

**CASPIAN ENERGY INC.**

**(the “Company” or “CEK”)**

**ANNOUNCES THIRD QUARTER 2006 FINANCIAL RESULTS**

Caspian Energy Inc. (TSX and AIM: CEK) announced today its financial results for the three and nine months ending September 30, 2006. Its interim unaudited financial statements for the period and related management's discussion and analysis have been filed with Canadian securities regulatory authorities and are available for viewing at [www.sedar.com](http://www.sedar.com).

For the three and nine months ending September 30, 2006, CEK's net loss was \$1,514,083 and \$2,885,665, respectively. For the three and nine months ending October 31, 2005, CEK's net loss was \$1,858,266 and \$8,692,830, respectively. Large non-cash items equal to \$1,182,872 (3Q 2005 - \$673,354) relating to stock-based compensation charges and \$840,497 (3Q 2005 - \$1,071,839) pertaining to foreign exchange losses contributed to the loss in 3Q 2006. During 3Q 2006, the Company recorded a recovery of \$500,612 pertaining to future income taxes in the Republic of Kazakhstan (3Q 2005, a charge - \$240,114).

CEK's operations used \$403,865 in cash during the three month period and provided \$164,214 for the comparative quarter of 2005. Realized foreign exchange losses of \$999,494 in the current period (prior period – nil) are included in these figures.

Oil revenues before transportation costs during 3Q 2006 were \$1,421,381 and for 3Q 2005 were \$843,847.

For the quarter ended September 30, 2006 operating costs were \$349,138 and for the 2005 comparative period, operating costs were \$343,008 and transportation expenses were \$63,737 and \$2,384, respectively. Administrative expenses for the same periods were \$830,002 and \$565,679, respectively.

Capital expenditures were \$11,040,667 for 3Q 2006 and \$9,233,035 for 3Q 2005. Capital expenditures are composed of advances to Aral and the Company's share of the expenditure of funds by Aral.

CEK today filed on SEDAR interim unaudited financial statements and MD&A with respect to its September 30, 2006 third fiscal quarter.

The Company is an oil exploration and development corporation operating in the Republic of Kazakhstan.

For further information contact:

Caspian Energy Inc.  
William Ramsay  
President and Chief Executive Officer  
00 7 3272 54 31 27

Bell Pottinger Corporate and Financial  
Ann-Marie Wilkinson/Geoff Callow  
00 44 (0) 20 7861 3232

## CAUTIONARY NOTE

Some of the statements and information contained in this news release may include certain estimates, assumptions and other forward-looking information. The actual performance, developments and/or results of the Company may differ materially from any or all of the forward-looking statements, which include current expectations, estimates and projections, in all or in part attributable to general economic conditions, and other risks, uncertainties and circumstances partly or totally outside the control of the Company, including oil prices, imprecision of reserve estimates, drilling risks, future production of gas and oil, rates of inflation, changes in future costs and expenses related to the activities involving the exploration, development, production and transportation of oil, hedging, financing availability and other risks related to financial activities, and environmental and geopolitical risks. Further information which may cause results to differ materially from those projected in the forward-looking statements is contained in the Company's filings with Canadian securities regulatory authorities. The Company disclaims any intention or obligation to update or revise forward-looking information, whether as a result of new information, future events or otherwise, except in accordance with applicable securities laws.

**NOT FOR DISTRIBUTION TO UNITED STATES NEWSWIRE SERVICES OR FOR DISSEMINATION IN THE UNITED STATES.**

## BUSINESS PROSPECTS AND OUTLOOK

The Company has been successful in establishing itself as an operating entity in the ROK and expects to continue with future growth through continued work there.

Prior to the end of the fourth quarter 2005, EZ#301 was drilled to a total depth of 4,846 metres and logged. The well was completed with the drilling rig before the rig was moved to the EZ#302 location. EZ#301 was matrix acidized and the two potentially productive hydrocarbon bearing zones were flow-tested. The lower zone (KT-2) was tested at 2,532 Bopd. The upper zone (KT-1) had difficulty maintaining an independent flow, so it was commingled with the lower zone and the well was tied-in to the Zhagabulak production facility. Subsequently, production logs were ran and it was determined that the KT-1 was producing 100 Bopd.

The second exploration effort, EZ#302, was spud on December 25, 2005. Acidizing and testing of the well were performed following removal of the drilling rig. The well showed all indications of hydrocarbons while drilling and logging; however, the stimulation efforts failed to cause the well to flow naturally. EZ#302 has recently been re-evaluated and a newly designed acid treatment prepared. The acid treatment is expected to begin in late November. The third location, EZ#303 is about 5.2 km southwest of EZ#302. EZ#303 spud on May 28, 2006. The well was permitted to a depth of 5,700 metres and is currently drilling towards a structural target below

the Carboniferous. Total depth is expected to be reached during November 2006. Intermediate logs have been run over the Carboniferous section with numerous hydrocarbon-bearing intervals being identified. A major workover is planned for our original producing well, EZ#213, which was drilled during the Soviet period. From logging results at EZ#301 and further interpretation of the Zhagabulak 3-D seismic survey, additional potentially productive zones were identified that were not opened in this well. Zones below the current perforations will also be investigated for perforation. The well will be acidized during the workover. A contract with a workover rig company has been signed and work began on November 1 2006. In addition, investigation of the condition of the re-entry candidate, EZ#216, a plugged and abandoned Soviet period well, will be performed with the workover rig following the workover of well EZ#213. Rigs, like all other oil field equipment and personnel remain in short supply.

Modifications to our processing plant in Zhagabulak were made to increase its through-put and to improve its reliability and safety. These modifications were completed in August 2006.

Ongoing petrophysical analyses of all wells penetrating the below salt reservoirs is being completed and correlations of these wells will aid in the identification of future drilling locations in the North Block. Identification and acquisition of well data within the extended territory will also be evaluated for inclusion into this process.

The Baktygaryn 3-D seismic program was completed in early November 2005. PGS-GIS, in Almaty, ROK was awarded the processing contract. Due to the presence of large salt bodies in the Baktygaryn Area, the 3-D data set was processed through PSTM (Pre-Stack Time Migration) and interpretation of this data has been completed. Pre-Stack Depth Migration analysis has also been conducted. The acquisition of the regional 2-D seismic survey covering the west and north areas of the North Block and tying into the Zhagabulak and Baktygaryn 3-D seismic surveys that was completed in March has also been processed and interpreted. The Baktygaryn 3-D program and the regional 2-D program were fully interpreted at the end of October 2006. Several of the 2-D seismic lines were selected for AVO analysis and this work is expected to be completed in the first half of November 2006.

Beginning in late February 2006, the Company began the acquisition of a regional, strategically-placed, 367 km 2-D seismic program covering a widespread area of the North Block. The knowledge gained from this 2-D acquisition program will add to the effort of identifying a third 3-D seismic acquisition area currently scheduled to begin in late 2006, depending on equipment availability and other ongoing activities. Drilling locations from the 3-D data are expected to be identified in late 2006 to early 2007.

For the remainder of the year drilling activity will continue at Zhagabulak, following completion of EZ#303, with the spudding of EZ#304 near mid-December 2006. Future plans for the North Block include the deepening of well EZ#216 to test the KT-2. The Company will then decide whether to continue drilling in Zhagabulak or to shift drilling activities to Baktygaryn. To contemporaneously achieve these two alternatives, a two rig drilling scenario is being considered. Seismic activity will include a third 3-D seismic acquisition, planned for late fourth quarter, based on the results of the ongoing 2-D seismic interpretation and AVO analysis.

## Consolidated Balance Sheet

	September 30, 2006 \$	December 31, 2005 \$
<b>Assets</b>		
<b>Current assets</b>		
Cash and cash equivalents	32,126,866	10,094,086
Accounts receivable	884,737	505,815
Prepays and other deposits	1,919,905	420,879
Inventory (note 3)	3,765,101	887,617
	<hr/>	<hr/>
	38,696,609	11,908,397
<b>Restricted cash</b> (note 2)	134,578	136,884
<b>Property, plant and equipment</b> (note 4)	100,525,080	68,331,221
	<hr/>	<hr/>
	139,356,267	80,376,502
<b>Liabilities</b>		
<b>Current liabilities</b>		
Accounts payable and accrued liabilities	3,360,265	3,216,450
Loan payable (note 10)	-	6,872,279
	<hr/>	<hr/>
	3,360,265	10,088,729
<b>Asset retirement obligation</b> (note 5)	98,498	88,900
<b>Future income taxes</b>	920,509	51,629
<b>Convertible debentures</b> (note 6)	17,415,028	-
	<hr/>	<hr/>
	21,794,300	10,229,258
<b>Shareholders' Equity</b>		
<b>Share capital</b> (note 7)	121,470,892	75,220,762
<b>Warrants to purchase common shares</b> (note 7)	1,439,941	667,738
<b>Contributed surplus</b> (note 9)	10,946,188	7,668,133
<b>Deficit</b>	(16,295,054)	(13,409,389)
	<hr/>	<hr/>
	117,561,967	70,147,244
	<hr/>	<hr/>
	139,356,267	80,376,502

## Consolidated Statement of Loss and Deficit

	Three months ended September 30, 2006 \$	Three months ended October 31, 2005 \$	Nine months ended September 30, 2006 \$	Nine months ended October 31, 2005 \$
<b>Revenue</b>				
Oil and gas revenue, net	1,421,381	843,847	3,531,842	2,014,464
Interest	413,236	231,438	1,007,519	935,824
Other	4,895	-	5,460	-
	<u>1,839,512</u>	<u>1,075,285</u>	<u>4,544,821</u>	<u>2,950,288</u>
<b>Expenses</b>				
General and administrative	830,002	565,679	2,248,425	2,070,902
Accretion of convertible debentures (note 6)	82,659	-	194,634	-
Interest	450,329	-	1,059,441	-
Operating	349,138	343,008	954,980	1,098,557
Transportation	63,737	2,384	82,092	11,633
Stock-based compensation (note 8)	1,182,872	673,354	1,794,250	3,589,794
Foreign exchange (gain) loss	840,497	1,071,839	36,297	4,319,033
Depletion, depreciation and accretion	54,973	37,173	152,360	111,066
	<u>3,854,207</u>	<u>2,693,437</u>	<u>6,522,479</u>	<u>11,200,985</u>
<b>Loss before income taxes</b>	(2,014,695)	(1,618,152)	(1,977,658)	(8,250,697)
<b>Future income taxes (recovery)</b>	(500,612)	240,114	908,007	442,133
<b>Net loss for the period</b>	(1,514,083)	(1,858,266)	(2,885,665)	(8,692,830)
<b>Deficit – Beginning of period</b>	(14,780,971)	(11,836,019)	(13,409,389)	(5,001,455)
<b>Deficit – End of period</b>	(16,295,054)	(13,694,285)	(16,295,054)	(13,694,285)
<b>Basic loss per share</b> (note 7)	(0.01)	(0.02)	(0.03)	(0.10)
<b>Diluted loss per share</b> (note 7)	(0.01)	(0.02)	(0.03)	(0.10)

## Consolidated Statement of Cash Flow

	Three months en September 30, 2006 \$	Three months en October 31, 2005 \$	Nine months end September 30, 2006 \$	Nine months end October 31, 2005 \$
<b>Cash provided by (used in)</b>				
<b>Operating activities</b>				
Net loss for the period	(1,514,083)	(1,858,266)	(2,885,665)	(8,692,830)
Items not affecting cash				
Stock-based compensation	1,182,872	673,354	1,794,250	3,589,794
Unrealized foreign exchange loss (gain)	(158,997)	1,071,839	(91,832)	4,319,033
Depletion, depreciation and accretion	54,973	37,173	152,360	111,066
Interest on convertible debentures	449,323	-	1,052,147	-
Accretion of convertible debentures	82,659	-	194,634	-
Future income taxes (recovery)	(500,612)	240,114	908,007	442,133
	(403,865)	164,214	1,123,901	(230,804)
Changes in non-cash working capital balances	1,496,595	(215,986)	(378,922)	(469,108)
	1,092,730	(51,772)	744,979	(699,912)
<b>Financing activities</b>				
Convertible debentures	(90,314)	-	17,652,052	-
Loan payable	(6,636,582)	(340,755)	(6,872,279)	(415,469)
Foreign exchange	158,997	(1,071,839)	91,832	(4,319,033)
Restricted cash	5,049	-	2,306	-
Issuance of common shares and warrants	-	-	50,804,650	135,301
Share issue expenses	-	-	(3,782,317)	(290,817)
	(6,562,850)	(1,412,594)	57,896,244	(4,890,018)
<b>Investing activities</b>				
Acquisition of property, plant and equipment	(11,040,667)	(9,233,035)	(32,366,571)	(15,366,726)
Asset retirement	-	(228)	-	1,001
Changes in non-cash working capital balances	(402,248)	(432,168)	(4,232,695)	(1,314,406)
	(11,442,915)	(9,665,431)	(36,599,266)	(16,680,131)
<b>Increase (decrease) in cash and cash equivalents</b>	(16,913,035)	(11,129,797)	22,041,957	(22,270,061)
<b>Cash and cash equivalents – Beginning of period</b>	49,043,003	31,926,206	10,094,086	43,066,470
<b>Cash and cash equivalents – End of period</b>	32,129,968	20,796,409	32,136,043	20,796,409
<b>Interest paid and received</b>				
Interest paid	-	-	-	-
Interest received	413,236	293,737	1,007,519	941,223

## Notes to the Consolidated Financial Statements

September 30, 2006

### 1 Nature of operations

Caspian Energy Inc. (“Caspian” or the “Company”) is engaged in the exploration for and development and production of oil and gas in the Republic of Kazakhstan. Its primary operating activities are carried out through its wholly-owned subsidiary, Caspian Energy Ltd. (“Caspian Ltd.”).

Caspian’s principal assets are a 50% interest in Aral Petroleum Capital LLP (“Aral”), held by Caspian Ltd. Through its interest in Aral, Caspian has the right to explore and develop certain oil and gas properties in Kazakhstan, known as the North Block, a 3,458 square kilometre area located in the vicinity of the Kazakh pre-Caspian basin. The Company also has minor resource interests in Canada.

Aral’s exploration and development rights to the North Block were granted pursuant to the terms of an exploration contract between the government of Kazakhstan and Aral (the “Exploration Contract”). The initial three-year term of the Exploration Contract has been extended for a two-year period (expiring in December 2007) and is subject to a further extension of two years thereafter, in accordance with the terms of the contract.

Under the terms of the Exploration Contract, Aral was obligated to spend at least US\$20.8 million under a minimum work program in respect of the North Block during the initial three-year term of the contract. The expenditures include processing and reinterpretation of geological and geophysical data of prior years, two dimensional and three dimensional seismic shoots and surveys, drilling exploration wells, well reactivations and well surveys and testing. As of December 31, 2005, Aral’s financial obligation under the minimum work program had been discharged.

Under terms of a shareholders’ agreement dated June 25, 2004, among Caspian Ltd., Azden Management Limited (“Azden”) and Aral, Caspian was committed to fund Aral’s US\$20.8 million obligation under the initial work program. This financial commitment was satisfied, in full, by the Company. In addition, Caspian Ltd. has undertaken, on a best efforts basis, to raise financing of US\$84.0 million to fund Aral’s operations pursuant to the Exploration Contract.

On November 30, 2005, Caspian announced a change in its fiscal year end date from January 31 to December 31 commencing with the year starting February 1, 2005. Accordingly, the comparative figures presented in these financial statements are for the three and nine months ended October 31, 2005.

## **2 Significant accounting policies**

The consolidated financial statements of Caspian are stated in Canadian dollars and have been prepared in accordance with Canadian generally accepted accounting principles.

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

### **Cash and cash equivalents**

Cash and cash equivalents are comprised of cash and short-term investments with an initial maturity date of three months or less.

### **Inventory**

Inventory is recorded at the lower of cost calculated using the weighted average method, and net realizable value. Cost comprises direct materials and where applicable direct labour costs and those overheads which have been incurred in bringing the inventories to their present location and condition. Net realizable value represents the estimated selling price less all estimated costs of completion and costs to be incurred in marketing, selling and distribution.

### **Joint ventures**

The Company's oil and gas exploration and development activities are conducted mainly in Kazakhstan through its 50% interest in Aral and, accordingly, these consolidated financial statements reflect only the Company's proportionate interest in such activities.

### **Property, plant and equipment**

#### **a) Capitalized costs**

The Company follows the full cost method of accounting for oil and natural gas operations, whereby all costs related to the acquisition, exploration and development of petroleum and natural gas reserves are capitalized. Such costs include lease acquisition costs, geological and geophysical costs, carrying charges on non-producing properties, costs of drilling both productive and non-productive wells, the cost of petroleum and natural gas production equipment and overhead charges directly related to exploration and development activities. Proceeds from the sale of oil and gas properties are applied against capital costs, with no gain or loss recognized, unless such a sale would change the rate of depletion and depreciation by 20% or more, in which case, a gain or loss would be recorded.

#### **b) Depletion, depreciation and amortization**

The capitalized costs are depleted and depreciated using the unit-of-production method based on proven petroleum and natural gas reserves, as determined by independent consulting engineers. Oil and natural gas liquids reserves and production are converted into equivalent units of natural

gas based on relative energy content on a ratio of six thousand cubic feet of gas to one barrel of oil. Significant development projects and expenditures on exploration properties are excluded from calculation of depletion prior to assessment of the existence of proved reserves.

Other property, machinery and equipment are recorded at historical cost. Depreciation is calculated on a straight-line basis at the following annual rates:

	Buildings	
8%		
	Machinery and equipment	8%
	Vehicles	
7%		
	Other fixed assets	10%

**c) Ceiling test**

The Company follows the Canadian accounting guideline on full cost accounting. In applying the full cost guideline, Caspian calculates its ceiling test for each cost centre by comparing the carrying value of oil and natural gas properties and production equipment to the sum of undiscounted cash flows expected to result from Caspian's proved reserves. If the carrying value is not fully recoverable, the amount of impairment is measured by comparing the carrying value of oil and gas properties and production and equipment to the estimated net present value of future cash flows from proved plus probable reserves using a risk-free interest rate and expected future prices. Any excess carrying value above the net present value of the future cash flows is recorded as a permanent impairment.

**d) Unproved property**

Costs of acquiring and evaluating unproven properties are initially excluded from costs subject to depletion, until it is determined whether or not proved reserves are attributable to the properties or, in the case of major development projects, commercial production has commenced, or impairment has occurred. Impairment occurs whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. When proven reserves are determined or the property is considered to be impaired, the cost of the property or the amount of the impairment is added to the costs subject to depletion for that country's cost centre.

**e) Asset retirement obligation**

Caspian records the fair value of asset retirement obligations (“ARO”) as a liability in the period in which it incurs a legal obligation to restore an oil and gas property, typically when a well is drilled or other equipment is put in place. The associated asset retirement costs are capitalized as part of the carrying amount of the related asset and depleted using a unit-of-production method over the life of the proved reserves. Subsequent to initial measurement of the obligations, the obligations are adjusted at the end of each reporting period to reflect the passage of time and changes in estimated future cash flows underlying the obligation. Actual costs incurred on settlement of the ARO are charged against the ARO.

**Income taxes**

Income taxes are calculated using the liability method of tax accounting. Temporary differences arising from the difference between the tax basis of an asset or liability and its carrying value amount on the balance sheet are used to calculate future income tax assets and liabilities. Future income tax assets and liabilities are calculated using tax rates anticipated to apply in the periods that the temporary differences are expected to reverse.

**Stock-based compensation**

The Company grants options to purchase common shares to employees and directors under its stock option plan. Under this standard, future awards are accounted for using the fair value of accounting for stock-based compensation. Under the fair value method, an estimate of the value of the option is determined at the time of grant using a Black-Scholes option-pricing model. The fair value of the option is recognized as an expense and contributed surplus over the vesting period of the option. Proceeds received on exercise of stock options, along with amounts previously included in contributed surplus, are credited to share capital.

**Revenue recognition**

Revenue from the sale of oil and natural gas is recognized based on volumes delivered to customers at contractual delivery points and rates. The costs associated with the delivery, including operating and maintenance costs, transportation, and production-based royalty expenses will be recognized in the same period in which the related revenue is earned and recorded.

**Measurement uncertainty**

The amounts recorded for depletion and depreciation of property, plant and equipment, the provision for asset retirement obligations and the amounts used for ceiling test calculations are based on estimates of reserves and future costs. The Company’s reserve estimates are reviewed annually by an independent engineering firm. The amounts disclosed relating to fair values of stock options issued are based on estimates of future volatility of the Company’s share price, expected lives of options, and other relevant assumptions. By their nature, these estimates are subject to measurement uncertainty.

## **Earnings (loss) per share**

Basic per share amounts are calculated using the weighted average number of shares outstanding during the period. Diluted per share amounts are calculated based on the treasury stock method whereby the weighted average number of shares is adjusted for the dilutive effect of options. The Company applies the treasury stock method for the calculation of diluted net income (loss) per share whereby the effect of the “in the money” instruments such as stock options and warrants affect the calculation. The treasury stock method assumes that the proceeds from the exercise are used to repurchase common shares of the Company at the weighted average market price during the year.

## **Financial instruments**

### *Fair values*

The fair values of accounts receivable, accounts payable and accrued liabilities, and loan payable approximate their carrying values due to their short-term maturity.

### *Credit risk*

Substantially all of the Company’s accounts receivable are due from companies in the oil and gas industry and are subject to the normal industry credit risks. The carrying value of accounts receivable reflects management’s assessment of the associated credit risks.

## **Foreign currency**

All operations are considered financially and operationally integrated. Results of operations are translated to Canadian dollars, using average rates for revenues and expenses, except depreciation which is translated at the rate of exchange applicable to the related assets. Monetary items denominated in foreign currency are translated to Canadian dollars at exchange rates in effect at the balance sheet date and non-monetary items are translated at rates of exchange in effect when the assets were acquired or obligations incurred. Foreign exchange gains and losses are recorded in the statement of loss.

## **Restricted cash**

Under the terms of the Exploration Contract, Aral has accrued 1% of the capital costs of exploration (the “Liquidation Fund”) in an amount of US \$241,580 and US \$235,600 as of September 30, 2006 and December 31, 2005, respectively (Caspian – Cdn. \$134,578 and Cdn. \$136,884, respectively) and deposited the cash in a restricted bank account. It is anticipated that the Liquidation Fund will be used to finance the restoration of the License Area upon expiration of the Exploration Contract, unless a production contract is awarded.

### 3 Inventory

	<b>September 30, 2006</b>	<b>December 31, 2005</b>
	\$	\$
Drilling materials	3,200,337	752,163
Oil inventory	69,491	39,651
Fuel	227,624	5,081
Construction materials	4,707	2,126
Spare parts	2,413	1,165
Other materials	260,529	87,431
	<u>3,765,101</u>	<u>887,617</u>

### 4 Property, plant and equipment

	<b>September 30, 2006</b>	<b>December 31, 2005</b>
	\$	\$
Petroleum and natural gas assets	98,894,230	67,414,481
Other assets	2,079,860	1,186,085
	<u>100,974,090</u>	<u>68,600,566</u>
Accumulated depletion and depreciation	(449,010)	(269,345)
	<u>100,525,080</u>	<u>68,331,221</u>

Excluded from the depletable base of oil and gas assets at September 30, 2006 are unproved properties of \$66,058,802 (December 31, 2005 – \$35,869,797).

Aral applied the ceiling test to its capitalized assets at September 30, 2006 and determined that there was no impairment of such carrying costs.

During the nine month period ended September 30, 2006, Aral capitalized \$365,565 (October 31, 2005 – \$381,328) of general and administrative expenses related directly to exploration and development activities.

## 5 Asset retirement obligation

The Company records the fair value of asset retirement obligations as a liability in the period in which it incurs the legal obligation.

The asset retirement obligation results 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 flows required to settle its asset retirement obligations at September 30, 2006 is approximately \$208,647, which will be incurred between 2014 and 2019. A credit-adjusted risk-free rate of 12.2% was used to calculate the fair value of the asset retirement obligations, and an inflation factor of 7.6%.

A reconciliation of the asset retirement obligation is provided below:

	<b>September 30, 2006 \$</b>
Balance – December 31, 2005	88,900
Liabilities incurred	420
Accretion	<u>9,178</u>
Balance – September 30, 2006	<u>98,498</u>

Under the terms of the Exploration Contract (note 1), the Company is required to create a fund to finance actual future restoration costs, equal to 1% of the capital costs of exploration. At September 30, 2006 and December 31, 2005, \$134,578 and \$136,884 respectively have been placed in a restricted bank account related to the funding requirement.

## 6 Convertible debentures

On March 1, 2006, the Company received US \$16 million and issued 10% per annum, convertible debentures in a like amount. The debentures mature on March 2, 2011 and are convertible at any time and from time to time into common shares of the Company at a conversion price of \$2.45 per share. The Company may repay the principal amount of the debentures, in whole or in part, or require conversion into common shares of the Company if the volume-weighted average trading price of the common shares, for 40 consecutive trading days, is at least \$4.08.

	Face amount \$	Discount \$	Interest \$	Carrying value \$
Debentures issued	18,432,479	(1,483,805)	-	16,948,674
Accretion of discount	-	194,634	-	194,634
Translation adjustment	(777,218)	-	(3,209)	(780,427)
Interest accrual	-	-	1,052,147	1,052,147
Balance – September 30, 2006	<u>17,655,261</u>	<u>(1,289,171)</u>	<u>1,048,938</u>	<u>17,415,028</u>

## 7 Share capital

### Authorized

Unlimited number of voting common shares, without stated par value

### Issued

	Number of shares	Amount \$
<b>Common shares</b>		
Issued and outstanding as at December 31, 2005	84,327,163	75,220,762
Exercise of warrants (i)	357,100	888,505
Private placement (ii)	19,609,000	49,056,442
Exercise of options (iii)	50,000	87,500
Share issue costs (iv)	-	(3,782,317)
Issued and outstanding as at September 30, 2006	<u>104,343,263</u>	<u>121,470,892</u>

- i) During the period, 357,100 broker warrants were exercised. The warrants had an exercise price of \$2.00 per common share.
- ii) On April 5, 2006, a private placement of 19,609,000 common shares were issued at \$2.55 per share.
- iii) On April 10, 2006, 50,000 common shares at \$1.75 per were issued pursuant to the Company's stock option plan.
- iv) Share issue costs have not been tax-effected.

## Stock options

The Company has a stock option plan (the “Plan”) under which it may grant options to directors, officers and employees for the purchase of up to 15% of the number of common shares from time to time. Options are granted at the discretion of the board of directors. The exercise price, vesting period and expiration period are also fixed at the time of grant at the discretion of the Board of Directors in accordance with terms of the Plan.

Changes to the Company’s stock options are summarized as follows:

	Number of options	Weighted average option price \$
Balance – December 31, 2005	9,166,499	1.72
Granted	1,043,433	1.25
Exercised	(50,000)	1.75
Expired	-	-
	<hr/>	
Balance – September 30, 2006	10,159,932	1.67
	<hr/>	
Exercisable – September 30, 2006	9,518,265	1.65
	<hr/>	

The following is a summary of stock options outstanding and exercisable as at September 30, 2006:

Range of exercise price	<u>Options outstanding</u>		<u>Options exercisable</u>	
	Options outstanding	Weighted average remaining contractual life in years	Weighted average exercise price	Options exercisable
\$0.75	2,079,090	3.4	\$0.75	2,079,090
\$1.25	1,043,433	5.0	\$1.25	1,043,433
\$1.61	843,271	3.9	\$1.61	843,271
\$1.75	1,100,000	3.9	\$1.75	983,333
\$2.00	1,050,000	3.6	\$2.00	525,000
\$2.15	4,044,138	3.4	\$2.15	4,044,138
	<hr/>		<hr/>	
	10,159,932		\$1.67	9,518,265
	<hr/>		<hr/>	<hr/>

## Per share amounts

The weighted average number of common shares outstanding during the period ended September 30, 2006 of 104,343,263 (October 31, 2005 – 84,327,163 shares) was used to calculate loss per share amounts.

In computing diluted loss per share, no shares were added to the weighted average number of common shares outstanding during the period ended September 30, 2006 (October 31, 2005 – nil) as they are anti-dilutive. The fully-diluted number as at September 30, 2006 was 127,585,828 shares (October 31, 2005 – 95,066,662).

## Warrants

588,270 broker warrants are outstanding at September 30, 2006 and all have vested. These warrants entitle the holder to purchase one common share at a price of \$2.77 until April 5, 2008. 357,100 broker warrants were exercised during the period. 1,599,170 broker warrants entitling the holder to purchase one common share at the price of \$2.00 expired, unexercised during the period. The fair value of the outstanding warrants using the Black-Scholes method was \$1,439,941.

## 8 Stock-based compensation

Options granted to both employees and non-employees are accounted for using the fair value method. The fair value of common share options amortized in the period ended September 30, 2006 was estimated to be \$1,794,250 (period ended October 31, 2005 – \$3,589,794) as at the grant date using a Black-Scholes option-pricing model and the following assumptions:

Risk free interest rate	3%
Expected life	5 year average
Expected volatility	83%
Expected dividend yield	0%

The estimated fair value of the options is amortized to expense and credited to contributed surplus over the option vesting period on a straight-line basis.

## 9 Contributed surplus

	September 30, 2006 \$	December 31, 2005 \$
Balance – Beginning of period	7,668,133	3,629,436
Stock options issued to employees, officers and directors	1,794,250	4,038,697
Fair value of debentures conversion option	1,483,805	-
	<hr/>	<hr/>
Balance – End of period	10,946,188	7,668,133

The term and vesting conditions of each option may be fixed by the board when the option is granted, but the term cannot exceed 5 years from the date upon which the option is granted.

The options granted to directors, officers and employees may be exercised over five years from the date of granting and expire from time to time to September 2011.

The debentures are convertible into common shares of the Company at a price of \$2.45 per share and mature on March 31, 2011.

## **10 Loan payable**

Aral was indebted to Azden, which holds the other 50% interest in Aral, in the amount of \$6,636,582 (December 31, 2005 – \$6,872,279). The amount was unsecured and was non-interest bearing and was to be repaid prior to January 1, 2006. Caspian is obligated to fund Aral's operations. During November 2005, Aral agreed to defer the repayment obligation of this loan to third quarter 2006. This liability was discharged during July 2006.

## **11 Commitments**

In accordance with the shareholders' agreement in respect of Aral, Caspian was obligated to fund the initial work program of Aral pursuant to the Exploration Contract. The minimum work program was US \$20.8 million and matured at the end of calendar 2005. As at December 31, 2005, this obligation was fully discharged. The work program extension to December 2007 includes drilling three wells to a combined total of 8,500 metres with a monetary obligation of US \$20.6 million. No additional seismic is required. The Company's calendar 2006 minimum work program with the Republic of Kazakhstan has been approved for US \$12.2 million and was discharged during this fiscal period. US \$8.4 million is the minimum commitment for calendar 2007.

## **12 Financial instruments**

Caspian's financial instruments included in the consolidated balance sheet are comprised of cash and cash equivalents, accounts receivable, other deposits, accounts payable and loan payable. The fair values of these financial instruments approximate their carrying amounts due to the short-term nature of the instruments. A substantial portion of Caspian's accounts receivable are with customers in the oil and gas industry and are subject to normal industry credit risks.

## **13 Foreign exchange risk**

A substantial portion of Caspian's activities are settled in foreign currencies and consequently, the Company is subject to fluctuations in currency translation rates.

## 14 Segmented information

The Company's activities are conducted in two geographic segments: Canada and Kazakhstan. All activities relate to exploration for and development of petroleum and natural gas.

	Canada \$	Kazakhstan \$	Total \$
Revenue	1,041,953	3,502,868	4,544,821
Expenses	6,797,654	(275,175)	6,522,479
Net income (loss)	(5,759,660)	2,873,995	(2,885,665)
Capital expenditures	-	32,366,571	32,366,571
Depletion, depreciation and accretion	3,750	148,610	152,360
Interest and other revenue	1,007,519	5,460	1,012,979
Current assets	31,183,760	7,512,849	38,696,609
Restricted cash	-	134,578	134,578
Property, plant and equipment, net	102,091	100,422,989	100,526,080
Total assets	31,285,851	108,070,416	139,356,267
Current liabilities	520,550	2,839,715	3,360,265
Total liabilities	17,415,028	4,379,272	21,794,300

## 15 Subsequent event

On November 1, 2006, the Company executed a Letter of Intent to dispose of its interest in a mining property located in Noyon Township, Quebec for consideration of \$150,000. This property was not consistent with the Company's business objective.

## 16 Reconciliation of International Financial Reporting Standards

Accounting practices under Canadian GAAP and International Financial Reporting Standards ("IFRS") are, as they affect these financial statements, substantially the same except for the following:

### Property and equipment

Under Canadian GAAP, an impairment loss should be recognized when the carrying amount of a cost centre is not recoverable and exceeds its fair value. The carrying amount is not recoverable if the carrying amount exceeds the sum of the undiscounted cash flows expected to result from its use and eventual disposition. Unproved properties and major development projects are included in this recoverability test. A cost centre impairment loss should be measured as the amount by which the carrying amount of assets capitalized in a cost centre exceeds the sum of:

- the fair value of proved and probable reserves; and
- the costs (less any impairment) of unproved properties that have been subject to a separate test for impairment and contain no probable reserves

IFRS requires (i) an impairment to be recognized when the recoverable amount of an asset (cash generating unit) is less than the carrying amount, rather than when there is a significant or prolonged

decline in value below the carrying amount; (ii) the impairment loss to be determined as the excess of the carrying amount above the recoverable amount (the higher of fair value less costs to sell and value in use, calculated as the present value of future cash flows from the asset), rather than the excess of the carrying amount above the undiscounted future cash flows of the asset; and (iii) the reversal of an impairment loss when the recoverable amount changes. IFRS 6, which has been adopted effective January 1, 2005, provides limited guidance on the financial reporting for exploration for, and evaluation of, mining resources. Upon adoption of IFRS 6, continued application of an entity's existing policy is permitted with modified procedures on impairment tests.

In the absence of specific guidance on the applicability of full cost accounting under IFRS, the Company continues to apply the full cost method for IFRS purposes. A ceiling test based on cash generating units did not reveal the need for an impairment charge.

This difference in accounting policy had no impact on these financial statements.

### **Impairment of long-lived assets**

Under Canadian GAAP, a long-lived asset should be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. An impairment loss should be recognized when the carrying amount of a long-lived asset is not recoverable and exceeds its fair value. Under IFRS, the carrying amounts of the Company's assets, other than oil and gas properties, inventories and deferred tax assets, are reviewed at each balance sheet date to determine whether there is any indication of impairment. If any such indication exists, the assets' recoverable amounts are estimated. An impairment loss is recognized when the carrying amount of an asset exceeds its recoverable amount. Impairment losses, if any, are recognized in the income statement. This difference in accounting policy has no impact on these financial statements.

Under Canadian GAAP, the carrying amount of a long-lived asset is not recoverable if the carrying amount exceeds the sum of the undiscounted cash flows expected to result from its use and eventual disposition. This assessment is based on the carrying amount of the asset at the date it is tested for recoverability, whether it is in use or under development. Under IFRS, the recoverable amount of the Company's assets other than oil and gas properties is the greater of their net selling price and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflect current market assessments of the time value of money and the risks specific to the asset. For an asset that does not generate cash inflows largely independent of those from other assets, the recoverable amount is determined for the cash-generating unit to which the asset belongs. This difference in accounting policy has no impact on these financial statements.

In respect of impairment of assets other than oil and gas properties, under Canadian GAAP, an impairment loss is not reversed if the fair value subsequently increases. For IFRS, an impairment loss may be reversed if there has been a change in the estimates used to determine the recoverable value.

An impairment loss, on assets other than oil and gas properties, is only reversed to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortization, if no impairment loss had been recognized. This difference in accounting policy has no impact on these financial statements.

### **Asset retirement obligation**

In re-measuring an asset retirement obligation for the passage of time, Canadian GAAP requires re-measurement based on the risk-free rate that existed when the liability was initially measured. IFRS requires the use of current market assessed interest rates in each estimate. This difference did not result in a material reconciling item.

### **Inventory**

Under Canadian GAAP, the Company measures its supplies inventory at the lower of historical cost or net replacement cost. Under IFRS, the lower of cost or net realizable value principle would apply. This difference did not result in a material reconciling item.