total Proved	56	8,593	192	1,680
Probable	17	2,647	52	510
Total Proved Plus Probable	73	11,240	244	2,190

(\$000's)	Net Present Values of Future Net Revenue							
	Before Income Taxes Discounted at %/year				After Income Taxes Discounted at %/year			
	0%	5%	10%	15%	0%	5%	10%	15%
Proved								
Developed Producing	30,035	24,528	20,961	18,447	29,280	23,847	20,343	17,883
Developed Non-Producing	2,396	1,934	1,660	1,477	1,781	1,378	1,138	977
Undeveloped	3,669	2,878	2,287	1,834	2,728	2,050	1,568	1,213
Total Proved	36,100	29,339	24,907	21,759	33,789	27,275	23,049	20,073
Probable	12,019	8,301	6,319	5,093	9,506	6,215	4,543	3,550
Total Proved Plus Probable	48,120	37,640	31,227	26,852	43,295	33,490	27,592	23,623

## Pricing Assumptions

### Forecast Pricing Assumptions

The following table sets for the benchmark reference prices, as at December 31, 2004, reflected in the reserves data. These price assumptions were provided by GLJ.

Year	OIL		NATURAL GAS AECO Gas Price (\$Cdn/mmbtu)	Inflation Rates(a) %/Year	Exchange Rate(b) (\$US/\$Cdn)
	WTI Cushing Oklahoma (\$US/bbl)	Edmonton Par Price 40° API (\$Cdn/bbl)			
Forecast					
2005	42.00	50.25	6.60	2.0	0.820
2006	40.00	47.75	6.35	2.0	0.820
2007	38.00	45.50	6.15	2.0	0.820
2008	36.00	43.25	6.00	2.0	0.820
2009	34.00	40.75	6.00	2.0	0.820
2010	33.00	39.50	6.00	2.0	0.820
2011	33.00	39.50	6.00	2.0	0.820

Notes:

(a) Inflation rates for forecasting prices and costs.

(b) Exchange rates used to generate the benchmark reference prices in this table.

### Constant Pricing Assumptions

The following sets for the benchmark reference prices, as at December 31, 2004, reflected in the reserves data. These price assumptions were provided by GLJ.

	OIL		NATURAL GAS AECO Gas Price (\$Cdn/mmbtu)	Exchange Rate (\$US/\$Cdn)
	WTI Cushing Oklahoma (\$US/bbl)	Edmonton Par Price 40° API (\$Cdn/bbl)		
December 31, 2004	43.45	46.54	6.79	0.8308

## FINANCIAL STATEMENTS

December 31, 2004

### MANAGEMENT'S RESPONSIBILITY STATEMENT

The financial statements of Midnight Oil Exploration Ltd. and all information in this annual report are the responsibility of management and have been approved by the Board of Directors. The financial statements have been prepared in accordance with Canadian generally accepted accounting principles. The financial statements include amounts that are based on estimates, which have been objectively developed by management using all relevant information. All financial and operating data in this annual report is consistent with the information in the financial statements.

Midnight Oil Exploration Ltd. maintains appropriate systems of internal control to give reasonable assurance that transactions are appropriately authorized, assets are safeguarded from loss or misuse and financial records are properly maintained to provide reliable information for the preparation of financial statements.

KPMG LLP, an independent firm of chartered accountants, has been engaged to examine the financial statements and provide their auditor's report. Their report is presented with the financial statements.

The directors are responsible for ensuring that management fulfills its responsibilities for financial reporting and internal control. The Board carries out this responsibility principally through its Audit Committee. The Audit Committee is comprised entirely of outside directors and meets regularly with management and with the Company's external auditors to discuss the results of their audit examination and to review issues related thereto. The external auditors have full access to the Audit Committee with and without the presence of management. The Audit Committee reviews the financial statements and Management's Discussion and Analysis and recommends their approval to the Board of Directors.



**Fred Woods**  
President and CEO



**Judy Stripling**  
Vice President Finance and CFO

Calgary, Alberta  
March 15, 2005

## **AUDITORS' REPORT TO THE SHAREHOLDERS**

We have audited the balance sheet of Midnight Oil Exploration Ltd. as at December 31, 2004 and the statements of income and retained earnings and cash flows for the period from November 29, 2004 to December 31, 2004. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2004 and the results of its operations and its cash flows for the period from November 29, 2004 to December 31, 2004 in accordance with Canadian generally accepted accounting principles.

*KPMG LLP*

### **Chartered Accountants**

Calgary, Canada  
March 15, 2005

# MIDNIGHT OIL EXPLORATION LTD.

## Balance Sheet

December 31, 2004  
(\$000's)

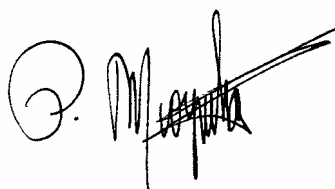
	<b>2004</b>
<b>Assets</b>	
Current assets:	
Cash and cash equivalents	\$ 5,031
Accounts receivable	1,132
	<u>6,163</u>
Future taxes (note 7)	145
Petroleum and natural gas assets (note 3)	35,812
	<u>\$ 42,120</u>
<b>Liabilities and Shareholders' Equity</b>	
Current liabilities:	
Accounts payable and accrued liabilities	\$ 3,261
Asset retirement obligations (note 5)	542
Shareholders' equity:	
Share capital (note 6)	38,240
Warrants (note 6)	47
Contributed surplus	15
Retained earnings	15
	<u>38,317</u>
	<u>\$ 42,120</u>

See accompanying notes to financial statements.

**On behalf of the Board:**



**Tom Medvedic**  
Director



**Paul Moynihan**  
Director

# MIDNIGHT OIL EXPLORATION LTD.

## Statement of Income and Retained Earnings

Period from November 29, 2004 to December 31, 2004  
(\$000's, except per share amounts)

	<b>2004</b>
<b>Revenues:</b>	
Petroleum and natural gas sales	\$ 977
Royalties	(211)
Other income	12
	<u>778</u>
<b>Expenses:</b>	
Operating	249
Transportation	1
General and administration	126
Stock-based compensation	15
Depletion, depreciation and accretion	329
	<u>720</u>
Income before taxes	58
Taxes (note 7):	
Future	43
	<u>43</u>
Net income	15
Retained earnings, beginning of period	-
<b>Retained earnings, end of period</b>	<b>\$ 15</b>
Income per share (note 6(c)):	
Basic	\$ 0.00
Diluted	\$ 0.00

See accompanying notes to financial statements.

# MIDNIGHT OIL EXPLORATION LTD.

## Statement of Cash Flows

Period from November 29, 2004 to December 31, 2004  
(\$000's)

	<b>2004</b>
<b>Cash provided by (used in):</b>	
<b>Operations:</b>	
Net income	\$ 15
Items not involving cash:	
Depletion, depreciation and accretion	329
Stock-based compensation	15
Future taxes	43
Abandonment expenditures	(5)
Funds from operations	397
Changes in non-cash working capital	(551)
	(154)
<b>Financing:</b>	
Issue of common shares	7,000
Issue of warrants	47
Debt assumed on conveyance of assets (note 2)	(2,000)
Changes in non-cash working capital	138
	5,185
<b>Investments:</b>	
Petroleum and natural gas additions	(2,680)
Changes in non-cash working capital	2,680
	-
Changes in cash	5,031
Cash, beginning of period	-
<b>Cash, end of period</b>	<b>\$ 5,031</b>

Cash is defined as cash and cash equivalents.

See accompanying notes to financial statements.

# MIDNIGHT OIL EXPLORATION LTD.

## Notes to Financial Statements

Period from November 29, 2004 to December 31, 2004  
(Tabular amounts are stated in thousands of dollars except share and per share amounts)

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### Nature of operations:

Midnight Oil Exploration Ltd. ("Midnight" or the "Company") was incorporated on September 10, 2004 and commenced operations on November 30, 2004 under a Plan of Arrangement entered into by Midnight Oil & Gas Ltd., Daylight Energy Trust ("Daylight"), Daylight Acquisition Corp. and Midnight ("Plan of Arrangement"). Under the Plan of Arrangement, Daylight Acquisition Corp. acquired all the issued and outstanding shares of Vintage Petroleum Canada, Inc ("Vintage") and Midnight Oil & Gas Ltd., with certain assets of Midnight Oil & Gas Ltd. and Vintage transferred to Midnight Oil Exploration Ltd. As a result, the financial statements presented are for the period from November 29, 2004 to December 31, 2004.

The principal business of the Company is the exploration for, exploitation, development and production of oil and natural gas reserves. All activity is conducted in Western Canada and comprises a single business segment.

### 1. Significant accounting policies:

The financial statements of the Company have been prepared in accordance with Canadian generally accepted accounting principles. The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and revenues and expenses during the reporting period. Actual results could differ from those estimated.

Specifically, the amounts recorded for depletion, depreciation and accretion of petroleum and natural gas assets and asset retirement obligations are based on estimates. The ceiling test is based on estimates of reserves, production rates, oil and gas prices, future costs and other relevant assumptions. By their nature, these estimates are subject to measurement uncertainty and the effect on the financial statements of changes in such estimates in future periods could be significant.

#### (a) Cash and cash equivalents:

Cash and cash equivalents are comprised of cash and all investments with a maturity date of three months or less.

#### (b) Petroleum and natural gas assets:

##### (i) Capitalized costs:

The Company follows the full cost method of accounting for petroleum and natural gas assets. Under this method, all costs related to the acquisition of, exploration for and development of petroleum and natural gas reserves are capitalized. These costs include land acquisition costs, geological and geophysical expenditures, rentals and other carrying charges on undeveloped properties, costs of drilling both productive and non-productive wells, oil and gas production equipment and facilities, asset retirement costs and administration expenses directly related to the acquisition, exploration and development activities. Proceeds from the disposition of oil and natural gas properties are accounted for as a reduction of capitalized costs, with no gain or loss recognized, unless such disposition would result in a change greater than 20% in the depletion or depreciation rate.

(ii) Depletion and depreciation:

Depletion of petroleum and natural gas assets and depreciation of production equipment are calculated using the unit-of-production method, based on production volumes before royalties in relation to estimated proven reserves as determined by an independent petroleum engineering firm. Natural gas reserves and production are converted to equivalent barrels of oil based upon the relative energy content of six thousand cubic feet of gas to one barrel of oil.

The cost of acquisition and evaluation of unproved properties are initially excluded from the depletion calculation. A separate impairment test is performed on these assets to determine whether the carrying value exceeds the fair value. Any excess in carrying value over fair value is an impairment. When proved reserves are assigned or a property is considered to be impaired, the cost of the property or the amount of the impairment will be added to the capitalized costs for the calculation of depletion.

Other assets are depreciated on a declining balance basis at rates ranging from 20% to 35%.

(iii) Ceiling test:

Petroleum and natural gas assets are evaluated in each reporting period to determine that the carrying amount is recoverable and does not exceed the fair value of the properties.

The carrying amounts are assessed to be recoverable when the sum of the undiscounted cash flows expected from the production of proved reserves, the lower of cost and market of unproved properties and the cost of major development projects exceeds the carrying amount of the cost centre. When the carrying amount is not assessed to be recoverable, an impairment loss is recognized to the extent that the carrying amount of the cost centre exceeds the sum of the discounted cash flows expected from the production of proved and probable reserves, the lower of cost and market of unproved properties and the cost of major development projects of the cost centre. The cash flows are estimated using expected future product prices and costs and are discounted using a risk-free interest rate.

(c) Asset retirement obligations:

The Company recognizes the asset retirement obligations for the future cost associated with removal, site restoration and asset retirement costs. The fair value of the liability for the Company's asset retirement obligation is recorded in the period in which it is incurred, discounted to its present value using the Company's credit adjusted risk-free interest rate and the corresponding amount recognized by increasing the carrying amount of petroleum and natural gas assets. The asset recorded is depleted on a unit of production basis over the life of the reserves. The liability amount is increased each reporting period due to the passage of time and the amount of accretion is charged to earnings in the period. Revisions to the estimated timing of cash flows or to the original estimated undiscounted cost could also result in an increase or decrease to the obligation. Actual costs incurred upon settlement of the retirement obligation are charged against the obligation to the extent of the liability recorded.

(d) Joint interest operations:

Substantially all of the Company's exploration, development and production activities related to oil and gas operations are conducted jointly with others and accordingly the accounts reflect only the Company's proportionate interest in such activities.

(e) Revenue recognition:

Revenue from the sale of petroleum and natural gas is recognized during the month when title passes to a third party.

(f) Income taxes:

The Company uses the liability method of tax allocation accounting. Under this method, future tax assets and liabilities are determined based on differences between the financial reporting and tax bases of assets and liabilities, and measured using the substantially enacted tax rates and laws that will be in effect when the differences are expected to reverse.

(g) Stock-based compensation plans:

The Company applies the fair value method for valuing stock option grants and warrants. Under this method, compensation cost attributable to all share options granted and warrants issued are measured at fair value at the grant and issuance date and expensed over the vesting period with a corresponding increase to contributed surplus. Upon the exercise of the stock options and warrants, consideration received together with the amount previously recognized in contributed surplus is recorded as an increase to share capital.

(h) Per share information:

Basic per share information is computed by dividing income by the weighted average number of common shares outstanding for the period. The treasury stock method is used to determine the diluted per share amounts, whereby any proceeds from the stock options, warrants or other dilutive instruments are assumed to be used to purchase common shares at the average market price during the period. The weighted average number of shares outstanding is then adjusted by the net change.

**2. Transfer of assets and commencement of commercial operations:**

Under the Plan of Arrangement certain assets of Midnight Oil & Gas Ltd. and Vintage were transferred to the Company. The Midnight Oil & Gas Ltd. shareholders along with the Daylight Energy Trust investors effectively received 0.50 of a voting share of the Company for every common share of Midnight Oil & Gas Ltd and for every Series U subscription of Daylight Energy Trust. At the time of the transaction, the entities were related and therefore the assets and liabilities of Midnight have been accounted for on a “continuity of interests” basis.

Net assets acquired:	
Petroleum and natural gas assets	\$ 33,456
Future taxes	188
Accounts receivable (1)	138
Debt assumed on conveyance of assets	(2,000)
Asset retirement obligations	(542)
Net assets transferred and share capital issued	\$ 31,240

(1) Options were transferred on the Plan of Arrangement and were exercised for proceeds of \$138,000.

### Relationship with Daylight

In conjunction with the Plan of Arrangement, Midnight and Daylight entered into an Administrative and Technical Services Agreement which provides for the shared services required to manage Midnight's activities and govern the allocation of general and administration expenses between the entities. Under this agreement, Daylight receives payment for certain technical and administration services provided to Midnight on a cost recovery basis. The Administrative and Technical Service Agreement has no set termination date and will continue until terminated by either party upon three months prior written notice to the other party. Pursuant to the Administrative and Technical Services Agreement, \$110,000 of fees were charged relating to general and administration activities and \$99,000 of fees were charged relating to capital expenditures for the period from commencement of operations on November 29, 2004 to December 31, 2004.

As a result of this technical service arrangement, the majority of the Company's accounts receivable and accounts payable as at December 31, 2004 are due from (to) Daylight.

### 3. Petroleum and natural gas assets:

2004	Cost	Accumulated depletion and depreciation	Net book value
Petroleum and natural gas properties	\$ 36,138	326	\$ 35,812
	\$ 36,138	326	\$ 35,812

During the period, the Company capitalized \$99,000 of general and administration expenses related to exploration and development activities.

The cost of unproven properties at December 31, 2004 of \$14,542,000 has been excluded from the depletion and depreciation calculation. Future development costs of proven reserves of \$3,500,000 have been included in the depletion and depreciation calculation.

At December 31, 2004, the Company applied a ceiling test to its petroleum and natural gas assets using expected future market prices of:

Benchmark reference price forecast	2005	2006	2007	2008	2009
WTI (\$US/bbl)	42.00	40.00	38.00	36.00	34.00
AECO (\$Cdn/mcf)	6.60	6.35	6.15	6.00	6.00

After 2009 the change in future prices are escalated at 2% per year to the end of the reserve life.

### 4. Bank facility:

Midnight has a revolving term credit facility available up to \$8 million with a Canadian chartered bank. The facility is available on a revolving basis until June 30, 2005. On June 30, 2005, at the Company's discretion, the facility is available on a non-revolving basis for a period of 366 days, at which time the facility would be due and payable. Alternatively, the facility may be extended for a further 364-day period at the request of the Company and subject to approval by the bank. The credit facility bears interest at the bank prime rate and is secured by a \$50 million first floating charge debenture and a

general securities agreement. At December 31, 2004, no funds were drawn on this facility. The \$8 million borrowing base is subject to a semi-annual and annual review by the bank.

Cash interest income received during the period totalled \$12,000.

#### 5. Asset retirement obligations:

The Company's asset retirement obligations result from net ownership interests in petroleum and natural gas assets including well sites, gathering systems and processing facilities. The Company estimates the total undiscounted amount of cash flow required to settle its asset retirement obligations is approximately \$1,627,000 which will be incurred between 2005 to 2054. The majority of the costs will be incurred between 2010 and 2020. An inflation factor of 2% has been applied to the estimated asset retirement cost. A credit-adjusted risk-free rate of 8% was used to calculate the fair value of the asset retirement obligations.

A reconciliation of the asset retirement obligations is provided below:

	<b>2004</b>
Transfer of assets through Plan of Arrangement	\$ 542
Liabilities incurred	2
Liabilities settled	(5)
Accretion expense	3
Balance, December 31, 2004	\$ 542

#### 6. Share capital:

##### (a) Authorized:

The authorized share capital consists of an unlimited number of common shares without par value.

##### (b) Issued and outstanding:

On November 29, 2004, prior to the completion of the Plan of Arrangement, Midnight completed a private placement of 4,666,666 common shares for gross proceeds of \$7 million.

	<b>Number of Shares</b>	<b>Amount</b>
Common shares:		
Issued on incorporation	1	\$ -
Issued pursuant to private placement	4,666,666	7,000
Issued pursuant to the Plan of Arrangement (note 2)	21,661,162	31,240
Balance, December 31, 2004	26,327,829	\$ 38,240

On November 30, 2004 the common shares were consolidated on a two for one basis, all number of shares and warrants and per share amounts have been restated to reflect the consolidation.

##### (c) Per share amounts:

Per share amounts have been calculated on the weighted average number of shares outstanding. The weighted average shares outstanding for 2004 were 25,650,919.

Diluted per share amounts are calculated based on the diluted weighted average number of shares outstanding. The diluted weighted average shares outstanding for 2004 were 25,804,126 because of the dilutive effect of warrants.

(d) Stock options:

The Company has reserved 2,581,670 common shares for granting under option to employees, directors and other persons who provide ongoing management or consulting services to the Company. Stock options are granted for a term up to five years and vest one third per year over three years on the anniversary from the date granted. The exercise price of each option equals the market price of the Company's common shares on the date of the grant. There were no options granted as at December 31, 2004.

(e) Warrants:

On November 29, 2004, Midnight issued by way of private placement, 2,333,333 warrants for gross proceeds of \$47,000 to officers, service providers and directors of the Company. Each warrant is exercisable into one common share of the Company at a price of \$3.00 per share, subject to the achievement of certain performance criteria. One-third of the warrants will vest on November 29, 2005 and will only be exercisable if the ten day weighted average trading price of Midnight shares is equal to or greater than \$3.00 per share. An additional one-third of the warrants will vest on November 29, 2006 and will only be exercisable if the ten day weighted average trading price of Midnight shares is equal to or greater than \$3.75 per share. The balance of the warrants will vest on November 29, 2007 and will only be exercisable if the ten day weighted average trading price of Midnight shares is equal to or greater than \$4.50 per share. The warrants expire on November 29, 2008. The fair value of the warrants was \$0.23 and will be amortized to income over the vesting period.

(f) Stock-based compensation:

The Company accounts for its stock-based compensation plan using the fair value method. Under this method, a compensation cost is charged over the vesting period for warrants and options granted to employees, officers, directors and other service providers to Midnight Oil Exploration Ltd.

The Company has not incorporated an estimated forfeiture rate for stock options that will not vest, rather the Company accounts for actual forfeitures as they occur.

The fair value of warrants granted were estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions used:

	<b>2004</b>
Weighted average fair value of warrants granted	\$0.23
Risk free interest	4.25%
Estimated hold period prior to exercise	4 years
Expected volatility	40%
Dividend per share	\$0.00

## 7. Taxes:

The provision for taxes in the financial statements differs from the result that would have been obtained by applying the combined federal and provincial tax rate to the Company's income before taxes. The difference results from the following items:

	<b>2004</b>
Income before taxes	\$ 58
Combined federal and provincial tax rate	38.6%
Computed "expected" tax expense	\$ 22
Increase (decrease) in taxes resulting from:	
Non-deductible crown charges	55
Resource allowance	(39)
Other	5
Future taxes	\$ 43

The components of the Company's future income tax liability at December 31 are as follows:

	<b>2004</b>
Future tax assets:	
Asset retirement obligations	\$ 188
	188
Future tax liabilities:	
Petroleum and natural gas assets	(43)
Net future tax asset	\$ 145

## 8. Risk management:

### (a) Credit risk:

Portions of the Company's accounts receivable are with joint venture partners in the oil and gas industry and are subject to normal industry credit risks. Purchasers of the Company's oil and natural gas products are subject to an internal credit review designed to mitigate the risk of non-payment.

### (b) Commodity price risk:

There were no financial instruments in place to manage commodity prices during the period ended December 31, 2004.

### (c) Foreign currency:

While substantially all of the Company's sales are denominated in Canadian dollars, the market prices in Canada for oil and natural gas are impacted by changes in the exchange rate between the Canadian and United States dollar.

(d) Fair value of financial instruments:

Financial instruments comprise cash and cash equivalents, accounts receivable and accounts payable and accrued liabilities. The fair values of these financial instruments approximate their carrying amounts due to their short-term maturities.

(e) Interest rate risk:

The Company is exposed to interest rate risk to the extent that changes in market interest rates will impact the Company's cash and cash equivalents that have a floating interest rate. The bank facility is also based on a floating interest rate. The Company had no interest rate swaps or hedges at December 31, 2004.

### Abbreviations

/d	per day	mboe	thousand barrels of oil equivalent
bbl(s)	barrel(s)	mmbtu	millions of British thermal units
mbbls	thousand barrels	ARTC	Alberta Royalty Tax Credit
mcf	thousand cubic feet	WTI	West Texas Intermediate crude oil
mmcf	million cubic feet	NGLs	natural gas liquids
bcf	billion cubic feet	Cdn	Canadian
boe	barrels of oil equivalent	US	United States

# MIDNIGHT OIL EXPLORATION LTD.

## CORPORATE INFORMATION

### DIRECTORS

**Paul E. Moynihan**, Chairman of the Board <sup>1,2,3</sup>  
Managing Director and Partner  
Mustang Capital Partners Inc.  
Calgary, Alberta

**Jay D. Squiers** <sup>1,2,3</sup>  
Senior Vice President  
Prudential Capital Group  
Dallas, Texas  
United States

**Tom J. Medvedic** <sup>1,2,3</sup>  
Vice President, Finance and Chief Financial Officer  
Calfrac Well Services Ltd.  
Calgary, Alberta

**Frederick N. Woods**  
President and Chief Executive Officer  
Midnight Oil Exploration Ltd.  
Calgary, Alberta

**Anthony M. Lambert**  
Vice-President, Operations and Chief Operating Officer  
Midnight Oil Exploration Ltd.  
Calgary, Alberta

Members of the following Committees

1 Audit

2 Compensation

3 Reserves

### OFFICERS

**Frederick N. Woods**  
President and Chief Executive Officer

**Anthony M. Lambert**  
Vice-President, Operations and Chief Operating Officer

**Thomas F. Moslow**  
Vice-President, Exploration

**Judith A. Stripling**  
Vice-President, Finance and Chief Financial Officer

**Andrew D. Weldon**  
Vice-President, Land

**David A. West**  
Vice-President, Engineering

**Chris von Vegesack**, Corporate Secretary  
Partner  
Burnet, Duckworth & Palmer LLP  
Calgary, Alberta

**Banker**  
Canadian Imperial Bank of Commerce  
Calgary, Alberta

**Legal Counsel**  
Burnet, Duckworth & Palmer LLP  
Calgary, Alberta

**Auditors**  
KPMG LLP  
Chartered Accountants  
Calgary, Alberta

**Evaluation Engineers**  
Gilbert Laustsen Jung Associates Ltd.  
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**Registrar and Transfer Agent**  
Valiant Trust Company  
Calgary, Alberta

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**MIDNIGHT**

Oil Exploration Ltd.