RIO ALTO EXPLORATION LTD.

1985 ANNUAL REPORT

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MAP ABBREVIATIONS

DST	— Drillstem test
OHT	— Open hole test
BOPD	— Barrels of oil per day
MMCFGPD.	— Million cubic feet of gas per day
BWPD	— Barrels of water per day
THP	— Tubing head pressure
IP	— Initial production
OWC	— Oil water contact
API	— American Petroleum Institute
BSL	— Below Sea Level

CONVERSION FACTORS

1 mile	= 1.6 Kilometres
1 foot	= 0.3 metres
1 cubic foot	= 0.028 cubic metres (natural gas)
1 barrel	= 0.159 cubic metres (crude oil)
1 acre	= 0.405 hectares

CORPORATE INFORMATION

DIRECTORS

John C. Anderson	Calgary, Alberta
Carmen W. Byler	Calgary, Alberta
Patrick A. Campbell Fraser	Edinburgh, Scotland
Robert E. Humphreys	Calgary, Alberta
M. Jaffar Khan	Calgary, Alberta
Norman E. Brown	Calgary, Alberta
James R. Smith	Calgary, Alberta

OFFICERS

John C. Anderson	President
Samuel W. Ingram	Secretary
Edward J. Cleary	Assistant Secretary

HEAD OFFICE

1900, 801 - 6 Avenue S.W.
Calgary, Alberta T2P 3W2

SUBSIDIARY

Rio Alto Exploration Inc.

BANK

Toronto Dominion Bank

TRANSFER AGENT AND REGISTRAR

The Canada Trust Company

LEGAL COUNSEL

McLaws & Company

AUDITORS

Collins Barrow

STOCK LISTING

Toronto Stock Exchange
Stock Exchange Symbol: RAX

The Annual General Meeting of Shareholders will be held at 10:30 a.m. on Friday, May 16, 1986 in the Boardroom of The 400 Club, Calgary, Alberta.

HIGHLIGHTS OF ACTIVITIES

	Dec. 31 1985	Dec. 31 1984
FINANCIAL		
Gross revenues	$ 2,923,149	$ 948,900
Cash flow (after tax)	2,074,737	569,111
Net earnings (loss)	(2,782,173)	518,954
Growth expenditures	6,200,699	1,855,521
Working capital (deficiency)	(393,783)	2,777,400
PRODUCTION		
Average barrels of oil per day	213	20
Average thousand cubic feet gas per day	368	200
RESERVES		
Proven oil (barrels)	620,000	252,200
Proven gas (MCF)	1,073,000	1,138,000
WORKING INTEREST WELLS		
Oilwells	167	46
Gaswells	160	152
1985 DRILLING RESULTS		
Oil	113	22
Gas	3	1
Dry	8	7

LAND HOLDINGS (ACRES)

	WORKING INTEREST GROSS	WORKING INTEREST NET	ROYALTY INTEREST
CANADA			
Saskatchewan	19,159	2,789	8,683
Manitoba	5,133	606	0
Alberta	55,302	4,225	4,320
PAKISTAN			
Karachi Permit	880,000	418,000	0
SICILY			
C.R100.HO	66,273	1,325	66,273
C.R117.IM	91,286	15,199	0
C.R116.CN	47,375	11,844	0
C.R108.HO	0	0	110,468
C.R112.HO	0	0	121,946
ITALY			
D.R56.CL	147,689	7,384	147,689
D.125 DR-CN	0	0	187,320
Basentello	66,260	12,424	0
FRANCE			
Saint Saens	531,544	53,154	0
Altkirch	176,852	17,685	0
IRELAND			
Permit 42/7 and 42/12	105,000	577	0
UNITED STATES	6,469	631	310
TOTALS	2,198,342	545,843	647,009
ACREAGE UNDER APPLICATION			
France	595,773	120,952	0
Sicily	0	0	53,626

TO THE SHAREHOLDERS

During the past year the Company participated in the drilling of 124 wells, and of these 102 were in the Kerrobert area. 113 were completed as oil wells, 3 as gas wells, and 8 were abandoned for a 94% success ratio. During the month of December 1985, the Company's net oil production was 391 barrels per day. The Company's cash flow was lower than budget due to the longer than expected time required to get the Kerrobert wells on production after completion.

During December, a memorandum of understanding was signed with the Pakistan government which awarded the Company an 880,000 acre exploration permit. We are joint venturing this with Canada Northwest Energy Limited. Further details on this can be found in the body of the report.

The accompanying financial statements report cash flow of $2,074,737 (29 cents per share) and net profit before writedown and taxes of $1,359,601 (19 cents per share). Because of changing accounting rules and lower oil prices, the Company was facing a yearly writedown particularly on its US oil and gas properties. Rather than report a yearly writedown on US oil and gas properties, the directors decided to approve a one time writedown in the amount of $3,958,910 (56 cents per share), net of deferred tax recovery. We have written down all of our US oil and gas properties to $1.00 and all mining properties to $1.00 resulting in a loss of $2,782,173 (39 cents per share) for the year.

The Company had prepared, and the Board had approved a $4.8 million exploration budget for 1986. Subsequent events have caused us to reduce this budget to $2.1 million, most of this was committed for the first quarter of 1986 and was underway. Until oil prices stabilize we will be spending only enough to maintain our interests.

The Company had a working capital deficiency of $393,783 at December 31, 1985. Our 1986 Exploration budget will be funded by internally generated funds plus some bank borrowing. Steps are being taken to insure the Company will not encounter any financial difficulty during 1986, and will be able to take advantage of any opportunity to purchase Western Canadian production at a reasonable price should the occasion arise.

The Board of Directors extends its thanks to the Company staff for their dedication and loyalty during the past year.

J C Anderson

John C. Anderson
President

Calgary, Alberta
March 27, 1986

ACTIVITIES IN EUROPE:

Italy and Sicily

Permit C.R100.H0

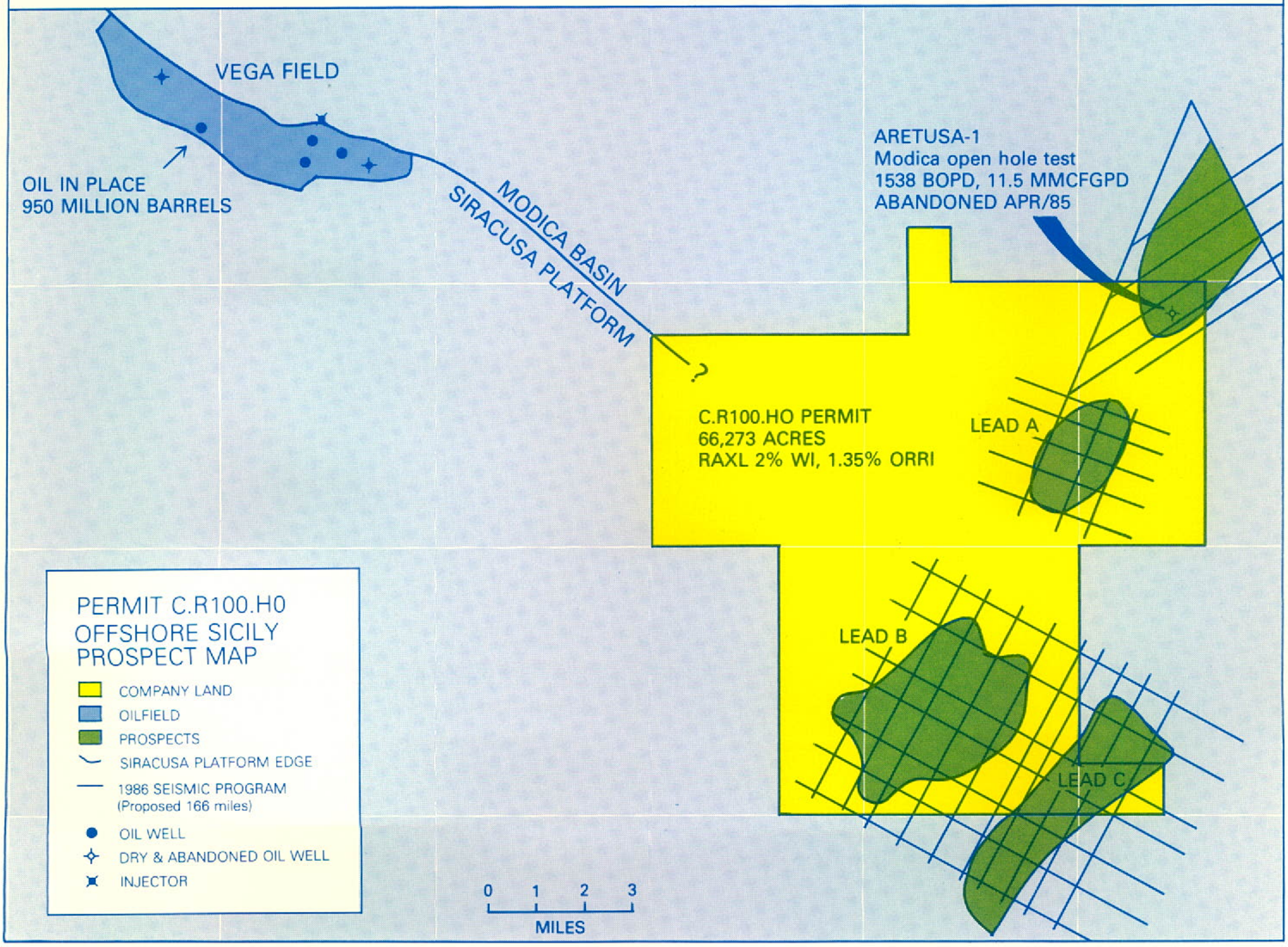
The Company holds a 2% working interest and a 1.35% overriding royalty interest in the 66,273 acre permit offshore Sicily. The C.R100.HO permit is located 9 miles southeast of the Vega Oilfield where industry estimates of oil in place is 950 million barrels in the Siracusa/Inici Formation.

During the first quarter of 1985, the Aretusa-1 penetrated a 2,025 foot section of oil stained marlstone interpreted to be the basinal facies of the Lower Cretaceous Siracusa carbonate platform. After acidizing the zone, an open hole test measured flow rates up to 1,538 BOPD of 37 degree api oil and 11.5 million cubic feet of gas per day. The Aretusa-1 well was abandoned after pressure surveys indicated reservoir depletion.

A 40 mile experimental marine seismic survey was shot in the summer and resulted in a dramatic improvement of seismic data quality. The working interest partners agreed to utilize these seismic innovations by re-evaluating the permit with a 166 mile seismic program in early 1986. The proposed seismic grids (see map) are positioned to detail the four existing structural leads. A second well located on the permit will be selected in 1986 after the new seismic data defines the most prospective lead.

Basentello Permit

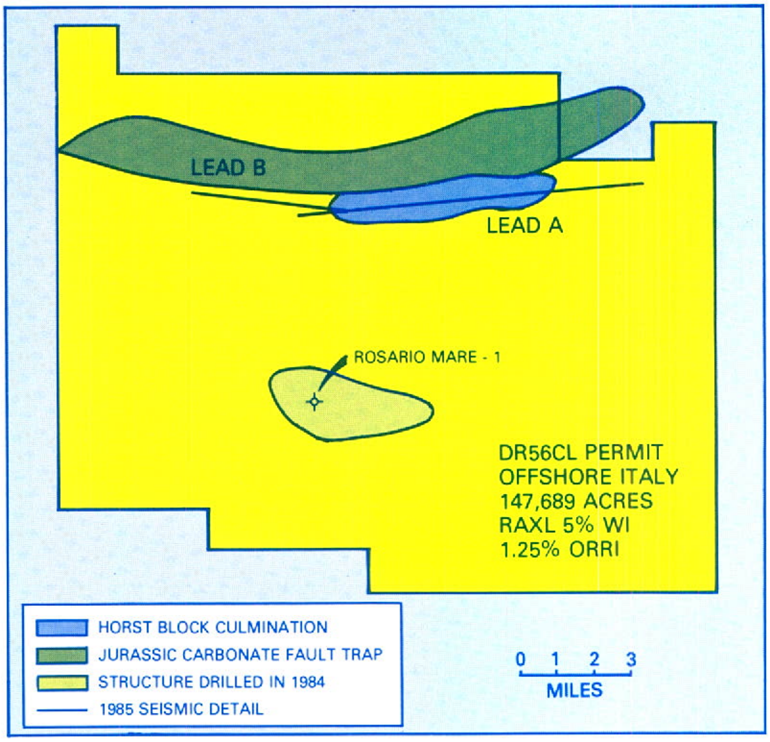
Exploration will be directed to the southern part of the Basentello Permit in 1986 where the Company holds an 18.75% working interest in 66,260 acres. A seismic review in 1985 identified four Tertiary fault leads. Drilling targets are Pleistocene sandstones which produce gas from fields adjacent to the permit. In 1986 a 45 mile seismic program will be shot to detail the leads and firm up a drilling location.



ACTIVITIES IN EUROPE:

Permit D.R56.CL

A 19 mile marine seismic program was completed in late 1985 to detail a horst feature on the northern part of the permit (see map - Lead A). Primary drilling objectives are the Jurassic Scaglia limestone in fault traps (Lead B) and Lower Cretaceous reefs. The Company has a 5% working interest and a 1.25% overriding royalty on this 147,689 acre block. Seismic work will continue in 1986 with processing and interpretation of the 1985 survey.



DR56CL PERMIT

Other Permits

In Sicily, the Avanella d301CR-LA and d124DR-IM applications were rejected. The d244CR-BV application was relinquished in order to join another company in the d287CR-FI application. Permit C.R118.IM was relinquished in the spring of 1985 after a seismic survey failed to find any leads. In 1986 a seismic survey will commence on Permit C.R117.IM where the Company has a 16.65% working interest in 91,286 acres. Seismic surveys are also planned for Permits C.R116.CN, C.R108.HO and C.R112.HO, offshore Sicily.

COMPANY INTERESTS IN IRELAND & FRANCE

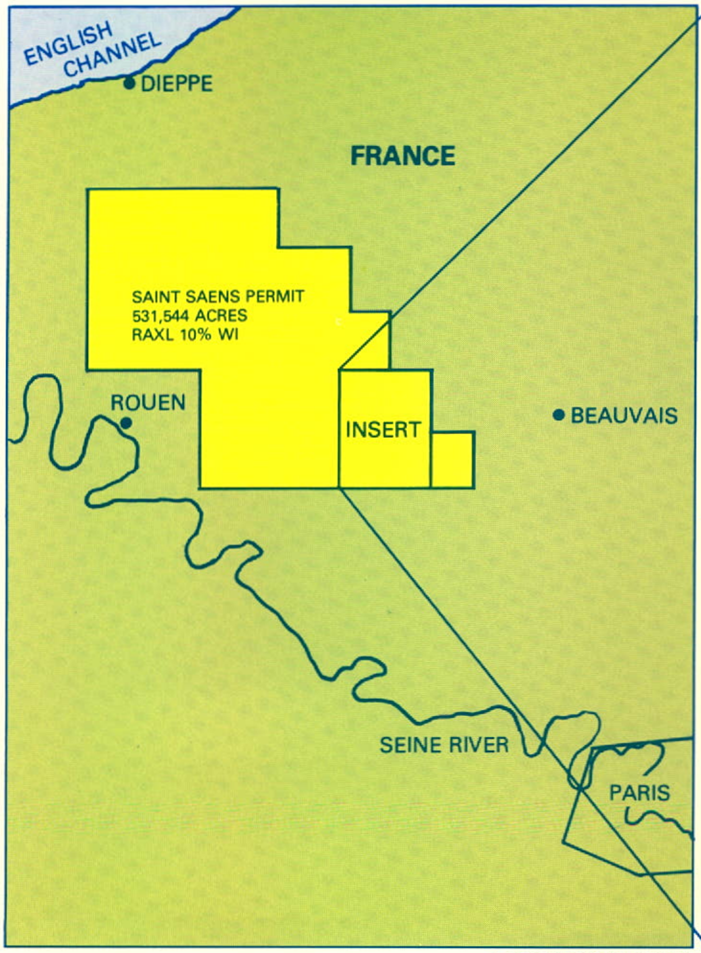
Ireland

In August, the Company farmed out its 1.375% working interest in Permits 42/7 and 42/12 for a well commitment in February, 1986. Two seismic programs totalling 356 miles of data identified a number of substantial structures. After the test well is drilled in 1986, the Company will retain a 0.55% working interest in the well and 105,000 acre property.

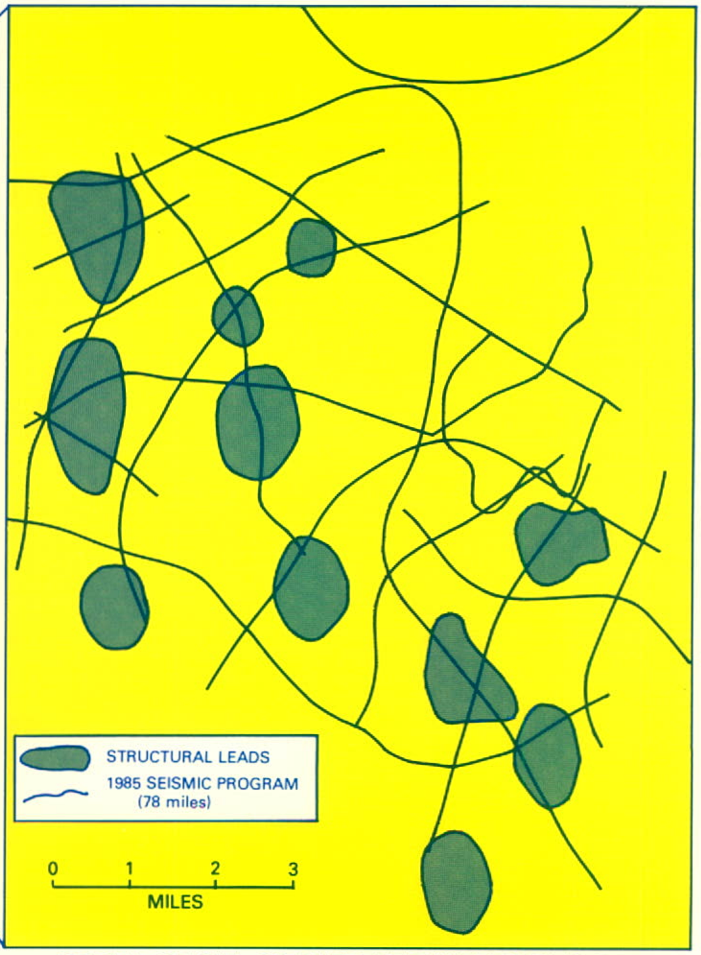
France

Saint Saens Permit

Several Triassic structural leads (see map) were discovered in the southeast corner of the Saint Saens permit after 78 miles of reconnaissance and infill seismic data were shot and interpreted in 1985. The Company has a 10% working interest in the 531,544 acre permit located 30 miles northwest of Paris, France. Exploration activity in the Paris basin increased in 1985 as the hunt for more oilfields like Chaunoy continues. Industry estimates of production from the Chaunoy Oilfield are up to 12,000 BOPD for 1986. The low development cost, shallow drilling depths and ready market for oil make the Saint Saens Permit particularly attractive. The Company has approved its 10% share of the drilling costs for a Triassic exploration test in 1986.

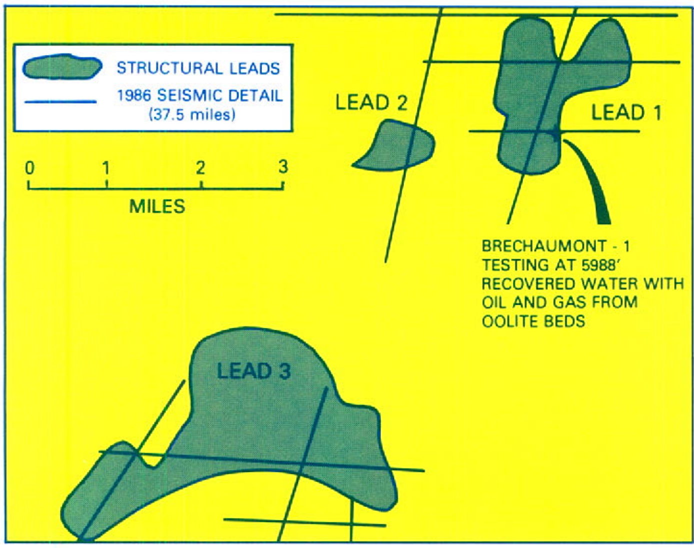


LOCATION MAP

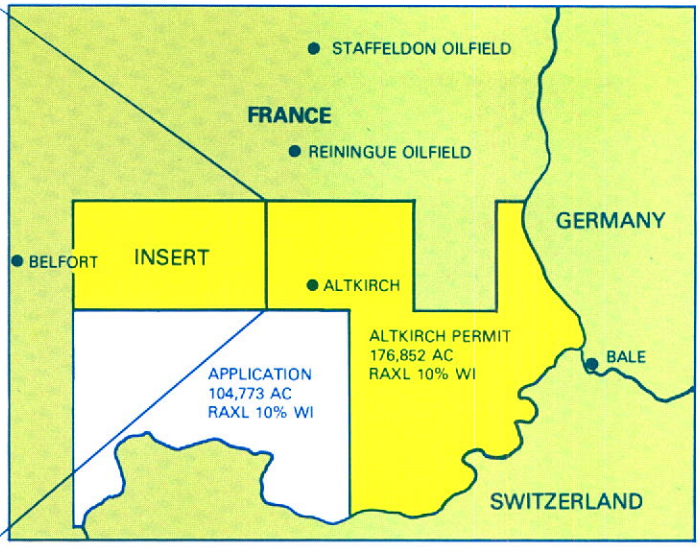


DETAIL OF S.E. CORNER OF SAINT SAENS PERMIT

ACTIVITIES IN EUROPE:



DETAIL OF N.E. CORNER OF ALTKIRCH PERMIT



LOCATION MAP

Altkirch Permit

In 1985, the Company participated for 10% in a 100 mile seismic survey which identified three prospects on the western part of the permit (see map). The seismic indicates a structurally higher drilling location to the Brechaumont-1 well where water, oil and gas were recovered from a porous oolite reservoir. A further 37.5 miles of seismic work will be done to upgrade the Brechaumont structure (Lead 1) and the larger fault trap structure (Lead 3). The Company has budgetted $70,000 in 1986 for its 10% cost share of an exploration well to evaluate the 176,852 acre permit. The operator has applied for a 104,773 acre permit adjacent to the southeast boundary of the Altkirch Permit.

Cherbourg Maritime Application

The Cherbourg Maritime Application is expected to be granted in 1986. The Company will have a 22.5% working interest in the 491,000 acre offshore block.

Future International Activities

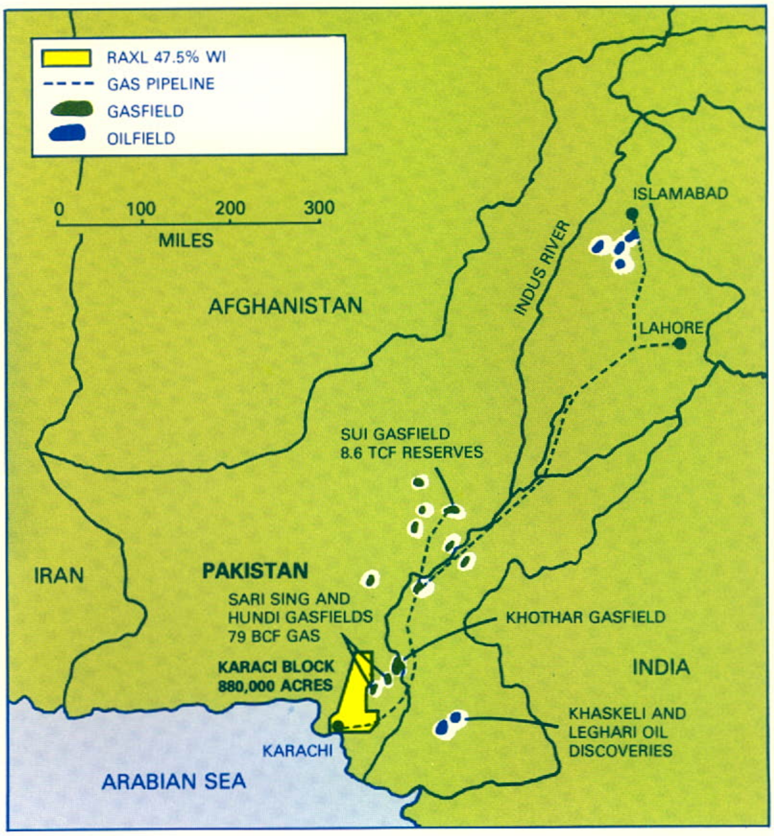
It is the Company's policy to farm out all its international oil and gas properties and negotiations are currently under way on several exploration permits.

ACTIVITIES IN PAKISTAN:

Karachi Permit

A memorandum of understanding has been signed with the Pakistan government and sets out the exploration terms for an 880,000 acre permit near the city of Karachi. The permit is located in a geologically favourable part of the gas prone South Indus Basin. Ten gas fields in the basin have reserves ranging from 30 billion cubic feet to 8.5 trillion cubic feet of gas. Estimates of recoverable reserves from the adjacent Sari Sing and Hundi gas fields (see map) are 79 billion cubic feet of gas. Several surface structures on the Karachi Permit have never been drilled.

The Company is joint venturing a portion of its interest in the Permit to retain a 47.5% working interest during the exploration phase. The Pakistan owned oil company has a 5% working interest which reverts to a 50% working interest on discovery of a commercial oil or gas pool.



KARACHI BLOCK

ACTIVITIES IN THE UNITED STATES:

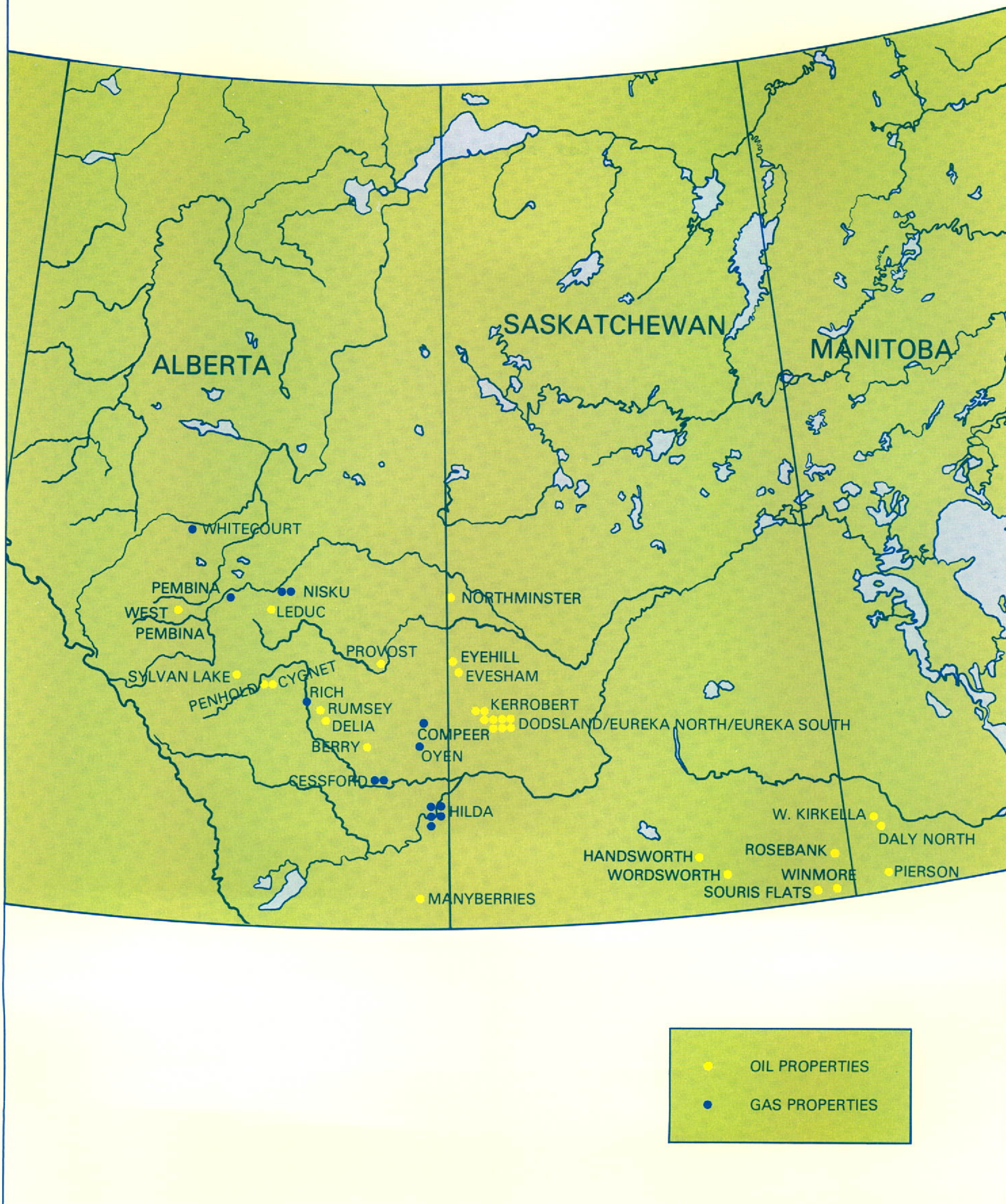
The Company is continuing to reduce its oil and gas interests in the United States. A 50% interest in 15,000 acres of expiring leases in Ohio and Indiana were assigned to a joint partner in lieu of annual rental payments. The Company's 15% working interest in the Voyager-1 and Redbud-1 producing wells was sold for $20,000 U.S. In addition, a 7.5% interest in the Bowles-1 well and a 0.83% interest in the Lena-1 and Lena-2 wells were sold for $2,050 U.S.

The Company's gaswells in Dewey County, Oklahoma continue to generate most of the revenue for the United States subsidiary, Rio Alto Exploration, Inc. Two offers to purchase Rio Alto Exploration, Inc. were rejected in 1985.

Mining Activity

In November, the Company exchanged its 24% working interest in the Rusty Springs property for a 10% net profits interest. The Rusty Springs Property includes 380 claims on a potential silver, lead, copper and zinc deposit.

ACTIVITIES IN WESTERN CANADA:



ACTIVITIES IN WESTERN CANADA:

Kerrobert, Saskatchewan

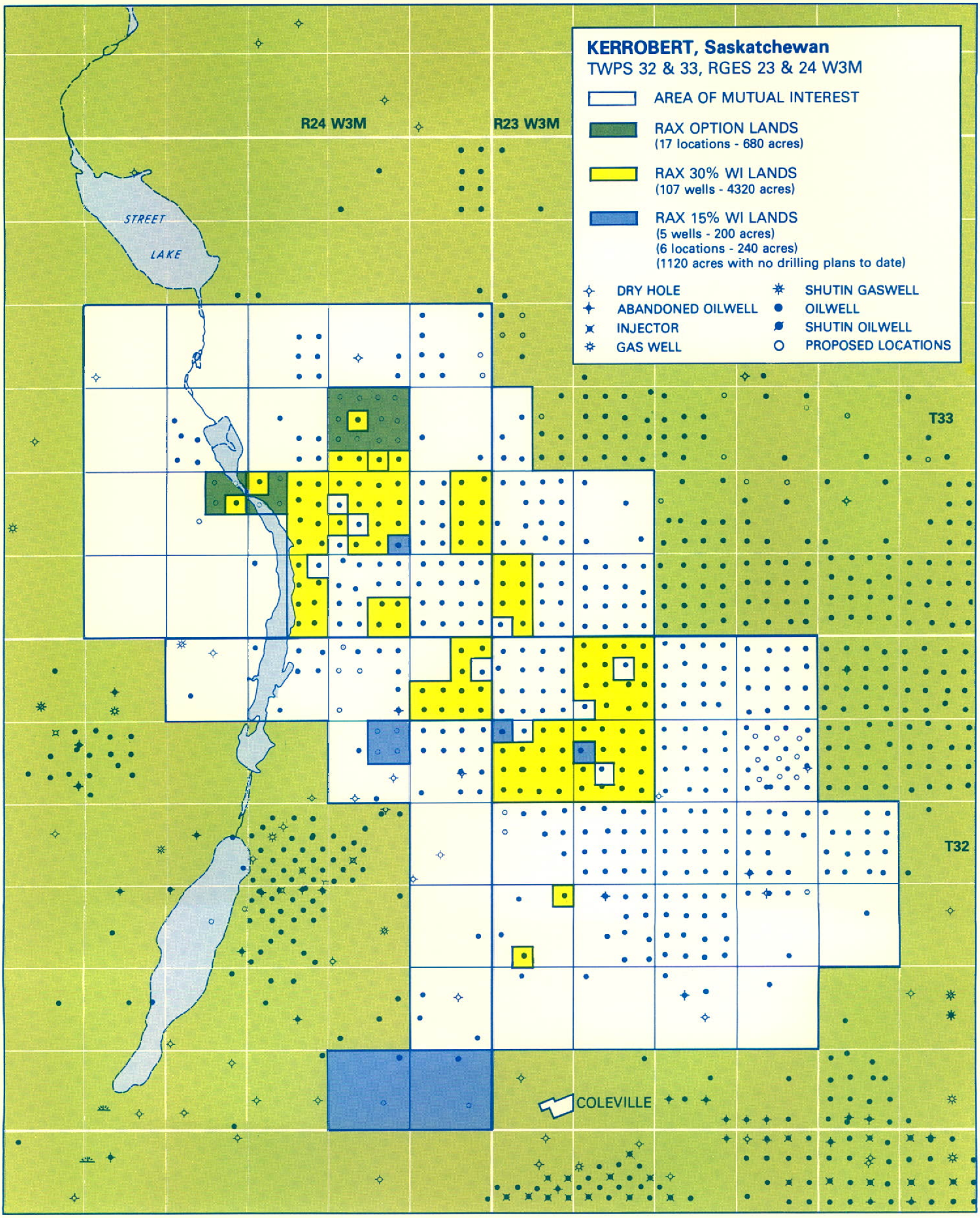
In late 1984, the Company committed to a 30% working interest participation in a drilling option covering 6,400 acres in the Kerrobert area of Saskatchewan. The value of this acreage became apparent after 10 consecutive Viking oilwells were drilled on a wide evaluation pattern and completed for an average daily rate of 35 BOPD per well. The success of this initial drilling phase reduced dry hole risk substantially and set the course for a major 40 acre infill drilling campaign in 1985.

In fiscal 1985, the Company participated in the drilling of 102 Viking oilwells for an estimated net cost of $3.3 million after petroleum incentive grants. The Company also approved construction of a gas processing plant, gas compressor plant, eight satelite batteries and the purchase of 2.25 sections of Crown land for an estimated cost of $500,000 net to the Company. This capital expansion was financed primarily from available working capital and cash flow from operations. In April, a $1,500,000 operating line of credit, secured by a floating debenture, was obtained to ensure monies were available to cover the Company's drilling commitments.

In 1986, the Company will participate in the drilling of 23 Viking wells to bring the total to 135 wells on the Kerrobert property.

The Company's net share of oil production at December 31 was 350 BOPD from 81 wells onstream. 1986 cash flow is expected to increase when the remaining 54 wells are put onstream. Sales of solution gas will enhance revenues when a gas gathering and processing system is completed in 1986.

The Company's share of proven reserves at Kerrobert is estimated to be 492,000 BO and 109 MMCFG from primary production. Waterflood pilot projects in the Dodsland area are being monitored to optimize secondary recovery methods for implementation at Kerrobert in 1987. Net probable reserves attributable to the future waterflood is calculated to be 450,000 barrels of oil.

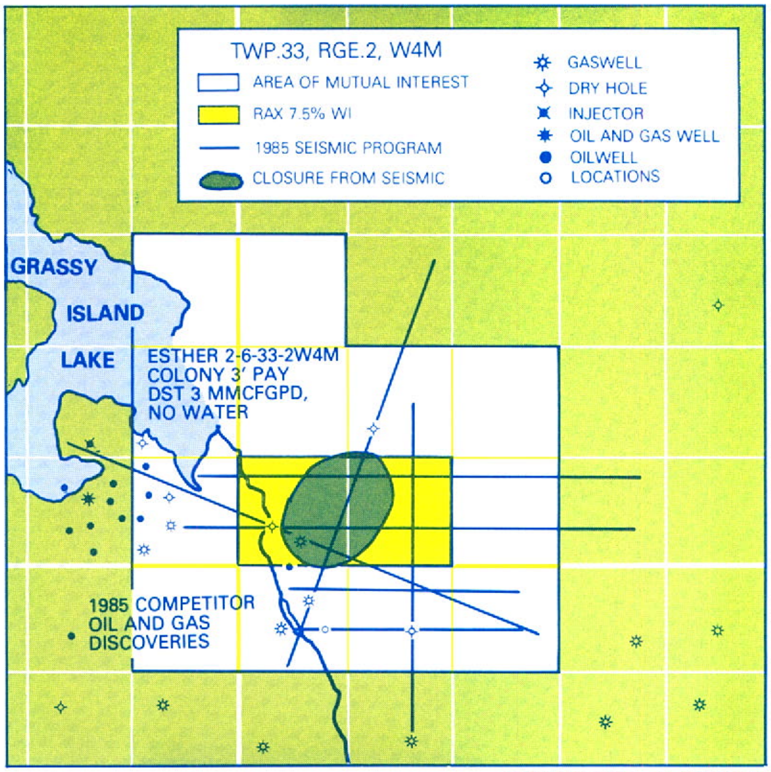

KERROBERT, Saskatchewan
TWPS 32 & 33, RGES 23 & 24 W3M
AREA OF MUTUAL INTEREST
RAX OPTION LANDS
(17 locations - 680 acres)
RAX 30% WI LANDS
(107 wells - 4320 acres)
RAX 15% WI LANDS
(5 wells - 200 acres)
(6 locations - 240 acres)
(1120 acres with no drilling plans to date)
DRY HOLE
ABANDONED OILWELL
INJECTOR
GAS WELL
SHUTIN GASWELL
OILWELL
SHUTIN OILWELL
PROPOSED LOCATIONS
R24 W3M
R23 W3M
STREET
LAKE
T33
T32
COLEVILLE

ACTIVITIES IN WESTERN CANADA:

Compeer, Alberta

The Company farmed in for 7.5% on two sections of land on a Cretaceous Colony channel play in Southern Alberta. Esther 2-6-33-2W4M was drilled in June and found three feet of pay on a seismically defined closure covering 640 acres. The zone was tested and flowed 3 million cubic feet of gas with no oil or water.

After an oilwell was drilled on the flank of the structure, on competitor lands to the south, the Company agreed to participate in a 20 mile seismic program to define further the extent of the structure and to evaluate offsetting crown lands. A shallow Colony test is budgetted for 1986 to search for the oil leg in the pool.

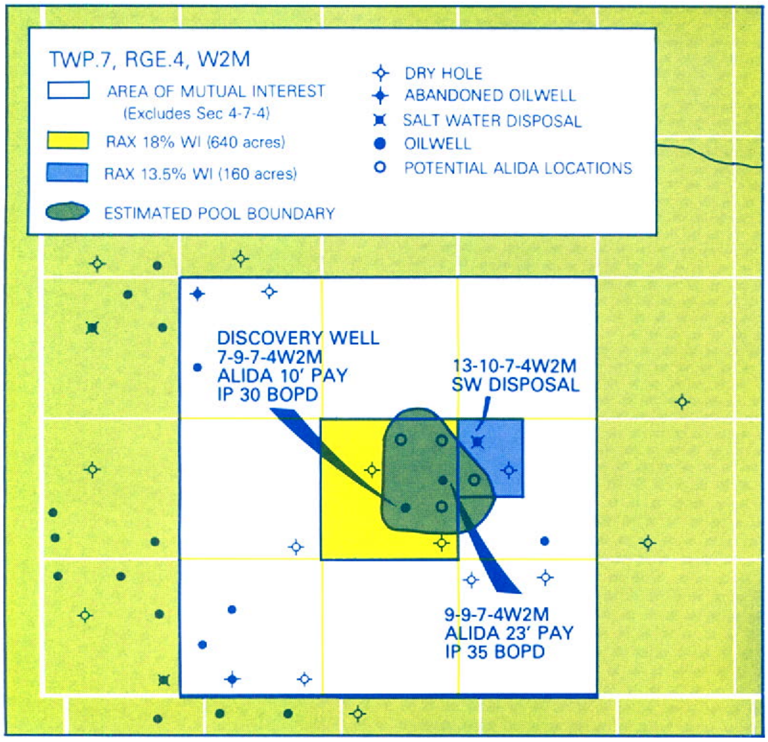


COMPEER, ALBERTA

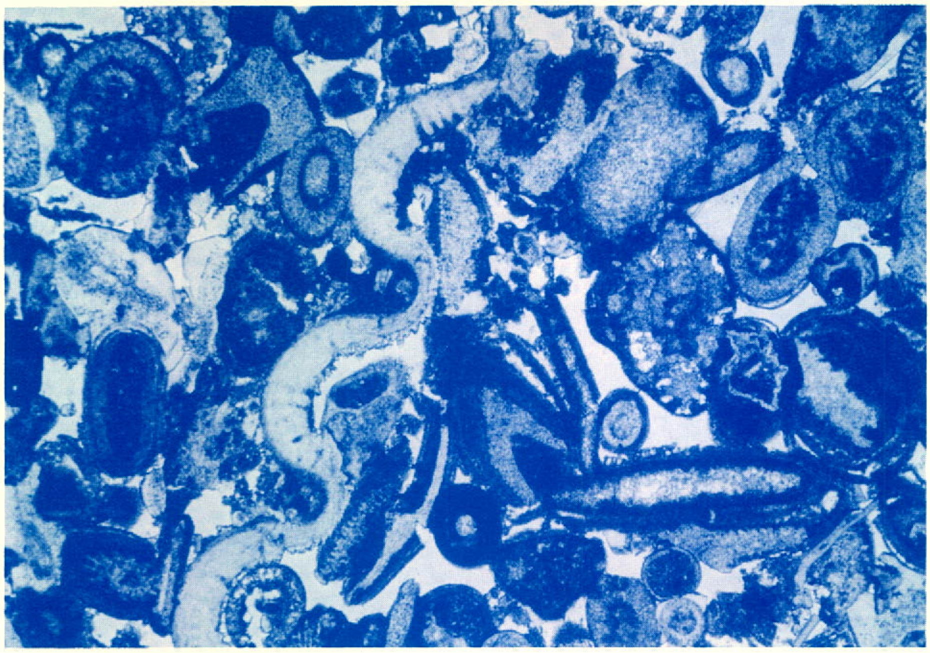
Wordsworth, Saskatchewan

The Company participated for 18% in an Alida oil discovery at 7-9-7-4W4M in August. A ten foot thick pay zone was completed and produced an average of 30 BOPD in November. The first offset well at 9-9 found 23 feet of Alida pay and later produced an average of 35 BOPD during the first month onstream.

The northeast limit of the oilpool was defined by the 13-10 dry hole in which the Company participated for 13.5% under a drilling option agreement. The 13-10 well found the Alida structurally high but the reservoir facies was not developed. The operator is converting the 13-10 well to a salt water disposal well. At December 31, the Company's net share of proven reserves from the 7-9 and 9-9 oilwells was 19,000 barrels of oil.



WORDSWORTH, SASKATCHEWAN



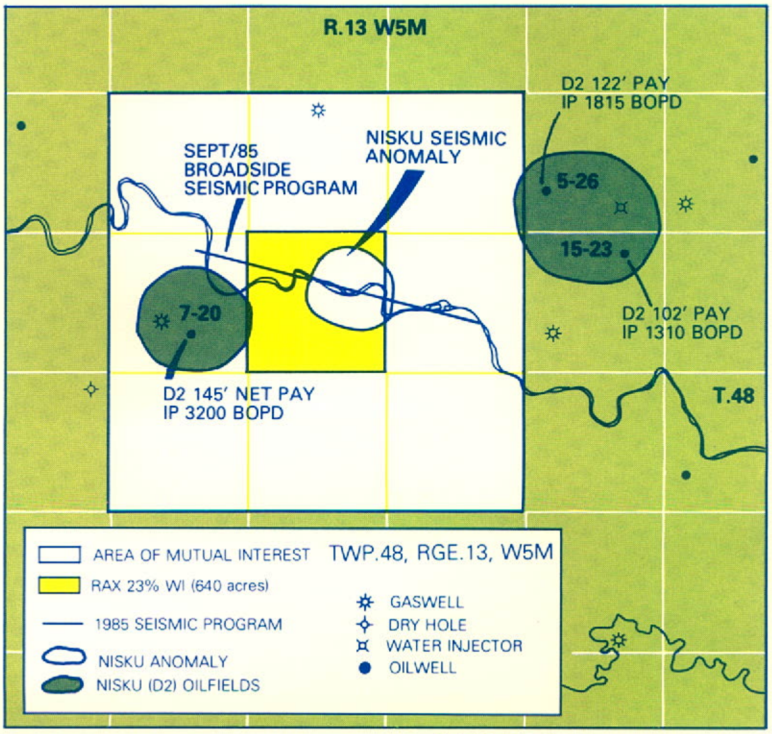
Thin section photograph of the Alida reservoir from Wordsworth 7-9-7-4W2M, Saskatchewan. This oolitic grainstone has a rich variety of fossil fragments with excellent porosity and permeability.

West Pembina, Alberta

In September, a 3.5 mile broadside seismic program was shot to evaluate the Devonian Nisku reef potential under the Pembina River. A Nisku seismic anomaly was discovered on Section 21-48-13W5M and the Company subsequently purchased a 23% working interest in Section 21 for $46,000 at the October 30 Crown Land Sale.

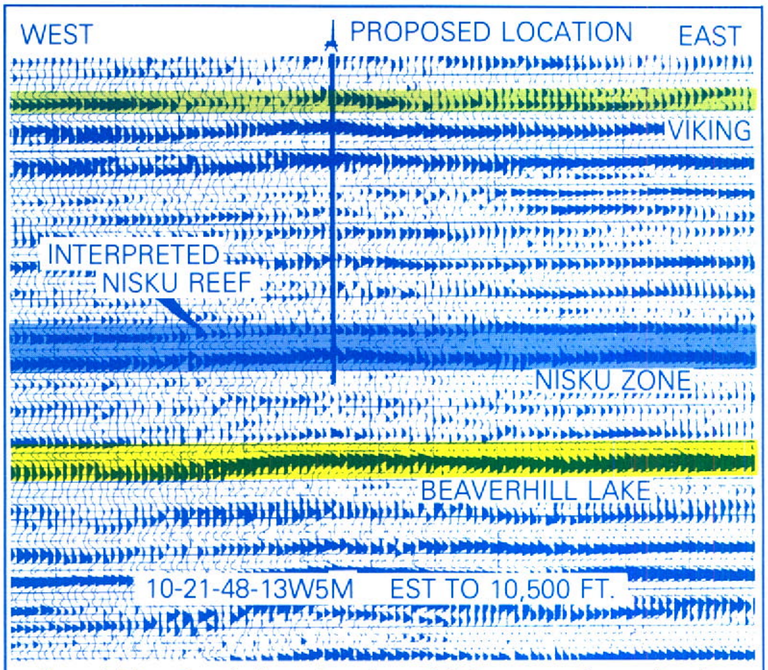
Seismic characteristics of the anomaly are similar to those of reefs drilled in the area. The anomaly shows pull up at Beaverhill Lake level, structural drape at Viking level, and character change at the Nisku level (see seismic section). A 40 x 50 metre three dimensional seismic survey was started in December to define the areal extent of the feature.

Nisku reefs within a radius of 5 miles of Section 21 have net pay sections up to 230 feet thick and wells are producing at rates between 800 and 6,000 BOPD. In 1986, the Company will seek an industry partner to help develop this attractive property.



WEST PEMBINA, ALBERTA

ACTIVITIES IN WESTERN CANADA:



Broadside seismic line showing a Nisku anomaly under the Pembina River, Alberta (SEE MAP FOR LOCATION).

POTENTIAL NISKU LOCATION

Manyberries, Alberta

Development drilling at Manyberries commenced in May when another company drilled the 12-15-5-4W4M well and found 3 feet of oil sand in the cretaceous Sunburst zone. The zone was completed for initial production of 297 BOPD but the well allowable is restricted to 30 BOPD. The Company has a 0.6 to 1.8% sliding scale royalty interest on production before payout, which is convertible to a 7.5% working interest after payout.

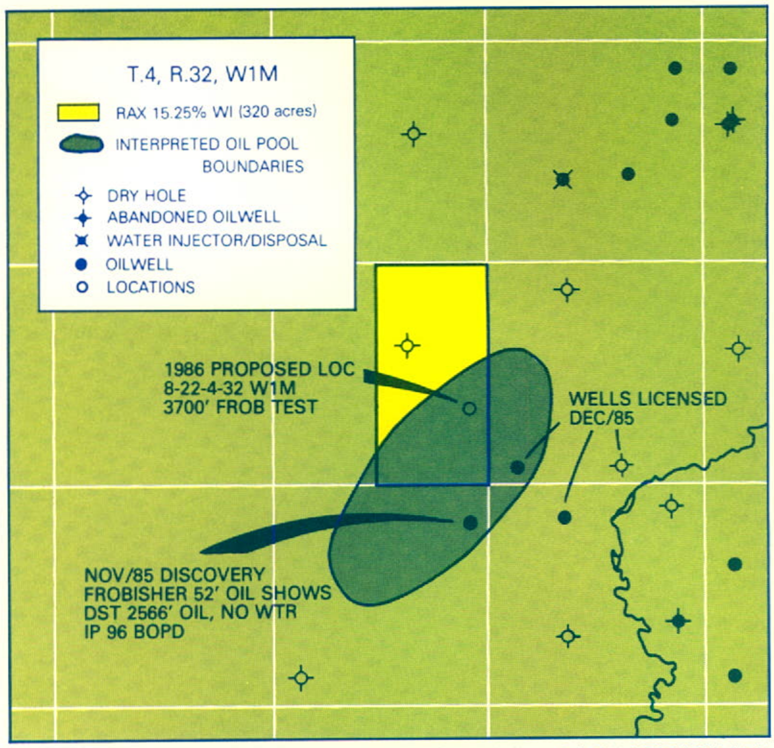
The Company participated for 8.1% in the 4-15-5-4W4M Sunburst oilwell which found 5 feet of pay. Initial production was 250 BOPD but, because of well allowables and offtarget penalties, production is confined to 30 BOPD. The 4-15 and 12-15 wells are expected to generate a steady cash flow for many years.

The Company had disappointing drilling results after participating for 15% in the 7-14 offset location to the successful 1984 recompletion at 2-14. The 7-14 well found 6.5 feet of pay but was structurally low. Water production increased while oil production declined to 5 BOPD at year end. In November, the Company participated for 13.5% in the drilling of the 3-14 well, where the Sunburst zone had no reservoir development and was subsequently abandoned. The 1986 the Company will participate for 7.5% in the drilling of the 6-22-5-4W4M location.

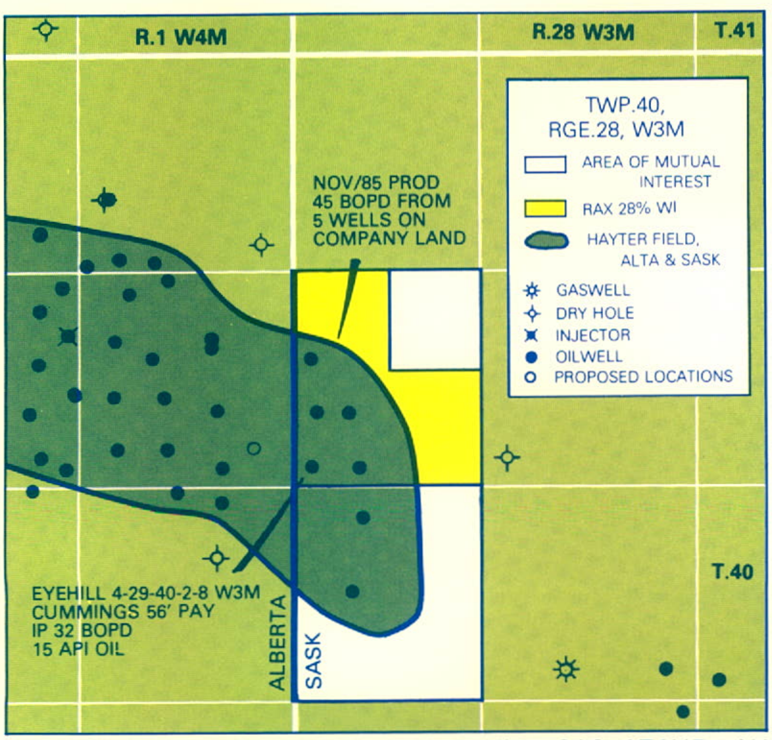
Rosebank, Saskatchewan

On December 10, the Company was successful in a bid for 320 acres of mineral rights at the Saskatchewan Crown Land Sale. A 15.25% working interest in the east half of section 22-4-32W1M was purchased for $45,750. Prior to the land sale a well at 16-15-4-32W1M was drilled and found excellent oil shows over a 52 foot Frobisher interval. The zone was drillstem tested and 2,566 feet of clean oil was recovered with no water. The well was completed in December for initial production of 96 BOPD. Three offset locations on competitor land were licensed in December at 14-14, 2-23 and 4-23-4-32W1M.

Nearby wells in the Rosebank and Nottingham fields have recovered up to 1 million barrels of oil from pay sections similar to the 16-15 well. The Company has agreed to participate for 15.25% in the drilling of the 8-22 location in 1986.



ROSEBANK, SASKATCHEWAN



EYEHILL, SASKATCHEWAN

Eyehill, Saskatchewan

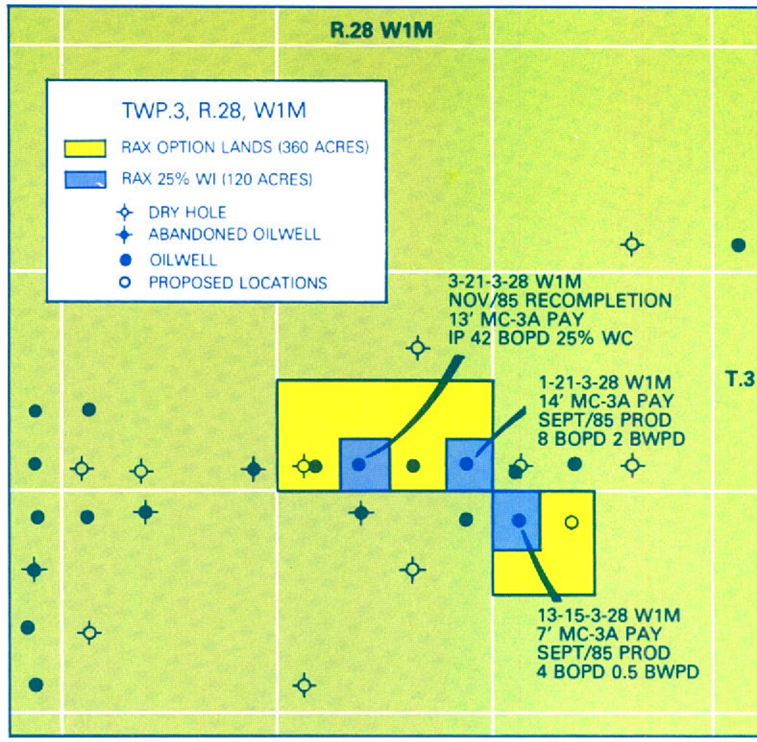
In March, the Company purchased a 28% working interest in the west half of section 29-40-28W3M for $17,452. A well at 4-29 was drilled and found 56 feet of oil pay in the Cretaceous Cummings sand. The 4-29 well was completed and had initial production of 32 BOPD with 2% watercut. Subsurface mapping showed that the Hayter Field extended over Company lands and four additional oil wells were drilled on lsds 3, 5, 6 and 12. Total production declined to 45 BOPD at year end while watercuts increased to 50%. Drilling in 1985 has delineated the boundaries of the 15 api gravity oilpool on Company lands and no further drilling is planned for 1986. The Company's 28% share of proven reserves in the Cummings zone is estimated at 25,000 barrels of oil.

ACTIVITIES IN WESTERN CANADA:

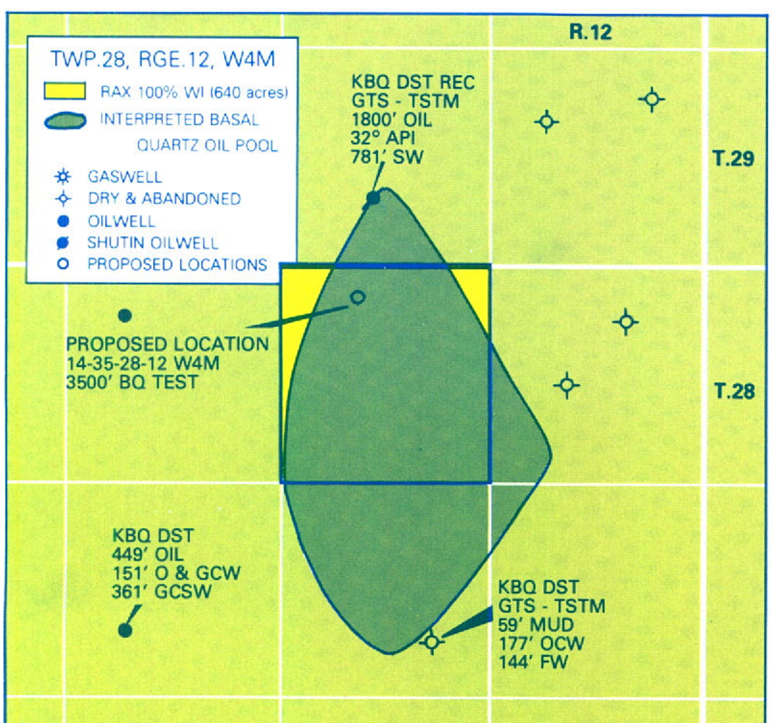
Pierson, Manitoba

The 3-21-3-28W1M well was re-entered in November and completed in the Mission Canyon 3A zone for initial production of 41 BOPD. Offsetting wells at 2-21 and 4-21 have produced 64,000 and 46,000 barrels of oil respectively. Oil production from 3-21 will be monitored for a few months to establish if further development drilling is warranted.

The 1-21 and 13-15 wells continue to produce at modest rates, having combined production of 10 BOPD in September. The Company has a continuous drilling option on 360 acres of land at Pierson to earn a 25% working interest by paying 35% of the drilling and completion costs.



PIERSON, MANITOBA



NORTH BERRY, ALBERTA

North Berry, Alberta

Subsurface mapping has defined a Basal Quartz oil prospect on Section 35-28-12W4M where the Company holds a 100% working interest. A proposed location at 14-35 is expected to find the Basal Quartz oil sand 25 feet higher than in the 6-2 well where 1,800 feet of 32 api oil and 781 feet of salt water was recovered on drill stem test.

In 1986, the Company will seek a partner to share in the drilling cost of the 14-35 location. The Basal Quartz sand has good permeability and production rates of 100 BOPD could be expected.

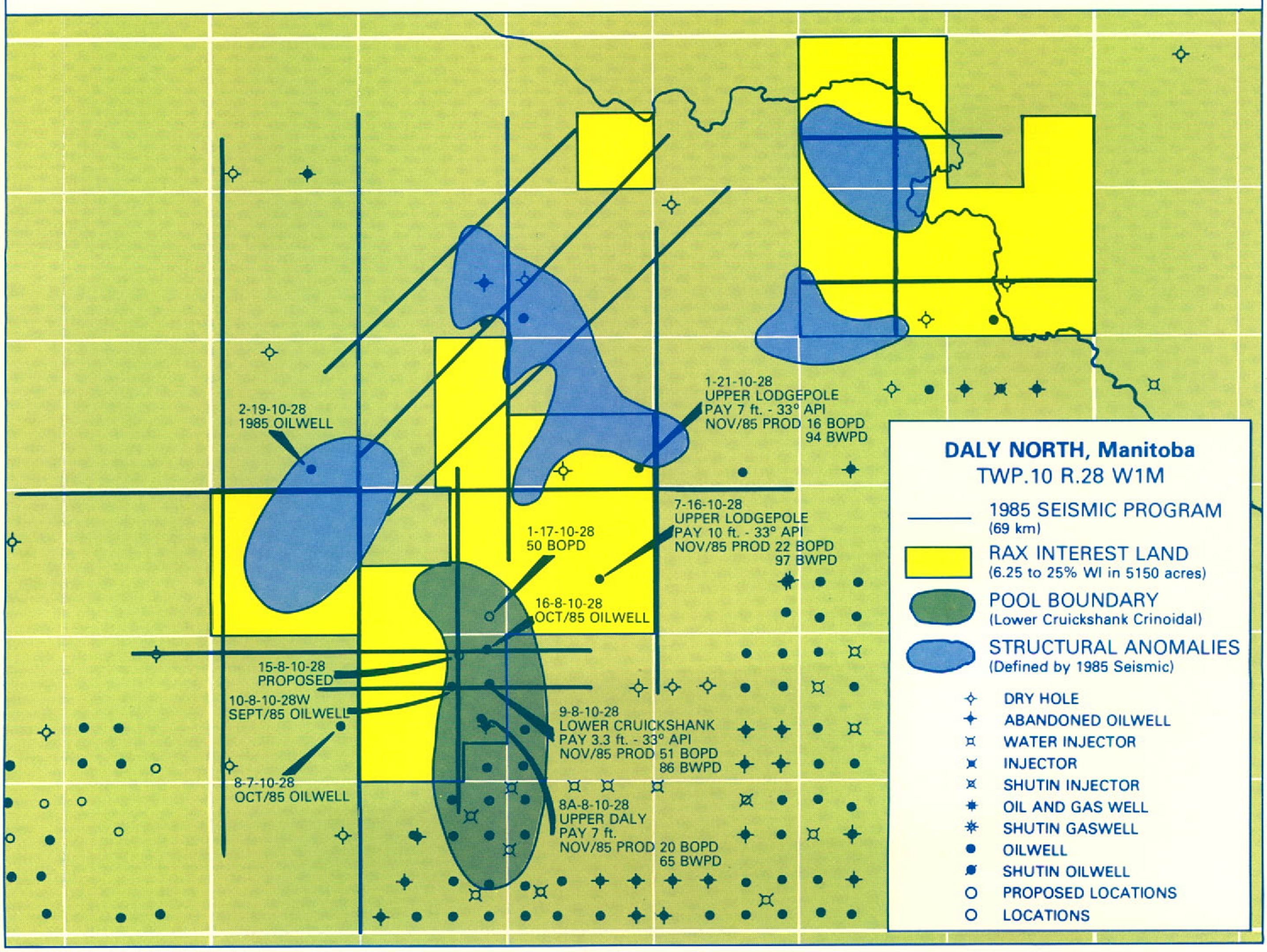
Daly North, Manitoba

In June, the Company participated for 12.5% in the drilling of the a8-8-10-28W1M well offsetting the 9-8 discovery of 1984. The a8-8 well was completed in the Upper Daly Crinoidal zone for initial production of 15 BOPD. The Company did not participate in the 10-8 and 16-8 oilwells drilled in 1985 but retains a 9.375% back in working interest after 200% of the well costs are recovered from production.

In September, the 9-8 well reached payout and the Company's working interest reduced from 25% to 12.5%. The 9-8 well averaged 51 BOPD and 86 BWPD in November. The rumoured success of the 16-8 well encouraged the Company to participate for 12.5% in the 1-17 location which was drilled in December. The 1-17 well found the Lower Cruikshank zone structurally higher than the 9-8 well and the 1-17 well was completed for initial production of 50 BOPD. The Company has agreed to drill the 15-8 location in early 1986.

Competitor drilling in 1985 resulted in oil discoveries at 2-19 and 8-7-10-28W1M, which immediately offset Company interest lands.

A 43 mile seismic survey was completed in 1985 to evaluate 4,614 acres of undeveloped lands. The seismic found four Mississippian structured leads which will be evaluated by drilling in 1986.



ACTIVITIES IN WESTERN CANADA:

Other Western Canada

The Company sold its 1% interest in a proposed Viking waterflood unit in the Avon Hills Oilfield of Saskatchewan for $110,000.

Eight dry holes were drilled in 1985. The Company participated for 10% in the Provost 14-29-40-10W4M well, 33.3% in the Northminster 5-14-50-27W3M well, 29% in the Handsworth 1-2-11-8W2M well, 8.3% in Souris Flats 10-24-1-34W1M, and minor interests in four other dry holes.

At Winmore, Saskatchewan, the Company farmed in on the W/2 of Section 31-1-30W1M where the Hastings zone in an existing well is interpreted to have bypassed pay. The Company will pay 43.5% of the drilling and completion costs of a 3,750 foot well in 1986 to earn a 43.5% interest before payout and 21.75% interest after payout.

The Company farmed out its 21% working interest in the Medicine Hat formation of Section 24-23-11W4M for a two well drilling commitment. The farmee has an area gas contract and they will pay Rio Alto a 1.5% gross overriding royalty on gas sales from these two wells.

FINANCIAL SUMMARY

1. OIL AND GAS REVENUE

The accompanying financial statements show a 393% increase in oil and gas sales, net of royalties, from $542,720 in 1984 to $2,676,909 in 1985. This significant increase has largely resulted from the Kerrobert drilling program (see page 14). The average oil price received during 1985 was $36.47 per barrel or approximately $26US per barrel. The majority of the Company's production is light oil which brings the best available price.

2. CASH FLOW

Cash flow from operations has increased to 29 cents per share from 8 cents per share in 1984 again due to the commencement of production at Kerrobert.

Cash flow in 1986 is estimated to be in the range of 28 cents per share based on $15US oil. It is anticipated that the recent decline in price from $26US to $15US will largely be offset by increased production.

3. NET EARNINGS

Net earnings have been changed with a $3,145,000 write-down of oil and gas interests in the United States partially dictated by an external engineering evaluation of the Company's properties in North America. Further, management has chosen to recognise a $996,774 write-down of its remaining mining interests in the Yukon and Ontario as the expenditure of further funds on these properties may not be warranted due to weak mineral markets.

4. CAPITAL BUDGET

During 1985, the Company spent or committed to spend approximately $5.4 million (before petroleum incentives), 78% of which was in the Kerrobert area. The 1986 budget has been revised downward by 58% to approximately $2.1 million. The Company has committed $975,000 to wells which have been drilled in Western Canada in 1986 to take best advantage of the Petroleum Incentive Program, which expires March 31, 1986.

5. GENERAL AND ADMINISTRATIVE

The Company continued with the same level of staff as 1984. General and administrative expenses have risen from $502,461 in 1984 to $795,073 in 1985 due to the significant increase in activity.

In 1986, the Company intends to share 50% of the cost of operating a branch office in Karachi, Pakistan, where seismic activities will commence on our permit adjacent to Karachi.

At December 31, 1985 the Company effected the amalgamation of its three Canadian companies into Rio Alto Exploration Ltd. and its two United States subsidiaries into Rio Alto Exploration Inc. The elimination of three subsidiaries will contribute to cost efficiencies in management of the underlying assets.

RIO ALTO EXPLORATION LTD.

CONSOLIDATED BALANCE SHEET
DECEMBER 31, 1985

ASSETS

	1985	1984
CURRENT ASSETS		
Cash and term deposits	$ -	$ 2,834,193
Accounts receivable	1,944,933	746,550
	1,944,933	3,580,743
DUE FROM AN OFFICER (note 2)	70,700	-
FUNDS IN ESCROW (note 3)	551,963	310,801
PROPERTY AND EQUIPMENT (note 4)	15,424,489	15,167,797
OTHER ASSETS	97,190	58,480
	$18,089,275	$19,117,821

LIABILITIES

	1985	1984
CURRENT LIABILITIES		
Bank overdraft	$ 143,220	$ -
Accounts payable and accrued liabilities	2,195,496	803,343
	2,338,176	803,343
LONG-TERM DEBT (note 5)	400,000	-
DEFERRED REVENUE (note 6)	332,880	345,324
DEFERRED INCOME TAXES	-	182,864
SHAREHOLDERS' EQUITY		
SHARE CAPITAL (note 7)	17,441,798	17,428,236
RETAINED EARNINGS (DEFICIT)	(2,424,119)	358,054
	15,017,679	17,786,290
CONTINGENT LIABILITY (note 12)		
	$18,089,275	$19,117,821

Approved on behalf of the Board,

J C Anderson ,Director

,Director

CONSOLIDATED STATEMENT OF LOSS
YEAR ENDED DECEMBER 31, 1985

	1985	1984
REVENUE		
Oil and gas sales, net of royalties	$ 2,676,909	$ 542,720
Alberta royalty tax credit	44,121	26,564
Interest, management fees, other	202,119	379,616
	2,923,149	948,900
EXPENSES		
Production	447,084	137,236
General and administrative (note 4)	401,328	242,553
	848,412	379,789
EARNINGS BEFORE THE FOLLOWING	2,074,737	569,111
ITEMS NOT REQUIRING FUNDS		
Write-down of North American oil and gas properties to estimated net realizable value	3,145,000	-
Write-down of mining properties to estimated net realizable value	996,774	205,840
Write-down of Tunisia properties to estimated net realizable value	-	45,500
Depreciation	271,000	56,100
Depletion	627,000	233,000
	5,039,774	540,440
EARNINGS (LOSS) BEFORE INCOME TAXES AND EXTRAORDINARY ITEM	(2,965,037)	28,671
DEFERRED INCOME TAXES (recovery)	(182,864)	19,951
EARNINGS (LOSS) BEFORE EXTRAORDINARY ITEM	(2,782,173)	8,720
EXTRAORDINARY ITEM	-	510,234
NET EARNINGS (LOSS)	$ (2,782,173)	$ 518,954
EARNINGS (LOSS) PER SHARE BEFORE EXTRAORDINARY ITEM	$ (0.39)	$ 0.001
EARNINGS (LOSS) PER SHARE	$ (0.39)	$ 0.07
CASH FLOW PER SHARE	$ 0.29	$ 0.08

CONSOLIDATED STATEMENT OF DEFICIT
YEAR ENDED DECEMBER 31, 1985

	1985	1984
RETAINED EARNINGS (DEFICIT), BEGINNING OF YEAR, AS PREVIOUSLY REPORTED	$ 358,054	$ (46,212)
RETROACTIVE ADOPTION OF ONE COST CENTRE IN RESPECT OF COSTS CAPITALIZED IN NORTH AMERICA UNDER THE FULL COST METHOD OF ACCOUNTING FOR OIL AND GAS PROPERTIES	-	(114,688)
AS RESTATED	358,054	(160,900)
NET EARNINGS (LOSS)	(2,782,173)	518,954
RETAINED EARNINGS (DEFICIT), END OF YEAR	$ (2,424,119)	$ 358,054

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION YEAR ENDED DECEMBER 31, 1985

	1985	1984
WORKING CAPITAL WAS PROVIDED BY		
Current operations	$ 2,074,737	$ 569,111
Petroleum incentive payments	734,816	200,989
Increase in long-term debt	400,000	-
Proceeds on disposal of oil and gas properties	157,212	-
Proceeds from the issue of share capital	13,562	33,219
Decrease in other assets	-	29,019
Repayment of note receivable	-	50,000
	3,380,327	882,338
WORKING CAPITAL WAS USED FOR		
Additions to property and equipment	6,188,494	2,056,510
Increase in funds in escrow	241,162	-
Increase in other assets	38,710	-
Advance to officer	70,700	-
Decrease in deferred revenue	12,444	-
Net assets received on redemption of shares	-	73,261
	6,551,510	2,129,771
DECREASE IN WORKING CAPITAL	(3,171,183)	(1,247,433)
WORKING CAPITAL, BEGINNING OF YEAR	2,777,400	4,024,833
WORKING CAPITAL (DEFICIENCY), END OF YEAR	$ (393,783)	$ 2,777,400

AUDITOR'S REPORT

To the Shareholders
Rio Alto Exploration Ltd.

We have examined the consolidated balance sheet of Rio Alto Exploration Ltd. as at December 31, 1985 and the consolidated statements of loss, 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 consolidated financial statements present fairly the financial position of the company as at December 31, 1985 and the results of its operations and 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.

Collins Barrow
CHARTERED ACCOUNTANTS

Calgary, Alberta
MARCH 21, 1986

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEAR ENDED DECEMBER 31, 1985

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements of the Company are stated in Canadian dollars and have been prepared in accordance with accounting principles generally accepted in Canada which, in the case of the Company, conform in all material respects with International Accounting Standards. The significant accounting policies are summarized below:

(a) Principles of consolidation

The consolidated financial statements include the accounts of the Company and wholly-owned subsidiaries and its proportionate share of assets, liabilities, revenues and expenses of Rio Alto Drilling Fund (1976) (a limited partnership).

(b) Oil and gas operations

The Company follows the full cost method of accounting for oil and gas operations wherein all costs relating to the exploration for and development of oil and gas reserves are capitalized in cost centres. These costs are depleted on the unit-of-production method based on the estimated proven reserves of oil and gas in each cost centre as determined by independent and company engineers. Proceeds on minor property sales are credited to the net book value of property and equipment without recognizing any gain or loss on disposition. Gains or losses on major property sales are recognized in the earnings statement. Capitalized expenditures are accumulated in cost centres as follows: North America, Italy, France and Ireland.

Depletion is provided on costs accumulated in North America (Canada and the United States).

Expenditures incurred in the Italy, France and Ireland cost centres are being capitalized pending the results of exploration in progress. Realization of any underlying value of these assets is dependent upon future exploration and development to determine the existence of oil and gas reserves capable of commercial production.

The Company employs a ceiling test annually on the North America cost centre whereby capital costs would be written off should they exceed the present value of future net revenues from estimated production of proven reserves, together with undeveloped land at the lower of cost and net realizable value.

(c) Mining operations

The Company follows the practice of capitalizing all acquisition and exploration costs relating to mining operations on a prospect area basis. If a prospect area is subsequently abandoned or sold, all capitalized costs relating to the area are charged to earnings.

(d) Joint venture accounting

A substantial portion of the company's exploration and production activities related to oil and gas are conducted jointly with others and accordingly the accounts reflect only the Company's proportionate interest in such activities.

(e) Depreciation

Depreciation of production equipment is provided for on the unit-of-production method. Depreciation of sundry equipment is provided for on the declining balance method at 20% per annum.

(f) **Foreign currency translation**

The accounts of the foreign subsidiaries and other foreign operations have been translated to Canadian dollars using the temporal method on the following basis: monetary items at the rate of exchange at the year-end; other assets and liabilities at the historical rate of exchange. The items in the statement of earnings are translated at the average rates of exchange prevailing during the year except for depletion and depreciation, which are translated at the same rates as used for the related assets. Material translation gains and losses on monetary items are included in the statement of loss.

(g) **Earnings per share**

Basic earnings per share have been calculated using the weighted average number of common shares outstanding during the year.

The exercise of the options would not be dilutive.

(h) **Cash flow per share**

Cash flow per share refers to working capital generated from operations and has been calculated using the weighted average number of common shares outstanding during the year.

The exercise of share options would not be dilutive.

2. DUE FROM AN OFFICER

During the year, the Company advanced $70,700 to an officer of the Company for the purpose of acquiring common shares of the Company on the open market. The loan is non-interest bearing with no fixed terms of repayment.

3. FUNDS IN ESCROW

Funds in escrow consist of the following amounts:

	1985	1984
Monies held in lawyer's trust account	$ 296,323	$ 310,801
Term deposit held by a Canadian chartered bank	255,640	-
	$ 551,963	$ 310,801

a) The monies held in trust by the company's lawyer represent repayments made in advance of delivery of gas under a take-or-pay agreement (see note 6). The trustee invests the trust funds in term deposits and distributes interest monthly. Portions of these monies are distributed to the Company after the value of gas delivered is determined at the expiry of each contract year.

b) The term deposit held by a Canadian Chartered bank is under lien as security for that bank issuing a $360,000 U.S. letter of credit in favor of the Italian government. This letter of credit is required in order to hold an oil and gas permit in Italy and will be maintained for the length of time necessary to fully evaluate the permit. Therefore, the account is classified as a long-term debt.

4. PROPERTY AND EQUIPMENT

	1985			1984
	Cost	Accumulated Depreciation and Depletion	Net	Net
Oil and gas properties — North America	$ 5,418,547	$ 815,740	$ 4,602,807	$ 4,964,292
Deferred exploration and development — Foreign	8,927,005	-	8,927,005	8,619,255
Mining properties	1	-	1	996,353
Production equipment	2,121,409	294,373	1,827,036	496,681
Sundry equipment	141,986	74,346	67,640	91,216
	$ 16,608,948	$ 1,184,459	$ 15,424,489	$ 15,167,797

During the year the Company capitalized general and administrative expenses in the amount of $393,745 (1984 - $259,908) of total general and administrative expenses incurred of $795,073 (1984 - $502,461).

5. LONG-TERM DEBT

During the year, the Company negotiated a $1,500,000 credit facility with a Canadian chartered bank to assist with certain exploration and development programs, of which $400,000 has been borrowed at December 31, 1985. Monies borrowed under this credit facility are repayable over an eighteen month period at $83,333 per month commencing January 1986. However, no repayments of principal are required until the amount borrowed exceeds the original line of credit, which is being reduced by $83,333 per month commencing January 1986. Therefore, the bank loan has been classified as a long-term liability.

Interest is calculated at prime plus ¼% up to December 31, 1985 and prime plus ¾% thereafter. The Company has granted as security a general assignment of book debts, a first floating charge debenture of $1,500,000 together with certain negative pledges and an undertaking to provide certain oil and gas property security at the option of the bank.

6. DEFFERED REVENUE

Pursuant to natural gas sales agreements, the Company is entitled to received $332,880 (1984 - $345,324) for natural gas that will not be delivered until future years. The revenue has been deferred and will not be recognized in the statement of earnings until such time as the natural gas is delivered.

7. SHARE CAPITAL

a) Authorized

1,000,000 Preferred shares of no par value
20,000,000 Common shares of no par value

b) Issued

	1985		1984	
Common Shares	Number of Shares	Amount	Number of Shares	Amount
Balance, beginning of year	7,118,411	$ 17,428,236	7,106,311	$ 17,395,017
Exercise of share options	8,750	13,562	12,100	33,219
Balance, end of year	7,127,161	$ 17,441,798	7,118,411	$ 17,428,236

c) At December 31, 1985, 181,250 common shares were reserved for options issuable to officers and employees as follows:

Number of Shares	Price	Date Granted	Expiry Date
25,000	$1.60	May 7, 1984	May 7, 1989
30,000	$1.60	June 29, 1984	June 29, 1989
26,250	$1.55	July 17, 1984	July 17, 1989
100,000	$1.46	December 20, 1984	December 20, 1989
181,250			

8. INCOME TAXES

The provision made for income taxes in 1985 and 1984 is different from the amount which would have been expected if it were assumed that the reported pre-tax earnings were subject to the Canadian Federal and Provincial statutory income tax rates for the year. The principal reasons for the differences between such "expected" income tax provisions and the amounts actually provided were as follows:

	1985	1984
Effective Canadian tax rate	47%	50%
Computed "expected" tax expense (recovery)	$(1,391,087)	$ 14,336
Increase (decrease) in taxes resulting from		
Non-deductible crown royalties	441,300	33,531
Earned depletion allowance	70,132	(24,249)
Resource Allowance	(31,490)	(6,750)
Alberta royalty tax credit	(20,737)	(13,282)
Tax benefit not recognized due to lack of virtual certainty of realization	749,018	-
Other	-	16,365
	$ (182,864)	$ 19,951

9. REMUNERATION OF SENIOR OFFICERS AND DIRECTORS

The total remuneration paid to directors and officers of the Company (including the five highest paid employees) amounted to $223,193 (1984 - $130,302).

10. SEGMENTED INFORMATION

	1985			
	Canada	United States	Italy, France and Ireland	Total
Oil and gas sales	$ 2,568,679	$ 108,230	$ -	$ 2,676,909
Operating profit	$ 2,183,979	$ 89,967	$ -	$ 2,273,946
General and administrative expense				401,328
Interest, management fees, other				(202,119)
Items not requiring funds				5,039,774
Deferred income tax recovery				(182,864)
				5,056,119
Net loss				$ (2,782,173)
Total identifiable assets	$ 9,098,394	$ 63,876	$ 8,927,005	$ 18,089,275

	1984			
	Canada	United States	Italy, France and Ireland	Total
Oil and gas sales	$ 372,329	$ 170,391	$ -	$ 542,720
Operating profit	$ 277,656	$ 154,392	$ -	$ 432,048
General and administrative expense				242,553
Interest, management fees, other				(379,616)
Items not requiring funds				540,440
Deferred income taxes				19,951
				423,328
Net earnings before extraordinary item				8,720
Extraordinary item				510,234
Net earnings				$ 518,954
Total identifiable assets	$ 7,188,231	$ 3,310,335	$ 8,619,255	$ 19,117,821

11. RELATED PARTY TRANSACTIONS

The Company has the following arrangement with an officer and an employee:

a) An officer receives a 1.5% net production revenue interest on all wells drilled in North America after June 1, 1985 and a 0.5% net production revenue interest before payout and 1.0% after payout on all wells drilled outside of North America. The total amount earned by the officer in 1985 amounted to $22,272.

b) The employee receives a 1% net production revenue interest on all wells drilled after July 17, 1984. The total amount earned by the employee in 1985 amounted to $18,796 (1984 - $2,182).

12. CONTINGENT LIABILITY

The Company has a contingent liability in respect of possible withholding taxes being claimed by the Internal Revenue Service. The Internal Revenue Service claims that the Company owes withholding taxes of $93,374 in regard to imputed interest on the Company's loan to its U.S. subsidiary. The final outcome of this dispute cannot be reasonably predicted at the present time.

RIO ALTO EXPLORATION LTD.

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