DYNEX
Petroleum Ltd.

1984 Annual Report

Corporate Profile

Dynex Petroleum Ltd. is an integrated petroleum company involved in the exploration, development and production of petroleum and natural gas reserves and the operation of a contract drilling division primarily in Western Canada. The Company's principal area of interest is in the Medicine Hat field of southeastern Alberta where the company has substantial reserves of natural gas which are contracted to TransCanada PipeLines.

The contract drilling division, Dolphin Drilling, has four shallow depth rigs which operate in Alberta and southwestern Saskatchewan. In addition, the Company has minor oil and gas interests in the U.S. The Company is listed on both the Toronto and Alberta Stock Exchange and trades under the symbol "DPL".

As of April 4, 1985, the 14,958,000 outstanding common shares of Dynex were held by 680 registered shareholders. F. M. Parsons & Associates Ltd., a private Canadian company, held 5,500,000 of those shares.

Table of Contents

Highlights

Financial and Operating Highlights (thousands of dollars except per share amounts)		**1984**		1983
Financial				
Net loss	**$**	**519**	$	4,405
Per share	**$**	**0.03**	$	0.30
Cash flow from operations	**$**	**2,836**	$	1,124
Per share	**$**	**0.19**	$	0.08
Long term debt (1)	**$**	**25,998**	$	58,093
Shareholders' equity (1)	**$**	**(13,577)**	$	(37,682)
Operating				
Gross crude oil and natural gas liquids production (bbls)				
Canada		**91,918**		88,361
United States		**7,569**		29,444
Per day		**272**		323
Gross natural gas production (mcf)				
Canada		**5,951,336**		5,968,205
United States		**80,063**		302,875
Per day		**16,479**		17,181
Drilling days		**969**		761
Average utilization		**66.2%**		52.1%

(1) 1984 figures reflect the scheduled conversion of $25 million in bank debt to preferred shares relative to the restructuring of the Company's direct and indirect obligations to the Bank of Montreal.

Quarterly Summary of Stock Prices and Volumes

	High	**Low**	**Shares Traded**
Jan/84 - March/84	$0.44	$0.27	117,549
Apr/84 - June/84	$0.34	$0.21	179,290
July/84 - Sept/84	$0.33	$0.20	149,552
Oct/84 - Dec/84	$0.33	$0.18	357,328

Report to Shareholders

I am very pleased to be able to report that the past year has been one of considerable progress. We have made a number of fundamental changes that will enable Dynex Petroleum Ltd. to go forward with confidence. The most significant accomplishments were:

- The establishment of a strong management team.
- The restructuring of Dynex's debt.
- The "Canadianization" of the Company.

Our revitalized, cohesive management group is proceeding with its mandate to operate Dynex effectively and efficiently with a strong cost-conscious attitude. This team has, over the past year, reduced overhead costs significantly and tightened up the systems and procedures in all areas of operation.

The refinancing agreement, which was completed in May 1985, provides for a conversion of $25,000,000 of our debt into a five-year term preferred share issue which will carry an interest rate of ½ of prime plus two percent. The remaining portion of our debt has been converted into a loan at ¾ percent over prime and provides for an orderly payment of debt well within our projected cash flow capabilities.

This agreement will enable us over the next five years to re-invest a minimum of $10 million of our cash flow into the operations of Dynex. This will assist us in achieving our objectives of maintaining deliverability of gas reserves and accelerating the development of non-producing reserves and lands.

I am pleased to report to the shareholders that the refinancing was accomplished with no dilution to shares outstanding. The details of the agreement are elaborated upon in the financial section of this report.

Control of the Company, which formerly was held in the U.S., was returned to Canada largely through the purchase of 47 percent of the voting shares by F. M. Parsons & Associates Ltd.

1984 Results

In 1984, we reduced our losses considerably from previous years, and succeeded in increasing cash flow from $1.1 million to $2.8 million.

We recorded a loss of $0.03 per share compared with a loss of $0.30 per share in 1983. The Company would have been able to report a profit for the year if we had not had to accommodate a significant adjustment for foreign currency exchange on a large portion of our debt, which is denominated in U.S. dollars. We intend to reduce this exchange risk in 1985 by repatriating the loan into Canadian dollars.

Certain properties that were peripheral to our principal operations, and which would have required significant capital expenditures to maintain, were sold during 1984. Further reductions in general and administrative expenses, including staff reductions, have also improved our operating results.

Dynex's exploration activities over the past year were concentrated on our own lands, and were limited primarily to development drilling and low risk opportunities, in keeping with our emphasis on consolidation and reorganization. Now, with our improved financial situation, we intend to pursue a more aggressive exploration program in the future.

The Dolphin Drilling division continues to be a real asset to Dynex. In 1984, it operated at its highest utilization level in four years, and is one of the leaders in its field.

Corporate Strategy

With the refinancing in place, it is Dynex's intent to move forward to rebuild the Company's oil and gas reserves.

Our first and foremost priority is to reinvest in our existing production areas to ensure that we maintain the deliverability of our gas reserves. The strength of our Company lies in these long-life reserves and in ensuring that they are produced and delivered in the most cost-effective manner.

Our next priority is to invest in our existing lands and properties to maximize their value through further drilling.

Every effort will be made to maintain Dolphin Drilling as a quality operation which provides a strong cash flow. With the increased Canadian drilling demand, we expect that maximum usage of the rigs will be maintained over the next year.

We will continue to focus on keeping overhead low and ensuring that we have an efficient operation. We have brought in several new managers who, with our existing management team, have the ability to create a dynamic future for Dynex.

Finally, we will be alert and open to further opportunities that may present themselves; however we will not lose sight of the fact that maintaining our fiscal health is paramount.

The interests of the shareholder continue to be foremost in our minds as we decide upon company actions and policies. My own confidence in Dynex's future is reflected in the fact that I have acquired a significant ownership in the Company. I will continue to ensure that Dynex is operated to maximize its value to the shareholders.

F M Parsons

F. M. Parsons
President, Chairman and
Chief Executive Officer

May 31, 1985


NORTHWEST TERRITORIES
ALBERTA
BRITISH COLUMBIA
SASKATCHEWAN
UNITED STATES
Dahl
Pickell
Beaton
Umbach
Nig
Nettle
Bull Rush
Buick Creek
Rigel
Hotchkiss
Cub
Northern
Little Cadotte
West Utikuma
Nipisi
Swan Hills
Freeman. R.
Thunder
Little Paddle
Corbett Creek
Oldman
Brock Lake
Alexis
North Lamont
EDMONTON
Stoney Plain
Thorsby
Holborn
Ferrybank
Leedale
Sylvan Lake
Castor
Caroline
Nevis
Penhold
Sedalia
CALGARY
Buffalo
Countess
Medicine Hat
Enchant
Turin
Del Bonita
WESTERN CANADA
GAS PRODUCING PROPERTY
OIL PRODUCING PROPERTY
UNDEVELOPED PROPERTY

Exploration and Development

Dynex participated in the drilling of 19 wells during 1984, five of which were drilled in Canada and 14 in the United States. Participation was mainly through farmout agreements, so the net cost to Dynex was minimal.

Our objective for 1984 was to maximize production levels from existing properties and to sell assets deemed to be non-essential. This was accomplished. With the financial restructuring completed, development of existing lands has become our new priority. In conjunction with this, Dynex has initiated plans to bring shut-in gas wells on stream in 1985.

Expansion into new exploration plays is being investigated. The Company has planned for growth through partner-initiated plays or development of our own projects.

Medicine Hat Area

The Medicine Hat project produced at 51.7 percent of minimum annual obligation, an increase of 4.7 percent from 1983 levels. The continued lack of demand for gas has delayed the drilling of additional infill wells until such time as TransCanada PipeLines (TCPL) takes approach the original contract level of 90 percent.

Drilling Activity

	Gross	
	Exploration	Development
Oil	0	13
Gas	0	0
Dry	3	3
Total	3	16

Land Holdings (in acres)
December 31, 1984

	Developed		Undeveloped		Total	
	Gross	Net	Gross	Net	Gross	Net
Canada						
Alberta	88,289.7	38,687.1	78,636.0	23,683.8	166,925.7	62,370.9
British Columbia	—	—	12,950.1	6,330.6	12,950.1	6,330.6
Total Canada	**88,289.7**	**38,687.1**	**91,586.1**	**30,014.4**	**179,875.8**	**68,701.5**
United States						
Montana	1,280.0	410.0	4,797.3	253.9	6,077.3	663.9
New Mexico	—	—	320.0	72.0	320.0	72.0
Oklahoma	2,820.1	1,163.3	148.4	100.1	2,968.5	1,263.4
East Texas	640.8	483.7	—	—	640.8	483.7
Total U.S.A.	**4,740.9**	**2,057.0**	**5,265.7**	**426.0**	**10,006.6**	**2,483.0**
Total — Canada and U.S.A.	**93,030.6**	**40,744.1**	**96,851.8**	**30,440.4**	**189,882.4**	**71,184.5**

Production

Dynex produced 6.03 BCF of gas in 1984, 98 percent of which was produced in Canada and two percent in the United States. Crude oil and natural gas liquids production amounted to 99,487 barrels, 92 percent produced in Canada and eight percent in the United States.

During 1984, TCPL recovered four percent of "take or pay" volumes as defined under the TOPGAS Allocation Agreement. TCPL will recover a further 10 percent during 1985.

The sale of gas into the discount market accounted for 2.2 BCF during 1984 with a daily average of 6.01 MMCF/D. The blended price of discount sales averaged $1.89/MCF.

Reserves

The Corporate Reserves summary table represents volumes of Canadian oil and gas as of December 31, 1984. The numbers have been determined by independent consulting engineers. Dynex did not calculate reserve figures for the United States properties because of their minimal impact on the Company. Accordingly, no estimate has been included for 1984.

The evaluation of Canadian properties, effective December 31, 1984, found the Company's proven natural gas reserves to be 104.7 BCF. Although this represents a decrease of 4.7 BCF from December 31, 1983, cumulative Canadian production for the year was 5.95 BCF. This small decline reflects both the long-term life of our core Medicine Hat properties and their continued better than forecasted performance.

Proven crude oil and natural gas liquids reserves totalled 586,300 barrels at December 31, 1984 compared to 656,000 barrels at December 31, 1983.

Corporate Reserves
December 31, 1984

	Working Interest Reserves Before Royalties		Before Tax Present Value (000's) at 15%
	Gas (MMCF)	Oil (STB)	
Proven reserves			
Proved producing	84,591	580,900	$66,252
Proved undeveloped	20,115	5,400	10,956
	104,706	586,300	77,208
Probable reserves	2,009	316,500	4,542
Total proven plus probable	106,715	902,800	$81,750

Divisions

Dolphin Drilling

Dolphin Drilling contracts in 1984 were primarily with very active small to intermediate sized exploration companies. Dolphin recorded an impressive 66 percent activity level compared to the 50 percent average for the drilling industry.

Gross revenue for 1984 for the drilling division was $6,732,000 which is an increase of 13 percent over 1983. This increase in gross revenue coupled with efficient operations netted an operating income of $990,000, an increase of 31 percent over 1983.

Dolphin operates four drilling rigs. Rig 1 (capacity of 3,500 feet) drilled primarily in east central Alberta. Rig 2 (capacity of 2,500 feet) was active in central Alberta and southwest Saskatchewan. Rigs 1 and 2 are trailer mounted, making them very suitable for fast, efficient moves. Rigs 3 and 4 are both rated for drilling 6,500 feet and are designed for rapid moves and rig up time. Rig 3 was active in the Cherhill and Edmonton areas of Alberta. Rig 4 drilled primarily in the south central area of Alberta. The four rigs drilled a total of 221 wells for a total of 666,931 feet with an average of 242 drilling days per rig. This is an increase of 27 percent over 1983.

It is anticipated that 1985 drilling activity will be at 1984 levels or higher, and that the division will show another increase in profits.

During the spring of 1985, Dolphin Drilling started upgrading Rig 2 to a 3,500 foot depth capacity. When completed in 1986, this added versatility will allow the rig to drill heavy oil wells in Saskatchewan as well as gas wells in central Alberta.

M-P Oils Ltd.

In 1983, Dynex sold its LPG marketing division to M-P Oils Ltd. (M-P), a company owned by the former employees of the division. M-P was formed to purchase, resell and ship propane and butane to wholesale and retail distributors throughout North America. Under the terms of the sales agreement, Dynex is entitled to a 50 percent share of the pre-tax profits of M-P over a maximum three year period expiring in 1985 and the assumption, by M-P, of the Company's remaining tank car obligations. M-P elected to terminate the arrangement on January 1, 1985 by assuming the liability on the unexpired tank car leases. Dynex's share of M-P profits was $127,000 for 1984.

Five Year Operating Summary (Canada and U.S.A.)

	Year Ended December 31,		Seven Months Ended December 31, 1982	Year Ended May 31,	
	1984	1983		1982	1981
Gross Products Sales					
Natural Gas — MMCFD	**16.479**	17.181	14.713	20.210	18.050
Crude Oil — BOPD	**272**	323	406	375	320
Average Sale Price					
Natural Gas $/MCF	**2.41**	2.32	2.92	2.59	2.47
Crude Oil $/Bbl	**37.91**	34.28	31.00	31.15	26.52
Total Reserves (After Royalties)					
Natural gas — BCF	**73.7**	80.4	89.2	103.1	104.1
Crude Oil (Bbls. x 1,000)	**587.3**	698.4	998.2	1,314.3	1,494.1
Land Holdings					
Canada					
Gross Acres	**179,875**	243,319	260,784	264,921	239,900
Net Acres	**68,701**	98,072	99,475	110,701	108,100
United States					
Gross Acres	**10,006**	14,868	73,494	89,120	112,300
Net Acres	**2,483**	6,262	32,299	37,736	51,000
Total					
Gross Acres	**189,881**	258,187	334,278	354,041	415,200
Net Acres	**71,184**	104,334	131,774	148,437	165,400
Wells Drilled					
Gas	**—**	5	29	9	47
Oil	**13**	6	8	11	30
Dry	**6**	3	2	8	19
Total	**19**	14	39	28	96

Five Year Financial Summary

(000's of dollars except per share amounts)	Year Ended December 31, 1984	1983	Seven Months Ended December 31, 1982 (restated)	Year Ended May 31, 1982 (restated)	1981 (restated)
Revenue					
Oil and gas	**$ 11,856**	12,284	7,669	12,735	11,201
Drilling	**6,732**	5,932	3,830	7,230	7,678
Operating revenue	**18,588**	18,216	11,499	19,965	18,879
Interest and other	**873**	644	490	724	1,345
	19,461	18,860	11,989	20,689	20,224
Costs, expenses and taxes					
Operating cost of sales	**7,064**	7,905	5,414	9,300	7,773
General and administrative	**1,986**	2,934	1,234	2,590	2,511
Interest	**6,701**	6,759	5,886	11,873	5,914
Depletion, depreciation and amortization	**2,262**	2,106	3,223	6,771	4,335
Provision for asset impairment	**—**	2,910	4,539	11,566	9,403
Loss (gain) on foreign exchange	**881**	1,072	36	(304)	(93)
Loss on discontinued operation	**—**	—	127	1,863	372
Taxes	**1,086**	(421)	(1,012)	(1,719)	157
	19,980	23,265	19,447	41,940	30,372
Loss before extraordinary item	**519**	4,405	7,458	21,251	10,148
Extraordinary item	**—**	—	—	243	—
Net Loss	**$ 519**	4,405	7,458	21,008	10,148
Loss per share					
Before extraordinary item	**$ 0.03**	$ 0.30	$ 0.50	$ 1.44	$ 0.69
After extraordinary item	**$ 0.03**	$ 0.30	$ 0.50	$ 1.42	$ 0.69
Funds provided by (applied to) operations	**$ 2,836**	1,124	162	(2,104)	4,278
Capital employed					
Working capital (deficiency)	**(961)**	3,868	3,941	1,436	3,771
Property, plant and equipment	**29,448**	32,990	40,065	45,642	56,379
Other	**265**	263	524	3,753	659
	$ 28,752	37,121	44,530	50,831	60,809
Capital employed comprised of					
Long-term debt	**$ 50,998**	58,093	57,942	62,789	51,434
Deferred revenue	**$ 11,610**	13,289	11,216	4,949	4,576
Deferred income taxes	**$ 4,721**	3,421	2,921	3,184	3,684
Shareholders' equity	**$(38,577)**	(37,682)	(27,549)	(20,091)	1,115
Common shares outstanding (000's of shares)	**14,958**	14,940	14,780	14,780	14,780
Capital expenditures					
Acquisitions and land retention	**$ (21)**	360	538	1,617	7,255
Geological and geophysical	**122**	556	648	1,407	1,354
Drilling and equipping	**185**	605	1,010	9,188	24,914
Cost of finding and developing reserves	**286**	1,521	2,196	12,212	33,523
Other	**296**	67	102	840	2,246
	$ 582	1,588	2,298	13,052	35,769

(1) Years prior to December 31, 1983 have been restated to reflect the retroactive change in full cost accounting to separate cost centres for Canada and the United States and to reflect the settlement in 1983 of prior years' income tax reassessments.

Financial Review

Since 1981, the financial results of Dynex Petroleum Ltd. have been severely affected by high interest costs, a reduced export market for natural gas and lower than anticipated prices for both oil and natural gas.

For the year ended December 31, 1984, Dynex incurred a loss of $519,000 ($0.03 per share) compared to a loss of $4,405,000 ($0.30 per share) in 1983.

Revenue

Operating revenue for 1984 was $18.6 million, a two percent increase from the $18.2 million reported a year ago. The divisional results are summarized in the accompanying table of Comparative Results by Operating Segments.

Revenue from the sale of oil and natural gas amounted to $11.8 million in 1984, a reduction of 3.5 percent from the $12.3 million reported in 1983. Revenue gains experienced by the Company's Canadian oil and gas operations were more than offset by reduced U.S. revenue resulting from the sale of some producing properties.

The production of natural gas in the current reporting period averaged 16,479 mcf per day, a 4.1 percent decrease from the 17,181 mcf per day reported in 1983. Canadian natural gas production of 5,951 mmcf (16,260 mcf per day) was down marginally from a year ago due to the sale of our Rattlesnake property effective October 1, 1984. Sales of natural gas to TCPL, however, increased 16.2 percent to 3,729 mmcf. Accordingly, the average selling price for total Canadian gas production increased 7.6 percent to $2.39 per mcf. Revenue before royalties increased to $14.2 million from the $13.3 million reported in 1983. These results are summarized in the table below.

Oil production was also down from a year ago where decreased U.S. production more than offset any production gains in Canada. In 1984, production of 272 barrels per day (BOPD) was 15.8 percent lower than average 1983 daily production. However, average selling prices in Canada increased 14.8 percent to $38.94 per barrel from a year earlier. This increase is attributable to a full year of New Oil Reference Price (NORP) pricing for our principal oil property at Nipisi in 1984. Nipisi production did not become eligible for NORP pricing until July 1, 1983.

Drilling revenue of $6.7 million was 13.5 percent greater than the $5.9 million reported in 1983. This increase reflects higher levels of rig utilization which averaged 66 percent in 1984 compared to 52 percent in 1983.

Costs and Expenses

Operating cost of sales was $7.1 million in 1984 compared to $7.9 million in 1983, a decrease of 10.6 percent.

For the petroleum division, operating cost of sales of $1.3 million was 51.5 percent less than the $2.7 million reported in 1983. A reduction in U.S. cost of sales accounts for approximately one half of the improvement. In Canada, an increase in cost recoveries from third parties and lower turnaround costs at our two compressor stations account for the reduction in operating expenditures from a year earlier.

Higher levels of rig utilization in 1984 resulted in a reduction in operating cost of sales, expressed as a percent of revenue, from 87.3 percent in 1983 to 85.3 percent in 1984. Operating cost of sales was $5.7 million in 1984 compared to $5.2 million in 1983.

General and administrative expense was $2.0 million in 1984, a reduction of 32.3 percent from the $2.9 million reported last year. This improvement is largely a result of the closure of our U.S. offices.

Interest expense for 1984 was $6.7 million compared to $6.8 million for the previous year. Although average long term debt outstanding of $51.0 million was lower than the $56.4 million reported in 1983, higher interest rates in the second and third quarters of 1984 increased the average effective interest rate for 1984 to 13.2 percent from the 11.9 percent reported in 1983.

Depletion, depreciation and amortization was $2.3 million for 1984 compared to $5.0 million for 1983. The decrease of $2.7 million is attributable to the $2.9 million provision for impairment in the carrying value of oil and gas properties which was recognized in 1983.

The loss on foreign exchange results from the translation of U.S. dollar denominated bank debt to its Canadian dollar equivalent using the year end rate of exchange. The foreign exchange loss for 1984 amounted to $0.9 million versus $1.1 million for 1983.

Higher Canadian oil and gas revenue and lower production expenses resulted in a 27 percent increase in Petroleum and Gas Revenue Tax (PGRT) in 1984. PGRT was $1.1 million in 1984 versus $0.8 million in 1983. A reduction in the Alberta Royalty Tax Credit (ARTC) from 75 percent of Alberta Crown royalties to 50 percent effective January 1, 1984 resulted in a 26.9 percent reduction in ARTC for 1984. Increased revenues and lower expenses in Canada were the major contributing factors which resulted in an increase in deferred taxes from $0.5 million in 1983 to $1.3 million in 1984.

Analysis of Canadian Gas Sales

	Sales (mmcf)		Revenue (1) (000's)		Price/mcf ($)	
	1984	1983	1984	1983	1984	1983
TPCL	**3,729**	3,208	**$10,056**	8,203	**2.70**	2.56
Discount and other	**2,222**	2,760	**4,196**	5,604	**1.89**	1.84
Total	**5,951**	5,968	**$14,252**	13,267	**2.39**	2.33

(1) Before Crown and freehold royalties.

Comparative Results By Operating Segments

(000's of $)	CANADA		UNITED STATES		TOTAL	
	1984	1983	1984	1983	1984	1983
Operating Revenue						
Oil and gas	**$11,312**	10,355	**544**	1,929	**11,856**	12,284
Drilling	**6,732**	5,932	**—**	—	**6,732**	5,932
	$18,044	16,287	**544**	1,929	**18,588**	18,216
Operating Cost of Sales						
Oil and gas	**$ 1,125**	1,818	**197**	910	**1,322**	2,728
Drilling	**5,742**	5,177	**—**	—	**5,742**	5,177
	$ 6,867	6,995	**197**	910	**7,064**	7,905

Changes in Financial Position

Funds provided from operations increased 152 percent to $2.8 million from $1.1 million a year ago. The disposition of the Company's Rattlesnake property generated $1.9 million in sales proceeds. Additional bank borrowings. which is attributable to the foreign exchange adjustment on our U.S. dollar denominated debt, provided $865,000 in working capital. An increase in deferred natural gas revenue and an issuance of shares contributed a further $98,000 resulting in total funds available for capital expenditures and debt retirement of $5.7 million.

Capital expenditures, including $125,000 in capitalized overhead, amounted to $582,000 in 1984. A reduction in long term debt of $8.3 million includes a reclassification of $6.5 million from long term to current. This debt reclassification consists of a demand made on certain bank guaranteees for advances made to various associated companies of Dalco Petroleum Corporation (formerly the controlling shareholder), on which Dynex has not paid. Deferred natural gas revenue was reduced by $1.6 million in 1984, including $1.1 million reclassified to current liabilities.

Working capital was reduced by $4.8 million in 1984 and amounted to a deficiency of $961,000 at December 31.

Financial Restructuring

During May 1985, we successfully concluded its negotiations with the Bank of Montreal and Revenue Canada relative to the restructuring of Dynex's consolidated bank indebtedness which amounted to $57.4 million, including $6.5 million reclassified to current liabilities, at December 31, 1984.

Under the terms of the restructured credit facility, $25 million of debt will be converted to preferred shares having a maximum term of five years, as allowed under the provisions of the Income Tax Act, Canada. Preferred share dividends will be payable at one-half of Bank of Montreal prime rate plus two percent. The preferred shares are redeemable and retractable at their face value.

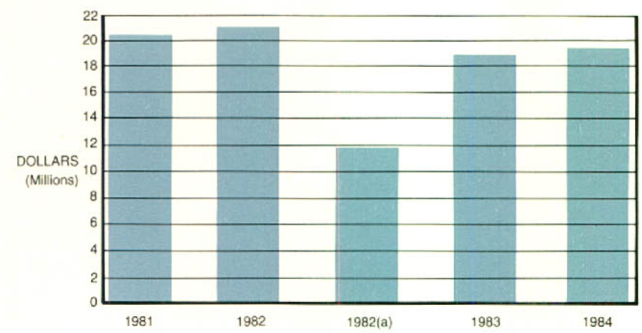
The remaining $32.4 million of bank debt will bear interest of bank prime plus ¾ of one percent per annum. At the Company's option, however, interest in excess of 10 percent on $21.4 million of the remaining debt can be paid in the form of non-interest bearing Interest Deferral Notes (IDN's) which will have an expected maturity date of June 30, 1990 and which can be converted in whole or in part, at the Bank of Montreal's option, to common shares of the Company at the then prevailing market price. The IDN's, however, are viewed as a "safety valve" to protect the Company from any dramatic increases in interest rates and it is our current intention that all future interest obligations will be paid in cash. As a consequence, existing shareholders will suffer no dilution under the terms of the refinancing agreement.

The restructured facility requires that the Company make debt repayments of $5.5 million over a five year period payable in quarterly installments commencing in July 1986. Annual repayments for the years ended June 30 are $500,000 in 1987, $2,000,000 in each of 1988 and 1989 and $1,000,000 in 1990.

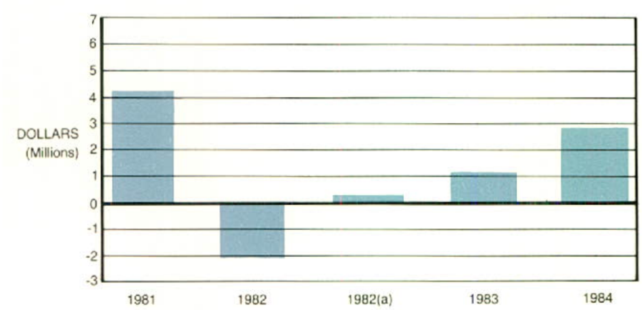
The Company is authorized, however, to commit to an aggregate of $10 million in capital expenditures during the five year term the preferred shares are outstanding. This will allow Dynex to expand upon its existing oil and natural gas reserve base in Western Canada and facilitate the accelerated and enhanced development of its non-producing reserves.

This restructuring, which is expected to generate a minimum of one million dollars in additional cash flow during each of the five years of the agreement results in the following:

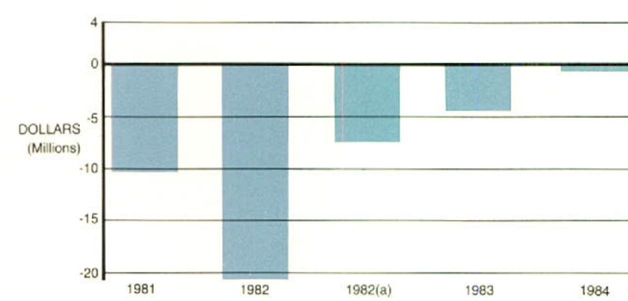
1. Although our debt is still at floating rates, the preferred share issue will substantially reduce our exposure to any future increase in interest rates.
2. Our debt has been rescheduled to provide for an orderly repayment well within our cash flow capabilities, with a deferral of mandatory repayments until July 1986. The rescheduling also makes provisions for capital reinvestment to facilitate future growth.
3. The restructuring has been completed with no present or anticipated future dilution to existing shareholders.
4. Dynex is now positioned to raise additional equity capital once the financial community gives recognition to the Company's new financial strength.



GROSS REVENUE



CASH FLOW



NET EARNINGS

(a) For the seven months ended December 31, 1982.

Consolidated Balance Sheet

	December 31, 1984	1983
ASSETS		
Current assets		
Cash and short term deposits	**$ 7,418,000**	$ 2,817,000
Accounts receivable	**4,427,000**	7,670,000
Income tax recoverable	**—**	1,013,000
Inventories	**87,000**	134,000
Prepaid expenses and other assets	**59,000**	323,000
Total current assets	**11,991,000**	11,957,000
Property, plant and equipment (Note 2)	**85,791,000**	85,209,000
Less accumulated depreciation and depletion	**56,343,000**	52,219,000
	29,448,000	32,990,000
Other assets (Note 3)	**265,000**	263,000
	$41,704,000	$45,210,000
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable and accrued liabilities	**$ 5,355,000**	$ 5,889,000
Deferred revenue (Note 5)	**1,100,000**	—
Current portion of long term debt	**6,497,000**	2,200,000
Total current liabilities	**12,952,000**	8,089,000
Long term debt (Note 4)	**50,998,000**	58,093,000
Deferred revenue (Note 5)	**11,610,000**	13,289,000
Deferred income taxes	**4,721,000**	3,421,000
Shareholders' equity		
Share capital (Note 7)	**9,978,000**	9,972,000
Deficit	**(46,068,000)**	(45,167,000)
Receivable in respect of employee share purchase plans (Note 8)	**(2,487,000)**	(2,487,000)
	(38,577,000)	(37,682,000)
Contingencies (Notes 4 and 9)		
	$41,704,000	$45,210,000

On behalf of the Board

F.M. Parsons, Director   A.R. Smith, Director

See accompanying notes to consolidated financial statements.

Consolidated Statement of Earnings

	Year Ended December 31, 1984	1983
Revenue		
Operating	**$18,588,000**	$18,216,000
Interest and other	**873,000**	644,000
	19,461,000	18,860,000
Expense		
Operating cost of sales	**7,064,000**	7,905,000
General and administrative	**1,986,000**	2,934,000
Interest on long term debt	**6,701,000**	6,759,000
Depletion	**1,495,000**	1,103,000
Depreciation and amortization	**767,000**	1,003,000
Provision for impairment in carrying value of oil and gas properties	**—**	2,910,000
Loss on foreign exchange	**881,000**	1,072,000
	18,894,000	23,686,000
Earnings (loss) before taxes	**567,000**	(4,826,000)
Taxes (Note 6)		
Petroleum and gas revenue tax	**1,083,000**	853,000
Alberta royalty tax credit	**(1,297,000)**	(1,774,000)
Deferred income taxes	**1,300,000**	500,000
	1,086,000	(421,000)
Net loss	**$ 519,000**	$ 4,405,000
Loss per share	**$ 0.03**	$ 0.30

See accompanying notes to consolidated financial statements.

Consolidated Statement of Deficit

	Year Ended December 31, **1984**	1983
Deficit, beginning of year	**$45,167,000**	$34,647,000
Net loss	**519,000**	4,405,000
Payment demanded under bank guarantees issued on associated companies indebtedness (Note 9)	**382,000**	6,115,000
Deficit, end of year	**$46,068,000**	$45,167,000

See accompanying notes to consolidated financial statements.

Auditors' Report to the Shareholders

We have examined the consolidated balance sheet of Dynex Petroleum Ltd. as at December 31, 1984 and the consolidated statements of earnings, deficit and 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 financial statements present fairly the financial position of the Company as at December 31, 1984 and the 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.

Calgary, Canada
March 8, 1985

Peat, Marwick, Mitchell & Co.
Chartered Accountants

Consolidated Statement of Changes in Financial Position

	Year Ended December 31, 1984	1983
Working capital derived from		
Operations		
Net loss	**$ (519,000)**	$(4,405,000)
Depletion, depreciation and amortization	**2,262,000**	2,106,000
Provision for impairment in carrying value of oil and gas properties	**—**	2,910,000
Deferred income taxes	**1,300,000**	500,000
Provision in respect of employee share purchase plan	**—**	202,000
Deferred revenue — product exchange	**(207,000)**	(189,000)
Funds provided from operations	**2,836,000**	1,124,000
Guarantees of associated companies debt (Note 9)		
Increase in long term debt	**382,000**	6,115,000
Payment demanded under bank guarantees	**(382,000)**	(6,115,000)
	—	—
Recovery of prepaid income taxes	**—**	733,000
Proceeds on sale of property, plant and equipment	**1,862,000**	3,647,000
Increase in deferred natural gas revenue	**92,000**	2,316,000
Increase in long term debt	**865,000**	968,000
Issue of shares	**6,000**	150,000
	5,661,000	8,938,000
Working capital applied to		
Reduction of long term debt	**8,342,000**	6,932,000
Additions to property, plant and equipment	**582,000**	1,588,000
Reduction of deferred natural gas revenue	**1,564,000**	54,000
Prepayment of income tax assessment	**—**	436,000
Other	**2,000**	1,000
	10,490,000	9,011,000
Working capital (deficiency)		
Increase (decrease) in working capital	**(4,829,000)**	(73,000)
Working capital, beginning of year	**3,868,000**	3,941,000
Working capital (deficiency), end of year	**$ (961,000)**	$ 3,868,000

See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements

Year Ended December 31, 1984

1. **Summary of Accounting Policies**

(a) **Principles of Consolidation**

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, Dynex Energy Inc. Approximately 52 percent of all issued and outstanding shares of the Company are owned by Dalco Petroleum Corporation, a company currently in Chapter 11 bankruptcy proceedings in the United States.

(b) **Foreign Currency Translation**

Foreign currency balances included in the consolidated financial statements have been translated to Canadian dollars on the following basis:

Monetary assets and liabilities — at the year end rate of exchange.

Non-monetary assets and liabilities — at the exchange rate in effect at the date of the transaction.

Revenue and expense — at the average rate of exchange for the period except depletion, depreciation and amortization which are translated on the same basis as the assets to which they relate.

The resultant gains or losses are included in the statement of earnings, consistent with the recommendations of The Canadian Institute of Chartered Accountants.

(c) **Oil and Gas Operations**

The Company follows the full cost method of accounting for petroleum and natural gas properties and related expenditures under which all costs related to the exploration for and the development of petroleum and natural gas reserves are capitalized into separate Canadian and United States cost centres. Such costs include those related to lease acquisitions and retention, geological and geophysical activities including overhead related to exploration and the costs of drilling productive and non-productive wells.

The Company applies a "ceiling test" to capitalized costs for each cost centre to ensure that such costs do not exceed the estimated future net revenues from production of total proven reserves, at current prices and costs, plus the estimated fair market value of undeveloped acreage.

Depletion of petroleum and natural gas properties and depreciation of production equipment are calculated on the unit-of-production method based upon estimated net proven developed reserves in each country.

Other equipment is depreciated on a declining balance basis at rates varying from 10 percent to 30 percent per annum.

Substantially all of the Company's petroleum and natural gas exploration and production activities are conducted jointly with others and accordingly, these financial statements reflect only the Company's proportionate interest in such activities.

(d) **Inventories**

Inventories of materials and supplies are stated at the lower of average cost and current replacement cost.

(e) **Deferred Natural Gas Revenue**

Deferred natural gas revenue represents amounts received pursuant to "take-or-pay" natural gas contracts. These amounts have been deferred pending recovery through future gas deliveries.

(f) **Investment Tax Credits**

Income tax expense is reduced by the flow through of allowable investment tax credits.

(g) **Earnings Per Share**

Basic earnings per share is calculated using the weighted average number of shares outstanding. Fully diluted earnings per share, which assumes the exercise of all outstanding share options, is anti-dilutive and therefore not presented.

2. Property, Plant and Equipment

	1984		1983	
	Assets At Cost	**Accumulated Depreciation and Depletion**	Assets At Cost	Accumulated Depreciation and Depletion
Petroleum and gas interests including exploration and development costs thereon	**$69,607,000**	**$48,474,000**	$69,378,000	$46,029,000
Production equipment and related facilities	**9,479,000**	**4,434,000**	9,423,000	3,249,000
Drilling rigs and equipment	**6,146,000**	**2,974,000**	5,852,000	2,538,000
Other	**559,000**	**461,000**	556,000	403,000
	16,184,000	**7,869,000**	15,831,000	6,190,000
	$85,791,000	**$56,343,000**	$85,209,000	$52,219,000

3. Other Assets

	1984	1983
Due from parent company, net of provision for loss (Note 11)	**$167,000**	$159,000
Investment, at cost (no quoted market value)	**76,000**	76,000
Other	**22,000**	28,000
	$265,000	$263,000

4. **Long Term Debt**

The long term debt of the Company is comprised of the following loans and contracts:

	1984	1983
Demand non-revolving bank loan bearing interest at prime plus ¾% with repayment from net revenues derived from present and hereafter acquired properties, assets and undertakings and from the net proceeds of asset sales. The facility is secured by a registered assignment of certain oil and gas properties under Section 177 of the Bank Act; a pledge to hold and continue to hold all moneys of the Company as cash collateral for the benefit of the bank; a debenture creating a first fixed mortgage and charge on drilling rigs and a first floating charge on the Company's remaining properties, assets and undertakings; an assignment of proceeds which accrue to the Company pursuant to sales agreements with the Company's principal gas purchaser and a general assignment of book debts	**$ 6,900,000**	$ 6,294,000
Notes payable (see below)	**22,549,000**	25,728,000
Demand non-revolving bank loan in the amount of U.S. $16,250,000 (1983 — U.S. $17,400,000) bearing interest at U.S. prime plus 1¼% with repayment from net cash flow from operations and the net proceeds of asset sales. The bank loan is secured by a registered assignment of the Company's interest in hydrocarbons, equipment, accounts, contract rights, and other properties in the United States. The loan is also guaranteed by Dalco Petroleum Corporation and is secured by 4,000,000 common shares of Dynex Petroleum Ltd.	**21,472,000**	22,079,000
Demand of U.S. $4,917,000 made under certain bank guarantees for advances made to associated companies of Dalco Petroleum Corporation (see Note 9)	**6,497,000**	6,115,000
Other	**77,000**	77,000
	57,495,000	60,293,000
Less current portion	**6,497,000**	2,200,000
	$50,998,000	$58,093,000

Notes payable of $22,549,000 (1983 — $25,728,000) consist of Bankers' Acceptances maturing on January 9, 1985 with a weighted average interest rate of 12.9 percent. These notes payable are shown as long term debt because they are supported by the availability of loans under the Company's Canadian non-revolving credit line.

The Company is in default under the terms and provisions of its outstanding debt instruments with its principal banker. This default arises from the inability of the Company to satisfy its obligations to its principal banker on a timely basis in respect of those demands made pursuant to guarantees for advances made to certain associated companies of Dalco Petroleum Corporation. Although the bank can accelerate payment under the terms of the outstanding loan agreements, it has not done so. If the financial support of the bank is withdrawn, the Company may be unable to continue realizing its assets and discharging its liabilities in the normal course of business. The financial statements have been prepared on a going concern basis and accordingly do not include any adjustments relating to the recoverability and classification of the recorded asset amounts and classification of liabilities should the support of the principal banker be withdrawn.

5. **Deferred Revenue**

	1984	1983
Deferred natural gas revenue, net of current portion	**$10,498,000**	$11,970,000
Deferred revenue — product exchange	**1,112,000**	1,319,000
	$11,610,000	$13,289,000

(a) **Deferred Natural Gas Revenue**

This represents amounts received for annual contracted volumes not taken by gas purchasers. The delivery of gas and the recognition of revenue in respect of those payments attributable to the Company's major gas purchaser commenced in November, 1984. Under the terms of the applicable contracts, the take or pay volumes are recovered from future gas production at a rate varying between 10 percent and 20 percent per contract year. Accordingly, $1,100,000 in take or pay volumes estimated to be recoverable in 1985 is classified as a current liability.

During the year, the Company received $92,000 (1983 — $2,316,000) for contracted volumes not taken and $464,000 (1983 — $54,000) was recovered through gas deliveries.

(b) **Deferred Revenue — Product Exchange**

	1984	1983
Reduction in product exchange liability	**$ 6,116,000**	$ 6,116,000
Loss on underground storage construction contract	**(1,044,000)**	(1,044,000)
Overriding royalties — Odessa	**(303,000)**	(303,000)
Payment received under royalty agreement	**200,000**	200,000
Write-down of Dalco Petroleum, Inc. account (1976)	**(1,857,000)**	(1,857,000)
	3,112,000	3,112,000
Amortization	**2,000,000**	1,793,000
	$ 1,112,000	$ 1,319,000

In 1974 and 1975 a series of transactions were entered into with the El Paso Company ("El Paso") and others, which transactions were accounted for as related transactions.

The resultant gain on these transactions is being amortized to income in amounts proportionate to royalty payments made under the Odessa overriding royalty agreement.

6. **Taxes**

Total taxes amounted to $1,086,000 (1983 — a recovery of $421,000). The total is different from the expected amount computed by applying the combined expected Canadian federal and provincial tax rates to earnings (loss) before taxes. The reasons for these differences are as follows:

	1984	1983
Computed tax expense	**$ 266,000**	$(2,268,000)
Add (deduct):		
Disallowed payments to Crown, net of provincial rebates and credits	**(111,000)**	(483,000)
Loss of subsidiary	**1,907,000**	3,108,000
Petroleum and gas revenue tax	**1,083,000**	853,000
Resource allowance on resource profits	**(1,665,000)**	(1,566,000)
Earned depletion on resource profits	**(373,000)**	(184,000)
Other	**(21,000)**	119,000
	$1,086,000	$ (421,000)

The Company had unused non-capital losses and various other tax pools aggregating $48,900,000 (1983 — $46,600,000) for both Canadian and U.S. tax purposes, the tax benefits of which have not been recognized in the accounts. For Canadian tax purposes, the portion of the unused deductions which are applicable to non-capital losses expire as follows: 1985 — $1,800,000; 1986 — $3,700,000; 1987 — $6,300,000; 1988 — $6,300,000 and 1989 — $6,700,000. For U.S. purposes, however, the tax benefits pertaining to these deductions do not begin expiring until 1995. In addition, the Company has unrecognized investment tax credits of $868,000 (1983 — $996,000) for deduction against future income taxes.

7. **Share Capital**

(a) **Authorized and Issued Shares**

The authorized and issued share capital of the Company is as follows:

	Authorized		Issued	
	1984	1983	**1984**	1983
First Preference preferred shares of a nominal or par value of $10 each	**10,000,000**	10,000,000	**—**	—
Second Preference preferred shares of a nominal or par value of $1 each	**144**	144	**—**	—
Class A Voting Shares without nominal or par value	**100,000,000**	100,000,000	**10,317,999**	10,299,999
Class B Non-Voting Shares without nominal or par value	**100,000,000**	100,000,000	**4,640,001**	4,640,001

The Class B Non-Voting Shares are fully participating and rank equally with the Class A Voting Shares of the Company but have no voting privileges attached. The Class A Voting and Class B Non-Voting Shares are inter-convertible on a one-for-one basis with the restriction that after conversion, the registered holder of Class B Non-Voting Shares cannot be the registered owner of more than 50 percent of the then issued and outstanding Class A Voting Shares of the Company. This restriction shall be automatically waived in the event of a bonafide offer to purchase all or a major portion of the Class A Voting and Class B Non-Voting Shares.

During the year, the Company issued 18,000 Class A Voting Shares at an ascribed value of $6,000 for consulting services provided by a former director of the Company.

(b) **Stock Options**

As at December 31, 1983, options were outstanding to acquire 212,000 Class A Voting Shares of the Company at a price of 50 cents per share on varying dates to December 31, 1985. Options to acquire 112,000 Class A Voting Shares were cancelled in 1984. During the year, an option to acquire an additional 300,000 Class A Voting Shares at an exercise price of 30 cents per share was granted. The option so granted may be exercised as to one third of the option awarded for each of the three years subsequent to the date of grant and expires two years from the date exercisable for each of the three years of the plan. At December 31, 1984, options to acquire 400,000 Class A Voting Shares of the Company were outstanding.

8. **Employee Share Purchase Plan**

As at December 31, 1984 and 1983 there were 527,700 shares remaining to be distributed on which there were outstanding loans of $2,487,000. These shares are held by a trustee and the loan is only realizable against the shares. The Company has suspended all further earnings under the plan and all allocated shares in the plan are unearned.

9. **Contingencies**

(a) **Bank Guarantees**

The Company is liable as a guarantor for advances to associated companies in the amount of $6,497,000 (U.S. $4,917,000) on which the Company's principal banker has demanded payment. This amount has been reflected as long term debt (Note 4) in the accounts. In the event the guarantees demanded are paid, the Company may also be liable for withholding tax of approximately $650,000 and interest charges in the approximate amount of $1,350,000 calculated at a rate of 117.5 percent per annum of bank prime from the date of demand. If the Company makes any payments pursuant to the said guarantees, it may be subrogated to the rights of the principal banker and may be entitled to seek contribution from the other co-guarantors of the outstanding bank debt of the Company's associated companies. In addition, the Company may be entitled to indemnification by the associated companies who were the recipients of the bank advances. The amount of any additional liability or potential recovery of funds in relation to these guarantees has not been reflected in the accounts since they are contingent upon the amount of the monies, if any, to be advanced pursuant to the outstanding guarantees.

(b) **Kansas Lawsuit**

The Company was a defendant in a lawsuit alleging conspiracy and wrongful diversion of corporate opportunity which lawsuit was originally filed in 1977 in the United States District Court of Kansas. The Company and its former co-defendants at trial incurred a judgment in the amount of U.S. $4.7 million, reduced upon appeal to U.S. $3.9 million. This judgment has been fully paid by the Company's co-defendant.

Dalco Petroleum Corporation has agreed to indemnify the Company from any liability arising out of the legal proceedings described above and has posted two million Class "B" Non-Voting Shares of the Company as security against such indemnity. The Company, upon satisfying itself that there is no ancillary liability relating to the above proceedings, will consent to the release of the security.

(c) **Net Profits Interest**

The holders of a net profits interest on one of the Company's principal gas properties have alleged that they are not subject to interest costs associated with amounts received by the Company, as a working interest holder, in respect of contracted gas volumes not taken by gas purchasers. Examinations for Discovery have been concluded and the Company is currently awaiting the establishment of a trial date. The amount of the claim has not been determined and the Company's counsel is of the opinion that the Company's position is defensible should the litigation proceed.

10. **Segmented Information** (thousands of dollars)

The operations of the Company are divided into two business segments. Oil and gas includes the exploration for, and the development and production of petroleum and natural gas reserves and the drilling operations involve the activities of four drilling rigs in Canada.

	Oil and Gas		Drilling	Other		Consoli-dated
	Canada	U.S.	Canada	Canada	U.S.	
Industry and Geographic — 1984						
Revenue earned from outside the enterprise	$11,312	544	6,732	856	17	19,461
Segmented operating profit	$ 8,258	277	266	791	17	9,609
General corporate expenses						1,460
Interest expense						6,701
Loss on foreign exchange						881
Taxes						1,086
						10,128
Net loss						$ 519
Identifiable assets	$34,935	1,246	5,002	318	202	41,704
Capital expenditures	$ 264	22	294	2	—	582
Depletion, depreciation and amortization	$ 1,690	70	436	66	—	2,262
Industry and Geographic — 1983						
Revenue earned from outside the enterprise	$10,355	1,929	5,932	616	28	18,860
Segmented operating profit	$ 6,407	(1,592)	43	565	(28)	5,395
General corporate expenses						2,390
Interest expense						6,759
Loss on foreign exchange						1,072
Taxes						(421)
						9,800
Net loss						$ 4,405
Identifiable assets	$36,732	3,799	4,130	427	122	45,210
Capital expenditures	$ 1,391	130	85	(18)	—	1,588
Depletion, depreciation, amortization and provision for impairment	$ 1,876	2,608	424	51	57	5,016

11. **Related Party Transactions**

None of the Directors or Officers or any shareholder of the Company, and no associate or affiliate of any of them, has any material interest in any transaction which has materially affected or will materially affect the Company, other than the following, or as otherwise disclosed in the Notes to Consolidated Financial Statements:

(a) At December 31, 1984, Dalco Petroleum Corporation ("Dalco") owed the Company \$726,000 (1983 — \$684,000). The receivable less a \$559,000 (1983 — \$525,000) provision for loss on collectibility has been included in other assets (Note 3) pending a final resolution of the Chapter 11 bankruptcy proceedings of Dalco.

(b) Of the 9,710,000 Class A Voting and Class B Non-Voting Shares of the Company which Dalco owned on January 1, 1984, an aggregate of 7,500,000 shares had been pledged as collateral with various secured lenders including 5,500,000 shares which are still held by the Company's principal banker. During the year, two of the secured lenders realized on their security. The 2,000,000 shares that they held were subsequently sold to a company controlled by a director and officer of the Company.

12. **Remuneration of Directors and Officers**

The aggregate remuneration paid or payable to directors and senior officers (as defined by the Companies Act, Alberta, which term includes the five highest paid employees of the Company) during the year amounted to \$730,000 (1983 — \$739,000).

Corporate Information

DIRECTORS

*F. M. Parsons — Chairman,
President, Chief Executive Officer
Dynex Petroleum Ltd.

*Ross R. Curtis
Member, Advisory Board
Marsh & McLennan Limited

George E. Longphee
President
Georma Investments Ltd.

*George W. Oughtred
Chairman of the Board
Commercial Oil & Gas Ltd.

William F. Procter
Executive Vice President
Gardiner Watson Limited

*Arthur R. Smith
President
Lavalin Services Inc.
(Western Region)

*Member of Audit Committee

HEAD OFFICE

900 Ford Tower
633 - 6 Avenue S.W.
CALGARY, Alberta
T2P 2Y5
(403) 261-9810

SUBSIDIARY COMPANY AND DIVISION

Dynex Energy Inc.
Dolphin Drilling (403) 261-8985

PRINCIPAL BANKER

Bank of Montreal
Calgary, Alberta

OFFICERS AND KEY PERSONNEL

Francis M. Parsons
President

Robert A. Wall
Vice-President, Finance

Lorraine A. Lawrence
Corporate Secretary/Manager, Administration

Les J. Margetak
Production Manager

Robert C. MacKenzie
Field Superintendent, Production

Terry L. Risling
Field Superintendent,
Dolphin Drilling

Lynn A. Dyson
Landman

Bruce K. Gibson
Controller

SOLICITORS

Code Hunter
#1900, 736 - 6 Avenue S.W.
CALGARY, Alberta
T2P 3W1

AUDITORS

Peat, Marwick, Mitchell & Co.
2500, 700 - 2 Street S.W.
CALGARY, Alberta
T2P 2W2

TRANSFER AGENTS

Royal Trust Corporation of Canada
in Calgary and Toronto

STOCK LISTING

Toronto Stock Exchange
Alberta Stock Exchange
(Symbol — DPL)

Ronalds-Federated