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BlueSky Oil & Gas Ltd.

Annual Report

1986

CONTENTS

Highlights For Fiscal 1986

FINANCIAL HIGHLIGHTS

Gross Revenues		$31,881,000
Cash Flow from Operations		$18,356,000
Per Share*		71.6¢
Net Income Including Extraordinary Items		$12,020,000
Per Share*		46.5¢
Net Income Excluding Extraordinary Items		$ 8,136,000
Per Share*		31.6¢

OPERATIONAL HIGHLIGHTS

Reserves		
Natural Gas (million cubic feet)		
Proven	130,400	
Probable	64,300	194,700
Oil (barrels)		
Proven	9,172,000	
Probable	2,248,000	11,420,000
Natural Gas Liquids (barrels)		
Proven	2,425,000	
Probable	1,231,000	3,656,000
1986 Production		
Natural Gas (billion cubic feet)		5.3
(million cubic feet per day)		14.4
Oil (barrels)		891,000
(barrels per day)		2,440
1986 Drilling		
Total Wells		128
Gas Completions		36
Oil Completions		60

*See Note 6 of Financial Statements.

Report to Shareholders

Last year in my report to shareholders, I pointed to the improved business climate within the Canadian energy resource sector. This improvement had been brought about by beneficial changes in government fiscal policy and by positive changes in regulatory attitudes toward our industry. The financial community were quick to join in praising the Western Accord and the incentives offered by the producing provinces of Western Canada. The general outlook and attitude was optimistic and with very few exceptions our industry looked toward 1986 as a year for increased profits, increased cash flow and new investment within the energy sector.

For the first nine months of our fiscal year, this optimism proved to be fact. Daily production rates of petroleum, natural gas and natural gas liquids reached all time highs. Gross revenue, net income and cash flow showed substantial increase over the corresponding quarters of the previous fiscal year. Drilling activity was also well ahead of the average of the three previous years. The final quarter, however, brought home the reality that the collapse of the Organization of Petroleum Exporting Countries (OPEC) and the severe erosion of crude oil prices, would place our industry under pressure more drastic than during the years of the National Energy Program.

The decline in oil prices from \$28 to \$13 U.S. has created a devastating blow to the activities of all companies. Exploration and development budgets have been severely reduced and for those companies electing to pursue drilling projects, declining prices have all but stripped economic returns. However, in this financial environment, care must be taken to guard against the temptation to return to Government price controls. Instead, the industry must use this time of crisis to convince governments of the need for lower royalty rates, the need to eliminate the Petroleum and Natural Gas Revenue Tax, and the need to review fiscal policy on depletion, all of which will provide long term benefits. It is imperative that if we are to build a strong industry guaranteeing security of supply, that pure economics must govern the industry's expenditures. A Canadian energy sector whose activities are governed by profits and rates of return rather than government incentives will, in the long term, be stronger and more adapt at surviving the peaks and valleys that are bound to prevail within our industry during the next five years.

During 1986 Bluesky sought and obtained a favourable tax ruling from Revenue Canada. One of the effects of this ruling was a requirement for the Company to restate its prior year's net income before and after tax. I would refer you to note 2 of the financial statements for an analysis of these changes. For the current year net income, before extraordinary items, totalled \$8,136,000 or 31.6¢ per share versus restated net income of \$6,974,000 or 26.6¢ per share in fiscal 1985. Extraordinary items associated with the Company's withdrawal from its West German Limited Partnership added additional income of \$3,884,000 or 14.9¢ per share. Total net income including extraordinary items for the year was \$12,020,000 or 46.5¢ per share versus comparable figures of \$7,096,000 or 27.1¢ per share in fiscal 1985.

Gross revenue for 1986 was \$31,881,000 as compared to restated gross revenue of \$31,575,000 in the previous year. Despite the severe drop in world crude oil prices during our final quarter, revenues were maintained through increased production rates of all products. This increased production was a direct result of the year's successful drilling programs. The Company participated in the drilling of 128 wells, resulting in 60 oil wells and 36 gas wells for an overall success ratio of 75%. These statistics include not only wells drilled by Bluesky but also wells drilled by third parties at no cost to the Company on farmouts of exploratory acreage. Of the total wells drilled, 55% were exploratory wells and 45% were drilled as development locations. Our activities were concentrated in the Provinces of Alberta and Saskatchewan. Cash flow for the year totalled \$18,356,000 or 71.6¢ per share versus restated cash flow of \$19,586,000 or 76.3¢ per share in the Company's 1985 fiscal year.

Daily oil production during fiscal 1986 increased 11% to average 2,440 barrels per day as compared to 2,203 barrels per day last year. Natural gas production increased 22% to average 14.4 million cubic feet per day versus 11.8 million cubic feet per day in fiscal 1985. Natural gas liquids, which were not produced in Bluesky's previous year, averaged 266 barrels per day. In January, the Company achieved all time highs in daily production rates when it averaged 2,877 barrels of oil per day, 20.5 million cubic feet of natural gas per day and 436 barrels of natural gas liquids per day.

At year end, the Company's proven plus probable reserves as calculated by independent engineers totalled 11.4 million barrels of oil, 195 billion cubic feet of natural gas and 3.7 million barrels of natural gas liquids. Bluesky's total reserves have an undiscounted future cash flow value of $1,095,911,000 over the production life of the properties. At a discount rate of 12%, the present worth value is $305,803,000.

Over the past 12 months, the Company added, through drilling, proven and probable oil reserves of 1,117,000 barrels and natural gas reserves of 5.3 billion cubic feet. Production during this period was 891,000 barrels of oil and 5.3 billion cubic feet of natural gas. Performance adjustments on the Company's 858 producing wells were also made, resulting in a slight overall decrease in oil reserves when compared to last year and a 17% decrease in natural gas reserves mainly in the Deep Basin Area of Alberta. In the Deep Basin Area of Alberta, a detailed engineering review of production data, pressure surveys, and the geology of the Cadomin Zone indicated that the recoverable reserves of natural gas would be significantly lower than originally estimated, As a result, the Company's working interest reserves have been reduced. In addition, natural gas reserves were adjusted to eliminate those reserves which because of price per thousand cubic feet are no longer economic to produce. If natural gas prices increase in excess of $3.00 per thousand cubic feet, this classification of reserves will be restated. A corresponding reduction in natural gas liquid reserves has also been made due to the direct relationship.

Despite the low prices of today, we continue to hold a thread of optimism. We firmly believe in the long term future of our industry and there is truth in the statement that wherever there is a crisis, there is an opportunity.

Drilling Rig, Ponoka area.

Recent low prices for undeveloped exploratory acreage, coupled with reduced drilling and seismic costs are good examples of this cliche. In these times, companies must concentrate on maximizing profits from existing production and producers must emphasize quality rather than quantity. One of our priorities for the next fiscal year will be to reduce operating costs on existing production. The installation of central facilities, and with it the reduction of lifting costs, was commenced in the final quarter of fiscal 1986. These activities will continue in fiscal 1987 and they will have both short term and long term impact on profitability. Bluesky will concentrate on finding new gas markets for shut in natural gas reserves and we have set a goal for increased gas production of 5 million cubic feet per day in fiscal 1987. The magnitude and duration of price declines will continue to occupy the minds of oil executives and analysts for the next five years. Notwithstanding these uncertainties, Bluesky's activities will continue and ways will be found to provide growth that will benefit the Company and its shareholders.

Management and directors express their sincere thanks to the staff of Bluesky for their dedication and hard work this past year. The patience, understanding, and continued support of our shareholders during these unsettled times is also appreciated.

On Behalf of the Directors

BW Harrison

BARRY W. HARRISON
President &
Chief Executive Officer

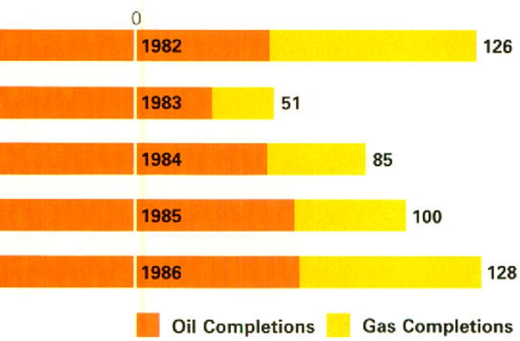
July 25, 1986
Calgary, Alberta

Exploration Highlights

During the last quarter of the financial year the industry experienced a sharp price decline in its product. The Company had by this time substantially completed its drilling progam which resulted in a record year for drilling activity. Bluesky participated in 128 wells resulting in 60 oil wells and 36 gas wells for a success ratio of 75%. All but three wells were drilled in Canada.

The Company's gross drilling budget for fiscal 1986 was $25,000,000 with Bluesky's net share equalling $8,389,061. Of this budget approximately 55% or $4,800,000 was expended on development drilling while approximately 45% or $3,600,000 was expended on exploration drilling. This program added 1.1 million barrels of oil reserves to Bluesky's account plus 5.4 billion cubic feet of natural gas. It should be noted that those development wells drilled to convert probable reserves to proven, while adding cash flow, do not add new reserves to the company. In addition, we participated in seismic programs totalling $296,095 to Bluesky and we expended $3,800,000 on the acquisition of new mineral rights. Our share of capital expenditures on tangible equipment totalled $5,062,736.

Wells Drilled



Summary of Net Wells:

Drilled by Bluesky:	**Number**	**%**
Oil	22.2	77.3%
Gas	2.6	9.0%
Total Successful	24.8	86.3%
Abandoned	4.0	13.7%
Total	28.8	100%
Wells Drilled by Farmouts		
Oil	0.3	22.9%
Gas	0.5	34.5%
Total Successful	0.8	57.4%
Abandoned	0.6	42.6%
Total	1.3	100%

In fiscal 1987 the company will diversify its exploration and development programs from strictly pursuing oil prospects to a blend of oil and natural gas. Bluesky has not actively explored for new gas reserves during the last five years. In fiscal 1987 our gross drilling budget will be $30,861,000 with Bluesky's net share equalling $5,000,000. Seismic programs are budgeted to cost $500,000, projected land acquisitions at $1,000,000 and capital expenditures including tangible equipment acquisitions at $3,190,000.

Drilling activity during the year will be governed by product prices. With low prices, productivity becomes the influencing factor in determining whether to pursue the drilling of a well. In our opinion, the following requirements must exist before a well can be drilled when oil prices are $14 per barrel U.S. and/or natural gas prices are $2.00 per thousand cubic feet Canadian:

1. The cost to drill, complete and equip the well for taking of production must not exceed $575,000.

2. Assuming these costs, drilling must result in a well that will maintain production levels of 55-60 barrels of oil per day or 1 million cubic feet per day of gas. To receive such a daily allowable under existing pro-rationing legislation, reserves of at least 200,000 barrels of oil or 4.5 billion cubic feet of natural gas per spacing unit must exist. In addition, the reservoir being drilled for must have a history of being able to maintain stabilized production rates.

3. A well meeting the above parameters will result in a 15% pre tax rate of return on one's investment, unrisked.

LAND

Bluesky expended $3,800,000 on mineral rights acquisition in Alberta, Saskatchewan and British Columbia during the past fiscal year.

	Gross	Net	Average $/Net Acre
Saskatchewan	35,680	33,760	$ 29.58
Alberta	25,760	10,091	252.52
British Columbia	1,280	1,280	67.95

The above table illustrates the acreage acquired by province and the acreage price per net acre spent.

Acquisitions were made on oil & gas prospects in the Heath-Ribstone, Acadia, Altario, Pembina, Utikuma North and Lubicon areas of Alberta, as well as in the Shackleton, Hoosier, Shallow Lake and Cactus Lake areas of Saskatchewan, and the Stoddart region in British Columbia.

Realizing the oil & gas potential in Saskatchewan, coupled with relatively low land costs, Bluesky continued its aggressive land acquisition program by purchasing more than 33,000 net acres which included two Permits totalling more than 29,000 acres in size in the Shackleton area of southwest Saskatchewan. Since acquiring these permits the Company has concluded a farmout to an industry partner which will substantially recover its land acquisition costs.

In the Lubicon area of Northern Alberta, the Company participated to the extent of a 33.33% working interest in purchasing a 3840 acre Crown parcel for $1,000,000. The Company acquired 1920 acres in the East Central Alberta prospect of Kinsella for $450,000. Bluesky currently holds a 50% working interest in this acreage after being reimbursed for 100% of the land costs through a farmout with an industry partner. The first well drilled on the acreage was successful.

Over the past year, Bluesky has primarily concentrated on land *and exploration* activity in Canada and will proceed to do so as the company continues to divest its interest in undeveloped land holdings in the United States through sales and/or surrenders.

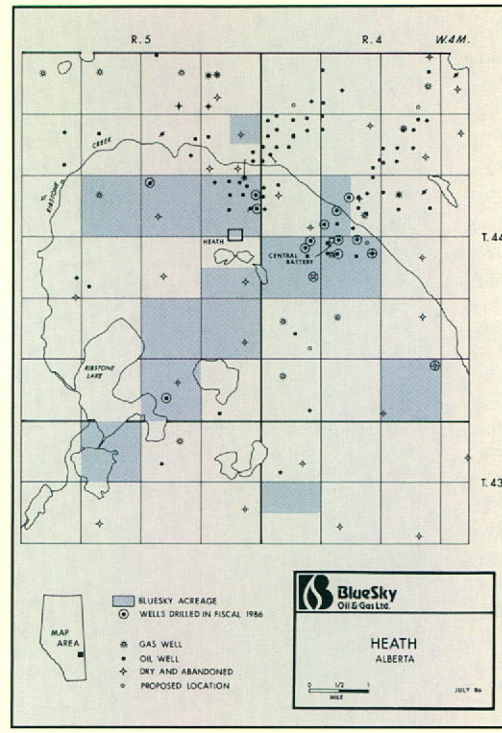
Although the currently depressed price of oil has curtailed industry activity, the Company feels that there is an opportunity to benefit during the upcoming year by acquiring acreage on Company generated prospects. There has been an erosion of land cost evident at recent Crown Sales and this weakness offers an opportunity to the Company.

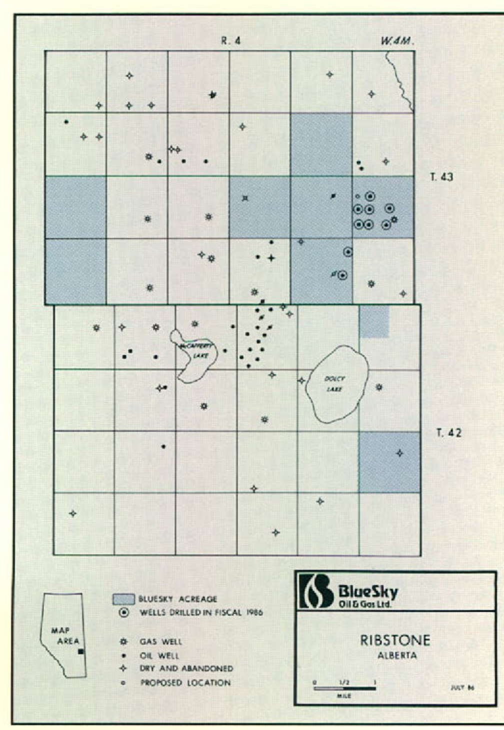
DRILLING — 1986

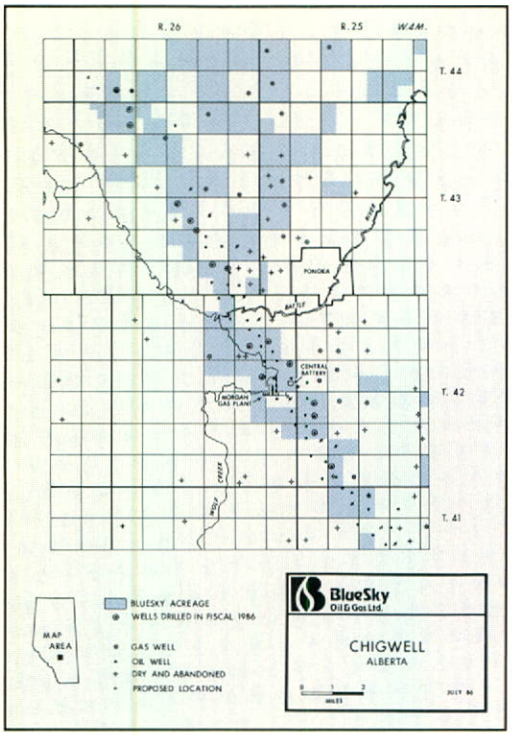
Heath-Ribstone

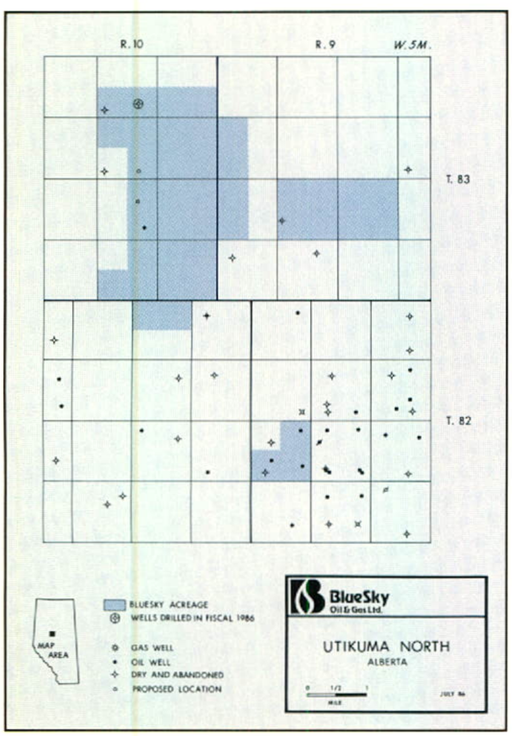
The Heath prospect is located six miles southeast of the Wainwright oil field in east central Alberta. To date, Bluesky has an interest in 5,360 gross acres and 16 producing oil wells with the company's interest varying from 26.1% to 97.5%. Central facilities are under construction to reduce per barrel operating costs and are expected to be functioning during the first quarter of fiscal 1987. The major objective is the Devonian Nisku formation which has proven recoverable reserves of 50,000 barrels per spacing unit of 40 acres.

In the Ribstone area, Bluesky has a 47.5% interest in 3,200 gross acres and eight producing wells. This acreage is located seven miles southeast of the Heath prospect and is geologically analogous to Heath. This prospect possess the same reserve potential in the Nisku plus has a secondary objective in the Camrose which can equal the Nisku reserves. To date only one well is productive from both zones in a single well. Bluesky presently averages 438 barrels of oil per day from this prospect.









Dual Producing Well
Utikuma Lake, Alberta

Chigwell

At Chigwell in central Alberta, Bluesky has varying interests from 20% to 100% in 35 producing oil wells. During the year the Company participated in the drilling of 15 wells and all but one were producing oil wells. Bluesky drilled one well during the second quarter of the 1986 fiscal year on the basis of a 100% working interest. This well is currently capable of producing in excess of its allowable of 50 barrels of oil per day has been assigned reserves of 132,000 barrels of recoverable oil. Central gathering and production facilities were installed during the year and they have been in operation since November 1985. Bluesky has an average 48% interest in this facility and is the designated operator. A gas plant to be operated by a Bluesky partner is also under construction to market the solution gas and known deeper gas reserves. Bluesky will have a 10% working interest in the plant which is designed with a through put capacity of 5 million cubic feet per day.

Utikuma and Red Earth

Bluesky continues to be active in the Utikuma-Red Earth areas of north central Alberta through land acquisition and drilling.

On the Utikuma North prospect, the Company completed the 1-11-83-10W5M Slave Point oil discovery which was drilled and cased the previous fiscal year but not completed. This well has been on production as a flowing oil well for four months and it can maintain an allowable of 100 barrels of oil per day with no water cut. It has been assigned proven recoverable reserves of 336,500 barrels. Bluesky has a 45% working interest in the well and 4,800 gross acres adjacent to this prospect. A second well approximately two miles north of this discovery was drilled in January 1986 but did not encounter reservoir quality rock.

At Red Earth, the Company participated in the drilling of three wells which resulted in two Slave Point oil wells and one Granite Wash oil well. Bluesky acquired

Deep Basin Gas and Straddle Plant
Elmworth, Alberta

320 net acres on the Granite Wash play, bringing the Company's land holdings to 3,840 gross acres, in which Bluesky has an average 24% working interest. The Company has an interest in two dual zone wells producing from the Granite Wash and the Slave Point formations and nine wells producing from the Slave Point formation. Flow lines have tied all wells to a central battery allowing for uninterrupted year long production. The Slave Point formation has excellent secondary recovery through waterflood potential and a waterflood recovery scheme has been implemented in one area.

A second structure in the area was drilled and encountered eighteen feet of gas pay in the Bakken formation. It has proven gas reserves of 2.7 billion cubic feet. This well has stabilized open flow rate of 14.5 million cubic feet per day and a deliverability rate of 10.0 million cubic feet per day.

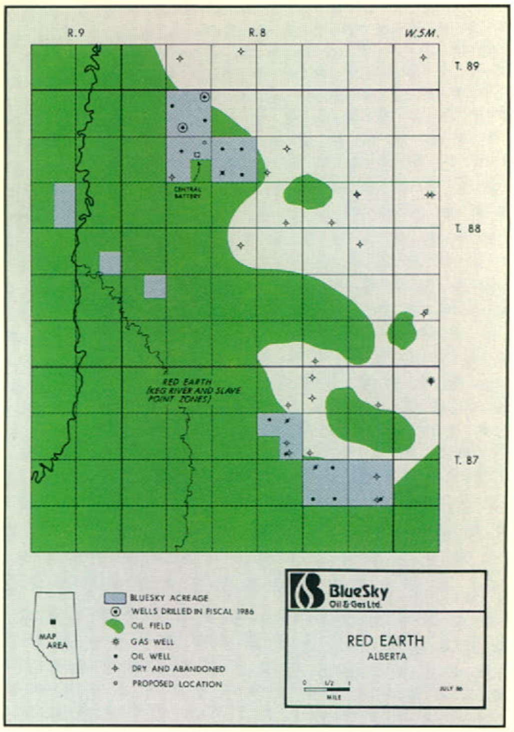
Bluesky is presently pursuing a market for these new gas reserves and hopes to have wells on production by December of 1986. The Company also plans to drill six wells in the area during fiscal 1987, five of which are on similar Bakken structures. This is the largest single budgetary program in Bluesky's portfolio for fiscal 1987.

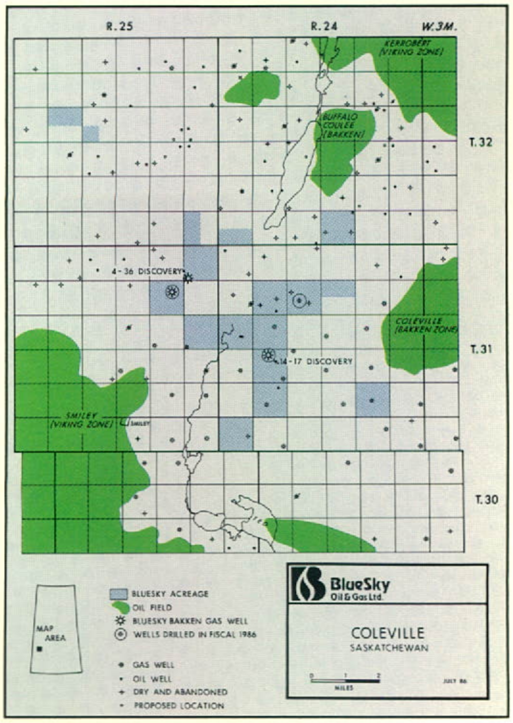
Coleville

At Coleville, in southwestern Saskatchewan, Bluesky participated in three wells and all three were cased as gas wells. The discovery well encountered twenty eight feet of net gas pay in the Bakken formation with a stabilized absolute open flow rate of 25.6 million cubic feet per day and a deliverability rate of 7.9 million cubic feet per day. The gross reserves in the Bakken formation for this well are 3.4 billion cubic feet. The second well drilled into this feature encountered twenty three feet of net pay and drill stem tested 4.2 million cubic feet per day. This well is assigned 4.4 billion cubic feet of gross reserves. Both wells have a secondary zone, the McClaren formation, which adds an additional 8.7 billion cubic feet of reserves to these lands.

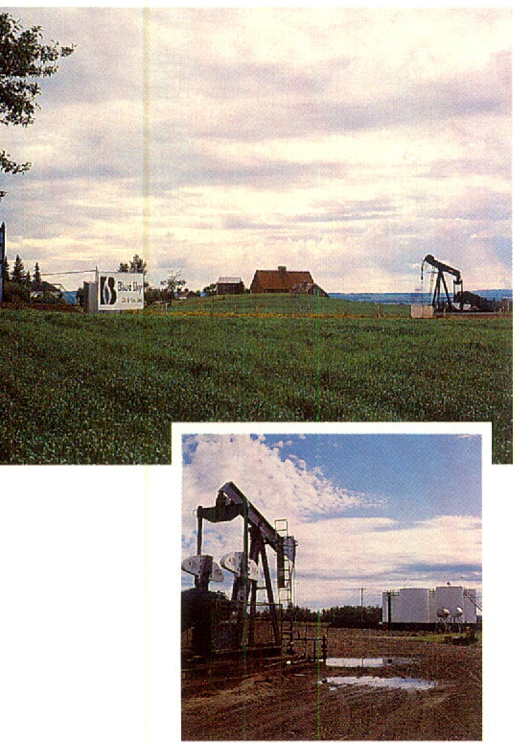
Colombia, South America

Bluesky has been involved in the Llanos Basin of Colombia since 1983, originally acquiring a 20% working interest in 889,057 gross acres. Following various pooling and farmout agreements, the Company and its partners entered into an agreement with Burmah Oil wherein the entire working interest was sold for an aggregate $(U.S.) 11,000,000 plus the reservation of a 7% net revenue interest in 1,200,000 acres. Bluesky's share of these proceeds was $1,900,000 and the reservation of an approximate 1% net revenue interest in all lands. The net revenue interest will eliminate any need for Bluesky to expend exploration and/or development funds in Colombia as the interest will be carried in all future activities.





Bluesky's Top Revenue Properties



Pumping Well & Central Battery (inset) Ponoka, Alberta

Since incorporation in 1974 the Company has been engaged in oil and gas exploration, development and production in Canada and the United States. During these 12 years the Company has been involved in several significant discoveries. Bluesky's top properties are summarized as follows:

Elmworth/Wapiti

Natural gas from the Deep Basin's Elmworth and Wapiti gas plants was contracted in 1979 and since that time has been Bluesky's largest single revenue property. Bluesky has an interest in 185 gas wells in this area, 88 of which are tied into production facilities. The Company has net reserves of 74 billion cubic feet of natural gas and 4,063,700 barrels of natural gas liquids assigned to this prospect. During fiscal 1986 Bluesky averaged a production rate of 8.6 million cubic feet per day plus 266 barrels of natural gas liquids.

Crystal-Unit

The Crystal field was first drilled in 1978 and until 1981 it was operated by Bluesky. Since discovery, 46 oil wells have been drilled into this field and the pool is presently under waterflood. The Crystal Unit has gross recoverable reserves of 27,500,000 barrels of oil and has a daily production rate of 4,700 barrels. Bluesky has a 7.5% working interest in the Unit which is now operated by Westcoast Petroleums. The Crystal Field is the largest single pool discovery made in Alberta during the last five years and it represents the Company's largest oil revenue producer. Bluesky has net reserves of 2.1 million barrels assigned to this prospect.

Nipisi/Utikuma Field

Bluesky has been actively involved in this area for ten years and the Company's success has been consistantly above the industry average. Bluesky presently has varying interests in 20 producing oil wells. The major objective is the Keg River Sandstone at an average depth of 6,000 feet. The Keg River formation is recognized as the best reservoir in Alberta having an average primary recovery factor of 30%. Wells in the area average 250,000 barrels of recoverable reserves, however, wells exist with reserves in excess of 1 million barrels of recoverable oil. Bluesky has net reserves of 1.9 million barrels assigned to this prospect.

Chigwell Field

At Chigwell in central Alberta, Bluesky drilled a new pool discovery in 1982 that has developed into a major field. An industry total of 65 producing oil wells have been drilled of which Bluesky has varying interests in 35. The Company assigns 1.4 million barrels to this prospect and has a net daily production of 330 barrels of oil.

This long, narrow Viking bar (1 mile wide, 18 miles long) will require further drilling to determine its ultimate aerial extent. The economics of a secondary recovery scheme are directly related to oil prices and the feasability of such a project will be reviewed during the next 12 months.

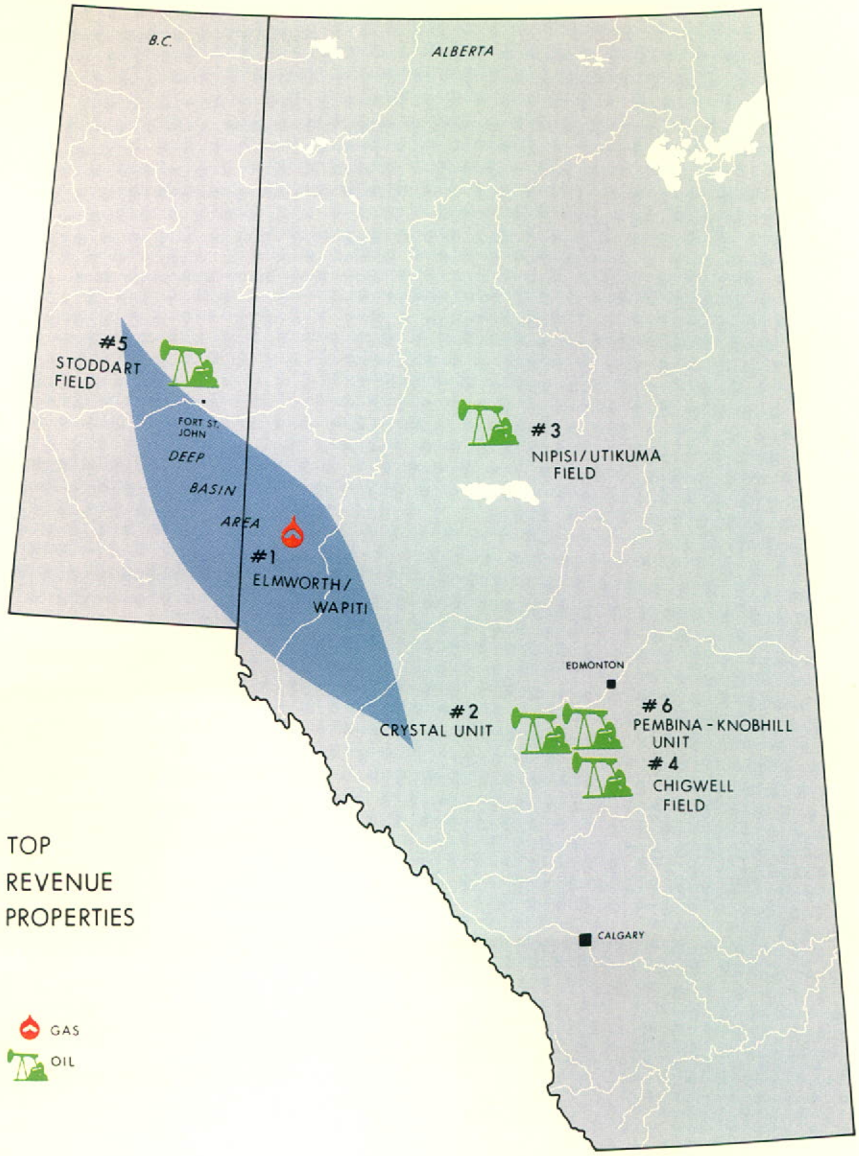
Stoddart Field

The Stoddart prospect is located in northeast British Columbia near Fort St. John. Bluesky has an interest varying between 14.93% and 61.44% in 19 producing oil wells with all but one of these producing from the Belloy formation, the remaining well produces from the Triassic Doig. Net reserves to Bluesky in the Stoddart area are 1,331,000 barrels of oil and 721 million cubic feet of natural gas, with current net production to Bluesky of 173 barrels of oil per day and 827 thousand cubic feet of gas per day. The Stoddart field was originally developed on 160 acre spacing, however, to increase production the field has been despaced to 80 acres. This infill drilling will benefit fully from the new government royalty incentive which gives two year royalty holidays to oil from new wells. Two of these infill wells have been drilled and each well retains its full allowable based on reserves assigned to the original location.

Pembina-Knobhill Unit

The Knobhill Belly River oil field was discovered in 1978 and it was acquired by Bluesky through merger in 1979. Bluesky completed the development and unitized the pool later that year. The Company has a 25.7% working interest in the unit and operates the facilities.

The unit has 10 producing oil wells to which independent engineers assign 507,000 barrels of net reserves that produce 118 barrels of oil per day to the Company's account. Recent activity adjacent to this unit has demonstrated that this pool is aerially larger than previously mapped. Bluesky is presently evaluating these new wells to determine if the unit should be enlarged. The Company has also become aware of a second productive sand that is presently being evaluated through recompletion of low productivity wells and an infill program. Three wells are budgeted to be drilled within this area during fiscal 1987. This new objective could potentially double the productivity and reserves.



TOP REVENUE PROPERTIES

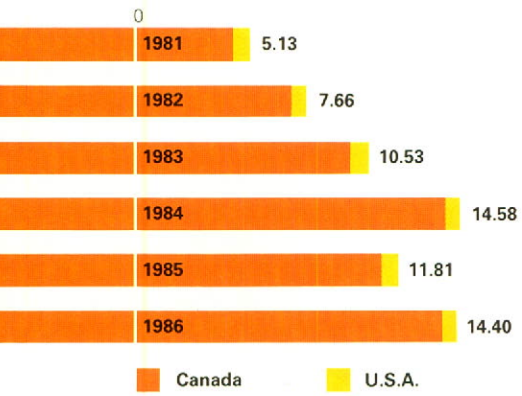
UNDEVELOPED LAND HOLDINGS As of April 30, 1986

Canada*	Gross	Net
Alberta	1,314,789	135,616
British Columbia	939,717	54,582
Saskatchewan	46,070	39,517
SUBTOTAL	2,300,576	229,715
United States		
Company Lands	55,934	15,960
COHO JV	315,775	2,409
American Hunter JV	1,178,168	28,073
SUBTOTAL	1,549,877	46,442
TOTAL	3,850,453	276,157

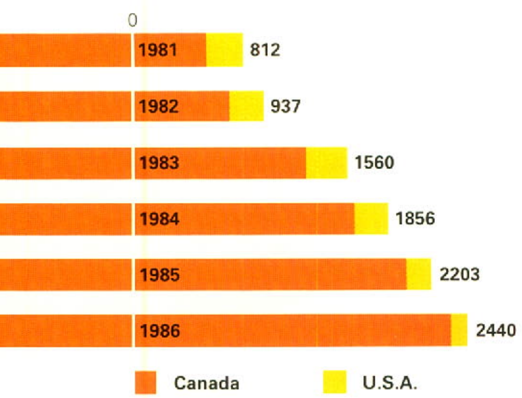
* Includes acreage originally in Canadian Hunter Joint Venture.

Operations—Production

Average Daily Gas Production
(Million Cubic Feet)



Average Daily Oil Production
(Barrels)



The past year has seen several changes in what had become the normal way of doing business in the Canadian Oil & Gas Industry, most significantly in the marketing of crude oil and natural gas production.

On June 1st of 1985 the Canadian Government abandoned the regulated pricing system for petroleum and the Alberta Government ceased being the sole purchaser of crude oil from crown leases in the Province. As a result each producing company has had to become active in the marketing of this product. Bluesky has successfully marketed its production to various purchasers generally based on the geographical area of the fields and the type and gravity of the oil. Canadian crude oil prices varied within a narrow range until the end of 1985 at which time the impact of international competition for markets caused a dramatic fall in prices from $38 per barrel ($27 U.S.) for light oil in December to a low of $15.50 per barrel ($11 U.S.) in April 1986.

Since May of 1985 the combination of low market demand from the refineries and lack of capacity in the interprovincial pipeline systems have caused numerous cutbacks in oil production and on average reduced the Company's crude oil sales by 180 to 200 barrels per day. This situation was partially alleviated on October 1st, 1985 when the Alberta Energy Resources Conservation Board introduced a Supplementary Crude Oil Sales Program which allows the industry to sell the incremental production volumes in excess of the Provincial Allowable to any market available. Bluesky has taken full advantage of this program wherever pipeline capacity has been available.

The three Western Provinces and the Federal Government agreed in their Western Accord to deregulate natural gas and go to a market-oriented pricing mechanism. A few small steps were taken on November 1st, 1985, in regards to domestic natural gas sales with full deregulation now scheduled for November 1st, 1986. It is now obvious that the Natural Gas Industry will remain heavily regulated even after November 1st of this year.

Since the advent of the Accord, Bluesky has begun to actively seek direct marketing opportunities and it is our expectation that gas sales from a number of our non-producing properties will commence later this year after the regulations affecting transportation to Eastern Canadian and United States market areas are clarified.

CRUDE OIL PRODUCTION

Bluesky produced a total of 890,720 barrels of crude oil during the year for a daily average of 2440 barrels per day, an increase of eleven percent from one year ago. During the first five months oil production was reduced by approximately 200 barrels per day by allowable cutbacks due to poor market demand. In October 1985 a Supplemental Oil Sales Program was introduced in Alberta which the Company used to market most of the shut-in production up to the limits of pipelines to move the oil out of Alberta.

Pipeline capacity on the Interprovincial Line east from Alberta will continue to limit oil shipments on a periodic basis until expansion of the facilities is completed sometime in 1987.

Heavy oil production became significant in the Company's operations for the first time during this reporting period as a result of drilling programs at Heath and Ribstone in Alberta. Production of heavy oil averaged 307 barrels per day for the twelve months and reached a level of 438 barrels per day by the year end.

Edgerton Battery

NATURAL GAS LIQUIDS

Both of the Company's Straddle Plants located in the Deep Basin area of Alberta commenced operations during the year; the Elmworth Plant on June 1st, and the Wapiti Plant on October 10th, of 1985. Combined these plants have the capacity to extract 29,750 barrels per day of liquids from 595 million cubic feet of natural gas.

For the twelve month period Bluesky's share of Natural Gas Liquids (NGL's) production averaged 266 barrels per day, reaching a level of 361 barrels per day in April 1986.

The volume of NGL's produced is in direct proportion to the level of natural gas production and therefore varies with the daily natural gas nominations received from the gas purchaser.

NATURAL GAS PRODUCTION

Natural gas production totalled 5,255.4 million cubic feet for the year for a daily average of 14.4 million cubic feet; a 22 percent increase from the previous year when production averaged 11.8 million cubic feet per day. Demand for natural gas peaked during our third quarter and for the month of January natural gas production averaged 20.5 million cubic feet per day.

Natural gas markets continue to be depressed and are now losing market share to heating oil because of the low prices in world oil markets. The past winter continued a recent trend of above-normal temperatures during the peak heating season which has reduced sales volumes, particularly in exports to the United States.

Very significant changes are occuring in the regulation, transportation, and marketing of Canadian natural gas which are causing major alterations in the way our industry has conducted its business for many years.

Bluesky sees opportunities in the new business environment which is emerging and is positioning itself to actively compete for gas markets in both Canada and the United States which will result in production from currently non-producing properties and from new exploration projects.

RESERVES

At April 20th, 1986, the Company's reserves were 11,420,000 barrels of crude oil, 3,656,200 barrels of natural gas liquids, and 194.7 billion cubic feet of natural gas as determined by an independent engineering firm.

Undiscounted future cash flow from these reserves over the life of the properties will be $1,095,911,000. The present value of this future cash flow, discounted at 12 percent is $305,803,000. Crude oil and natural gas prices used in determining these values reflect current market realities at the time of the study.

In the Deep Basin Area of Alberta a detailed engineering review of the Cadomin Gas Pools indicated that the recoverable reserves of natural gas could be significantly lower than originally estimated and as a result the Company's working interest reserves of natural gas and natural gas liquids (NGL's) have been reduced and is reflected under performance adjustment in the accompanying reserve table. This reduction in reserves will not affect current production and cash flow because these pools were not scheduled to commence production for several years. Reserves will be rebooked in future years based on development drilling results in the various pools.

Changes in reserves during the twelve months are detailed in the following table:

	Oil (MBbls)	NGL (MBbls)	Natural Gas (MMCF)
Reserves at April 30, 1985	11,829.0	5,105.9	234,665
Less Production	(890.7)	(97.2)	(5,255)
Exploration Drilling	250.3		3,010
Development Drilling	866.6		2,393
Performance Adjustment	(635.2)	(1,352.5)	(40,113)
Reserves at April 30, 1986	11,420.0	3,656.2	194,700

OPERATIONS

Chigwell Viking Field

Central gathering and production facilities have been installed to process the production from this field located near Ponoka, Alberta, and have been in operation since November 1985. These facilities effected an average reduction in well operating costs of 45 percent, a saving of $1800 per well per month. There are forty-two wells currently producing in this pool of which Bluesky has an interest in 35 wells. Solution gas conservation facilities are being constructed and gas processing is expected to start in August with volumes in the range of 750,000 cubic feet per day.

To test the feasibility of secondary recovery for this pool a pilot flood using one injection well is being evaluated for possible startup this fall using produced water from the central facilities. This will also result in further savings in operating costs by eliminating trucking and disposal charges.

Heath/Ribstone Area

Construction of Central production facilities has been completed and operations commenced on May 26th, 1986, treating the heavy oil production from the Company's twenty-four wells in this area. Applications for the installation of a water disposal system are awaiting regulatory approval at this time and when operational, these facilities will reduce operating costs by an estimated $1.75 per barrel in addition to greatly improving our flexibility in marketing clean oil and providing the maximum economic benefit to the Company.

Loading Oil at Edgerton Battery

Natural Gas Properties

Since the advent of gas deregulation on November 1st the Company has been systematically working to place shut in gas reserves on production, first utilizing those properties requiring low capital investment. Over the course of the next one to two years as markets are acquired, we expect to increase the Company's production by 7 to 10 million cubic feet per day.

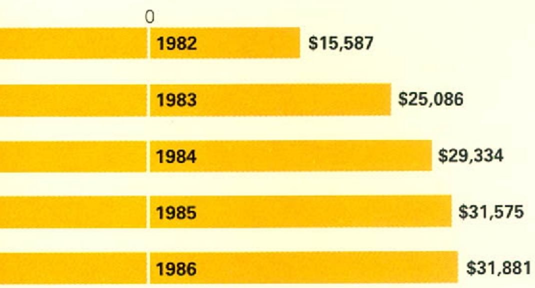
Three properties located at Mikwan, Karr, and Campbell Creek, in Alberta, now have the necessary flow lines and facilities and are contributing an additional 1.7 million cubic feet per day to Bluesky's production capability.

At Fireweed in British Columbia the flowline was installed in late March and production equipment is now in place to handle 1.0 million cubic feet per day with startup expected this summer.

During the summer of 1986 additional wells will be connected to existing production facilities at Keg River, Drumheller, and Acadia Valley, all in Alberta, which will add a net 1.6 million cubic feet per day.

Financial Review

Total Revenue
(Thousands of Dollars)



The Company's major financial event of the past year was the favorable tax ruling received from Revenue Canada dated February 28, 1986 which permitted the following actions:

1. The elimination of the "loans receivable" from the Alberta Limited Partnerships, effective as of the date originally issued, and the corresponding elimination of the deferred income thereon (in the same amount as the loans eliminated) effective as of the same dates. The Company was required to re-calculate its net income, taxable income and income tax in accordance with the above elimination of the loans and deferred income thereon with the result that all prior years' net income before income tax, income tax provision and net income have been restated to reflect the effect of the tax ruling and also to reclassify the "Share of Limited Partnerships net income" from one revenue amount to allocate the respective revenue and expense classifications as previously reported in the notes to the financial statements. The 1985 restated revenue and expense figures are shown in detail in the Statement of Income and the major restated revenues, net income and cash flow figures for 1982, 1983 and 1984 are shown in the "Consolidated Five Year Summary" portion of this report.

2. The wind-up of all of the Alberta Limited Partnerships effective January 1, 1986.

3. The amalgamation of all West German Limited Partnerships into one new West German Limited Partnership effective January 1, 1986 and the winding up of all of the original West German Limited Partnerships effective January 2, 1986. The first year end of the new West German Limited Partnership was completed March 31, 1986.

4. The withdrawal of the Company's interest in the new German Limited Partnership effective April 1, 1986 whereby the Company received its share of the Partnership's working interest in Canadian oil and gas properties and also the Company's share of the Partnership's net other assets as at April 1, 1986. The Company's withdrawal from the new West German Limited Partnership will result in the complete elimination of the Company's share of Partnership general and administrative expenses which have been as follows (thousands of dollars):

Year Ended	
April 30, 1986	$1,279
April 30, 1985	$1,021
April 30, 1984	$1,357
April 30, 1983	$1,833

During the past year the net income before extraordinary income increased 16.7% (from restated 1985 of $6,974) to $8,136 or 31.6¢ per share; the net income increased 69.4% (from restated 1985 of $7,096) to $12,020 or 46.5¢ per share; and cash flow decreased 6.3% (from restated 1985 of $19,586) to $18,356 or 71.6¢ per share.

The slight reduction in cash flow was mainly due to the world-wide collapse of crude oil prices in January, 1986 with crude oil prices remaining at approximately $14.00 (U.S.) as at the writing of this report. The Company had realized all-time record daily production of oil, gas and gas liquids for the first nine months of its fiscal year, ending January 31, 1986, with a corresponding record net production revenue for that period. The dramatic oil price reduction in the fourth quarter of 1986 resulted in converting the increase in production income to the end of the third quarter into a slight decrease in net production income for the full year of 5.3% (from restated 1985 of $29,743) to $28,162.

The Company reacted to the January, 1986 collapse of the crude oil price by immediately implementing the following actions:

1. The budget for the final quarter ending April 30, 1986 was amended based on a light crude oil price of $14.00 (U.S.) and the capital expenditure budget was decreased to remain within the limit of the amended cash flow.

2. Effective April 1, 1986 salaries of all management personnel and professional staff were frozen until October 31, 1986 at which time it is expected the price of light oil will be a minimum of $18.00 (U.S.). They will remain frozen if the price of light oil remains below $18.00 (U.S.).

3. Effective April 1, 1986 all staff additions were frozen with only replacement staff permitted.

4. The withdrawal from the new amalgamated German Limited Partnership effective April 1, 1986 results in the complete elimination of the Company's share of Partnership general and administrative expenses effective as of that date.

In addition to the above actions, the Company has reduced the U.S.A. general and administrative expenses by the following:

1. The elimination of all building lease costs due to the December 31, 1985 termination of the Houston building lease and the March, 1986 termination of the Denver building lease. These costs totalled $310,600 (Canadian) in 1986 and were expensed.

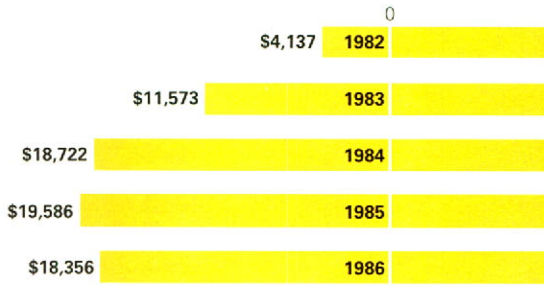
2. The elimination of the legal costs incurred and expensed in 1986 totalling $340,400 (Canadian) to successfully defend a U.S. lawsuit.

In accordance with the Corporate objective set in 1982, the Company increased its average ownership participation in the ninety-one (91) "Cost Participation Wells" drilled in 1986 to 31.6%, from 27.9% in 1985. 86.3% of the cost participation wells were successful. In addition the Company farmed out thirty-six (36) in which its ownership participation averaged 3.7%, with no Company cost participation, of which 57.4% were successful.

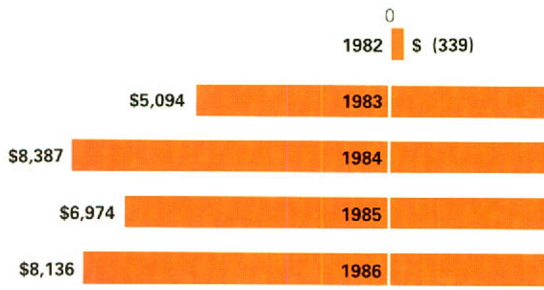
Due to the uncertainty as to the world oil pricing, the Company has prepared three separate budgets for its fiscal 1987 year based on $14.00 (U.S.) per barrel; $18.00 (U.S.) per barrel and $22.00 (U.S.) per barrel. To ensure that the Company continues to limit capital expenditures to the amount of the cash flow, the detailed capital expenditures budget has been prepared based on the low oil pricing budget of $14.00 (U.S.).

The Company has received offers to acquire certain West German Limited Partners' interests in the Canadian oil and gas properties in exchange for Series A convertible, cumulative preferred shares. The Series A preferred shares will be convertible on a 2 for 1 basis (2 common for 1 preferred) and each Series A preferred will have an annual dividend of 50¢. The exchange will be based on an asset value of the Company's common shares of $9.94 per share. The West German Limited Partners agree to sell their working interest in Canadian oil and gas properties to the Company utilizing a Section 85(1) election and also a "successor election" both elections under the Canadian Income Tax Act. The exchange will be effective July 1, 1986. Based on individual offers received at the time of writing this report, we are estimating the issuance of 250,000 Series A preferred shares.

Cash Flow From Operations
(Thousands of Dollars)



Net Income (loss) Before Extra-Ordinary Income
(Thousands of Dollars)



BlueSky Oil & Gas Ltd.

Consolidated Financial Statements

Bluesky Oil & Gas Ltd.

Consolidated Balance Sheet

As At April 30, 1986

(Thousands of Dollars)	1986	1985 Restated (Note 2)
ASSETS		
Current		
Cash in bank	**$ 39**	$ 21
Accounts receivable, trade	**7,308**	10,507
Income taxes refundable	**2,451**	181
Current portion of agreement receivable (Note 4)	**2,838**	2,286
Investment in shares, at cost	**—**	12
Marketable securities, (market value $1)	**1**	1
Inventories	**420**	253
Prepaid expenses	**107**	97
	13,164	13,358
Property and equipment, at cost		
Petroleum and natural gas properties including well development expenditures	**227,601**	212,071
Plant and equipment (Note 3)	**31,577**	26,913
Mineral properties	**2,994**	2,965
	262,172	241,949
Less accumulated depreciation and depletion	**26,591**	19,938
	235,581	222,011
Other assets		
Other loans receivable	**383**	1,365
Notes receivable (Note 9)	**1,839**	1,797
Agreement receivable	**—**	2,286
	2,222	5,448
	$250,967	$240,817

On Behalf Of The Board

Director

Director

The accompanying notes form an integral part of this statement.

	1986	1985 Restated (Note 2)
LIABILITIES		
Current		
Accounts payable and accruals	**$ 10,941**	$ 13,504
Deposit on future services	**—**	89
Deferred income	**—**	158
Petroleum and gas revenue tax payable	**270**	527
Income tax payable	**536**	618
	11,747	14,896
Deferred take-or-pay income	**5,904**	6,446
Deferred income taxes	**28,517**	25,930
Long-term debt (Note 5)	**50,596**	51,426
	96,764	98,698
SHAREHOLDERS' EQUITY		
Share capital (Note 6)		
Common		
Authorized		
100,000,000 shares		
Issued and outstanding		
25,476,792 shares	**110,155**	110,146
Preferred		
Authorized		
2,000,000 shares		
Contributed surplus	**772**	772
Retained earnings	**41,550**	29,530
Equity adjustment from foreign currency translation	**1,726**	1,671
	154,203	142,119
	$250,967	$240,817

Bluesky Oil & Gas Ltd.

Consolidated Statement of Income and Retained Earnings

For The Year Ended April 30, 1986

(Thousands of Dollars)	1986	1985 Restated (Note 2)
Revenue		
Production derived income, net of royalties and petroleum and gas revenue tax	**$28,162**	$29,743
Gain on sale of petroleum and natural gas properties	**1,940**	—
Other income	**1,779**	1,832
	31,881	31,575
Expenses		
Production	**5,594**	3,729
General and administrative	**3,871**	2,746
Interest	**6,138**	7,947
Depletion and depreciation	**6,586**	4,731
	22,189	19,153
Net income before income tax and extraordinary income	**9,692**	12,422
Income tax		
Alberta royalty tax credit	**(2,082)**	(2,000)
Income tax provision (Note 7)	**3,638**	7,448
	1,556	5,448
Net income before extraordinary income	**8,136**	6,974
Extraordinary income		
Gain on redemption of preferred shares, net of $70 income tax	—	122
Share of Limited Partnership's debt settlement	**3,884**	—
Net income	**12,020**	7,096
Retained earnings, beginning of period as restated (Note 2)	**29,530**	22,634
Preferred share dividends	—	(200)
Retained earnings, end of period	**$41,550**	$29,530

The accompanying notes form an integral part of this statement.

Bluesky Oil & Gas Ltd.

Consolidated Statement of Changes in Financial Position

For The Year Ended April 30, 1986

(Thousands of Dollars)	1986	1985 Restated (Note 2)
Financial resources were provided by		
Operations		
Net income before extraordinary income	**$ 8,136**	$ 6,974
Add non-cash items		
Depletion and depreciation	**6,586**	4,731
Deferred income tax	**3,634**	7,881
	18,356	19,586
Share of Limited Partnership's debt settlement	**2,906**	—
Proceeds on redemption of preferred shares	**2,286**	4,556
Less agreement receivable	—	(2,286)
	2,286	2,270
Decrease in investment in shares	—	12
Foreign exchange translation adjustment	**2**	34
Proceeds on issue of shares		
Common	**9**	547
Series A Preferred converted to common	—	(244)
Less notes applicable thereto	—	(140)
	9	163
Decrease in other loans receivable	**984**	33
	24,543	22,098
Financial resources were used for		
Purchase of property and equipment		
Petroleum and natural gas properties	**15,421**	15,221
Plant and equipment	**4,610**	2,802
Mineral properties, net of recoveries	**3**	(19)
	20,034	18,004
Decrease (increase) in long-term debt	**970**	(10,261)
Increase in notes receivable	**42**	—
Decrease in deferred take-or-pay	**542**	328
Redemption of Series A preferred shares	—	5,711
Preferred share dividend	—	200
	21,588	13,982
Increase in working capital	**2,955**	8,116
Working capital (deficiency), beginning of period	**(1,538)**	(9,654)
Working capital (deficiency), end of period	**$ 1,417**	$(1,538)

The accompanying notes form an integral part of this statement.

Notes to Consolidated Financial Statements

As At April 30, 1986

(Amounts Expressed in Thousands of Dollars Except for Per Share Amounts)

1 SIGNIFICANT ACCOUNTING POLICIES

These financial statements have been prepared in accordance with generally accepted accounting principles in Canada, which do not differ significantly from International Accounting Standards except no presentation has been made to provide for the effects of either specific or general price level changes. Accordingly, these financial statements reflect the following policies:

Basis of consolidation

The consolidated financial statements have been prepared based on the April 30, 1986 financial statements of the Company and its wholly-owned subsidiaries Bluesky Oil & Gas Inc., Bluesky Mining Ltd. and eee Petroleum Company Inc.

Included in the consolidated financial statements is the Company's proportionate share of increases and decreases in assets, liabilities, revenues and expenses, in respect of its interest in ten West German Limited Partnerships, since acquisition January 1, 1982. Effective January 1, 1986 all of the West German Limited Partnerships in which the Company held an interest were amalgamated into one new West German Limited Partnership.

The first year end of the new West German Limited Partnership was March 31, 1986. Accordingly, the Company has included its proportionate share of increases and decreases in the assets, liabilities, revenues and expenses of the new West German Limited Partnership for the period January 1, 1986 to March 31, 1986 in the consolidated financial statements.

Effective April 1, 1986 the Company withdrew its interest in the new West German Limited Partnership receiving its share of the Partnership's working interest in Canadian oil and gas properties and net other assets.

Translation of foreign subsidiary accounts

The accounts of the Company's wholly-owned United States subsidiaries, Bluesky Oil & Gas Inc. and eee Petroleum Company Inc., have been translated to Canadian dollars using the current rate method applicable to a self-sustaining operation. Accordingly, assets and liabilities are translated at the year end exchange rate, while income and expenses are translated at average rates in effect during the year. Exchange gains or losses arising from the translation of assets and liabilities are included as a separate component of Shareholders' Equity.

Costs of interests in petroleum and natural gas properties

The Company accounts for its investment in exploration and development activities under the full cost method of accounting. All costs related to the acquisition and development of petroleum and natural gas properties are capitalized into a North American cost centre or other country cost centre as applicable. Such costs include land acquisition costs, geological and geophysical costs, lease costs on non-producing properties, costs of drilling both productive and non-productive wells, and overhead related to exploration activities. These costs are reduced by the proceeds from the sale of oil and gas properties and by government grants.

A proportionate share of capitalized costs is netted against proceeds on disposal of a significant proportion of the Company's interest in a given cost centre. Any resulting gain or loss on such disposal is taken into income.

The Company compares the carrying value of its investment in petroleum and natural gas properties to the estimated net present value of cash flow from its oil and gas properties discounted at the Company's cost of capital, net of a provision for income taxes. Any excess of carrying values over estimated future cash flow resulting from this comparison is charged against operations.

Mineral properties

Acquisition and exploration costs of mineral properties are capitalized pending further development of the properties. Accordingly, the recovery of this investment is dependent upon the discovery of mineral reserves in commercial quantities. These costs are reduced by royalty advances received pursuant to various farmout agreements.

Inventories

Inventories consist of oilfield supplies and are carried at the lower of cost and net realizable value.

Depletion

Exploration and development costs are accumulated in a North American cost centre or other country cost centre and depleted under the revenue method of depletion on a cost centre basis.

Depreciation

Depreciation of plant and equipment is provided for under the straight-line method at rates considered to be sufficient to amortize the costs of these assets over their estimated useful lives.

Income taxes

The Company follows the tax allocation method of accounting for income taxes. Under this method, the Company provides for deferred income taxes to the extent that income taxes otherwise payable are deferred by claiming capital cost allowance and expensing exploration and development costs, for tax purposes, in excess of the depreciation and depletion provisions reflected in the financial statements.

2 PRIOR YEARS' RESTATEMENT OF INCOME

In accordance with the favorable income tax ruling received from Revenue Canada, dated February 28, 1986, the Company was permitted to:

(a) Eliminate the "loans receivable" from the Alberta Limited Partnerships effective as of the date originally issued.

(b) Eliminate the deferred net income applicable to the loans receivable.

(c) File amended income tax returns giving effect to (a) and (b) above plus give effect to the Company's share of the Limited Partnerships' amended net income for tax due to the elimination, by the Partnerships, of the loans in (a) above.

The Company was required to re-calculate its net income, taxable income and income tax in accordance with the ruling with the result that the prior years' net income has been restated as follows:

Prior years' increase (decrease)	1981 & Prior	1982	1983	1984	1985	Total
Net income before tax	$(2,951)	$ 932	$ 207	$ (329)	$ (241)	$(2,382)
Income tax						
Income tax provision	(1,867)	1,101	(542)	741	654	87
Alberta royalty tax credit	—	26	1,000	(243)	—	783
Net income	$(1,084)	$ (195)	$ (251)	$ (827)	$ (895)	$(3,252)

In addition, the comparative figures have been reclassified to conform with the current year's presentation.

3 PLANT AND EQUIPMENT

	April 30, 1986			April 30, 1985
	Cost	Accumulated Depreciation	Net Book Value	Net Book Value
Production equipment	$17,753	$ 6,038	$11,715	$10,295
Plant and gathering equipment	11,622	3,575	8,047	6,572
Office equipment	2,202	1,800	402	744
	$31,577	$11,413	$20,164	$17,611

4 AGREEMENT RECEIVABLE

The agreement receivable totalling $2,838 includes $2,286 which together with accrued interest at 7 1/2% per annum is secured by an irrevocable bank letter of credit due January 31, 1987.

5 LONG-TERM DEBT

During the year, the Company renewed its bank line of credit of $60,000 with interest at the bank prime rate, letter of credit availability of $5,600, tender credit facility of $1,000 for purposes of bidding at Crown lease sales and its $500 cheque cashing facility in New York for Bluesky Oil & Gas Inc. The bank line and additional credit facilities are secured by a debenture with a floating charge on the assets of the Company. The bank line may be utilized by the Company at any time up to December 1, 1987 and the Company has the option to convert the outstanding balance to a five-year term loan with interest at bank prime rate plus 1/2%.

In accordance with the terms of the loan agreement, the April 30, 1986 loan balance of $50,596 has been classified as a long-term debt. This amount includes $9,500 of U.S. dollar loans.

6 SHARE CAPITAL

A Common shares

(a) During the year, the Company issued the following common shares:

	Number Of Shares Issued	Amount
Pursuant to exercise of employee share options	3,000	$ 9
Balance issued April 30, 1985	28,648,592	110,146
	28,651,592	110,155
Less shares held by subsidiary at cost	3,174,800	—
Issued and outstanding, April 30, 1986	25,476,792	$110,155

As at April 30, 1986, the Company's wholly-owned subsidiary, Bluesky Oil & Gas Inc., owned 3,174,800 shares of the Company's common shares which represents 11.08% of the common shares then issued. Under an Agreement dated October 11, 1979, the Company has granted an option to a Director to purchase 48,000 of the shares then owned by the subsidiary at a price of $5.00 per share. Under the Agreement, the Director may elect to purchase 25% of the shares each year commencing October 1, 1979 of which 12,000 have been exercised.

(b) Employee Stock Option Plan

Options granted during the year at a price of $2.15 per share	239,850
Options granted during the year at a price of $2.45 per share	400,000
Options cancelled during the year	(595,350)
Net granted during the year	44,500
Options exercised during the year at $3.00	(3,000)
Balance outstanding, April 30, 1985	598,350
Balance outstanding, April 30, 1986	639,850
Shares reserved under the Employee Stock Option Plan as at April 30, 1986	358,817

The above options are exercisable at prices of either $2.15 or $2.45 per share and expire within 1 or 3 years.

B Preferred shares

Authorized — 2,000,000 shares which may be issued in a series	
Issued and outstanding	NIL

7 INCOME TAXES

The provision for income taxes for the year ended April 30, 1986 of $3,638 (restated 1985 - $7,448) have been determined as follows:

	1986	1985 Restated
Income before extraordinary income and taxes	**$ 9,692**	$12,422
Corporate income tax at 48.29% (1985 — 47.32%)	**$ 4,680**	$ 5,877
Add (deduct) the tax effect of:		
Non-deductible Crown charges	**5,849**	5,567
Earned depletion and resource allowance	**(3,756)**	(3,466)
Provincial resource royalty rebates	**(7)**	(206)
Depletion provision with no corresponding tax deduction	**727**	95
Non-taxable dividend income	**—**	(43)
Share of Limited Partnership tax pool claims with no corresponding financial deductions:		
Capital cost allowance	**(1,291)**	—
General Partners' fees	**(52)**	(118)
Eligible capital	**(2,486)**	(223)
Miscellaneous	**(26)**	(35)
Total income tax provision	**$ 3,638**	$ 7,448

8 NET EARNINGS PER COMMON SHARE

	1986	1985 Restated
(a) Basic		
Net earnings, before extraordinary income	**31.9¢**	26.6¢
Net earnings	**47.2¢**	27.1¢
(b) Fully diluted		
Net earnings, before extraordinary income	**31.6¢**	—
Net earnings	**46.5¢**	—

Net earnings per common share calculations exclude shares owned by the Company's wholly-owned subsidiary and are based on the monthly weighted average number of common shares outstanding after dividend requirements on the Series A preferred shares.

Where the exercise of the options referred to in Note 6 are non-dilutive, the fully diluted earnings have not been presented.

9 RELATED PARTY TRANSACTIONS

As at April 30, 1986 notes receivable from officers of the Company totalled $1,839 (1985 — $1,797) which notes are interest free until June 30, 1987 at which time $782 of the notes bear interest at 10%.

10 SEGMENTED INFORMATION

In view of the different economic environment under which the oil and gas industry operates in Canada and the United States, segmented information is presented on a geographical basis separating the Company's operations and total assets between Canada and the United States. The Company operates only in one business segment.

	1986			1985 Restated		
	Canada	**United States**	**Total**	**Canada**	**United States**	**Total**
Revenue	$ 27,868	$ 4,013	$ 31,881	$ 28,301	$ 3,274	$ 31,575
Expenses						
Depletion and depreciation	5,881	705	6,586	3,869	862	4,731
Other	7,741	1,724	9,465	5,755	720	6,475
	13,622	2,429	16,051	9,624	1,582	11,206
Segmented income before undernoted items	$ 14,246	$ 1,584	$ 15,830	$ 18,677	$ 1,692	$ 20,369
Interest expense			6,138			7,947
Income tax			1,556			5,448
Net income before extraordinary income			8,136			6,974
Share of Limited Partnerships' debt settlement			3,884			—
Gain on shares, net of $70 of income tax			—			122
Net income			$ 12,020			$ 7,096
Total Assets	$234,998	$15,969	$250,967	$220,007	$20,810	$240,817

11 SUBSEQUENT EVENTS

The Company has received offers to acquire certain West German Limited Partners' interests in the Canadian oil and gas properties, which until April 1, 1986 were held by the new West German Limited Partnership referred to in Note 1 under Basis of Consolidation, in exchange for Series A convertible, cumulative preferred shares. The Series A preferred shares will be convertible on a 2 for 1 basis (2 common for 1 preferred) and each Series A preferred will have an annual dividend of 50¢. The exchange will be based on an asset value of the Company's common shares of $9.94 per share. The West German Limited Partners agree to sell their working interest in Canadian oil and gas properties to the Company utilizing a Section 85(1) election and also a "successor election", both elections under the Canadian Income Tax Act. The exchange will be effective July 1, 1986.

Auditors' Report

TO THE SHAREHOLDERS

We have examined the consolidated balance sheet of Bluesky Oil & Gas Ltd. as at April 30, 1986 and the consolidated statements of income and retained earnings and of changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the Company as at April 30, 1986 and results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Deloitte Haskins & Sells.

Chartered Accountants
Calgary, Alberta
July 11, 1986

Consolidated Five Year Summary

For The Years Ended April 30		Restated (Note 3)			
FINANCIAL	**1986**	**1985**	**1984**	**1983**	**1982**
Earnings					
Production derived income, net of royalties & PGRT	**$ 28,162**	$ 29,743	$ 27,490	$ 23,169	$ 10,582
Total revenue	**$ 31,881**	$ 31,575	$ 29,334	$ 25,086	$ 15,587
Net income (loss) before extraordinary income	**$ 8,136**	$ 6,974	$ 8,387	$ 5,094	$ (339)
Cash flow from operations	**$ 18,356**	$ 19,586	$ 18,722	$ 11,573	$ 4,137
Earnings (loss) per share, before extraordinary income	**31.6¢**	26.6¢	31.0¢	18.8¢	(7.9)¢
Cash flow per share	**71.6¢**	76.3¢	69.1¢	44.9¢	22.0¢
Capital					
Property and equipment	**$262,172**	$241,949	$220,198	$204,250	$151,161
Total assets	**$250,967**	$240,817	$225,556	$208,594	$177,031
OPERATIONAL					
Reserves					
Natural gas (million cubic feet)	**194,695**	234,665	250,754	263,900	147,530
Oil (thousand barrels)	**11,420**	11,829	12,173	11,342	8,453
Natural gas liquids (thousand barrels)	**3,656**	5,106	5,437	—	—
Year's production					
Total year					
Natural gas (million cubic feet)	**5,255**	4,312	5,339	3,845	2,797
Oil (million barrels)	**890**	804	679	569	342
Natural gas liquids (million barrels)	**97**	—	—	—	—
Per day					
Natural gas (million cubic feet)	**14.40**	11.81	14.59	10.53	7.66
Oil (barrels)	**2,440**	2,203	1,856	1,560	937
Natural gas liquids (barrels)	**266**	—	—	—	—
Drilling					
Total wells (no injection wells)	**128**	100	85	51	126
Gas completions	**36**	16	22	15	43
Oil completions	**60**	58	48	28	49
Success ratio (percentage)	**75%**	74%	82%	84%	76%
Land holdings					
Gross (thousand acres)	**3,850**	5,354	5,740	7,994	13,005
Net (thousand acres)	**276**	321	353	479	415

Corporate Information

DIRECTORS

Dr. Ulrich Christopeit, 1
Managing Director,
Deutsche Tiefbohr
AG, Bad Bentheim, West Germany

Barry W. Harrison*
President & Chief Executive Officer
Calgary, Alberta

Klaus Hebben*, 1
Chairman, CAL Futures Limited
London, England

John A. Masters
President, Canadian Hunter
Exploration Ltd.
Calgary, Alberta

Ronald W. Springer*
Vice-President, Finance
Calgary, Alberta

Dr. Dietrich H. Welte
Director of Institute of Research for
Petroleum and Organic Chemistry
at the Nuclear Research Centre
Juelich, West Germany

Robert A. Wisener *,1
Managing Partner,
The MerBanco Group
Calgary, Alberta

OFFICES

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T2P 3B6 (403) 263-0690

* — Member of the Executive Committee
1 — Member of Audit Committee

WHOLLY-OWNED SUBSIDIARIES

Bluesky Oil & Gas Inc.
Bluesky Mining Ltd.
eee Petroleum Company Inc.

REGISTRAR & TRANSFER AGENT

The Canada Trust Company
Calgary, Toronto, Vancouver

AUDITORS

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Calgary, Alberta
T2P 3G6

EXCHANGE LISTINGS

The Toronto Stock Exchange
Trading Symbol: BKY

KEY EMPLOYEES

Barry W. Harrison
President & Chief Executive Officer

Arthur C. Eastly
Vice-President, Production

Ronald W. Springer
Vice-President, Finance & Secretary

Clem J. Benteau
Vice-President, Exploration

Gordon J. Kerr
Corporate Controller

Daryl W. Cook
Manager of Engineering

James G. Feeney
Manager of Operations

METRIC CONVERSION TABLE

Traditional Unit	S1 Unit	Conversion Factor
Barrel	Cubic Metre (m^3)	1 Barrel = 0.15891 Cubic Metre 1 Cubic Metre = 6.293 Barrels
Cubic Foot	Cubic Metre (m^3)	1 Cubic Foot = 0.02817 Cubic Metre 1 Cubic Metre = 35.494 Cubic Feet
Foot	Metre (m)	1 Foot = 0.30480 Metre 1 Metre = 3.281 Feet
Mile	Kilometre (km)	1 Mile = 1.60934 Kilometres 1 Kilometre = .621 Mile
Acre	Hectare (ha)	1 Acre = 0.40469 Hectare 1 Hectare = 2.471 Acres

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