CASPIAN ENERGY Inc.

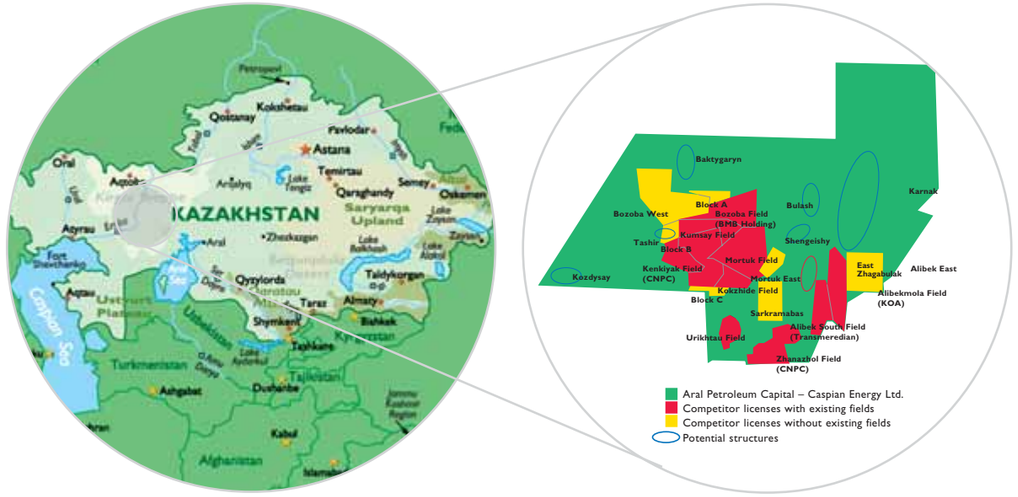
Annual Report and Accounts 2005

Caspian Energy Inc. is an oil and gas exploration company operating in Kazakhstan where it has a number of targets in the highly prospective Aktobe Oblast of Western Kazakhstan. It holds an exclusive license which entitles it to explore and develop certain oil and gas properties known as the "North Block", an area of 3,458km^2. The Company's license area lies immediately adjacent to various producing fields, including the Alibekmola, Zhanazhol and Kenkiyak fields.

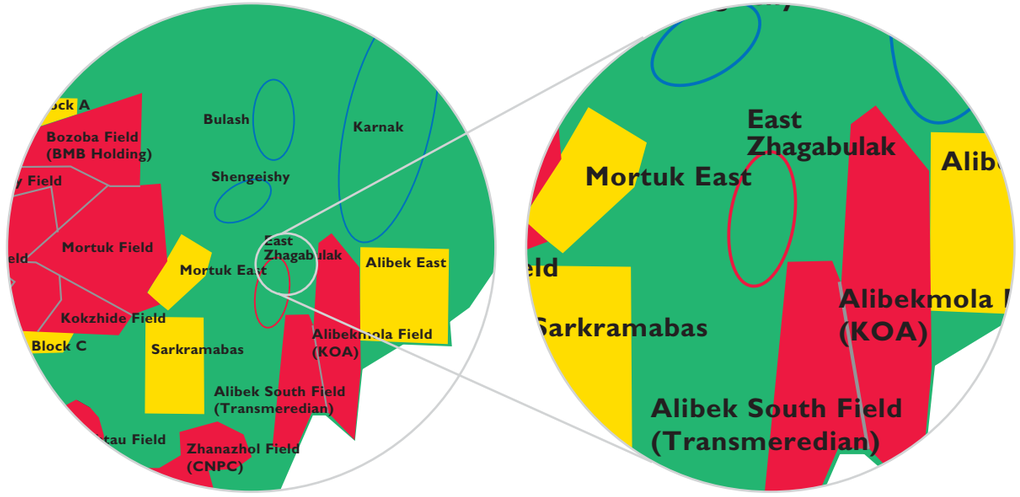
Caspian Energy Inc. (formerly known as Northway Explorations Limited: a Canadian junior natural resource exploration company) completed a merger in September 2004 with Caspian Energy Ltd, a private Ontario company. Following the merger, Caspian Energy Inc. raised £22m on admission to AIM, the London Stock Exchange's specialist market for growth companies. Caspian's shares are also listed on the Toronto Stock Exchange.

Strategy

Caspian will utilize its resources in focusing on the exploration and development of the North Block using the latest western technologies to prove up the maximum amount of reserves from the minimum number of wells. The Company will build shareholder value either through selected developments or through a targeted programme of disposals, at the appropriate stage of development of its assets in the North Block.



East Zhagabulak – the North Block



Republic of Kazakhstan
Location: Central Asia, south of Russia and west of China
Area: 2,717,300km²
Population: 16,763,795
GDP growth rate: 9.2%

North Block overview
The North Block is located on the eastern margin of the Pre-Caspian Basin. The northern boundary of the block is located approximately 270km south of the city of Aktobe in the Aktyubinsk Oblast.

Overview of major oilfields within the North Block
There are nine existing fields in the North Block area: Zhanazhol, Alibekmola, Kenkiyak, Urikhtau, Kokzhide, Kumsay, South Alibek, East Zhagabulak and Bozoba.

The East Zhagabulak field is located within the North Block approximately 270km south of the city of Aktobe in the Aktyubinsk Oblast. Last year, we re-entered one of the older exploration wells in the East Zhagabulak field, EZ-213, and re-perforated and tested the well.

The well was put on production in early February 2004 and started producing at a stable rate of approximately 500 barrels of light crude oil per day in early May 2004.

There are two Carboniferous age oil bearing zones in the field known as the KT-2-1 and the KT-2-2. These zones range in depth from 4,084m to 4,663m.

The KT-2-1 zone consists of a clean limestone with minor dolomite and shale layers and the reservoir rocks consist of algal, foraminiferal and biomorphous limestone with primary and secondary porosity.

The KT-2-2 formation consists of algal, foraminiferal and biomorphous limestone deposited as a massive carbonate bank in a shallow marine or restricted lagoon development.

2005 Highlights

- June 2004, Caspian Energy Ltd. acquired 50% ownership of Aral Petroleum Capital.
- August 2004, Aral Petroleum Capital started a 400km^2 3-D seismic program in the East Zhagabulak area.
- September 2004, Northway Exploration merger with Caspian Energy Ltd. completed to form Caspian Energy Inc.
- September 2004, Caspian Energy Inc. raised £22m on admission to AIM.
- December 2004, Brian Korney appointed as Chief Financial Officer and Secretary.
- December 2004, Aral Petroleum Capital ordered tangible drilling equipment for two 5,000m exploration wells.
- January 2005, production from well 213 was diverted from temporary facilities to the newly constructed 8,000 bopd oil production facility in East Zhagabulak.
- Oil revenues for the period ending January 31, 2005 were CAD$1,618,511.
- Operating expense averaged CAD$5.07/barrel.

President and Chief Executive Officer's Statement

"Our 3-D seismic has confirmed the existence of a significant structure. Over the next nine months we intend to have drilled two wells on this structure in the Zhagabulak area."

This is my first statement to shareholders as President and Chief Executive Officer of your Company and I am pleased to report that we have made significant progress in the year ended January, 31 2005. At the time of its merger in September 2004, Caspian set itself some ambitious targets and I am pleased to report continued progress against each and every one of them.

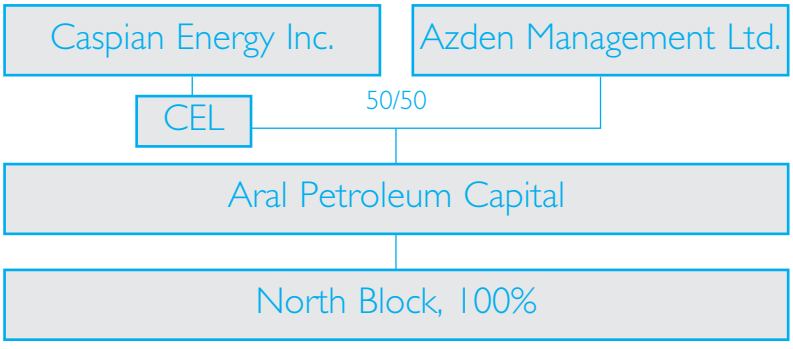
BUSINESS PROGRESS Caspian's vision is to prove up the significant reserves of oil contained within the "North Block". According to the Kazakhstan Government's Reserves Estimate, the aggregate oil-in-place is 2.4 billion barrels; ascribed recoverable reserves are deemed to be 726 million barrels. With seven distinct prospects having been identified within the "North Block", your Board decided to prioritize the "Zhagabulak" prospect.

Whilst the sub-soil rights to the "North Block" are held exclusively by Aral Petroleum Capital (a local limited liability parternship), Caspian owns 50% of Aral and, having signed the Letter of Intent, on April 19, 2004, Caspian assumed responsibility for the "North Block". From that point onwards, Caspian's operational activities have been in accordance with a work program, as agreed with the Ministry of Energy and Mineral Resources.

At the time of completion of the merger and admission of Caspian's shares to trading on AIM in September 2004, and the attendant financing (in which CAD$51.98 million was raised), we stated that we would conduct a 400km^2 3-D seismic shoot over Zhagabulak. Following the interpretation of this data set, we are now in a position to commence drilling our first well. We expect to begin drilling in the second quarter of this calendar year, and we are progressing according to our declared timetable.

I would particularly like to welcome all new shareholders. Following the admission of Caspian's shares to AIM, the Company can benefit from its broad geographical spread of investors, which now extends over Continental Europe, the UK and Canada.

CORPORATE ACTIVITY On March 7, 2005 we announced that Aral Petroleum Capital had completed negotiations with the Government of Kazakhstan and was awarded 1,110km^2 of adjacent territory to the north and west of the North Block. The North Block lies immediately adjacent to the various producing fields, including Alibekmola, South Alibek, Zhanazhol, and Kenkiyak fields. With this acquisition, the size of the North Block over which we have exploration rights has been expanded by 47%, to a combined



territory of 3,458km². We also announced that Aral has received approval from the Government of Kazakhstan to extend its exploration contract for a further two years, throughout calendar 2006 and 2007.

PEOPLE We have been most fortunate in the quality and the experience of our local professionals within Aral Petroleum. A small group of expatriates have been recruited over time, and the successful blending of experienced expatriates and local management is more than evidenced by the timely implementation of the work program and the procurement of materials. In particular, the depth of management's drilling experience, both within Kazakhstan and elsewhere, will stand Caspian in good stead.

MANAGEMENT CHANGES On December 16, 2004 we announced that Brian Korney joined the Company as the Chief Financial Officer. Brian has a wealth of experience within the energy sector and we are delighted that he has joined our team. Overall, I am very pleased to have such a wealth of senior management experience and with the appointment of Brian our team is complete and ready to take the Company forward.

OUTLOOK The "North Block" is a highly prospective area for hydrocarbons, and Zhagabulak is flanked by several sizeable oil producing fields. However, as an oil exploration company our future will critically depend on the success of our drilling campaign. Our 3-D seismic has confirmed the existence of significant structures, with our one "producing" well being situated on the north-eastern margin of this structure. Over the next nine months we expect to have drilled two wells on this structure in the Zhagabulak area.

WILLIAM RAMSAY
President and Chief Executive Officer
May 3, 2005

Review of Operations

> The Company considers the East Zhagabulak area its first target due to the coverage density of the Soviet age 2-D seismic survey, the existence of significant neighbouring oil producing fields, as well as the presence of the Company owned producing well EZ-213 in the northern part of the East Zhagabulak field.

OPERATIONS SUMMARY Current and near future operations in the Company's North Block territory are focusing on the East Zhagabulak field area located in the south-eastern corner of the concession. The Company considers the East Zhagabulak area its first target due to the coverage density of the Soviet age 2-D seismic survey, the existence of significant neighbouring oil producing fields, as well as the presence of the Company owned producing well EZ-213 in the northern part of the East Zhagabulak field.

Beginning in August 2004 the Company undertook its plans to acquire a 400km^2 3-D seismic survey in the East Zhagabulak area for the purpose of defining new drilling targets and planning of future drilling operations. Preliminary interpreted 3-D seismic data from the 400km^2 area has been received and to date 140km^2 of the data has been processed and interpreted, indicating the presence of significant structures and several potential drilling locations. Digitisation and calibration of the existing Soviet age well log data and inclusion of this well data into the 3-D seismic data set has further aided in the understanding of the subsurface targets. The processing and interpretation of the remaining 260km portion of the 3-D seismic survey is expected to be completed in early summer leading to additional potential drilling locations.

The Company has signed a contract with Nabors Drilling International Inc. for the drilling of two exploration wells in the Zhagabulak area. Subject to dry weather conditions, it is anticipated that drilling of the first well will commence at the end of the second quarter, 2005. Agreements with all drilling service companies have been reached and materials required to carry out the drilling operations have been acquired and are being delivered. The new exploration well has been staked and we have started building the site for the drilling rig.

In addition to operations supporting the upcoming two well drilling program, the Company is undertaking to reprocess and interpret approximately 3,000km of Soviet age 2-D seismic data in other areas of the concession.

The results of this effort will identify new areas to shoot 3-D seismic. This second seismic programme will start in late summer 2005.

A small production plant (8,000 bopd) has been constructed at East Zhagabulak. It was commissioned on February 5, 2005. Currently it is processing the oil from well 213. Well 213, drilled during the Soviet Period, continues to produce at about 400 bodp.

CHARLES SUMMERS
Chief Operating Officer
May 3, 2005

Directors and Advisors

WILLIAM A.G. RAMSAY

PRESIDENT, CHIEF EXECUTIVE OFFICER AND DIRECTOR

President and Chief Executive Officer of the Company from September 2004 to present. President and Chief Executive Officer of Caspian Energy Ltd. from April 2004 to present. Prior to thereto and since 1997, engaged in private equity investments primarily in Kazakhstan.

CHARLES J. SUMMERS

CHIEF OPERATING OFFICER AND DIRECTOR

Chief Operating Officer of the Company from September 2004 to present and Chief Operating Officer of Caspian Energy Ltd. from June 2004 to present. Prior thereto, general manager for Kerr-McGee Oil & Gas Corporation (an oil and gas exploration and production company) for eight years in Kazakhstan.

BRIAN D. KORNEY

VICE-PRESIDENT, FINANCE, CHIEF FINANCIAL OFFICER AND SECRETARY

Vice-President, Finance, Chief Financial Officer and Secretary of the Company from December 2004 to present. Prior thereto, Vice-President, Finance, and Chief Financial Officer of Innova Exploration Corporation for four years.

ROBERT S. POLLOCK

NON-EXECUTIVE DIRECTOR

Senior Vice-President of Quest Capital Corporation (a merchant banking organization) from September 2003 to present. Prior thereto, Vice-President of Investment Banking for Dundee Securities Corporation (an investment dealer).

ROBERT D. CUDNEY

NON-EXECUTIVE DIRECTOR

President and Chief Executive Officer of Northfield Capital Corporation (an investment company).

STANWILL G.P. GRAD
NON-EXECUTIVE DIRECTOR

Self-employed as a rancher.

GORDON D. HARRIS
NON-EXECUTIVE DIRECTOR

President and Chief Executive Officer of Choice Resources Corp. (an oil and gas company) from February 2004 to date. From 1999 to 2003, President of Roseland Resources Ltd. (an oil and gas company).

SECRETARY
BRIAN KORNEY

REGISTERED OFFICE
200 KING STREET WEST, SUITE 2300, TORONTO, ONTARIO M5H 3W5

NOMINATED ADVISOR AND BROKER
CANACCORD CAPITAL (EUROPE) LIMITED

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AS TO ENGLISH LAW: DENTON WILDE SAPTE
AS TO CANADIAN LAW: GOODMAN AND CARR LLP
AS TO KAZAKH LAW: DENTON WILDE SAPTE

REPORTING ACCOUNTANTS
DELOITTE & TOUCHE LLP

AUDITORS TO THE COMPANY AND CEL
DELOITTE & TOUCHE LLP

Forward-Looking Statements

Certain statements contained in this Annual Report, including statements made in management's discussion and analysis of the Company's financial results, constitute forward-looking statements. These statements relate to future events or the Company's future performance. All statements other than statements of historical fact may be forward-looking statements. Forward-looking statements are often, but not always, identified by the use of words such as "seek", "anticipate", "budget", "plan", "continue", "estimate", "expect", "forecast", "may", "will", "project", "predict", "potential", "targeting", "intend", "could", "might", "should", "believe" and similar words suggesting future outcomes or statements regarding an outlook. Forward-looking statements in this Annual Report include, but are not limited to, statements with respect to: the performance characteristics of the Company's oil and natural gas properties; drilling plans and the timing and location thereof; plans for the exploration and development of the North Block; plans for seismic acquisition and surveys; production capacity and levels, and the timing of achieving such capacity and levels; the level of expenditures for compliance with environmental regulations; the size of oil and natural gas reserves; projections of market prices and costs; supply and demand for oil and natural gas; expectations regarding the ability to raise capital and to continually add to reserves through acquisitions and development; and capital expenditure programs.

Forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause actual results or events to differ materially from those anticipated in such forward-looking statements. The Company believes the expectations reflected in those forward-looking statements are reasonable but no assurance can be given that these expectations will prove to be correct and readers are cautioned not to place undue reliance on forward-looking statements contained in this Annual Report . Some of the risks and other factors which could cause results to differ materially from those expressed in the forward-looking statements contained in this Annual Report include, but are not limited to: volatility of oil and natural gas prices; liabilities inherent in oil and natural gas operations; uncertainties associated with estimating oil and natural gas reserves; competition for, among other things, capital, acquisitions of reserves, undeveloped lands and skilled personnel; geological, technical, drilling and processing problems; fluctuations in currency and interest rates; product supply and demand; risks inherent in the Company's foreign operations; changes in environmental and other regulations or the interpretation of such regulations; political and economic conditions in the Republic of Kazakhstan; and the other factors discussed in this Annual Report.

Statements relating to "reserves" are deemed to be forward-looking statements, as they involve the implied assessment, based on certain estimates and assumptions, that the reserves described can be profitably produced in the future. Readers are cautioned that the foregoing lists of factors are not exhaustive. The forward-looking statements contained in this Annual Report are made as of the date hereof and the Company undertakes no obligation to update publicly or revise any forward-looking statements, whether as a result of new information, future events or otherwise. The forward-looking statements contained in this Annual Report are expressly qualified by this cautionary statement.

OIL AND GAS INFORMATION

The oil and gas industry commonly expresses production volumes and reserves on a "barrel of oil equivalent" basis ("BOE") whereby natural gas volumes are converted at the ratio of six thousand cubic feet to one barrel of oil. The intention is to sum oil and natural gas measurement units into one basis for improved analysis of results and comparisons with other industry participants. In this Annual Report, the Company has used the 6:1 BOE measure which is the approximate energy equivalency of the two commodities at the burner tip. BOE does not represent a value equivalency at the plant gate, which is where Caspian sells its production volumes, and therefore may be a misleading measure if used in isolation.

CURRENCY AND NON-GAAP MEASURES

Currency

All information included in this Annual Report is presented in Canadian dollars, unless otherwise indicated.

Non-GAAP measures

Cash Flow from Operations (cash flow) is a measure which is considered critical within the oil and gas industry, both in terms of measuring success in our historical operations and being an indicator of funding sources for on-going efforts to replace production volumes and increase reserve volumes. Canadian generally accepted accounting principles ("GAAP") require that "cash flow from operating activities" be the measurement focus. This latter term is derived from "cash flow" as defined by the Company adjusted for the change in non-cash working capital. The Company believes "cash flow" and "cash flow per share" to be more meaningful measures of our performance and therefore have used these terms throughout this Annual Report. Accordingly, we are required to advise the reader that: (a) these are non-GAAP measures for purposes of Canadian accounting standards and (b) our determinations may not be comparable to those reported by other companies.

May 3, 2005 – The following Management's Discussion and Analysis ("MD&A") of financial results as provided by the management of Caspian Energy Inc. ("Caspian" or the "Company") should be read in conjunction with the audited consolidated financial statements and notes for the period from incorporation on April 13, 2004 to January 31, 2005 and the audited financial statements and MD&A of Northway Explorations Limited ("Northway") for the year-ended January 31, 2004. This commentary is based upon information available to May 3, 2005.

The intention of this MD&A is for Caspian to explain to its shareholders and the investment community three analyses from management's perspective:

1. Caspian's performance in fiscal 2005
2. Caspian's current financial condition, and
3. Caspian's future prospects

This MD&A complements and supplements the disclosures in our audited financial statements which have been prepared according to Canadian generally accepted accounting principles ("GAAP").

References to "we", "us" and "our" in this MD&A are to the Company and all references to dollars are in Canadian dollars, unless otherwise indicated. Additional information relating to the Company, including its annual information form, is available on SEDAR at www.sedar.com.

BUSINESS COMBINATION

On September 21, 2004, the Company (formerly known as "Northway Explorations Limited") announced that it had completed a merger with Caspian Energy Ltd. ("CEL") that combined its own operations with the operations of CEL, which included a 50% indirect interest in Aral Petroleum Capital LLP ("Aral"), through which CEL has the right to explore and develop certain oil and gas properties known as the North Block, a 2,348km^2 area, located in the vicinity of the Kazakh pre-Caspian basin.

Upon completion of the merger, CEL became a wholly-owned subsidiary of the Company. However, CEL is deemed to be the acquirer for accounting purposes and the Company is deemed to be a continuation of CEL, such that the financial statements of the Company are those of CEL. Accordingly, the results of operations of the Company and Aral have been included with the results of operations of CEL from September 21, 2004 and June 25, 2004, respectively to the end of this fiscal period and reported as the consolidated results of operations of the Company.

INFORMATION RELATING TO NORTHWAY

During the year-ended January 31, 2004, Northway wrote-down (by $1,421,475) its mining properties to $66,670. This reduction was precipitated by the arm's-length purchase of an additional 7.5% in the same property at pro rata value from third parties. The Company now holds a 25% interest in this property. This independent assessment of value caused the Company to believe that value in the property had been seriously impaired and account for such reduction appropriately.

Further, Northway, in its July 31, 2004 interim financial statements recognized a gain on the sale of marketable securities equal to $882,330, justifying its historical carrying cost and reducing the balance in that account to $80,131. During this fiscal period, the balance was reduced to $11,731, a carrying cost less than market value of the underlying securities. A gain of approximately $32,000 was recognized on the disposition and is included in "Other income". The Company does not currently pursue investments in marketable securities.

BUSINESS OF THE COMPANY

On April 27, 2004, CEL raised US$9,750,000 through the issue and sale of 23,045,454 common shares by way of a private placement. Effective June 25, 2004, CEL acquired a 50% interest in Aral and a temporary 100% beneficial interest in the currently producing well of Aral from Azden Management Limited ("Azden"), in exchange for 16,545,454 common shares of CEL valued at $9,430,909 and payment of US$9.0 million in cash.

On September 20, 2004, prior to completion of the merger, CEL completed a private placement of 7,142,000 common shares at a price of $1.90 per share. On September 21, 2004, concurrently with the closing of the merger, the common shares of the Company were admitted to trading on the Alterative Investment Market (AIM) of the London Stock Exchange (and continue to be listed on the Toronto Stock Exchange) and the Company completed a private placement of 20,218,000 common shares at a price of 0.82 Pounds Sterling per share.

Collectively, the net proceeds raised by the Company and CEL in September of 2004 permit CEL to fund the obligations of Aral relating to a minimum work program pursuant to an exploration contract dated December 29, 2002 that Aral entered into with the Ministry of Energy and Mineral Resources (Republic of Kazakhstan – "ROK"). Under the terms of the work program, Aral has agreed to spend a minimum of US$20.8 million during the initial three year term of the exploration contract, of which US$5,159,200 remains to be expended in the calendar year 2005. The expenditures include such things as 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.

BUSINESS OF THE COMPANY (CONTINUED)

Under the terms of a shareholders' agreement dated June 25, 2004, as amended, between CEL, Azden and Aral, CEL is obligated to fund this initial work program. Further, under the terms of this same agreement, CEL has committed to use all reasonable commercial efforts to raise financing of US$84.0 million to fund the operations of Aral under the exploration contract. Funds are transferred to Aral via monthly instalments. The Company's strategy is to focus on the operations of Aral and the significant opportunity it presents in the North Block.

On February 18, 2005, the first extension of the "2 + 2 years" option pursuant to the exploration contract was approved by the ROK covering the 2006 and 2007 calendar years. During March 2005, Aral was awarded the exploration rights over an additional 1,110km^2 area adjacent to the north and west portions of the North Block.

Terms of Aral's exploration contract include a 3% royalty during the pilot phase, a 10% fee, based upon sales, after VAT (value-added tax), a 30% corporate income tax and the liability for an excess profits tax based upon a sliding scale (0% – 30%) internal rate of return.

Caspian accesses western capital markets and utilizes western technology to explore and exploit Kazakh assets. The proceeds of the capital issues during the period are being used to fund the exploration program and support pilot production. The operational strategy of the Company is as follows:

- To prove-up the maximum amount of reserves with the minimum number of wells
- To utilize 3-D seismic and international standards and evaluation technology
- To focus initially on the Zhagabulak area in the North Block, where the pilot production exists, and then move to other areas within the North Block
- To position the Company to maximize value to the investor through sales of discovered fields, selected developments, or sale of the North Block

To date, the initial 3-D seismic program covering 400km^2 is complete and, as at March 12, 2005, 140km^2 has been processed and interpreted with encouraging results. Two 5,000m exploration wells are planned for Zhagabulak. The first well is expected to spud during July 2005 and the second prior to year-end. The wells are expected to cost in the range of US$6.8 million to US$9.2 million depending upon the outcome.

ANNUAL ANALYSIS

	Period from incorporation (April 13, 2004) to January 31, 2005
Production volumes	
Oil (bbls/day)	400
Average selling price	
Oil – US$/bbl	15.45
Revenues ($000s)	1,903
Cash flow ($000s)	(825)
Per share – basic	(0.01)
Per share – diluted	(0.01)
Net income ($000s)	(5,001)
Per share – basic & diluted	(0.10)
Capital expenditures ($000s)	17,315
Total assets ($000s)	84,090
Total indebtedness ($000s)	—

SUMMARIZED INCOME STATEMENT $

Period	To April 30	Second quarter	Third quarter	Fourth quarter
Oil and gas revenues	—	250,740	640,781	726,990
Operating expenses	—	72,667	185,706	355,327
Operating income	—	178,073	455,075	371,663
Interest and other income	—	1,120	42,782	240,247
General & administrative	—	836,240	705,818	571,403
Cash flow	—	(657,047)	(207,961)	40,507
Depletion, depreciation & accretion	—	8,626	22,046	52,934
Stock-based compensation	—	—	3,157,292	472,144
Unrealized foreign exchange	—	—	1,185,222	(1,127,580)
Future income taxes	—	—	—	406,270
Net income	—	(665,673)	(4,572,521)	236,739
Net income per share basic and diluted	—	(0.01)	(0.08)	0.00

CONTRACTUAL OBLIGATIONS

Caspian is obligated to fund the initial work program of Aral pursuant to the exploration contract entered into with the ROK. The minimum work program aggregates US$20,800,000 and matures at the end of calendar 2005. To January 31, 2005, US$15,640,800 had been expended. Caspian has also undertaken to use all reasonable commercial efforts to raise US$84,000,000 to be loaned to Aral to fund the "first stage" of its exploration program, which is to succeed the initial work program.

(US $000s)	2005 (calendar)
Initial work program	5,159,200
Total contractual obligations	5,159,200

CASH USED IN OPERATIONS AND LOSS FOR THE PERIOD

Cash used in operations

Caspian's operations used $824,501 (calculated as $(1,504,611) + changes in non-cash working capital of $680,110) of cash for the period from incorporation on April 13, 2004 to January 31, 2005.

	Period from incorporation (April 13, 2004) to January 31, 2005
Cash used in operations:	$824,501
Basic	$0.01
Diluted	$0.01

Net loss

For the period from incorporation on April 13, 2004 to January 31, 2005, net loss was $5,001,455. Stock-based compensation charges, a non-cash item equal to $3,629,436, and non-cash deferred income taxes of $406,270 are major components of this figure – the remaining components being primarily the operating costs and general and administrative expenses (as described below):

	Period from incorporation (April 13, 2004) to January 31, 2005
Net loss:	$5,001,455
Basic	$0.10
Diluted	$0.10

CASH USED IN OPERATIONS AND LOSS FOR THE PERIOD (CONTINUED)

Sales volumes

Crude oil production is currently purchased at the wellhead by two different buyers and sold to domestic markets. The contract crude oil was recently renegotiated to a price of US$15.45 per barrel at the wellhead. Under terms of the exploration contract, Aral is obligated to send 100% of the hydrocarbons it produces to Kazakhstan refineries.

Under the exploration contract, Aral pays royalties at a rate of 3% of the volume of hydrocarbons produced and sold based upon the average selling price (less transportation expenses) of the production. Sales are also reduced by a 10% government take. Aral is obligated to allocate 10% of produced hydrocarbons to the Republic of Kazakhstan. The government is paid in cash (rather than in kind) after the production has been sold.

Current production levels are approximately 400 barrels of oil per day.

Revenues

For the period from incorporation on April 13, 2004 to January 31, 2005, revenues before transportation costs were $1,618,511.

Interest of $238,385 was earned during the period on short-term investment of the Company's cash reserves.

Operating expenses

For the period from incorporation on April 13, 2004 to January 31, 2005, operating costs were $545,099 and transportation costs were 68,601.

Operating netbacks

Operating netback for the period from incorporation on April 13, 2004 to January 31, 2005 was $1,004,811.

General and administrative expenses

	Period from incorporation (April 13, 2004) to January 31, 2005
Office expenses	$71,909
Travel and entertainment	187,765
Salaries/benefits	584,657
Professional fees	901,548
Website	19,862
Public relations	57,298
Aral	290,422
Total expense	2,113,461

Salaries and benefits relate primarily to the remuneration packages of the Chief Executive Officer (150,000 Pounds Sterling per annum) and the Chief Operating Officer (200,000 Pounds Sterling per annum), while professional fees for the period from incorporation on April 13, 2004 to January 31, 2005 are comprised of legal fees of $593,155 and reservoir engineering fees of $168,418, both pertinent to the Aral joint venture, administrative fees of $27,000 and audit, tax and accounting fees of $112,975. Administrative expenses of $290,422 for the period from incorporation on April 13, 2004 to January 31, 2005 relating to Aral operations have been included upon consolidation.

CAPITAL EXPENDITURES

Capital expenditures of $17,314,947 for the period from incorporation on April 13, 2004 to January 31, 2005 were incurred. Capital expenditures are composed of advances to Aral and the expenditure of funds by Aral.

DEPLETION, DEPRECIATION AND ACCRETION

Depletion, depreciation and accretion expense was $83,606 in the period from incorporation on April 13, 2004 to January 31, 2005.

LIQUIDITY AND CAPITAL RESOURCES

Our industry operates within several parameters affecting its liquidity and capital resources:

- It is capital intensive requiring cash infusions on a regular basis as it seeks to grow its business.
- Its inventory of product for sale – its reserves – needs to be constantly replenished and augmented.
- It is a price taker when selling its inventory of oil and natural gas reserves.

LIQUIDITY AND CAPITAL RESOURCES (CONTINUED)

Given these constraints Caspian finances its operations through equity sources and cash flows.

Caspian's working capital at January 31, 2005 was $35.0 million. Since January 31, 2005, approximately US$4.7 million has been transferred to Aral to fund the preliminary expenditures pertinent to the first exploration well to be drilled.

On September 21, 2004, the merger with CEL and admission to AIM was completed. Caspian began operations with approximately 450 bopd of production and working capital in excess of US$40 million. Dramatic growth, enhanced by the acquisition of 50% of the shares of Aral is projected through calendar 2005. Aral has operated in Kazakhstan since December 2002 and has recently assembled a team of both Kazakh and international executives who have extensive experience in the Kazakh operating and regulatory environment. See "Business of the Company".

The Company expects to be able to fund its capital expenditure program to the end of fiscal 2006 using cash flow from operations, working capital and, to the extent required or desirable, through funds raised in the capital markets.

OUTSTANDING SHARE DATA

At April 29, 2005, the number of common shares of the Company outstanding and the number of common shares issuable pursuant to other securities of the Company outstanding are as follows:

Common shares	Number
Outstanding	84,327,163
Issuable under options	7,173,228
Issuable under warrants	1,368,000

BUSINESS PROSPECTS AND OUTLOOK

Caspian is optimistic about its future prospects and the environment in which it operates. The Company has been successful in establishing itself as an operating entity in the Republic of Kazakhstan and expects to continue with future growth through continued work there.

The Company anticipates that fiscal 2006 average production will be 504 bopd. Caspian believes world and domestic market supply and demand factors, combined with political instability in the Middle East countries will result in continued strong prices for crude oil and natural gas during calendar 2005 and into 2006.

Presently, the Company anticipates executing the work program in Kazakhstan undertaken by Aral. See "Business of the Company".

ADDITIONAL DISCLOSURES

Critical accounting estimates

In the preparation of the financial statements, it was necessary for Caspian to make certain estimates that were critical to determining our assets, liabilities and net income. None of these estimates affect the determination of cash flow but do have a significant impact in the determination of net income. The most critical of these estimates is the reserves estimations and the resulting effect on various income statement and balance sheet measures.

Caspian engaged an independent engineering firm to evaluate 100% of our oil and natural gas reserves and prepare a report thereon. Their report was utilized in: a) the calculations of depletion and depreciation expense, b) the application of the ceiling test, and c) the calculation of asset retirement obligations. The estimation of the reserve volumes and future net revenues set out in the report is complex and subject to uncertainties and interpretations. Judgments are based upon engineering data, projected future rates of production, forecasts of commodity prices, and the timing of future expenditures. Inevitably the estimates of reserve volumes and future net revenues will vary over time as new data becomes available and estimates of future net revenues do not represent fair market value. The impact of such revisions in fiscal 2005 was not significant.

The significant accounting policies used by the Company are disclosed in the notes to the Company's annual consolidated 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. The following discussion outlines such accounting policies and is included in this MD&A to aid the reader in assessing the critical accounting policies and practices of the Company and the likelihood of materially different results being reported. The Company's management reviews its estimates regularly.

ADDITIONAL DISCLOSURES (CONTINUED)

The following significant accounting policies outline the major policies involving critical estimates.

Proved oil and gas reserves

Proved reserves are those reserves that can be estimated with a high degree of certainty to be recoverable. It is likely that the actual remaining quantities recovered will exceed the estimated proved reserves. The estimated quantities of proved crude oil, natural gas liquids and natural gas are derived from geological and engineering data that demonstrate with reasonable certainty the amounts that can be recovered in future years from known reservoirs under existing economic and operating conditions. Reserves are considered proved if they can be produced economically as demonstrated by either actual production or conclusive formation tests. The oil and gas reserve estimates are made using all available geological and reservoir data as well as historical production data. Estimates are reviewed and revised as appropriate. Revisions occur as a result of changes in prices, costs, fiscal regimes, reservoir performance or a change in the Company's plans.

Depletion expense

The Company uses the full cost method of accounting for exploration and development activities. In accordance with this method of accounting, all costs associated with exploration and development are capitalized whether successful or not. The aggregate of net capitalized costs and estimated future development costs less estimated salvage values is amortized using the unit-of-production method based upon proved oil and gas reserves. An increase in estimated proved oil and gas reserves would result in a corresponding reduction in depletion expense. A decrease in estimated future development costs would result in a corresponding reduction in depletion expense.

Withheld costs

Certain costs related to unproved properties may be excluded from costs subject to depletion until proved reserves have been determined or their value is impaired. These properties are reviewed quarterly and any impairment is transferred to the costs being depleted.

Impairment of long lived assets

The Company is required to review the carrying value of all property, plant and equipment, including the carrying value of oil and gas assets, for potential impairment.

The carrying value of the Company's petroleum and natural gas properties must not exceed their fair value. The fair value is equal to the estimated future cash flows from proved and probable reserves using future price forecasts and costs discounted at a risk-free rate. If impairment is indicated, the amount by which the carrying value exceeds the estimated fair value of the long lived asset is charged to income.

Asset retirement obligations

Asset retirement obligations are initially measured at fair value when they are incurred, which is the discounted future value of the estimated liability. This requires an estimate to be made of the future costs of retiring the asset at the point in time the asset is acquired.

Changes in accounting policies

The Canadian Institute of Chartered Accountants adopted several new accounting standards that become effective in calendar 2004. Caspian has adopted all of these standards in the preparation of its fiscal 2005 financial statements. Consequently, there were no changes in accounting policies in fiscal 2005.

Credit risk management

We are exposed to credit risk on our commodity contracts due to the potential for non-performance by the counter parties. We mitigate this risk by only dealing with well established marketing companies.

Fair value measurement

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

Related party transactions

During 2005, Caspian incurred $27,000 of administrative fees to a venture capital firm in which one of Caspian's directors is a principal. At January 31, 2005 accounts payable and accrued liabilities included $27,000 due to this related party.

Management's Report to the Shareholders

Management has prepared the accompanying consolidated financial statements of Caspian Energy Inc. in accordance with Canadian generally accepted accounting principles. Financial and operating information presented throughout this annual report is consistent with that shown in the consolidated financial statements.

Management is responsible for the intergrity and objectivity of the financial information. Where necessary, the financial statements include estimates that are based on management's informed judgements. Internal control systems are designed and maintained to provide reasonable assurance that assets are safeguarded, transactions are properly authorized and reliable, timing accounting records are produced for financial reporting purposes.

Deloitte & Touche LLP were appointed by the Company's shareholders to perform an examination of the corporate and accounting records so as to express an opinion on the consolidated financial statements. Their examination included tests and procedures as they considered necessary to provide reasonable assurance that the consolidated financial statements are presented fairly in accordance with Canadian generally accepted accounting principles.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal controls. The Board of Directors exercises its responsibilities primarily through the Audit Committee, which is composed of non-management directors. The Audit Committee meets quarterly with management and the independent auditors to ensure that management's responsibilities are properly discharged, to review the consolidated financial statements and to recommend that the consolidated financial statements be presented to the Board of Directors for approval.

The Audit Committee has reviewed the consolidated financial statements and recommended their acceptance to the Board of Directors. The Board of Directors has approved the consolidated financial statements for issuance to the shareholders.

(SIGNED) WILLIAM A.G. RAMSAY
President and Chief Executive Officer
May 3, 2005

(SIGNED) BRIAN D. KORNEY
Vice President and Chief Financial Officer
May 3, 2005

Auditors' Report to the Shareholders of Caspian Energy Inc.

We have audited the consolidated balance sheet of Caspian Energy Inc. as at January 31, 2005 and the consolidated statements of loss and deficit and cash flows for the period from incorporation on April 13, 2004 to January 31, 2005. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated 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 consolidated financial statements present fairly, in all material respects, the financial position of the Company as at January 31, 2005 and the results of its operations and its cash flows for the period from incorporation on April 13, 2004 to January 31, 2005 in accordance with Canadian generally accepted accounting principles.

CALGARY, ALBERTA
April 27, 2005

(SIGNED) "DELOITTE & TOUCHE LLP"
Chartered Accountants

Consolidated Balance Sheet

Expressed in Canadian Dollars

	January 31, 2005
Assets	
Current assets:	
Cash and cash equivalents	$43,066,470
Accounts receivable	181,387
Prepaids and other deposits	486,992
Other assets	11,731
	43,746,580
Property, plant and equipment (note 4)	40,419,409
Accumulated depletion and depreciation	(76,139)
	40,343,270
	$84,089,850
Liabilities and shareholders' equity	
Current liabilities:	
Accounts payable and accrued liabilities	$1,366,096
Loan payable (note 8)	7,336,841
	8,702,937
Asset retirement obligation (note 5)	70,540
Future income taxes (note 9)	644,376
	9,417,853
Shareholders' equity:	
Share capital (note 6)	75,376,278
Warrants to purchase common shares (note 6)	667,738
Contributed surplus (note 7)	3,629,436
Deficit	(5,001,455)
	74,671,997
	$84,089,850

See accompanying notes to consolidated financial statements.

Approved by the Board:

WILLIAM A.G. RAMSAY
Director

GORDON D. HARRIS
Director

Consolidated Statement of Loss and Deficit

Expressed in Canadian Dollars

	Period from incorporation on April 13, 2004 to January 31, 2005
Revenues:	
Oil and gas revenue, net	$1,618,511
Interest	238,385
Other income	45,764
	1,902,660
Expenses:	
General and administrative	2,113,461
Operating	545,099
Transportation	68,601
Stock-based compensation (note 7)	3,629,436
Unrealized foreign exchange loss	57,642
Depletion, depreciation and accretion	83,606
	6,497,845
Loss before income taxes	(4,595,185)
Future income taxes	406,270
Net loss for the period	(5,001,455)
Retained earnings, beginning of period	—
Deficit, end of period	$(5,001,455)
Basic and diluted loss per share (note 6)	$(0.09)

See accompanying notes to consolidated financial statements.

Consolidated Statement of Cash Flows

Expressed in Canadian Dollars

	Period from incorporation on April 13, 2004 to January 31, 2005
Cash provided by (used in):	
Operating:	
Net loss for the period	$(5,001,455)
Add non-cash items:	
Stock-based compensation	3,629,436
Unrealized foreign exchange loss	57,642
Depletion, depreciation and accretion	83,606
Future income taxes	406,270
Changes in non-cash working capital	(680,110)
	(1,504,611)
Financing:	
Issuance of common shares	65,794,363
Share issue expenses	(6,209,585)
	59,584,778
Investing:	
Acquisition of property, plant and equipment	(17,314,947)
Cash acquired on acquisition (note 3)	2,301,250
Changes in non-cash working capital	1,366,096
	(15,013,697)
Increase in cash and cash equivalents	43,066,470
Cash and cash equivalents, beginning of period	—
Cash and cash equivalents, end of period	$43,066,470
Interest paid and received:	
Interest paid	—
Interest received	$201,811

See accompanying notes to consolidated financial statements.

Period from incorporation on April 13, 2004 to January 31, 2005

1. NATURE OF OPERATIONS

The Company is engaged in the exploration and development of oil and gas properties in Kazakhstan.

During the period ended January 31, 2005 Northway Explorations Limited ("Northway"), a Toronto Stock Exchange listed company, acquired a private Ontario company, Caspian Energy Ltd. ("CEL") and subsequently raised US$9.75 million through the issuance of common shares. Under the terms of an exploration program entered into between the government of Kazakhstan and Aral Petroleum Capital LLP ("Aral") (the "Exploration Contract"), Aral has agreed to spend a minimum of US$20.8 million during the initial three year term of the program. As of January 31, 2005, US$15.6 million had been incurred with the remaining US$5.2 million required to be spent by December 29, 2005. 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. Under terms of a shareholders' agreement dated June 25, 2004, between Caspian, Azden Management Limited ("Azden") and Aral, Caspian committed to fund the US$20.8 million for this initial work program.

CEL's assets include a 50% indirect interest in Aral, and a temporary 100% beneficial interest in the currently producing well of Aral. Through Aral it will have the right to explore and develop certain oil and gas properties known as the North Block, a 2,348km^2 area, located in the vicinity of the Kazakh pre-Caspian basin. Following the acquisition of CEL, Northway changed its name to Caspian Energy Inc. (the "Company" or "Caspian") and became actively engaged in the exploration, production and development of oil and gas in Kazakhstan. The Company also has minor resource interests in Canada. The acquisition has been accounted for as a reverse takeover for accounting purposes (note 3).

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.

(a) 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.

(b) Joint ventures

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

(c) Property, plant and equipment

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.

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.

Ceiling test

The Company follows the Canadian accounting guideline on full cost accounting. In applying this 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.

2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

(c) Property, plant and equipment (continued)

Ceiling test (continued)

Costs of acquiring and evaluating unproven properties in Canada and costs of exploration and land in international cost centres are excluded initially 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 the country's cost centre. Proceeds from disposal of properties will normally be applied as a reduction of the cost of the remaining assets unless the disposal represents a significant disposition of reserves, in which case a gain or loss will be recorded.

Unproved property

Costs of acquiring and evaluating unproven properties in Canada and costs of exploration and land in Kazakhstan are excluded initially 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.

Asset retirement obligation

The Company has adopted the Canadian accounting standard for asset retirement obligations. In accordance with the new standard, Caspian records the fair value of an asset retirement obligation ("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.

(d) 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.

(e) Stock-based compensation

The Company grants options to purchase common shares to employees and directors under its stock option plan. The Company has adopted the new Canadian accounting standard relating to stock-based compensation and other stock-based payments as it applies to stock-based compensation granted to employees, officers and directors. 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.

(f) 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.

(g) 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/or 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.

(h) Earnings (loss) per share

Basic per share amounts are calculated using the weighted average number of shares outstanding during the year. 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.

2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

(i) 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 operations.

3. ACQUISITION OF CASPIAN ENERGY LTD.

On September 21, 2004, Caspian (formerly Northway) acquired all of the issued and outstanding shares of Caspian Energy Ltd. ("CEL"), an Ontario private company, by issuing 39,590,909 common shares. The transaction between Caspian (legal parent) and CEL (legal subsidiary) is accounted for as a reverse-takeover ("RTO"), using the purchase method of accounting. The shareholders of CEL owned the majority of the shares after the acquisition. In addition, the management team of CEL became the management team of Caspian and the CEL directors became Caspian directors. As a result, for accounting purposes, CEL was identified as the acquirer. Application of RTO accounting results in CEL being deemed the parent company for accounting purposes. The financial statements of the combined entity, issued under the name of the legal parent, are considered a continuation of the financial statements of the legal subsidiary, CEL.

Application of reverse takeover accounting results in the following

(i) the Caspian consolidated financial statements are a combination of CEL at its historical cost and Caspian at its fair value. There are no comparative figures presented as CEL was not incorporated until April 13, 2004.
(ii) shareholders' equity is presented as a continuation of CEL; however, the capital structure is that of Caspian.
(iii) the purchase price of $9,699,090, being the aggregate of the fair value of the equity interest in Caspian deemed to be given by CEL to the shareholders of Caspian was allocated to the assets and liabilities of Caspian as follows:

Cash	$2,301,250
Accounts receivable and other assets	140,527
Accounts payable	(13,851)
Petroleum and natural gas property	7,271,164
Total	$9,699,090

At the time of the acquisition, Caspian had approximately $1 million in tax loss carryforwards and other deductions. The Corporation has not recorded any tax benefit related to these losses due to the uncertainty of realization.

4. PROPERTY, PLANT AND EQUIPMENT

All of the Company's property, plant and equipment at January 31, 2005, relates to petroleum and natural gas properties, the majority of which relates to a contract for exploration work in the North Block located in the Aktyubinsk area of Kazakhastan.

The majority of the Company's property, plant and equipment is under development, with $623,598 of costs being subject to depletion and depreciation for 2005.

During 2005, the Company capitalized $153,000 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 January 31, 2005 is approximately US$100,000, which will be incurred between 2014 and 2019. A credit-adjusted risk-free rate was used to calculate the fair value of the asset retirement obligations.

A reconciliation of the asset retirement obligations is provided below:

Balance, beginning of period	—
Net liabilities incurred on acquisition	70,540
Balance, end of period	$70,540

Under the terms of the Exploration Contract, the Company is required to create a fund to finance actual future restoration costs, equal to 1% of the capital costs of exploration. At January 31, 2005, $47,514 has been placed in a restricted bank account related to the funding requirement.

6. SHARE CAPITAL

(a) Authorized

Unlimited number of voting common shares, without stated par value.

(b) Common shares issued

Common shares of CEL	Number	Amount
Issued on incorporation	1	$1
Private placement	23,045,454	13,069,048
Public offerings	27,360,000	51,469,066
Issued on acquisition of oil and gas properties (ii)	16,545,454	9,430,909
Issued and outstanding as at September 20, 2004	66,950,909	73,969,024
Exercise of warrants/options (iii)	2,068,333	1,256,250
Issued and outstanding as at January 31, 2005	69,019,242	75,225,274
Common shares of Caspian issued on business combination of Caspian and CEL (i) to former Caspian shareholders	21,012,012	9,699,090
Adjustment on RTO	(5,909,091)	(3,338,500)
Share issue costs (iv)	—	(6,209,585)
Total issued and outstanding as at January 31, 2005	84,122,163	$75,376,278

(i) On September 21, 2004, Caspian entered into a merger agreement with CEL to combine the companies on the basis of one share of Caspian for every one share of CEL.
(ii) In June 2004 CEL acquired a 50% indirect interest in Aral. The cost of the purchase of $9,430,909 was assigned to petroleum and natural gas property.
(iii) During the period from the date of the RTO to January 31, 2005, 1,633,333 warrants and 435,000 options to purchase common shares of CEL were exercised. The warrants had an exercise price of $0.66 per common share and the stock options were priced at $0.35, $0.40 and $0.50 per common share.
(iv) Share issue costs have not been tax-effected.

(c) 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 10,350,000 common shares. 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.

On September 21, 2004 options were granted to acquire 2,079,090 common shares at $0.75 per share and 4,044,138 at $2.15 per share. Of the total, 2,461,614 options vest yearly in one-third tranches beginning on the first anniversary of the grant date and 3,661,614 vest immediately. On December 5, 2004, options were granted to acquire 1,050,000 common shares at $0.75 per share, which vest one-quarter on the date of the grant and one-quarter for each of the next three years. All expire five years after grant date.

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

	2004	
	Number of options	Weighted average option price
Balance, beginning of period	—	—
Granted	7,173,228	$1.72
Exercised	—	$0.57
Expired	—	—
Balance, end of period	7,173,228	—
Exercisable, end of period	7,173,228	$1.60

The following is a summary of stock options outstanding and exercisable as at January 31, 2005:

	Options outstanding			Exercisable options
Range of exercise price	Number of options	Weighted average life (years)	Weighted average exercise price	Number of options
$0.75	2,079,090	4.7	$0.75	891,363
$2.00	1,050,000	4.9	$2.00	262,500
$2.15	4,044,138	4.7	$2.15	2,770,251
	7,173,228	4.7	$1.60	3,924,114

6. SHARE CAPITAL (CONTINUED)

(d) Per share amounts

The weighted average number of common shares outstanding during the period ended January 31, 2005 of 58,485,792 was used to calculate earnings per share amounts.

(e) Warrants

205,000 share purchase warrants are outstanding at January 31, 2005. No value was ascribed to the warrants at the date of grant. Each warrant entitles the holder to purchase one common share at a price of $0.66 until March 19, 2005. All of the warrants were exercised subsequent to year-end. 1,368,000 broker warrants are outstanding at January 31, 2005. Each warrant entitles the holder to purchase one common share at a price of $2.00 until September 20, 2006. The fair value of the warrants using the Black-Scholes method was $667,738.

7. 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 granted in the period ended January 31, 2005 was estimated to be $3,629,436 as at the grant date using a Black-Scholes option-pricing model and the following assumptions:

Risk-free interest rate	3%
Expected life	five year average
Expected volatility	30%
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.

8. LOAN PAYABLE

Aral is indebted to Azden, the other 50% partner in Aral, in the amount of $7,336,841. The amount is non-interest bearing and is to be repaid prior to January 1, 2006. Caspian is obligated to fund Aral's operations, consequently $7,336,841 has been added to property, plant and equipment of Caspian and shown as a current liability.

9. INCOME TAXES

Future income taxes reflect the net tax effects of temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and the amounts used for tax purposes. The Company has provided for certain taxes based upon statutory regulations of Kazakhstan. The Company is subject to permanent tax differences due to the fact that certain expenses are not deductible for income tax purposes under Kazakh law.

The provision for taxes differs from that computed using the combined Canadian federal and provincial statutory rate as follows:

Loss before income taxes	$(4,595,185)
Expected recovery at statutory tax rate of 38.62%	(1,774,660)
Tax rate difference of foreign jurisdiction	(55,461)
Non-deductible stock-based compensation	1,401,688
Other non-taxable amounts in foreign jurisdiction	(14,937)
Losses for which no benefit is being recognized	849,640
Future income taxes	$406,270

The tax effect on major temporary differences that give rise to the future tax liability as at January 31, 2005 are as follows:

Future tax asset:	
Tax losses available for carry forward	$849,640
Valuation allowance	(849,640)
Future income taxes	—
Future tax liability:	
Difference in the tax bases and carrying values of property, plant and equipment	$644,376

At January 31, 2005, the Company had Canadian non-capital losses available to be carried forward in the amount of $2.2 million, expiring in 2012. The benefit of these losses has not been recognized due to the uncertainty of realization.

10. 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, except for the loan payable, for which the estimated fair value at January 31, 2005 is $6,750,000.

11. 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.

12. 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 ($)
Revenues	293,522	1,609,138	1,902,660
Expenses	5,564,501	933,344	6,497,845
Income taxes	—	406,270	406,270
Net income (loss)	(5,270,979)	269,524	5,001,455
Capital expenditures	—	17,314,947	17,314,947

13. RECONCILIATION TO INTERNATIONAL FINANCIAL REPORTING STANDARDS

The Company has evaluated and determined there are no significant differences between Canadian generally accepted accounting principles and International Financial Reporting Standards. Accordingly, no differences in the Company's reported financial position at January 31, 2005 or results of operations or cash flows for the period from incorporation on April 13, 2004 to January 31, 2005 have been presented.

CASPIAN ENERGY Inc.

Listing on TSX and Admission to AIM

£22,435,206
(C$51,983, 947)

Placing of 20,218,000 common shares

at 82p (C$1.90) per share

and

7,142,000 common shares of

Caspian Energy Ltd.

at C$1.90 (82p)

September 2004

TSX Sponsor

CANACCORD CAPITAL

Nominated Adviser
Broker

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