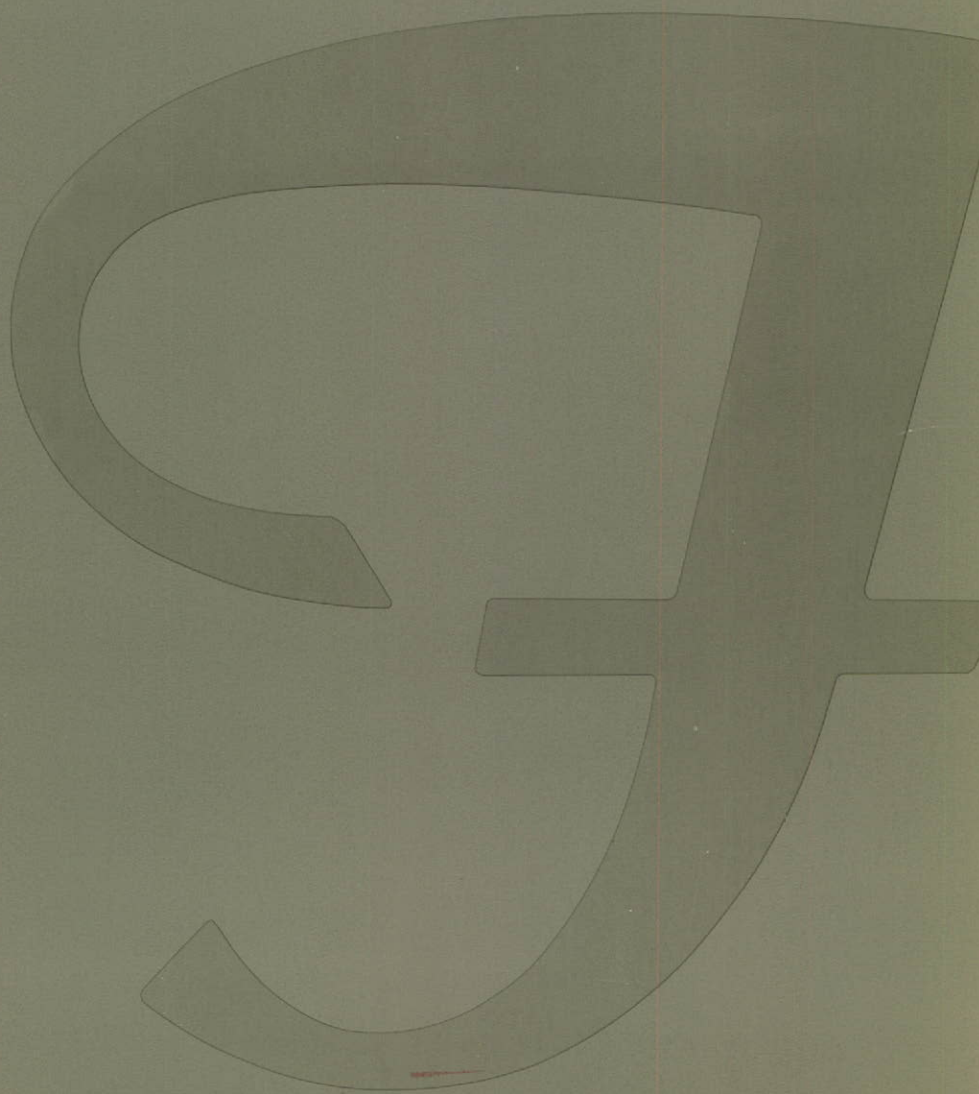


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FARADAY
RESOURCES
INC.

1988 ANNUAL REPORT



COMPANY PROFILE

Faraday Resources Inc. is a Canadian resource company. Its principal asset is its controlling interest in Conwest Exploration Company Limited, a company with extensive energy and mining interests in Canada. Faraday also has direct interests in producing oil and gas properties in western Canada.

Faraday has more than 5,200 shareholders. Its shares are listed on The Toronto Stock Exchange.

CORPORATE HIGHLIGHTS

	1988	1987	1986
Resource and other income	\$ 5,820,000	\$12,462,000	\$ 3,464,000
Net income	\$ 4,034,000	\$10,888,000	\$ 1,882,000
Net income per share	\$0.55	\$1.68	\$0.42
Equity per common share	\$5.79	\$5.48	\$4.03
Dividends per common share	\$0.22	\$0.22	\$0.18
Conwest shares owned by Faraday per Faraday common share	0.56	0.56	0.40

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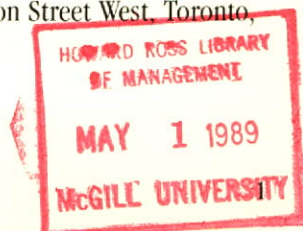
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ANNUAL MEETING

The annual meeting of shareholders of Faraday will be held in Salon I, Canadian Bar Association, 10th Floor, 120 Adelaide Street West, Toronto, Ontario at 9:15 a.m. on May 26, 1989.

FORM 10-K ANNUAL REPORT

Copies of Faraday's Form 10-K for 1988 are available, without charge, upon written request to the Vice-President and Secretary, Faraday Resources Inc., Suite 2000, 95 Wellington Street West, Toronto, Ontario M5J 2N7.





TO THE SHAREHOLDERS

1988 was a good year for your Company.

Faraday's controlling interest in Conwest continues to be its largest and most important asset. During 1988, Faraday increased its equity interest in Conwest from 21% to 26%. At the current price for Conwest shares (\$12½), the market value of this holding was \$7.00 per Faraday share.

With \$350 million in assets, Conwest provides Faraday with a broad exposure to several segments of the Canadian resource sector. A copy of Conwest's Annual Report for 1988, together with a recent feature article in The Northern Miner Magazine describing the Nanisivik Mine, are enclosed with this Report to provide Faraday shareholders with a comprehensive account of Conwest's operations and financial position.

During the past two years it has been Conwest's mining interests that have generated the most significant growth. The realization of its Hemlo gold investment in 1987 and the record operating results at Nanisivik, as a result of strong zinc prices in 1988, have provided the foundation for Conwest's expanding financial strength during this period. At the same time, the decline in oil and gas prices which began in 1985 has made it difficult to sustain a satisfactory level of cash flow from these operations.

In the future, Conwest's mining interests should continue to contribute good returns to cash flow and net income, even if not at the same levels that we have seen for the past two years. In addition, your Company continues to anticipate significant future growth from oil and gas interests. Since oil prices peaked in the early eighties, there has been a steady price erosion which appears to have culminated with the sharp declines in 1986. The decline in gas prices has been more recent, triggered by the deregulation of gas markets in 1986 as well as falling oil prices.

Oil and gas prices appear to be at or near the low end of the cycle and your Company believes that significant price gains will be achieved early in the decade beginning in 1990.

Both Faraday and Conwest are well positioned to profit from stronger petroleum prices. In 1988, for the first time in several years, Conwest spent more than its cash flow from oil and gas operations on new investment in petroleum interests. During the year, Conwest spent almost \$70 million acquiring additional producing properties and investing in operating oil and gas companies. Faraday has also been active for its own account and is currently completing, for just under \$1 million, the purchase of royalty interests on shallow gas production in Alberta.

Faraday's balance sheet remains strong. As shown in the chart, shareholders' equity has grown from \$17.0 million to \$44.4 million during the past five years. At year end, working capital and marketable securities exceeded \$5.1 million and the Company had no long term debt.

On behalf of the Board

Martin P. Connell
Chairman
of the Board

John C. Lamacraft
President and
Chief Executive Officer

Toronto, Ontario
April 10, 1989

OIL AND GAS INTERESTS

Faraday's cash flow from oil and gas operations increased from \$0.8 million in 1987 to \$1.2 million in 1988. Faraday produced 86 barrels per day of oil and natural gas liquids and 2.0 million cubic feet per day of gas during 1988. During 1988, Faraday completed the planned sale of 60% of its interest in the Manyberries and Figure Lake areas of Alberta for \$2.4 million. Subsequent to year end 1988, Faraday entered into an agreement, effective January 1, 1989, to acquire a private oil and gas company owning royalty interests on shallow gas production in Southeastern Alberta for \$950,000. During 1988 Faraday participated in four wells, at working interests of 2.4% to 16.7%, yielding 3 gas wells and 1 potential oil well.

MANYBERRIES

Faraday owns working interests ranging from 4.3% to 8.9% in 14 wells in the Manyberries area. Unitization negotiations have been proceeding steadily under the direction of Shell Canada Resources Limited. Faraday is expected to have a 2.5% working interest in the Manyberries Sunburst Q pool unit. On February 7, 1989 the Energy Resources Conservation Board approved a water injection enhanced recovery scheme. Upon approval, enhanced established reserves of 8.6 million barrels will be recognized for this pool. Commencement of injection has been delayed to the first quarter of 1990, but should proceed on schedule now that tentative unit agreement has been reached.

FIGURE LAKE

Faraday's working interests are 10% and 20%, respectively, in three producing and three shut in gas wells in the Figure Lake areas with a corresponding plant interest of 8.4% in the Mannville-Figure Lake gas plant at 4-29-64-16 W4. As Pan-Alberta net-backs improve, Faraday will work with the operator to recompleat shut-in wells and initiate development drilling. Faraday's working interest production from Figure Lake in 1988 was 0.2 million cubic feet per day.

LEO-MAPLE GLEN

Faraday owns extensive interests in the Leo-Maple Glen area. The Company's working interest production from the area in 1988 averaged 1.6 million cubic feet of gas per day, compared to 1987 average production of 1.5 million cubic feet of gas per day. The Company participated in the drilling of two gas wells in the area during the year.



OIL AND GAS INTERESTS

RESERVES AND DISCOUNTED PRESENT VALUE

Faraday has adopted the policy of retaining an independent consulting engineering firm to update its reserves every second year. The reserves and present values referred to in this report are based on detailed engineering evaluations prepared by Coles Gilbert Associates Ltd. as at December 31, 1987. Engineering reviews were performed effective

December 31, 1988 only on new drilling during the year and properties where production performance dictated significant revisions to reserves.

Proven and probable oil and natural gas liquids decreased to 213,000 barrels and proven and probable gas reserves decreased to 8.3 billion cubic feet primarily as a result of the planned disposition referred to previously.

SUMMARY OF PROVEN AND PROBABLE RESERVES WORKING INTEREST RESERVES

	1988	1987	1986
Natural Gas Reserves (mmcf)			
Proven	7,654	9,592	7,100
Probable	662	1,322	270
Proven and Probable	8,316	10,914	7,370
Oil and Natural Gas Liquids (bbls)			
Proven	164,400	300,500	460,000
Probable	48,300	92,900	300,000
Proven and Probable	212,700	393,400	760,000

FORECAST NET CASH FLOW AFTER OPERATING AND CAPITAL EXPENDITURES AND ROYALTIES AT YEAR END

(000's)

	Undiscounted			Discounted at 15%		
	1988	1987	1986	1988	1987	1986
Proven Reserves	\$29,459	\$41,559	\$32,120	\$ 8,676	\$13,156	\$10,750
Probable Reserves	3,437	9,123	12,505	915	2,068	3,190
	<u>\$32,896</u>	<u>\$50,682</u>	<u>\$44,625</u>	<u>\$ 9,591</u>	<u>\$15,224</u>	<u>\$13,940</u>



FINANCIAL REVIEW

OPERATIONS

Net income for the year decreased to \$4,034,000 (\$0.55 per share) from \$10,888,000 (\$1.68 per share) in 1987. The decline in 1988 earnings when compared to 1987 relates principally to non-recurring gains of \$4,602,000 on the sale of Faraday's Nipisi oil and gas interests and interests in Hydra Explorations Limited in 1987 and reduced equity in the earnings of Conwest. These items were partially offset by increased oil and gas income in 1988, principally arising from the December 31, 1987 acquisition of oil and gas interests.

Revenue from oil and gas production was \$1,485,000 compared to \$994,000 in 1987, reflecting the 1987 acquisition and improved natural gas prices offset by lower crude oil prices. Natural gas and crude sales revenue increased by 33% and 118%, respectively, when compared to 1987. Oil and gas production revenue, less related direct production costs, represented 58% of operating cash flow as compared to 42% in 1987.

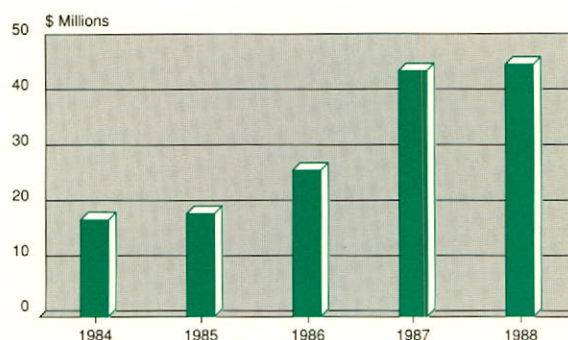
Faraday's equity in the earnings of Conwest declined as expected in 1988. In 1987 Conwest realized an after-tax gain of \$28,200,000 on the sale of its interest in Hemlo Gold Mines Inc. Conwest's 1988 earnings from the mining division improved significantly over those of 1987 as a result of the substantially higher zinc prices prevailing during 1988.

LIQUIDITY AND CAPITAL RESOURCES

Cash, including short-term deposits, decreased to \$815,000 at December 31, 1988 from \$2,139,000 at December 31, 1987. Working capital of \$1,021,000 at December 31, 1988 compared to a working capital deficiency of \$1,674,000 at December 31, 1987.

During 1988 the Corporation completed the planned sale, for \$2,400,000, of a 60% interest in the oil and gas interests it had purchased effective December 31, 1987.

SHAREHOLDERS' EQUITY





FINANCIAL STATEMENTS

MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL STATEMENTS

The accompanying financial statements of the Corporation were prepared by management in accordance with accounting principles generally accepted in Canada. Financial information presented throughout the Annual Report is consistent with that shown in the financial statements.

Management is responsible for the integrity of the financial statements. Financial statements generally include estimates which are necessary when transactions affecting the current accounting period cannot be finalized with certainty until future periods. Based on careful judgments by management, such estimates have been properly reflected in the accompanying financial statements. Systems of internal control are designed and maintained by management to provide reasonable assurance that assets are safeguarded from loss or unauthorized use and to produce reliable accounting records for financial reporting purposes.

The external auditors conduct an independent examination of corporate and accounting records in accordance with generally accepted auditing standards

in order to express their opinion on the financial statements. Their examination includes a review and evaluation of the Corporation's system of internal control and such tests and procedures as considered necessary to provide reasonable assurance that the financial statements are presented fairly.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal control. The Board exercises the responsibility through the Audit Committee of the Board. This Committee meets with management and the external auditors to satisfy itself that management's responsibilities are properly discharged and to review the financial statements before they are presented to the Board of Directors for approval.

J. C. Lamacraft
President and
Chief executive Officer

J. A. Patterson
Vice-President
and Secretary

AUDITORS' REPORT

To the Shareholders of
Faraday Resources Inc.

We have examined the balance sheets of Faraday Resources Inc. as at December 31, 1988 and 1987 and the statements of income, retained earnings and changes in financial position for each of the three years in the period ended December 31, 1988. 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 Corporation as at December 31, 1988 and 1987 and the results of its operations and the changes in its financial position for each of the three years in the period ended December 31, 1988 in accordance with generally accepted accounting principles applied on a consistent basis.

Toronto, Canada
March 29, 1989

Thorne Ernst & Whinney
Chartered Accountants



BALANCE SHEETS

As at December 31, 1988 and 1987

ASSETS

	1988	1987
CURRENT ASSETS		
Cash and short-term deposits	\$ 815,000	\$ 2,139,000
Accounts receivable and prepaid expenses	1,004,000	711,000
	<u>1,819,000</u>	<u>2,850,000</u>
INVESTMENTS (note 2)		
Conwest Exploration Company Limited	34,824,000	33,024,000
Other	4,512,000	4,990,000
	<u>39,336,000</u>	<u>38,014,000</u>
OIL AND GAS INTERESTS (note 3)	<u>4,294,000</u>	<u>6,941,000</u>
	<u>\$45,449,000</u>	<u>\$47,805,000</u>

LIABILITIES

CURRENT LIABILITIES		
Preference share dividends payable	\$ 167,000	\$ 141,000
Accounts payable and accrued liabilities	631,000	4,383,000
	<u>798,000</u>	<u>4,524,000</u>
DEFERRED REVENUE	<u>207,000</u>	<u>241,000</u>

SHAREHOLDERS' EQUITY

SHARE CAPITAL (note 4)		
Redeemable convertible preference shares	9,182,000	9,182,000
Common shares	14,465,000	14,465,000
	<u>23,647,000</u>	<u>23,647,000</u>
CONTRIBUTED SURPLUS	<u>1,506,000</u>	<u>1,506,000</u>
RETAINED EARNINGS	<u>22,559,000</u>	<u>20,507,000</u>
	<u>47,712,000</u>	<u>45,660,000</u>
Corporation's pro rata interest in the cost of its own shares held by Conwest Exploration Company Limited	(3,268,000)	(2,620,000)
	<u>44,444,000</u>	<u>43,040,000</u>
	<u>\$45,449,000</u>	<u>\$47,805,000</u>

Approved by the Board:

M. P. Connell, Director

J. C. Lamacraft, Director

The accompanying notes form an integral part of these statements.



STATEMENTS OF INCOME

Years ended December 31, 1988, 1987 and 1986

	1988	1987	1986
Resource and other income			
Equity in earnings of Conwest			
Exploration Company Limited	\$ 3,842,000	\$ 6,510,000	\$ 854,000
Oil and gas production	1,485,000	994,000	1,877,000
Gain on sale of oil and gas interests		3,564,000	
Gain on other investments	98,000	753,000	23,000
Dividends from Conwest Exploration			
Company Limited			442,000
Interest and other income	395,000	641,000	268,000
	<u>5,820,000</u>	<u>12,462,000</u>	<u>3,464,000</u>
Expenses			
Oil and gas production	318,000	184,000	276,000
General and administrative	685,000	855,000	795,000
Depletion and depreciation	481,000	347,000	424,000
Other	302,000	188,000	87,000
	<u>1,786,000</u>	<u>1,574,000</u>	<u>1,582,000</u>
Income before income taxes and extraordinary item . .	<u>4,034,000</u>	10,888,000	1,882,000
Income taxes (note 5)		2,174,000	221,000
Income before extraordinary item	<u>4,034,000</u>	8,714,000	1,661,000
Income tax reduction realized on application of			
resource expenditures of prior years (note 5) . .		2,174,000	221,000
NET INCOME	<u>\$ 4,034,000</u>	<u>\$10,888,000</u>	<u>\$ 1,882,000</u>
Income applicable to common shares	<u>\$ 3,420,000</u>	<u>\$10,754,000</u>	<u>\$ 1,882,000</u>
EARNINGS PER SHARE (note 4)			
Basic			
Before extraordinary item	\$0.55	\$1.34	\$0.37
Extraordinary item	—	0.34	0.05
Net income	<u>\$0.55</u>	<u>\$1.68</u>	<u>\$0.42</u>

The accompanying notes form an integral part of these statements.

STATEMENTS OF RETAINED EARNINGS

Years ended December 31, 1988, 1987 and 1986

	1988	1987	1986
BALANCE AT BEGINNING OF YEAR	\$20,507,000	\$11,158,000	\$10,202,000
Net income	4,034,000	10,888,000	1,882,000
	24,541,000	22,046,000	12,084,000
Dividends			
Preference shares	668,000	141,000	
Common shares	1,469,000	1,469,000	953,000
	2,137,000	1,610,000	953,000
Less portion applicable to the Corporation's pro rata interest in its own shares held by Conwest Exploration Company Limited	(155,000)	(71,000)	(27,000)
	1,982,000	1,539,000	926,000
BALANCE AT END OF YEAR	\$22,559,000	\$20,507,000	\$11,158,000

The accompanying notes form an integral part of these statements



STATEMENTS OF CHANGES IN FINANCIAL POSITION

Years ended December 31, 1988, 1987 and 1986

	1988	1987	1986
CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES			
Net income	\$ 4,034,000	\$10,888,000	\$ 1,882,000
Operating items not requiring a current cash payment			
Equity in earnings of Conwest Exploration Company Limited, net of dividends received	(2,295,000)	(5,088,000)	(335,000)
Gain on sale of oil and gas interests		(3,564,000)	
Gain on other investments	(98,000)	(753,000)	
Depletion and depreciation	481,000	347,000	424,000
Other			5,000
	<u>2,122,000</u>	<u>1,830,000</u>	<u>1,976,000</u>
Net change in non-cash working capital balances related to operations	(65,000)	182,000	67,000
Deferred revenue	(34,000)	5,000	(65,000)
	<u>2,023,000</u>	<u>2,017,000</u>	<u>1,978,000</u>
CASH PROVIDED BY (USED IN) INVESTMENT ACTIVITIES			
Investment in:			
Conwest Exploration Company Limited		(10,072,000)	(10,364,000)
Other	(1,710,000)	(5,662,000)	
Proceeds on disposal of fixed assets and oil and gas interests	2,400,000	5,411,000	
Oil and gas interests	(234,000)	(4,105,000)	(723,000)
Proceeds on disposal of investments	2,288,000	2,351,000	21,000
Net change in non-cash working capital balances related to investment activities	(3,954,000)	2,004,000	1,950,000
	<u>(1,210,000)</u>	<u>(10,073,000)</u>	<u>(9,116,000)</u>
CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES			
Dividends	(2,137,000)	(1,610,000)	(953,000)
Issue of share capital		9,182,000	7,772,000
	<u>(2,137,000)</u>	<u>7,572,000</u>	<u>6,819,000</u>
Decrease in cash and short-term deposits	(1,324,000)	(484,000)	(319,000)
Cash and short-term deposits at beginning of year . . .	2,139,000	2,623,000	2,942,000
Cash and short-term deposits at end of year	<u>\$ 815,000</u>	<u>\$ 2,139,000</u>	<u>\$ 2,623,000</u>

The accompanying notes form an integral part of these statements.

NOTES TO FINANCIAL STATEMENTS

December 31, 1988, 1987 and 1986

1. ACCOUNTING POLICIES

The financial statements of Faraday Resources Inc. have been prepared by management in accordance with generally accepted accounting principles in Canada and, except as disclosed in note 6, are also in all material respects in accordance with generally accepted accounting principles in the United States. The principal accounting policies followed by the Corporation are summarized below:

- (a) Long-term inter-corporate investments
 (i) Companies subject to significant influence
 The Corporation's investment in companies in which it has significant influence is accounted for on the basis of cost plus the Corporation's net equity in undistributed earnings in such companies since the date significant influence was acquired.

On September 1, 1986 the Corporation acquired significant influence in Conwest Exploration Company Limited ("Conwest").

Conwest owns a 26.5% equity interest in the Corporation and accounts for its investment in the Corporation on the equity method. In addition Conwest owns 175,126 first preference shares, series A of the Corporation. Since the Corporation owns shares of Conwest and Conwest owns shares of the Corporation, the Corporation has a pro rata interest in its own shares. Accordingly, the investment in Conwest and shareholders' equity are reduced by the pro rata interest in the cost to Conwest of its shares of the Corporation, and the Corporation's share of earnings of Conwest reflected in the statement of income is based on earnings of Conwest excluding its share of earnings of the Corporation. The portion of the Corporation's dividends applicable to its pro rata interest is deducted from dividends in retained earnings and added to the carrying value of the investment in Conwest.

- (ii) Other
 Other long-term investments are carried at cost or at cost less amounts written off to reflect a decline in value which is other than temporary.

Because of the number of shares held in certain companies, the quoted market values are not necessarily indicative of the value of such investments, which may be more or less than indicated by market quotations.

- (b) Oil and gas interests

The Corporation follows the full cost method of accounting for oil and gas interests as prescribed in the Guideline on Full Cost Accounting In The Oil and Gas Industry issued by the Canadian Institute of Chartered Accountants. The Corporation's oil and gas interests are all located in Canada. All costs of exploring for and developing oil and gas reserves are capitalized and accumulated in a single cost centre. Such costs include land acquisition costs, geological and geophysical expenses, carrying charges on non-producing properties and costs of both productive and unproductive drilling.

Costs, including the costs of production equipment, are depleted and depreciated on the unit of production method based on the estimated gross proven reserves derived from reports prepared by independent consultants. Oil and natural gas reserves and production are converted into equivalent units based upon estimated relative energy content.

Capitalized costs less accumulated depletion and depreciation in the Corporation's single cost centre are limited to an amount equal to the estimated future net revenue from proved reserves (based on prices and costs at the balance sheet date). Capitalized costs, less accumulated depletion and depreciation are further limited to an amount equal to the estimated future net revenue from proved reserves less estimated future general and administrative expenses, financing costs and income taxes.

Proceeds from the sale of oil and gas properties are applied against capitalized costs, with no gain or loss recognized, unless such a sale would significantly alter the rate of depletion and depreciation.

- (c) Deferred revenue

Payments received for undelivered gas are deferred and are recognized as revenue when deliveries are made or upon expiry of the period allowed for such deliveries.

- (d) Segmented information

The Corporation considers its oil and gas activities to be its dominant operating activity.



NOTES TO FINANCIAL STATEMENTS (CONT.)

2. INVESTMENTS

	1988	1987
(a)		
Companies subject to significant influence		
With quoted market value		
Conwest Exploration Company Limited (quoted market value \$35,545,000; 1987 — \$37,254,000)	\$34,824,000	\$33,024,000
Without quoted market value	195,000	195,000
Other shares with quoted market value (quoted market value \$4,332,000; 1987 — \$4,961,000)	4,134,000	4,678,000
Mortgages and other unquoted investments	183,000	117,000
	<u>4,512,000</u>	<u>4,990,000</u>
	<u>\$39,336,000</u>	<u>\$38,014,000</u>

(b) The investment in Conwest is comprised as follows:

	1988	1987
Class A shares	\$ 5,991,000	\$ 5,991,000
Class B shares	24,130,000	12,022,000
Redeemable retractable convertible first preference shares, series B		12,108,000
	<u>30,121,000</u>	<u>30,121,000</u>
Net equity in undistributed earnings of Conwest since the date significant influence was acquired	7,971,000	5,523,000
Corporation's pro rata interest in the cost of its own shares held by Conwest	(3,268,000)	(2,620,000)
	<u>\$34,824,000</u>	<u>\$33,024,000</u>

At December 31, 1988, the Corporation's investment in Conwest represents, on an undiluted basis, a 49.9% (1987 — 49.8%) voting interest and a 25.8% (1987 — 21.4%) equity interest.

In January 1988, the Corporation converted all of its series B preference shares of Conwest into Class B shares of Conwest. During 1987 the Corporation purchased 753,640 Class B shares and 82,657 series B preference shares of Conwest for \$10,072,000 cash.

The Corporation's equity in the net book value of the underlying assets of Conwest exceeded the aggregate cost of the Corporation's investment in Conwest by \$609,000 on the 1988 conversion and \$2,024,000 on the 1987 purchases. The fair value adjustments have been allocated to oil and gas interests.

The amounts allocated to oil and gas interests are being amortized over the remaining production life of these assets. At December 31, 1988, the unamortized balance of the fair value adjustments was \$6,013,000 (1987 — \$7,274,000).

(c) Canadian oil and gas production and mining are Conwest's principal operating segments.

Summarized financial information for Conwest is as follows:

Summarized Consolidated Balance Sheets

	December 31,	
	1988	1987
Assets:		
Cash and commercial paper	\$ 56,142,000	\$106,905,000
Other current	52,157,000	33,293,000
Current	108,299,000	140,198,000
Investments	71,525,000	58,988,000
Oil and gas interests	149,534,000	81,380,000
Fixed assets	17,752,000	20,650,000
Other	2,139,000	2,298,000
	<u>\$349,249,000</u>	<u>\$303,514,000</u>
Liabilities and shareholders' equity:		
Current liabilities	\$ 25,427,000	\$ 19,723,000
Long-term debt	84,900,000	75,900,000
Deferred revenue	3,944,000	3,603,000
Deferred income taxes	28,470,000	18,625,000
	<u>142,741,000</u>	<u>117,851,000</u>
Minority interest	42,347,000	33,104,000
Redeemable preference shares	5,000,000	15,317,000
Shareholders' equity attributable to common shares	159,161,000	137,242,000
	<u>164,161,000</u>	<u>152,559,000</u>
	<u>\$349,249,000</u>	<u>\$303,514,000</u>

Summarized Consolidated Statements of Income

	Years ended December 31,		
	1988	1987	1986
Resource and other income	\$97,700,000	\$105,660,000	\$27,212,000
Net income	12,872,000	33,873,000	9,597,000

(d) During 1987, the Corporation sold a part of its interest in Hydra Explorations Limited and ceased to account for this investment on the equity method. The Corporation realized a gain of \$1,273,000 on the sale. The Corporation's equity in the earnings of Hydra for the year ended December 31, 1986 was not significant.



NOTES TO FINANCIAL STATEMENTS (CONT.)

3. OIL AND GAS INTERESTS

	1988	1987
(a)		
Balance at beginning of year	\$6,941,000	\$5,030,000
Add:		
Acquisitions in year		4,000,000
Current year's expenditures	234,000	105,000
	<u>7,175,000</u>	<u>9,135,000</u>
Deduct:		
Dispositions in year	2,400,000	1,847,000
Depletion and depreciation	481,000	347,000
	<u>2,881,000</u>	<u>2,194,000</u>
Balance at end of year	<u>\$4,294,000</u>	<u>\$6,941,000</u>

(b) At December 31, 1988, accumulated depletion and depreciation of oil and gas interests amounts to \$2,804,000 (1987 — \$2,323,000).

Depletion and depreciation of oil and gas interests is provided on the unit-of-production method and the rate for 1988, 1987 and 1986 averaged \$3.15, \$3.20 and \$3.01 per equivalent barrel of production, respectively.

(c) Oil and gas production equipment, having a carrying value of \$1,901,000 (1987 — \$2,055,000) is included in oil and gas interests at cost less accumulated depreciation.

(d) Effective December 31, 1987 the Corporation purchased oil and gas interests for \$4,000,000. The purchase closed on January 29, 1988 and at December 31, 1987 the amount due on closing is included in accounts payable and accrued liabilities in the accompanying balance sheet. The cost of this acquisition was excluded from costs subject to depletion in 1987. Effective April 1, 1988, the Corporation sold a 60% interest in these properties for \$2,400,000.

(e) During 1987 the Corporation sold certain of its oil and gas interests for \$5,411,000 realizing a gain of \$3,564,000.



4. SHARE CAPITAL

(a) Authorized

The authorized capital of the Corporation consists of:

An unlimited number of first preference shares, issuable in series, of which 556,461 \$1.20 series A

cumulative redeemable retractable convertible first preference shares constitute the first series.

An unlimited number of common shares.

(b) Issued

	Preference shares		Common shares	
	Number	Amount	Number	Amount
Balance January 1, 1987			6,677,534	\$14,465,000
Issued for cash in 1987	556,461	\$9,182,000		
Balance December 31, 1988 and 1987	556,461	\$9,182,000	6,677,534	\$14,465,000

(c) Other information

(i) Each of the series A preference shares is convertible into three common shares of the Corporation until October 31, 1992. These shares are not redeemable prior to October 31, 1989, are redeemable in certain circumstances during the period from October 31, 1989 to October 31, 1992 and thereafter are redeemable without restriction. On and after October 31, 1994 the holders of such shares may require they be redeemed by the Corporation. The redemption price is \$16.50 per share.

(ii) At December 31, 1988 there were outstanding options to purchase 650,000 common shares of the Corporation, at a price of \$3.45 per share, exercisable prior to November 17, 1991.

(d) Fully diluted earnings per share

Fully diluted earnings per share for 1988, calculated as though all outstanding first preference shares, series A and the employee stock options had been converted or exercised, would be:

	1988	1987
Before extraordinary item	\$0.49	\$1.23
Extraordinary item	—	0.30
Net income	<u>\$0.49</u>	<u>\$1.53</u>

For years prior to 1987 there were no outstanding convertible securities or options.



NOTES TO FINANCIAL STATEMENTS (CONT.)

5. INCOME TAXES

At December 31, 1988 oil and gas interests, which are carried at \$4,294,000 (1987 — \$6,941,000) in the accompanying balance sheets, are fully deductible for income tax purposes. In addition, the Corporation has other deductions available to reduce or eliminate income taxes that would otherwise be recorded as a charge against income of future years. Details of these deductions, the tax effect of which has not been reflected in the financial statements, are approximately as follows:

Non-capital losses which expire as follows:

1990	\$ 710,000
1991	195,000
1992	905,000
1993	458,000
1994	130,000
1995	466,000
	<u>\$2,864,000</u>

No deductions of this type were used to eliminate the provision for income taxes for 1988 (amounts used in 1987 — \$2,174,000; 1986 — \$221,000).

The Corporation's effective income tax rate differs from the combined federal and provincial statutory income tax rates. The principal factors causing this difference are as follows:

	<u>1988</u>	<u>1987</u>	<u>1986</u>
Combined federal and provincial statutory income tax rates	<u>47.7%</u>	<u>51.4%</u>	<u>51.0%</u>
Non-deductible provincial and federal production royalties and taxes, net of rebates	<u>0.9</u>	<u>0.1</u>	<u>2.6</u>
Resource and depletion allowances	<u>(2.8)</u>	<u>(0.6)</u>	<u>(8.3)</u>
Non-taxable components of investment income	<u>(45.9)</u>	<u>(31.1)</u>	<u>(34.6)</u>
Other	<u>0.1</u>	<u>0.1</u>	<u>1.0</u>
Effective income tax rate	<u>Nil</u>	<u>19.9%</u>	<u>11.7%</u>

6. GENERALLY ACCEPTED ACCOUNTING PRINCIPLES IN CANADA AND THE UNITED STATES

(a) For each of the three years in the period ended December 31, 1988 there were no material differences in the computation of net income under generally accepted accounting principles in Canada and the United States. Primary earnings per share include the effect of common stock equivalents which

consist of stock options granted during 1987. The convertible preference shares are not considered common stock equivalents. Earnings per share computed under United States' principles are as follows:

	1988	1987	1986
Primary — before extraordinary item	<u>\$0.51</u>	<u>\$1.26</u>	<u>\$0.41</u>
— net income	<u>\$0.51</u>	<u>\$1.58</u>	<u>\$0.41</u>
Fully diluted — before extraordinary item	<u>\$0.49</u>	<u>\$1.22</u>	
— net income	<u>\$0.49</u>	<u>\$1.52</u>	

(b) Details of the net change in non-cash working capital balances related to operations, as reported in the statements of changes in financial position, are as follows:

	1988	1987	1986
Accounts receivable	<u>\$(293,000)</u>	\$108,000	\$ 96,000
Preference share dividends payable	<u>26,000</u>	141,000	
Accounts payable and accrued liabilities	<u>202,000</u>	<u>(67,000)</u>	<u>(29,000)</u>
	<u>\$ (65,000)</u>	<u>\$182,000</u>	<u>\$ 67,000</u>

7. OTHER INFORMATION

(a) Related party transactions

Conwest Exploration Company Limited owns 26.5% of the Corporation. As part of normal business operations extensive use is made of Conwest's management and technical services. During 1988 Conwest's charge to the Corporation for such services was \$300,000 (1987 — \$592,000; 1986 — \$556,000).

(b) Revolving credit facility

At December 31, 1988, the Corporation has available an unused revolving credit facility of \$6,000,000 with a Canadian chartered bank. This facility is secured by 825,000 Conwest Class B shares. Amounts drawn on this line bear interest at the bank's prime interest rate.



UNAUDITED SUPPLEMENTARY INFORMATION

(a) Selected Quarterly Financial Data

	Quarter Ended			
	Mar. 31	June 30	Sept. 30	Dec. 31
1988	(Thousands of dollars, except per share amounts)			
Oil and gas production				
Net sales revenue	\$ 594	\$ 349	\$ 349	\$ 193
Net production income ⁽¹⁾	365	119	143	59
Income before extraordinary item	1,555	1,200	1,173	106
Per share	0.23	0.17	0.16	(0.01)
Net income	1,625	1,152	1,151	106
Per share	0.24	0.16	0.16	(0.01)
1987				
Oil and gas production				
Net sales revenue	\$ 225	\$ 205	\$ 224	\$ 340
Net production income ⁽¹⁾	105	92	128	139
Income before extraordinary item	5,229	1,821	1,615	49
Per share	0.82	0.28	0.25	(0.01)
Net income	6,955	1,780	2,103	50
Per share	1.09	0.27	0.33	(0.01)

(1) Net sales revenue less direct production costs, depletion and depreciation.

(b) Oil and Gas Exploration and Production

Activities

The Corporation's oil and gas exploration activities are carried out in Canada. The following unaudited supplementary oil and gas information for the Corporation, and its equity accounted investee, Conwest Exploration Company Limited ("Conwest"), is provided in accordance with the United States' Financial Accounting Standards Board Statement

No. 69, "Disclosures about Oil and Gas Producing Activities".

(i) Capitalized Costs Relating to Oil and Gas Producing Activities

The Corporation's capitalized costs, all of which relate to proved properties, amount to:

	December 31,	
	1988	1987
	(Thousands of dollars)	
Petroleum and natural gas properties	\$ 7,097	\$ 9,264
Accumulated depletion and depreciation	2,803	(2,323)
Net capitalized costs	\$ 4,294	\$ 6,941
The Corporation's proportionate share of capitalized costs of Conwest	\$32,162	\$10,781

(ii) Costs Incurred

The following development costs were incurred by the Corporation in the past three years:

1988	\$234,000
1987	105,000
1986	723,000

During this three year period there was one acquisition of proved properties for \$4,000,000, which was effective December 31, 1987, and no exploration costs were incurred.

The Corporation's proportionate share of costs incurred by Conwest, amounts to:

	Canada	United States	Total
	(Thousands of dollars)		
1988			
Acquisition of properties (proved)	\$16,476	\$ 249	\$16,725
Acquisition of properties (unproved)	536		536
Exploration	1,364	92	1,456
Development	783		783
	<u>\$19,159</u>	<u>\$ 341</u>	<u>\$19,500</u>
1987			
Acquisition of properties (unproved)	\$ 393		\$ 393
Exploration	758	\$ 239	997
Development	624		624
	<u>\$ 1,775</u>	<u>\$ 239</u>	<u>\$ 2,014</u>

(iii) Results of Operations for Oil and Gas Producing Activities

	Year ended December 31,		
	1988	1987	1986
	(Thousands of dollars)		
Revenue, net of royalties	\$1,485	\$ 994	\$1,877
Production costs	318	184	276
Depletion and depreciation	481	347	424
	<u>799</u>	<u>531</u>	<u>700</u>
Results of operations for oil and gas producing activities (excluding general and administrative overhead and interest costs) . . .	<u>\$ 686</u>	<u>\$ 463</u>	<u>\$1,177</u>

The Corporation's proportionate share of results of operations of oil and gas producing activities of Conwest was \$1,105,000 for 1988, \$1,323,000 for 1987 and \$301,000 for 1986 from the date of acquisition of significant influence in Conwest on September 1, 1986.



UNAUDITED SUPPLEMENTARY INFORMATION (CONT.)

(iv) Proved Oil and Gas Reserve Quantities

The Corporation's proved reserves are based on estimates made by independent consultants. Proved oil and gas reserves are the estimated quantities of crude oil, natural gas and natural gas liquids which geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from known reservoirs under existing economic and operating conditions. Proved developed oil and gas reserves are reserves that can be recovered through existing wells with existing equipment and

operating methods. The Corporation has no significant proved undeveloped reserves. The process of estimating reserves is complex, requiring subjective judgments in the evaluation of available geological, engineering, economic and other data. All of the Corporation's proved reserves are located in Canada.

The calculation of reserves of crude oil, including condensate and natural gas liquids and natural gas is based on the Corporation's net shares of proved reserves.

	Crude oil			Natural gas		
	Year ended December 31,			Year ended December 31,		
	1988	1987	1986	1988	1987	1986
	(Thousands of barrels)			(Millions of cubic feet)		
Proved reserves, beginning of year	244	373	383	7,503	5,545	5,683
Sale of reserves	(122)	(337)		(1,295)	(66)	
Acquisition of reserves		203			2,158	
Revisions of previous estimates and improved recovery	32	16	38	220	418	348
Production	(29)	(11)	(48)	(665)	(552)	(486)
Proved reserves, end of year	<u>125</u>	<u>244</u>	<u>373</u>	<u>5,763</u>	<u>7,503</u>	<u>5,545</u>

At December 31, 1988, the Corporation's proportionate interest in the proved reserves of Conwest, all of which are located in Canada, was as follows:

Crude oil, including condensates and natural gas liquids (thousands of barrels)	2,287
Natural gas (millions of cubic feet)	16,763

(v) Standardized Measure of Discounted Future Net Cash Flows and Changes Therein

Estimated future cash inflows are computed by applying year-end prices, except for fixed and determinable escalation provisions in contracts, to year-end quantities of proved oil and gas reserves. Estimated future development costs, production costs, and income taxes are deducted from estimated future cash inflows to arrive at estimated future net cash flows. Future development and production costs are based on year-end costs and assume the continuation of existing economic and operating

conditions. Future income taxes are computed by applying the year-end statutory rates to the future pretax net cash flows, after making provision for the tax basis of the oil and gas properties. Future net cash flows are discounted at a rate of 10% per annum to arrive at discounted future net cash flows.

The Corporation cautions that the discounted future net cash flows from proved oil and gas reserves are neither an indication of fair market value of its oil and gas properties, nor of the future net cash flows expected to be generated from such properties. The discounted future net cash flows do not include the fair market value of undeveloped properties and probable or possible oil and gas reserves, nor is consideration given to the effect of anticipated future changes in crude oil and natural gas prices, development and production costs and possible changes to tax and royalty regulations. The prescribed discount rate of 10% may not appropriately reflect future interest rates.

Standardized Measure of Discounted Future Net Cash Flows

	Year ended December 31,		
	1988	1987	1986
	(Thousands of dollars)		
Future cash inflows	\$12,737	\$20,420	\$17,495
Future costs			
Production	(2,456)	(3,826)	(3,888)
Development	(174)	(382)	(41)
Future pretax cash flows	10,107	16,212	13,566
Future income taxes	(604)	(2,354)	(995)
Future net cash flows	9,503	13,858	12,571
10% annual discount for estimated timing of cash flows	(3,785)	(5,237)	(5,338)
Discounted future net cash flows	<u>\$ 5,718</u>	<u>\$ 8,621</u>	<u>\$ 7,233</u>

At December 31, 1988 the Corporation's proportionate interest in the standardized measure of discounted future net cash flows of Conwest was \$24,663,000.

Changes in Standardized Measures of Discounted Future Net Cash Flows

	Year ended December 31,		
	1988	1987	1986
	(Thousands of dollars)		
Revisions to reserves proved in prior years			
Revisions of previous quantity estimates	\$ 563	\$ 332	\$ (174)
Net changes in prices, production costs and PGRT	(1,580)	1,659	(7,855)
Net changes in estimated future development cost	218	(305)	531
Accretion of discount	862	722	1,283
	<u>63</u>	<u>2,408</u>	<u>(6,215)</u>
Changes during the year			
Acquisition of reserves		2,393	
Sales of oil and gas production, net of related costs	(1,174)	(850)	(1,587)
Sale of reserves	(2,631)	(1,965)	
	<u>(3,805)</u>	<u>(422)</u>	<u>(1,587)</u>
Total revisions and changes before income taxes	(3,742)	1,986	(7,802)
Net changes in income taxes	839	(598)	2,204
Total revisions and changes	(2,903)	1,388	(5,598)
Discounted future net cash flows at beginning of year	8,621	7,233	12,831
Discounted future net cash flows at end of year	<u>\$ 5,718</u>	<u>\$ 8,621</u>	<u>\$ 7,233</u>



CORPORATE INFORMATION

DIRECTORS

- W. Clarke Campbell,
*Partner of the firm Day, Wilson, Campbell
Barristers and Solicitors*
- Martin P. Connell,
*Chairman of the Board
Conwest Exploration Company Limited*
- Colin C. Coolican,
*Executive Vice President
Conwest Exploration Company Limited*
- John C. Lamacraft,
*President and Chief Executive Officer
Conwest Exploration Company Limited*
- Jules Loeb,
*General Manager,
Falcon Investments Limited*
- Howard A. Masson,
Retired Executive
- Robert J. Metcalfe,
*President,
Armada Properties Limited*
- William M. O'Shaughnessy,
Retired Executive

OFFICERS

- Martin P. Connell,
Chairman of the Board
- John C. Lamacraft,
President and Chief Executive Officer
- Colin C. Coolican,
Executive Vice-President
- William E. Barnett,
Vice-President
- James A. Kalman,
Vice-President
- S. Lawrence Koroluk,
Vice-President
- J. Andrew Patterson,
Vice-President and Secretary
- John S. Adams,
Treasurer

CORPORATE INFORMATION

- Registrar and Transfer Agent
*Montreal Trust Company of Canada
Toronto, Ontario*
- Co-Transfer Agent
*Bank of Montreal Trust Company
New York, N.Y.*
- Auditors
*Thorne Ernst & Whinney
Toronto, Ontario*
- Head Office
*Suite 2000, 95 Wellington St. W.
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