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RIO ALTO EXPLORATION LTD.

1986 ANNUAL REPORT

RIO ALTO EXPLORATION LTD.

CORPORATE PROFILE

Rio Alto Exploration Ltd. was incorporated under the laws of Alberta on May 13, 1970. The Company engaged in mineral exploration and development in its early years. Since 1984, the emphasis has been changed to oil and gas exploration and development. During this time, Rio Alto has participated in various plays in North America, Europe and Pakistan, and has assembled a significant land position and production base. Rio Alto is a Canadian Controlled Public corporation listed on the Toronto Stock Exchange.

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CORPORATE INFORMATION

DIRECTORS

John C. Anderson	Calgary, Alberta
Carman 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
Cuneyt S. Tirmandioglu	Assistant Secretary, Controller

HEAD OFFICE

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

SUBSIDIARY

Rio Alto Exploration Inc.

BANK

Toronto Dominion Bank
Royal Bank of Canada

TRANSFER AGENT AND REGISTRAR

The Canada Trust Company

LEGAL COUNSEL

Parlee McLaws

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 Wednesday,
May 13, 1987 in the Boardroom of
The 400 Club, Calgary, Alberta.

HIGHLIGHTS OF ACTIVITIES

	Dec. 31 1986	Dec. 31 1985
FINANCIAL		
Gross revenues	**$2,607,001**	$2,870,932
Cash flow	**1,451,008**	2,074,737
Loss for the year	**(11,415,992)**	(2,782,173)
Growth expenditures net of incentives	**1,620,166**	5,492,388
Working capital deficiency	**(41,037)**	(393,783)
PRODUCTION		
Average barrels of oil per day	**345**	213
Average thousand cubic feet gas per day	**509**	368
RESERVES		
Proven oil (barrels)	**535,000**	620,000
Proven gas (MCF)	**1,328,000**	1,073,000
WORKING INTEREST WELLS		
Oilwells - Gross	**257**	225
Gaswells - Gross	**173**	172
DRILLING RESULTS		
Oil	**32**	113
Gas	**1**	3
Dry	**8**	8

LAND HOLDINGS	**1986**		1985	
(in acres)	**Gross**	**Net**	Gross	Net
Canada	89,830	8,355	79,594	7,620
Foreign	1,189,693	443,710	2,118,748	538,223
	1,279,523	452,065	2,198,342	545,843

TO THE SHAREHOLDERS

The past year has been a very difficult one for our industry, fortunately our increased oil and gas production helped to offset the dramatic drop in oil prices to a large extent. Cash flow from operations was a healthy $1,451,008 or $0.20 per share for the year ended December 31, 1986, compared to $2,074,737 or $0.29 per share a year earlier.

During the year, the Canadian Institute of Chartered Accountants introduced a new guideline for companies using full cost method of accounting. Notwithstanding our reservations with certain aspects of the recommendations in particular with the concept of the enterprise ceiling test which in our opinion is contradictory with the going concern assumption of accounting, the Company's management has decided to comply with the new guidelines on a prospective basis. In conjuction with the ceiling test calculation, the Company's undeveloped properties in Italy, France and Ireland were put to a test of impairment. Despite significant upside potential, the carrying value of these properties was reduced by $8.7MM to a nominal $279,591 to prevent recurring write-downs in the future. The carrying value of the Canadian cost centre was reduced by $3.5MM primarily as a result of the enterprise ceiling test resulting in a total write-down of $12.2MM for the year.

The Company and its partners finalized the exploration agreement with the government of Pakistan on July 15th, 1986. The seismic program will commence about March 1st, 1987. The Company is very optimistic about the potential of this acreage.

In Western Canada the Company restricted its activities to work which had been committed to, prior to the decline in oil prices.

The Company participated in seismic programs on the CR100 and Basentello properties during the year, further information on these properties is contained in the body of the report.

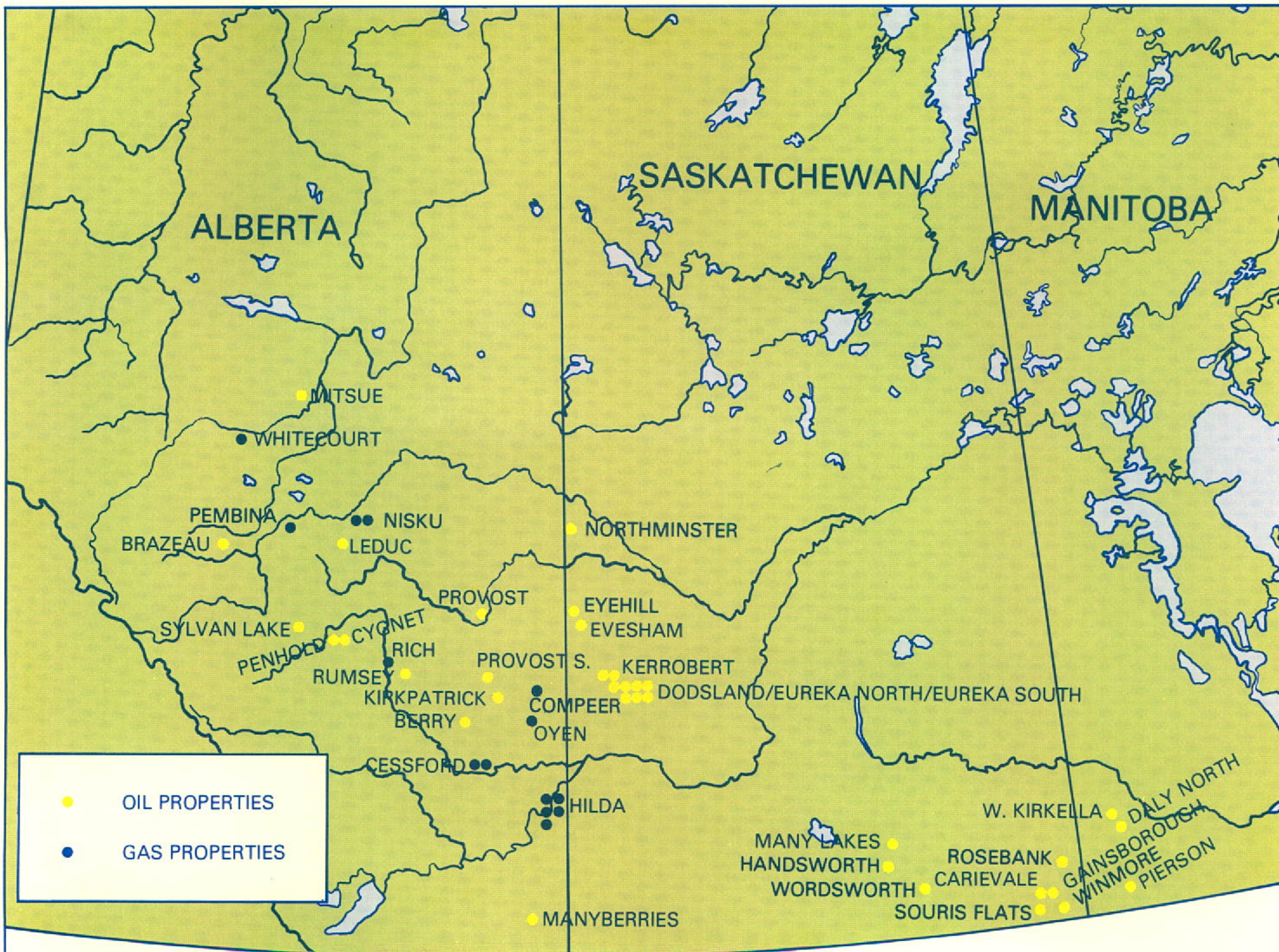
It appears that oil prices have a reasonable chance to stabilize around U.S. $18.00 per barrel, if this is the case, the Company is prepared to raise funds to re-activate our exploration program.

This has been a very difficult year for our staff, on behalf of the Board of Directors, I wish to thank them for their loyalty and their ability to adapt to ever changing circumstances.

J C Anderson

John C. Anderson
President

ACTIVITIES IN WESTERN CANADA:



During 1986 the Company participated in the drilling of 41 wells, of which, 32 were oilwells, 1 was a gaswell and 8 were dry and abandoned.

Although significant reserve additions were made from 1986 drilling in Saskatchewan, the Company's total proven producing oil reserves declined from 620,000 barrels at the end of 1985 to 535,000 barrels at the end of 1986. This 14% drop in proven oil reserves reflects oil that is no longer economic to recover at $18 US per barrel.

Gas reserves, however, have increased 24% from 1.07 bcf at the end of 1985 to 1.33 bcf at the end of 1986. The increase in gas reserves is attributable to Kerrobert solution gas sales which commenced in February, after the gas gathering and processing system were built.

Net production in 1986 averaged 345 bopd and 509 mcfgpd compared to 213 bopd and 368 mcfgpd in 1985. This represents an increase of 62% in oil production and 38% in gas production.

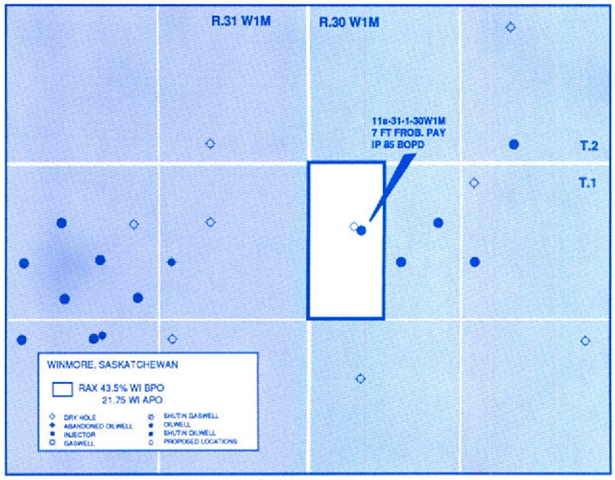
Exploration lands totalling 10,713 gross acres and 1,533 net acres were acquired in Alberta and Saskatchewan in 1986.

Due to the collapse of oil prices in 1986 the Company will shift its exploration emphasis from Saskatchewan to higher productivity and reserve potential areas of Alberta.

ACTIVITIES IN WESTERN CANADA:

WINMORE, SASKATCHEWAN

A bypassed oilwell was identified at 11-31-1-30W1M based on core analysis and wireline log analysis. The Company farmed in on the west half of Section 31 and drilled a twin well at 11a-31 which found 7 feet of net oil pay in the Frobisher Formation. The 11a-31 had initial production of 85 bopd with 4% watercut but production has been constrained by a well allowable of 39 bopd. The Company has a 43.5% working interest before payout and a 21.75% working interest after payout in the well and the west half of Section 31.



WINMORE, SASKATCHEWAN

1986 WELLS DRILLED

	Oil	Gas	Dry	Total
Kerrobert	16	—	—	16
Winmore	1	—	—	1
Macedon	10	—	5	15
Provost	1	—	—	1
Daly	2	—	—	2
Kirkpatrick	—	—	1	1
Cessford	—	1	—	1
Brazeau	1	—	—	1
Compeer	1	—	—	1
Manyberries	—	—	1	1
Ireland	—	—	1	1
	32	1	8	41

EXPLORATION LANDS ACQUIRED ALTA/SASK 1986

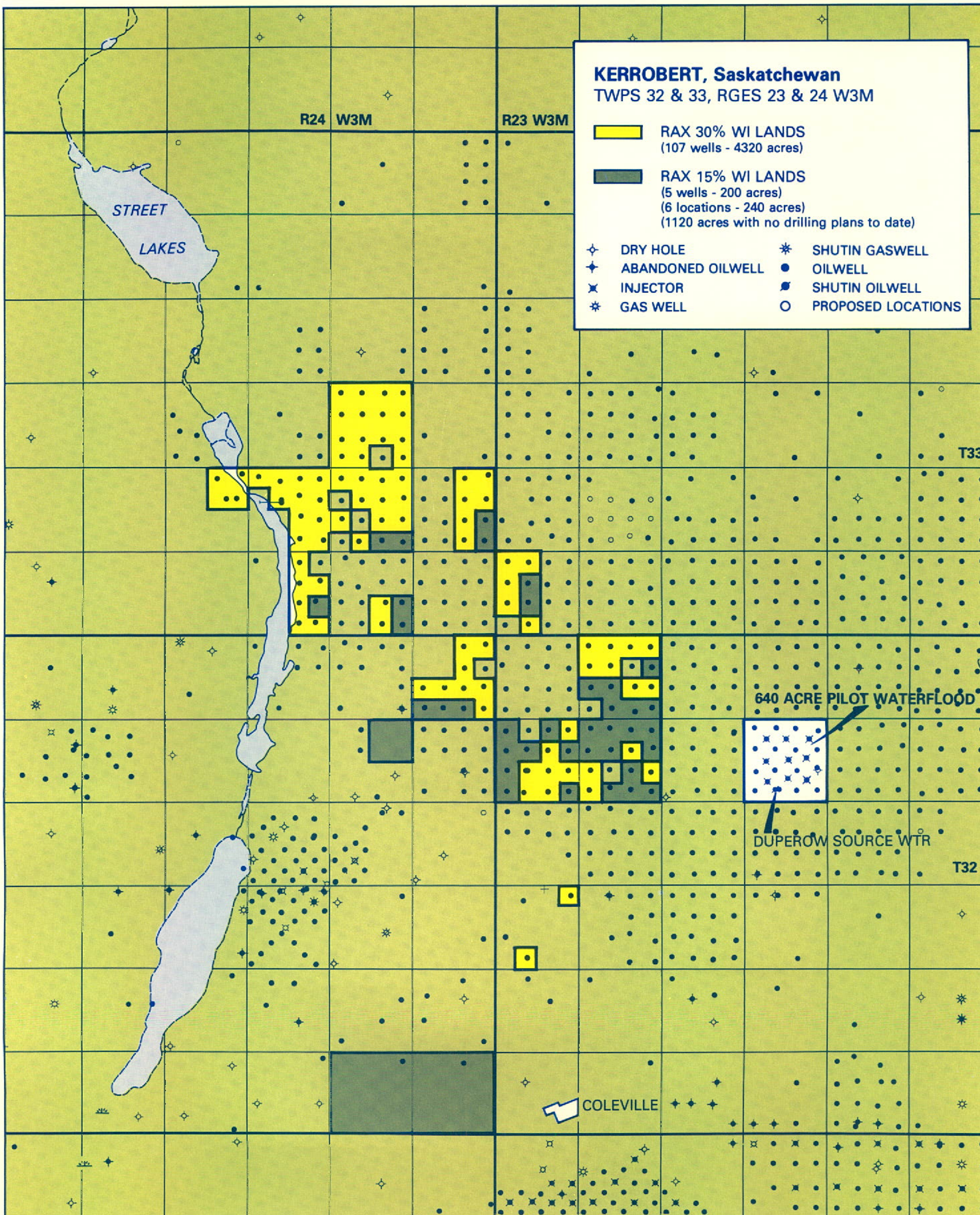
	Gross	Net
Carievale	631	158
Gainsborough	480	120
Many Lakes	802	200
Provost South	3,200	320
Kirkpatrick	4,640	464
Mitsue	160	18
Brazeau	640	213
Winmore South	160	40
	10,713	1,533

KERROBERT, SASKATCHEWAN

The Company has a 15% to 30% working interest in 6,400 acres of petroleum and natural gas leases in the Kerrobert area of Saskatchewan. During the first quarter of 1986, the Company participated in the drilling of 16 Viking oilwells to bring the total to 128 oilwells drilled on the property. In January, 83 wells were producing and by December, 124 wells were onstream. Construction of a gas gathering system and processing plant were completed and solution gas sales started in February.

The Company's share of production at Kerrobert averaged 283 bopd and 244 mcfgpd in 1986. At December 31st, a total of 39 wells had paid out, representing 30% of the total wells drilled. The Company's share of proven producing reserves at Kerrobert is estimated to be 491,000 barrels of oil and 393 million cubic feet of natural gas.

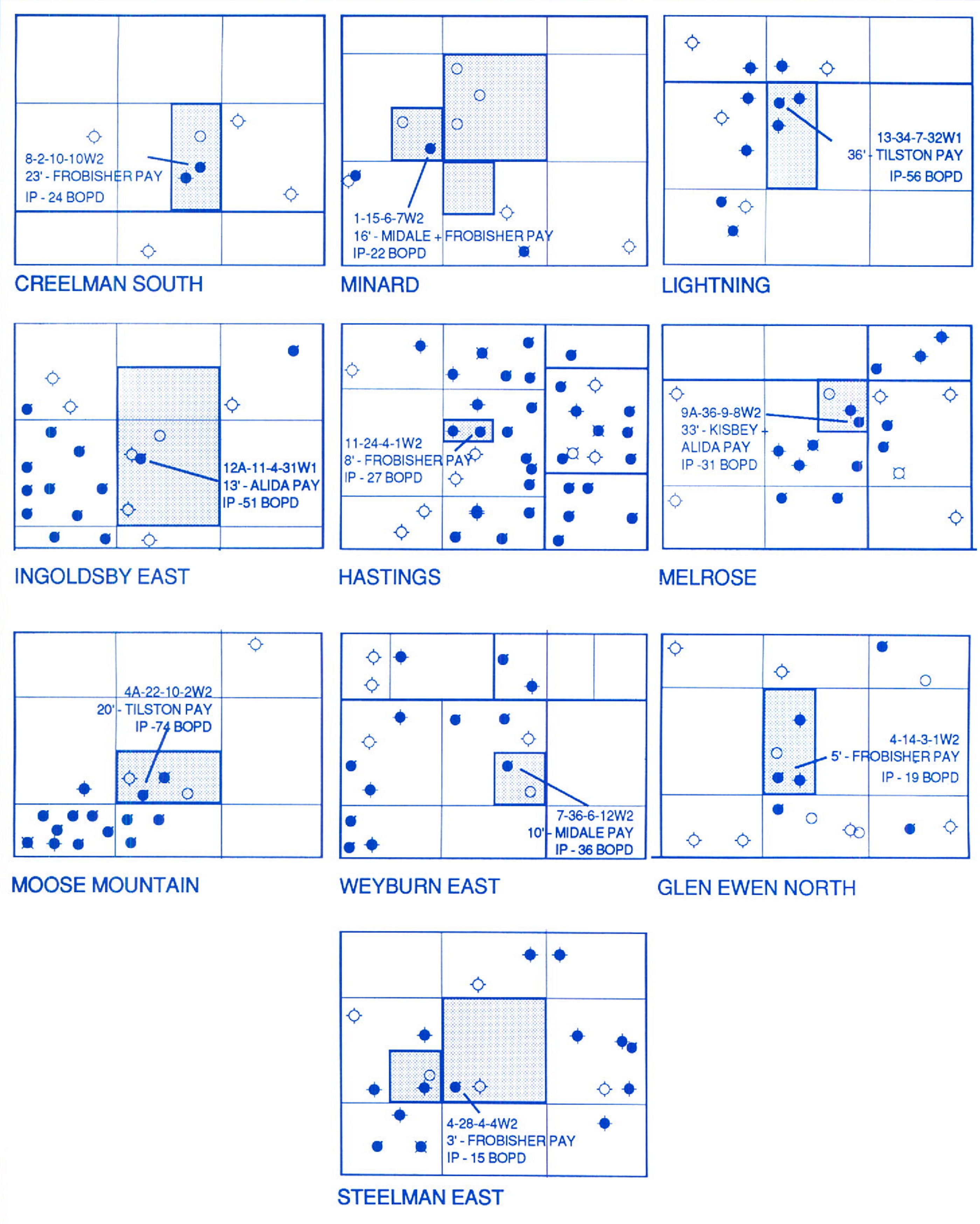
A pilot waterflood project on Section 27-32-23W3M was started in 1986 by another company. Source water from the 3-27 well is being injected into 9 wells to sweep oil towards the 16 producing oilwells on section 27. Oil production increases from this pilot waterflood are being monitored and will be used to evaluate the feasibility of a secondary recovery scheme for the Company's large probable oil reserves at Kerrobert.



KERROBERT, Saskatchewan
TWPS 32 & 33, RGES 23 & 24 W3M
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
LAKES
T33
T32
640 ACRE PILOT WATERFLOOD
DUPEROW SOURCE WTR
COLEVILLE

SASKATCHEWAN DRILLING PROGRAM

RAX 6% WORKING INTEREST OFFSET LOCATION S.



SASKATCHEWAN DRILLING PROGRAM

During the first quarter of 1986, the Company participated in a drilling program to evaluate 16 prospects spread widely over a broad area of southeast Saskatchewan. Under an agreement with Macedon Resources Ltd., the Company paid 7.5% of the land acquisition and drilling costs to earn a 6% working interest in the 16 Mississippian oil prospects.

Fifteen of the 16 wells were drilled in 1986, of which, 10 were oilwells and 5 were abandoned. The 10 oilwells were put onstream July 1st and production for the six months ended December 31st averaged 202 bopd. The Company's 6% share of production averaged 12 bopd for the period.

Of particular interest are the Creelman, Melrose, Moose Mountain, Minard, Weyburn, Ingoldsby, Steelman and Glen Ewen properties where a total of 11 development locations can be drilled on 40 acre offsets to the 1986 oilwells.

DALY, MANITOBA

The Company participated for 9.375% in the drilling of the 15-8-10-28W1M well and 6.25% in 4-16-10-28W1M well which were completed as Mississippian oilwells. Combined production for both wells from June to December averaged 15 bopd.

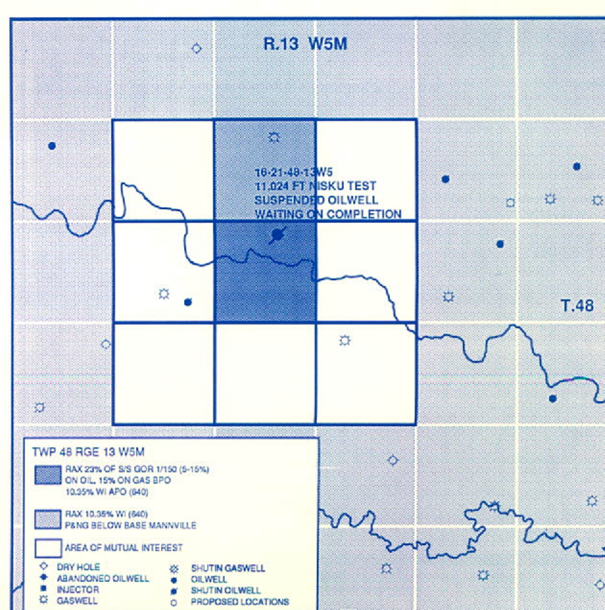
Due to the high royalty burdens and operating costs of the Daly property, the Company converted its working interest to a non-convertible royalty interest effective December 1st, 1986. The Company has a 1.5% GOR on the 9-8 well and a 1% GOR on the remaining 8 oilwells in Sections 8, 16, 17 and 21. Gross production from the Daly wells in December was 109 bopd.

In addition, the Company has a 1.0 to 1.5% GOR on future wells drilled on the property and a 1% royalty on gross revenues generated from any future water disposal system built on the lands.

BRAZEAU, ALBERTA

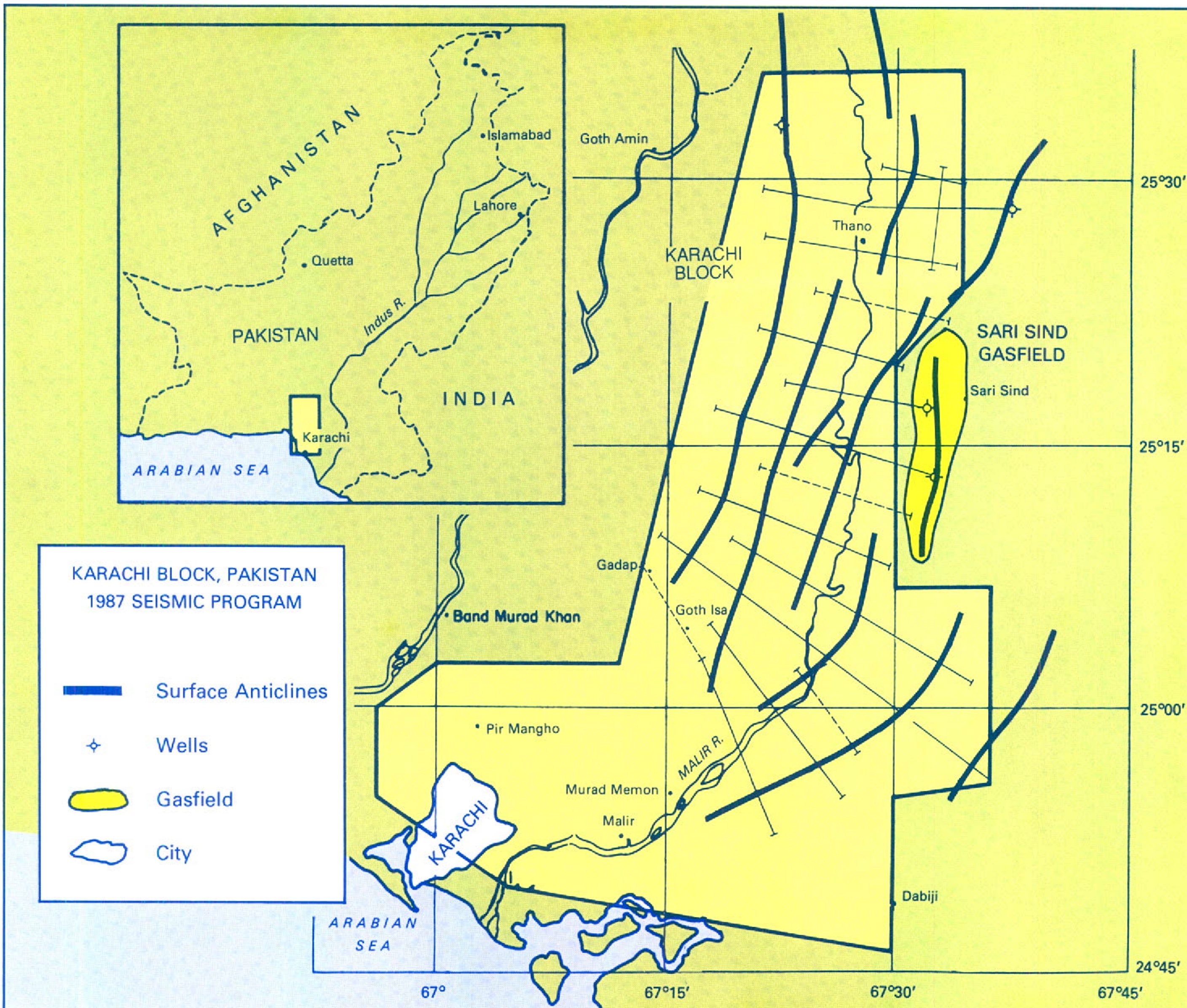
The Company farmed out its 23% working interest in Section 21-48-13W5M in 1986 and the 16-21 Devonian Nisku test was drilled in September to a depth of 11,024 feet. Unfortunately, no reservoir development was encountered over the Nisku interval and the zone was plugged. Casing was run over log indicated pay zones in Cretaceous sands uphole and tests of these intervals are planned for the first quarter of 1987.

The Company is participating for 10.35% in the reprocessing of the three dimensional and two dimensional seismic surveys to calibrate with the 16-21-48-13W5M well and reinterpret other Nisku seismic anomalies on Section 21.



BRAZEAU, ALBERTA

INTERNATIONAL ACTIVITIES:



KARACHI BLOCK, PAKISTAN

On July 15, 1986, an agreement was signed with the Pakistan Government setting out the exploration terms for the Karachi Block, onshore Pakistan. An initial term of 3 years was granted for the 880,000 acre exploration and prospecting licence. The Company has a 47.5% working interest during the exploration phase and a 25% working interest after a commercial discovery is made.

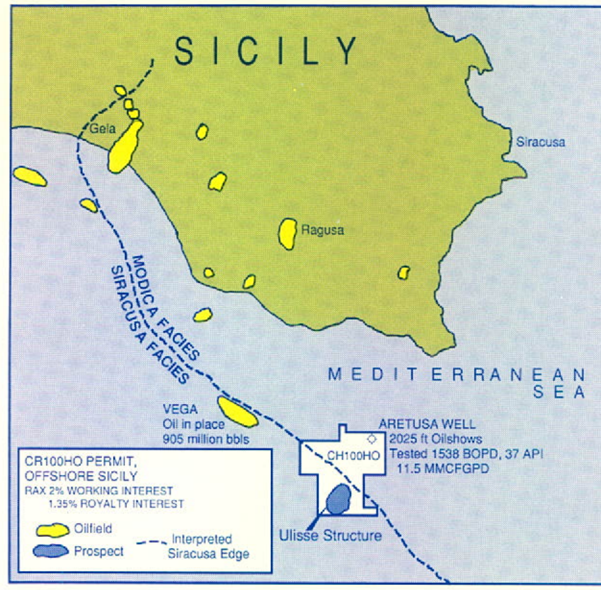
A consultant's report on the petroleum geology of the South Indus Basin was completed in 1986 and identified the Cretaceous Pab sandstone and Paleocene Ranikot sandstone and carbonate as primary drilling objectives. The Ranikot reservoir contains 80 billion cubic feet of natural gas reserves at the Sari Sing and Hundi Fields adjacent to the eastern boundary of the Karachi Block.

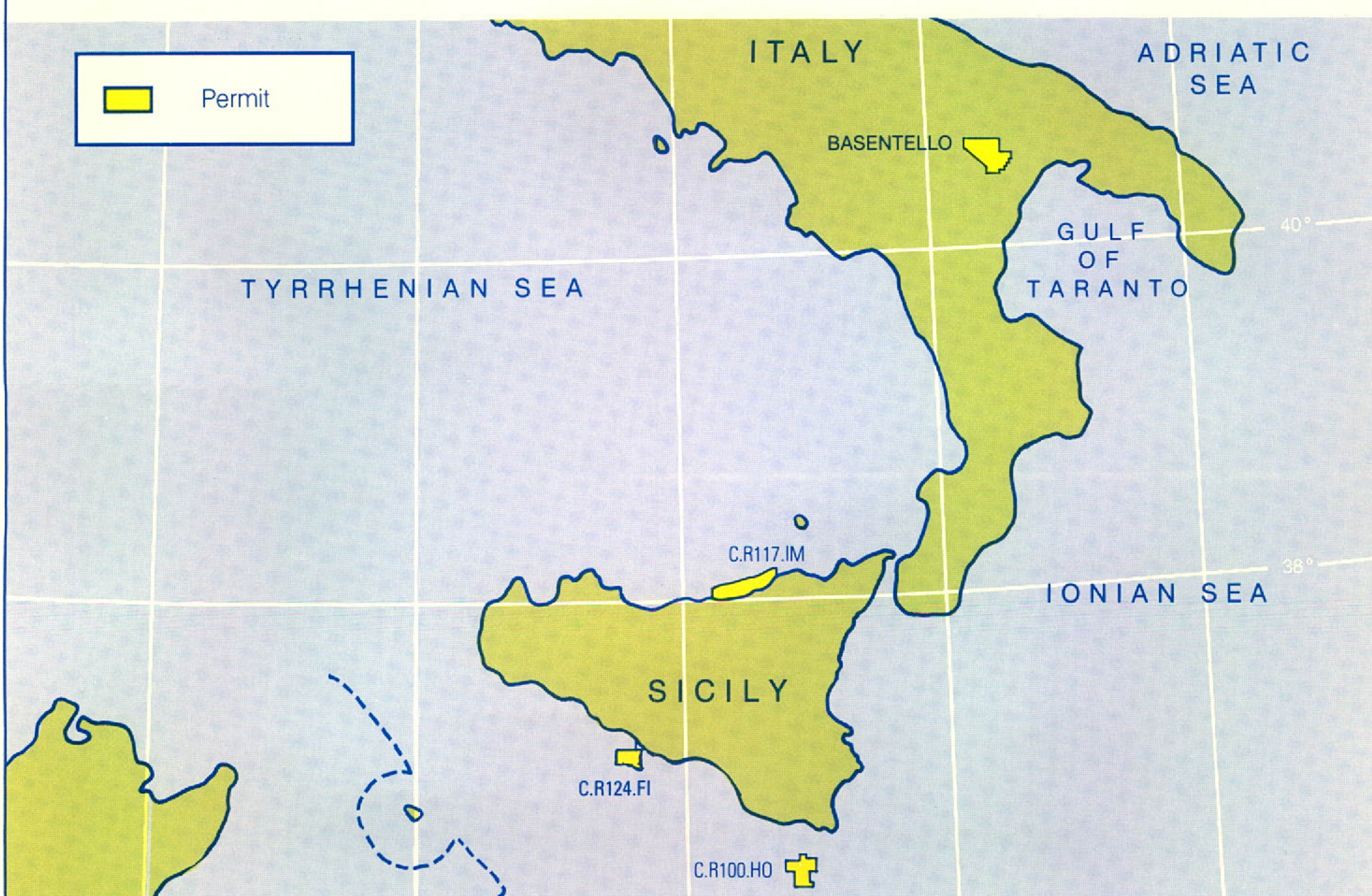
In 1987, the Company will participate in a 500 kilometre reconaissance seismic survey to define subsurface closures on 8 large surface anticlines on the Karachi Block.

CR100H0 PERMIT, OFFSHORE SICILY

In 1986 a 400 kilometre marine seismic survey was completed by Geoitalia on the CR100H0 Permit. Subsequent interpretation of the seismic data has confirmed a large central structure on the permit which the joint venture group has named the "Ulisse Structure". The Jurassic Siracusa Formation was identified as the primary drilling objective at a drill depth of 13,000 feet. Potential reserves calculated by the group are 162 million barrels of oil.

The Company has a 2% working interest and a 1.35% royalty interest in the 66,273 acre offshore permit. The 1987 work program includes reprocessing 150 kilometres of old seismic data and a geological assessment of the geophysical results. A contingency for a Siracusa well forms part of the 1987 budget and an economic evaluation of the drilling project will proceed when oil prices stabilize.





INTERNATIONAL ACTIVITIES:

SAINT SAENS AND ALTKIRCH PERMIT, FRANCE

A 60 kilometre seismic program on the Altkirch Permit was completed in January and defined a Jurassic Dogger structure showing 295 feet of vertical closure and 1.2 square kilometres of areal closure. Seismic detailing of structural leads of the Saint Saens Permit failed to identify any significant closures.

Due to the higher reserve potential of exploration prospects in Pakistan and offshore Sicily, the Company decided to reduce its capital exposure in France. In 1986, the Company sold its working interest in the Saint Saens and Altkirch Permits and retained a 0.50% royalty on future production from the properties.

OTHER INTERNATIONAL ACTIVITY

The Company farmed out its working interest in the 42/12 Permit in the Irish Sea. The farmee drilled a 9,265 foot Carboniferous test but no significant gas shows were encountered and the well was abandoned.

The DR56CL Permit, offshore Italy, was relinquished after a review of the 1985 and 1986 seismic results.

The Company relinquished 25% of the Basentello acreage, onshore Italy, to retain an 18.75% working interest in 43,237 gross acres. A small seismic program was shot in late 1986 to evaluate the gas prospectivity of the southwest corner of the permit.

The Cherbourg Maritime application, offshore France was rejected by the French Ministry in late 1986.

Land Holdings (acres)

	WORKING INTEREST GROSS	WORKING INTEREST NET	ROYALTY INTEREST
CANADA			
Saskatchewan	29,339	4,133	8,683
Manitoba	520	67	3,160
Alberta	59,971	4,155	5,920
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.R124.FI	0	0	53,626
ITALY			
Basentello	43,237	8,107	0
FRANCE			
Saint Saens	0	0	531,544
Altkirch	0	0	176,852
IRELAND			
Permit 42/7 and 42/12	105,000	577	0
UNITED STATES	3,897	502	160
TOTAL	1,279,523	452,065	846,218

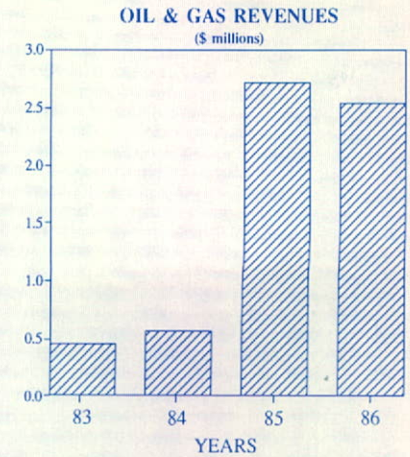
THREE YEAR FINANCIAL AND OPERATING SUMMARY

Years ended December 31	1986	1985	1984
EARNINGS			
Gross revenues	$ 2,607,001	$ 2,870,932	$ 948,900
Net operating income	1,815,274	2,273,946	432,048
Earnings (loss) before unusual and extraordinary items	793,208	(2,782,173)	8,720
Per common share	0.11	(0.39)	0.001
Net earnings (loss)	(11,415,992)	(2,782,173)	518,954
Per common share	(1.60)	(0.39)	0.07
CASH FLOWS			
Cash flow from operations	1,451,008	2,074,737	569,111
Per common share	0.20	0.29	0.08
BALANCE SHEET			
Working capital (deficiency)	(41,037)	(393,783)	2,777,400
Property and equipment - net	4,203,625	15,521,679	15,226,277
Long-term debt	583,335	400,000	-
Deferred revenue	293,442	332,880	345,324
Shareholder's equity	3,601,687	15,017,679	17,786,290
Number of common shares outstanding	7,127,161	7,127,161	7,118,411
OPERATIONS			
Wells drilled (gross)			
Oil	32	113	22
Gas	1	3	1
Dry	8	8	7
Annual production			
Oil - barrels	126,022	77,745	7,191
Gas - mcf	185,883	134,320	73,496
Daily production			
Oil - bopd	345	213	20
Gas - mcfpd	509	368	200
Reserves - proven			
Oil - barrels	535,000	620,000	83,350
Gas - mcf	1,328,000	1,073,000	795,000

FINANCIAL SUMMARY

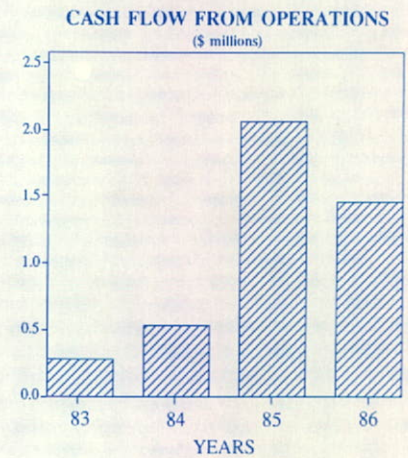
OIL AND GAS REVENUE

In 1986, the Company was able to mitigate the impact of depressed oil prices by significant gains in production. Oil production for the year averaged 345 bopd compared to 213 bopd in 1985, a 62% increase. Gas production was 509 mcfpd compared to 368 mcfpd in 1985, an increase of 38%. Oil and gas revenues net of royalties for the year was $2,533,060 compared to $2,721,030 in 1985, a decline of 7%. The average oil price received during 1986 was $20.44 per barrel compared to $36.47 in 1985, a decline of 44%. The Company's average net back in 1986 was $11.56 per barrel of oil and gas in energy equivalents as compared to $22.27 in 1985, a decrease of 48%.



CASH FLOW

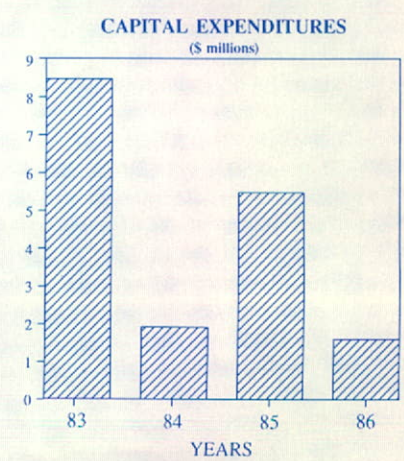
The cash flow from operations decreased to $1,451,008 ($.20 per share) in 1986 from $2,074,737 ($.29 per share) in 1985 as a direct consequence of low product prices. However, with effective working capital management the Company has been able to improve its cash position by $224,058 to $80,838 from an overdraft of $143,220 in 1985.



EXPENSES

Production expenses increased to $717,786 in 1986 from $447,084 a year earlier as a result of increased production. Average production expenses per barrel of oil and gas in energy equivalent were $4.58 in 1986 compared to $4.46 in 1985.

General and administrative expenses decreased to $682,410 from $742,856 in 1985, an 8.1% reduction. Of this amount, $332,500 (1985 - $393,745) has been capitalized and $349,910 (1985 - $349,111) has been expensed. Included in general and adminstrative expenses were approximately $50,000 representing charges of a non-recurring nature due to special projects and employee turnover. The Company is projecting a further reduction of 15% in general and administrative expenses in 1987.



CAPITAL PROGRAM

During the year, the Kerrobert drilling program was completed with the drilling of 16 Viking oilwells. In addition, a total of 25 prospects were drilled in various areas of southeast Saskatchewan, Alberta and Manitoba. Foreign property additions during the year were limited to seismic programs and the total spent on these programs amounted to $104,987. Total capital expenditures, before petroleum incentive payments, amounted to a modest $2.1 MM in 1986, which was substantially financed by internal cash flows. During the year, the Company received $503,531 in petroleum incentive payments. At December 31, 1986, there were outstanding applications entitling the Company to further incentives of $177,000.

WRITE-DOWN OF FIXED ASSETS

The Company has adopted the guideline issued by the Canadian Institute of Chartered Accountants (CICA) on full cost accounting on a prospective basis. In accordance with the recommendations of the guideline, the Company has carried out a ceiling test calculation and has reduced the carrying value of its petroleum and natural gas properties by $12,209,200. The reasons for the magnitude of this write-down are twofold. The new concept of enterprise ceiling test introduced by the guideline which requires a reduction from future revenues an amount representing future general and administrative expenses, financing costs and income taxes accounted for $3,510,800 of the total write-down.

Secondly, the Company had to take a conservative approach in determining whether impairment has occurred in its substantial holdings in Europe, most notably in Italy. Subsequently, the carrying value of the undeveloped European properties was reduced to $279,591, a total write-down of $8,698,400. It must be emphasized that the ceiling test recommended by the guideline is not intended to give an estimate of fair market value. It is a cost recovery test.

LONG TERM DEBT

The Company restructured its long-term debt with a Canadian chartered bank in December, 1986. The terms of the loan call for repayment in equal instalments of $27,777 per month and an interest rate of prime plus ¾%. Compared to the existing facility, the new loan will release $55,556 per month of the Company's cash flow for exploration and development spending.

FINANCIAL OUTLOOK IN 1987

The cash flow projection for 1987 is dependent on energy prices. Bearing no significant changes in current prices, the Company is projecting positive earnings and cash flows comparable to 1986 levels. The capital commitments for 1987, which are estimated to be $1.0 MM, will be met by internal cash flows.

Discretionary capital spending will be tailored to the level of cash flows net of commitments.

Reduced charges for general and administrative expenses and depletion and depreciation will impact earnings and cash flows positively.

CONSOLIDATED BALANCE SHEET
DECEMBER 31, 1986

ASSETS	1986	1985
CURRENT ASSETS		
Cash	$ 80,838	$ -
Accounts receivable	769,414	1,944,933
Due from an officer - current portion	7,000	-
	857,252	1,944,933
DUE FROM AN OFFICER (note 3)	56,700	70,700
FUNDS IN ESCROW (note 4)	259,176	551,963
PROPERTY AND EQUIPMENT (note 5)	4,203,625	15,521,679
	$ 5,376,753	$ 18,089,275
LIABILITIES		
CURRENT LIABILITIES		
Bank indebtedness	$ -	$ 143,220
Accounts payable and accrued liabilities	898,289	2,195,496
	898,289	2,338,716
LONG-TERM DEBT (note 6)	583,335	400,000
DEFERRED REVENUE (note 7)	293,442	332,880
SHAREHOLDERS' EQUITY		
SHARE CAPITAL (note 8)	17,441,798	17,441,798
DEFICIT	(13,840,111)	(2,424,119)
	3,601,687	15,017,679
CONTINGENT LIABILITY (note 13)		
	$ 5,376,753	$ 18,089,275

Approved on behalf of the Board,

J C Anderson ,Director

M Hillman ,Director

CONSOLIDATED STATEMENT OF LOSS AND DEFICIT
YEAR ENDED DECEMBER 31, 1986

	1986	1985
REVENUE		
Oil and gas sales, net of royalties	$ 2,533,060	$ 2,721,030
Interest and other	73,941	149,902
	2,607,001	2,870,932
EXPENSES		
Production	717,786	447,084
General and administrative (note 5)	349,910	349,111
Interest on long-term debt	88,297	-
Depletion and depreciation	657,800	898,000
Write-down of property and equipment	-	4,141,774
	1,813,793	5,835,969
EARNINGS (LOSS) BEFORE INCOME TAXES AND UNUSUAL ITEM	793,208	(2,965,037)
DEFERRED INCOME TAX RECOVERY	-	182,864
EARNINGS (LOSS) BEFORE UNUSUAL ITEM	793,208	(2,782,173)
UNUSUAL ITEM		
Write-down of property and equipment (note 2)	(12,209,200)	-
LOSS FOR THE YEAR	(11,415,992)	(2,782,173)
RETAINED EARNINGS (DEFICIT), BEGINNING OF YEAR	(2,424,119)	358,054
DEFICIT, END OF YEAR	$(13,840,111)	$ (2,424,119)
EARNINGS (LOSS) PER SHARE BEFORE UNUSUAL ITEM	$ 0.11	$ (0.39)
LOSS PER SHARE	$ (1.60)	$ (0.39)
CASH FLOW PER SHARE	$ 0.20	$ 0.29

CONSOLIDATED STATEMENT OF CASH FLOW
YEAR ENDED DECEMBER 31, 1986

	1986	1985
CASH PROVIDED BY (USED FOR)		
OPERATING ACTIVITIES		
Cash flow from operations	$ 1,451,008	$ 2,074,737
FINANCING ACTIVITIES		
Increase in long-term debt	600,000	400,000
Repayment of long-term debt	(416,665)	-
Issue of share capital	-	13,562
Decrease (increase) in non-cash working capital	(121,688)	193,770
Decrease (increase) in funds in escrow and deferred revenue	253,349	(253,606)
Repayments from (advances to) an officer	7,000	(70,700)
	321,996	283,026
INVESTING ACTIVITIES		
Property and equipment additions, net of petroleum incentive payments	(1,620,166)	(5,492,388)
Proceeds on disposal of oil and gas properties	71,220	157,212
	(1,548,946)	(5,335,176)
INCREASE (DECREASE) IN CASH	224,058	(2,977,413)
CASH (BANK INDEBTEDNESS), BEGINNING OF YEAR	(143,220)	2,834,193
CASH (BANK INDEBTEDNESS), END OF YEAR	$ 80,838	$ (143,220)

AUDITORS' REPORT

To the Shareholders
Rio Alto Exploration Ltd.

We have examined the consolidated balance sheet of Rio Alto Exploration Ltd. as at December 31, 1986 and the consolidated statements of loss and deficit and cash flow 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, 1986 and the results of its operations and cash flow for the year then ended in accordance with generally accepted accounting principles applied, except for the change in the method of accumulating exploration and development expenditures as explained in note 2 to the financial statements, on a basis consistent with that of the preceding year.

Calgary, Alberta
February 26, 1987

Collins Barrow
CHARTERED ACCOUNTANTS

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEAR ENDED DECEMBER 31, 1986

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in Canada which, in the case of the Company, confirm 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 its wholly-owned subsidiary, Rio Alto Exploration Inc., and its proportionate share of assets, liabilities, revenues and expenses of Rio Alto Drilling Fund (1976) (a limited partnership).

(b) Exploration and development costs

The Company follows the full cost method of accounting in accordance with the guideline issued by the Canadian Institute of Chartered Accountants, whereby all costs associated with the exploration for and development of oil and gas reserves are capitalized in cost centres on a country by country basis. Such costs include land acquisitions, drilling, geological and geophysical and overhead expenses related to exploration and development activities. Gains or losses are not recognized upon disposition of oil and gas properties unless crediting the proceeds against accumulated costs would result in a material change in the rate of depletion.

Costs capitalized in the cost centres are depleted using the unit-of-production method, based on estimated proven oil and gas reserves as determined by Company and independent engineers. For purposes of the depletion calculation, oil and gas reserves are converted to a common unit of measure on the basis of their relative energy content.

In applying the full cost method, the Company calculates a ceiling test which restricts the capitalized costs less accumulated depletion and depreciation for each cost centre from exceeding an amount equal to the estimated undiscounted value of future net revenues from proven oil and gas reserves, based on current prices and costs, and after deducting estimated future general and administrative expenses, financing costs and income taxes for each cost centre.

The Company periodically reviews the costs associated with undeveloped properties to determine whether the costs will be recoverable. An impairment allowance is made if the results of the review indicate an impairment has been incurred.

(c) Depreciation

Sundry equipment is depreciated on the declining balance method at rates varying between 20% and 30%.

(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) Foreign currency translation

The accounts of the foreign subsidiary 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 loss are translated at the average rate 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.

(f) Loss per share

Basic loss per share is calculated using the weighted average number of common shares outstanding during the year. Fully diluted earnings per share are not shown since there are no material dilutive factors.

(g) Cash flow per share

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

2. CHANGE IN ACCOUNTING POLICY AND UNUSUAL ITEM

The Company has prospectively adopted the recommendations of the guideline issued by the Canadian Institute of Chartered Accountants for oil and gas companies using the full cost method of accounting.

Under the previous method of full cost accounting followed by the Company, the capitalized expenditures were accumulated in cost centres in North America, Italy, France and Ireland and the ceiling test was applied to the net book value of the Company's oil and gas properties by estimating the present value of future net revenues from proved properties. The Company has since adopted a country by country cost centre concept and a cost recovery method for the ceiling test as recommended by the guideline.

In applying the ceiling test as discussed in note 1(b), costs in excess of the estimated value of property and equipment in each of the four cost centres in the amount of $12,209,200 have been written off against current earnings (note 5).

3. DUE FROM AN OFFICER

Due from an officer consists of the following:

	1986	1985
Non-interest bearing loan, repayable in equal annual installments of $7,000, due December 31, 1995	$ 63,700	$ 70,700
Less: Current portion	7,000	-
	$ 56,700	$ 70,700

4. FUNDS IN ESCROW

Funds in escrow consist of the following amounts:

	1986	1985
Monies held in lawyer's trust account	$ 259,176	$ 296,323
Term deposit held by a Canadian chartered bank	-	255,640
	$ 259,176	$ 551,963

a) The monies held in trust by the Company's lawyer represent payments made in advance of delivery of gas under a take-or-pay agreement (see note 7). The trustee invests the trust funds in term deposits and distributes interest quarterly. 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 was under lien as security for the bank issuing a $360,000 U.S. letter of credit in favor of the Italian government. As the letter of credit was no longer required, the term deposit was redeemed during the year.

5. PROPERTY AND EQUIPMENT

	1986				1985
	Cost	Accumulated Depreciation and Depletion	Write-down of Property and Equipment	Net	Net
Petroleum and natural gas leases, including exploration, development and equipment thereon					
Canada	$ 9,004,123	$ 1,733,113	$ 3,510,800	$ 3,760,210	$ 6,495,542
Italy	8,121,062	-	7,841,471	279,591	8,069,274
France	503,329	-	503,329	-	504,131
Ireland	353,600	-	353,600	-	353,600
Pakistan	65,544	-	-	65,544	31,491
Sundry equipment	207,426	109,146	-	98,280	67,641
	$ 18,255,084	$ 1,842,259	$ 12,209,200	$ 4,203,625	$ 15,521,679

During the year the Company capitalized general and administrative expenses in the amount of $332,500 (1985 - $393,745) of total general and administrative expenses incurred of $682,410 (1985 - $742,856).

6. LONG-TERM DEBT

The existing credit facility bears an interest rate of prime plus ¾% and is repayable in equal installments of $83,333 per month. On December 31, 1986, the Company negotiated a new $1,000,000 credit facility with a Canadian chartered bank, which bears an interest rate of prime plus ¾% and is repayable in equal installments of $27,777 per month, commencing March 1987.

The unused credit facility of $416,665 at December 31, 1986 exceeds the scheduled repayments of $277,770 for 1987, therefore the total amount of the bank loan has been classified as a long-term liability.

The bank loan is secured by a floating charge debenture of $1,500,000 on the Canadian assets of the Company, a general assignment under Section 177 of the Bank Act covering the major producing properties of the Company and a general assignment of book debts together with certain negative pledges.

7. DEFERRED REVENUE

Pursuant to natural gas sales agreements, the Company is entitled to receive $293,442 (1985 - $332,880) 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 loss until such time as the natural gas is delivered.

8. SHARE CAPITAL

a) Authorized

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

b) Issued

	1986		1985	
	Number of Shares	Amount	Number of Shares	Amount
Common Shares				
Balance, beginning of year	7,127,161	$ 17,441,798	7,118,411	$ 17,428,236
Exercise of share options	-	-	8,750	13,562
Balance, end of year	7,127,161	$ 17,441,798	7,127,161	$ 17,441,798

c) During the year, the Company cancelled and reissued all existing stock options at the closing market price on March 27, 1986.

At December 31, 1986, 206,250 common shares were reserved for options issuable to officers and employees as follows:

Number of Shares	Price	Date Granted	Expiry Date
156,250	$0.80	27 Mar 86	27 Mar 91
25,000	$0.71	21 Apr 86	21 Apr 91
25,000	$0.65	11 Dec 86	11 Dec 91
206,250			

9. INCOME TAXES

The provision made for income taxes in 1986 and 1985 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:

	1986	1985
Effective Canadian tax rate	47%	47%
Computed "expected" tax recovery	$(5,365,516)	$ (1,393,567)
Increase (decrease) in taxes resulting from		
Non-deductible crown royalties	53,291	52,018
Resource allowance	(195,565)	(302,332)
Depletion non-deductible for tax purposes	28,576	39,908
Difference between the Canadian corporate tax rate and those applicable to foreign operations	(16,023)	(15,364)
Alberta royalty tax credit	(19,026)	(20,737)
Tax benefit not recognized due to lack of virtual certainty of realization	5,515,177	1,459,707
Other	(914)	(2,497)
	$ -	$ (182,864)

10. 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 $240,323 (1985 - $223,193).

11. SEGMENTED INFORMATION

	1986			
	Canada	United States	Pakistan and Italy	Total
Oil and gas sales	$ 2,476,958	$ 56,102	$ -	$ 2,533,060
Operating profit	$ 1,767,076	$ 48,198	$ -	$ 1,815,274
General and administrative expenses				349,910
Interest and other				(73,941)
Interest on long-term debt				88,297
Items not requiring funds				12,867,000
				13,231,266
Loss for the year				$ (11,415,992)
Total identifiable assets	$ 5,024,812	$ 6,806	$ 345,135	$ 5,376,753

	1985			
	Canada	United States	Pakistan, Italy, France and Ireland	Total
Oil and gas sales	$ 2,612,710	$ 108,320	$ -	$ 2,721,030
Operating profit	$ 2,183,979	$ 89,967	$ -	$ 2,273,946
General and administrative expenses				349,111
Interest and other				(149,902)
Items not requiring funds				5,039,774
Deferred income tax recovery				(182,864)
				5,056,119
Loss for the year				$ (2,782,173)
Total identifiable assets	$ 9,066,903	$ 63,876	$ 8,958,496	$ 18,089,275

12. 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 or completed 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 1986 amounted to $22,899 (1985 - $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 1986 amounted to $17,743 (1985 - $18,796).

13. CONTINGENT LIABILITY

The Company has a contingent liability in respect of possible withholding taxes being claimed by the U.S. 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.

14. COMPARATIVE FIGURES

Certain of the 1985 comparative figures have been restated to conform to the 1986 statement presentation.

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