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TEMAGAMI Oil & Gas Ltd.

annual report

1981

OFFICERS AND DIRECTORS

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J. Kenneth Grove, President, Chief Executive Officer and Director
Carl Roland Jonsson, Secretary and Director
George E. McClure, Director
Robert J. Peers, Vice President, Land
Stephen G. Roman Jr., Director
Andrew Sarlos, Chairman of the Board and Director
Norman F. Talbot, Vice President, Treasurer and Director
Peter B. Watkins, Vice President, Operations and Director
Barry Zukerman, Director

TRANSFER AGENT AND REGISTRAR

Guaranty Trust Company of Canada
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Vancouver, British Columbia V6C 2V7

Guaranty Trust Company of Canada
88 University Street
Toronto, Ontario M5J 1T8

GENERAL COUNSEL

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Vancouver, British Columbia

AUDITORS

Collins Barrow
Calgary, Alberta

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Bank of British Columbia
Canadian Imperial Bank of Commerce

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Vancouver, British Columbia V6E 2L3

CORPORATE OFFICE

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1550 - 8th Street S.W.
Calgary, Alberta T2R 1K1

TO OUR SHAREHOLDERS:

During the past fiscal year, your Company has expanded its exploration activities significantly. In keeping with established company policies, all such new ventures are located in the United States of America.

The Canadian National Energy Policy has in no way encouraged Temagami to explore in Canada. On the contrary, development of the Canadian interests is virtually complete and the Company is not entertaining new Canadian ventures at this time. The only significant Canadian interests which have been retained, are the 14,520 acre Turner Valley project in Alberta, and the 33,178 acre Liard project on federal leases in the Northwest Territories. In both of these projects, major sized reservoirs are the goal.

In the United States, Temagami has exploration projects in Texas, Kansas, Indiana, Michigan, and Wyoming as well as a small interest in Montana acreage. These projects are described in the body of this report, but it should be noted here some exploration projects take months and even years to mature from prospects to productive projects.

A growing company such as Temagami must work continuously towards finding new reserves, in order not only to replace production, but to increase its reserve holdings and its assets.

Although your company has made no substantial discoveries during the past year, significant ground work and progress has been made for the future. Further, development of established production has proceeded in an orderly manner, so that the company can best use its management, technical and financial resources for the growth of the company.

At the year end your company was building a 3 MMCFD gas plant to process the gas produced along with oil from the Hiland leases in Wyoming. This plant will be on stream by the end of October and natural gas and liquid products will be sold, thereby substantially enhancing the cash flow and profitability of this operation. The Company obtained a $4,000,000 bank loan to finance the construction of this gas plant and development wells in addition to other exploration.

Cash flow from operations for the year ended May 31, 1981, amounted to $3,864,735 as compared with $836,696 for the preceding year. Earnings for the year were $913,939 compared with $362,081 for the year ended May 31, 1980.

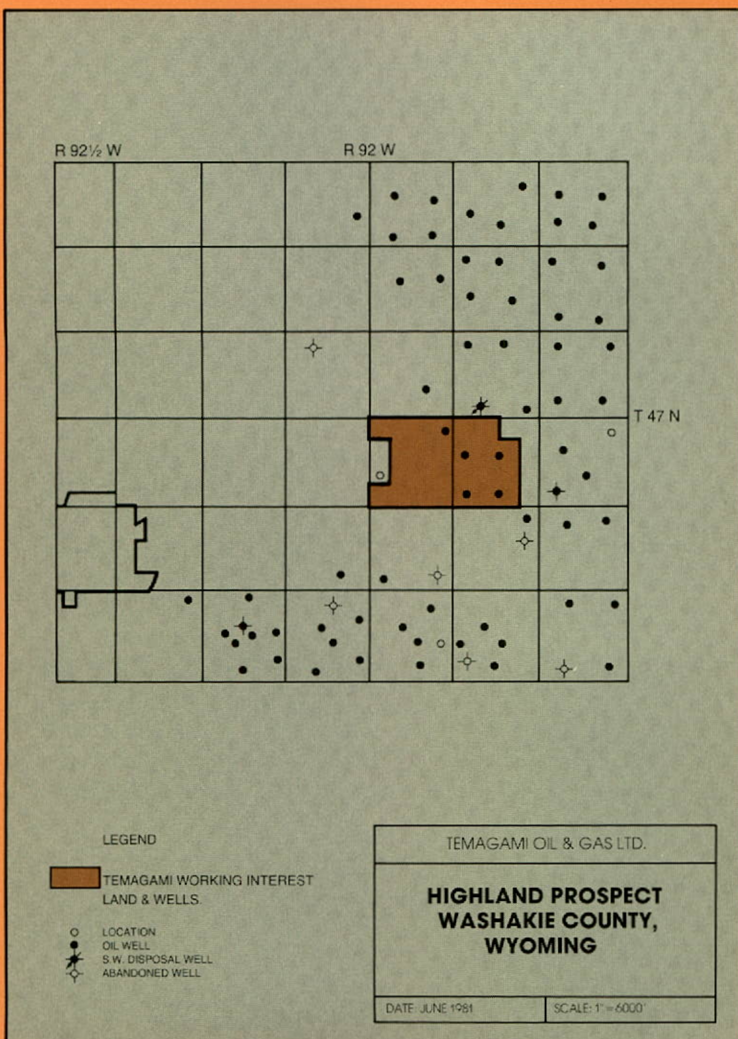
In August, subsequent to the end of the fiscal year, agreement was reached with Roman Corporation Limited whereby Roman converted its debenture into 3,750,000 common shares of the Company, making it the largest single shareholder. This debenture was secured by a first charge against the company's properties and with this charge removed, the company now has full borrowing power, thus providing greater flexibility and opportunities for growth.

During the year, Richard R. Kennedy and John D. Pennal resigned from your Board of Directors and we thank them for their valuable contribution. They were replaced by George E. McClure, President of Roman Corporation, and Peter B. Watkins, Vice President, Operations of Temagami Oil & Gas Ltd. Previously Norman F. Talbot, Vice President and Treasurer of Temagami Oil & Gas Ltd., also joined the Board.

Respectfully Submitted,

J. Kenneth Grove
President & Chief Executive Officer

EXPLORATION AND DEVELOPMENT



WYOMING

A total of five successful Phosphoria oil wells have now been drilled on the 1000 acre Hiland lease, all of which are high productivity wells, and at least five proven 80 acre locations remain to be developed. Another company is drilling a direct western offset to the Temagami Oil & Gas Inc. lease, which if successful will establish a total of nine additional 80 acre locations. Because substantial volumes of wet gas are produced with the oil, a company owned gas plant is being built to recover natural gas liquids and sulphur, so that the residue gas may be sold. To the extent that excess plant capacity is available, Temagami will also be processing gas from other producers. Long-term contracts for the sale of gas and liquids are being negotiated. The Company owns a 60 per cent working interest in the plant.

Two wells were drilled on the North Marshall leases at no cost to the company, resulting in one dry hole and one well producing a small amount of oil.

In Park County, the Shoshone well is awaiting completion as a potential Frontier oil well.

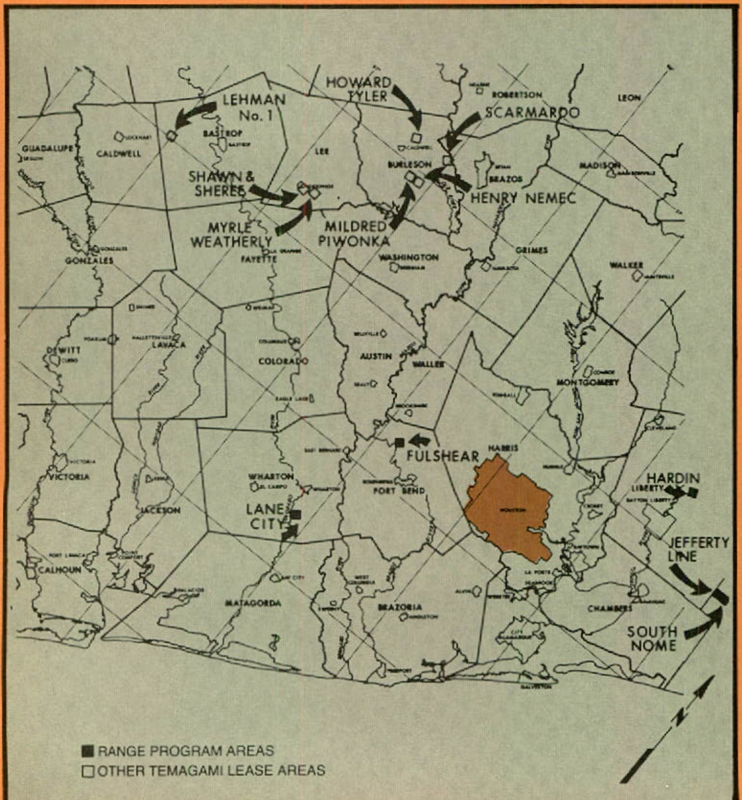
TEXAS

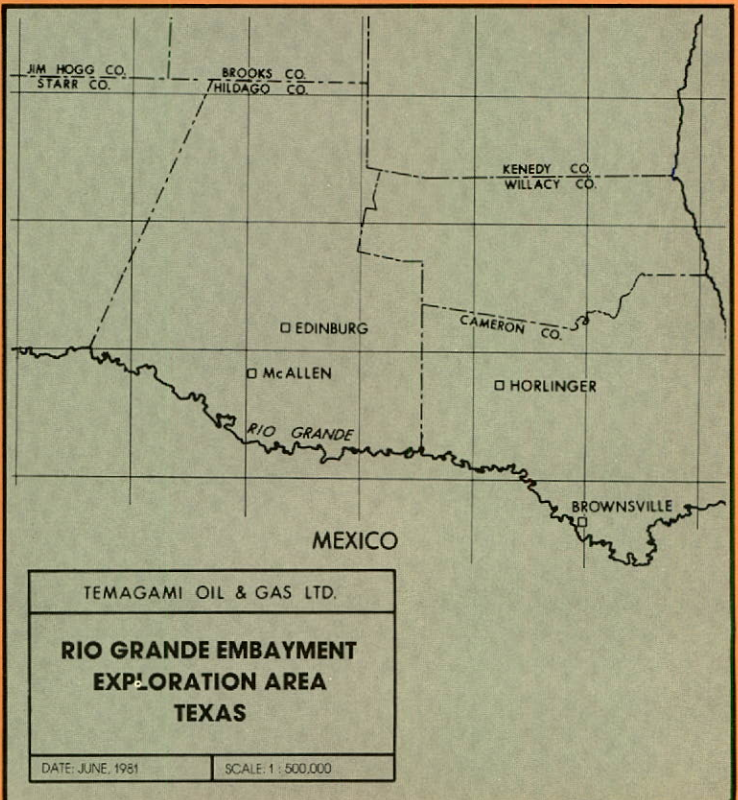
In Texas, a successful Austin Chalk exploratory well was drilled on the Company's Scarmardo leases and, so far, one follow up well has been completed. The company owns a 61.75 per cent working interest in this discovery well which also found oil production in the underlying Buda Lime and Georgetown reservoirs, although the Buda Lime reservoir is of very limited areal extent.

A successful offset to last year's Howard Tyler discovery has also been drilled and completed as an Austin Chalk oil well producing 175 barrels per day. The associated gas, produced with the oil, from both of these wells and the Scarmardo 1A well is being sold.

Two new exploration ventures are underway in Texas. The first is the five prospect "Range" program, in which Temagami will pay 10 per cent of the costs for a 15 per cent working interest. At the time of writing the first well had been drilled and abandoned. The prospects are located in an arc around the city of Houston.

The second program involves a 2500 square mile area of the "Rio Grande Embayment", encompassing all of Cameron, Hidalgo and Willacy Counties and part of Brooks County in the extreme south of Texas. This is a five year exploration and development program, in which Temagami will own an approximate 14½ per cent working interest. To date, in excess of 400 miles of long line seismic have been utilized to identify several prospects, on which land acquisition is underway. The first prospects will be drilled in the near future. The company also owns a small carried interest in a 5000 acre six well exploratory project in North Texas.

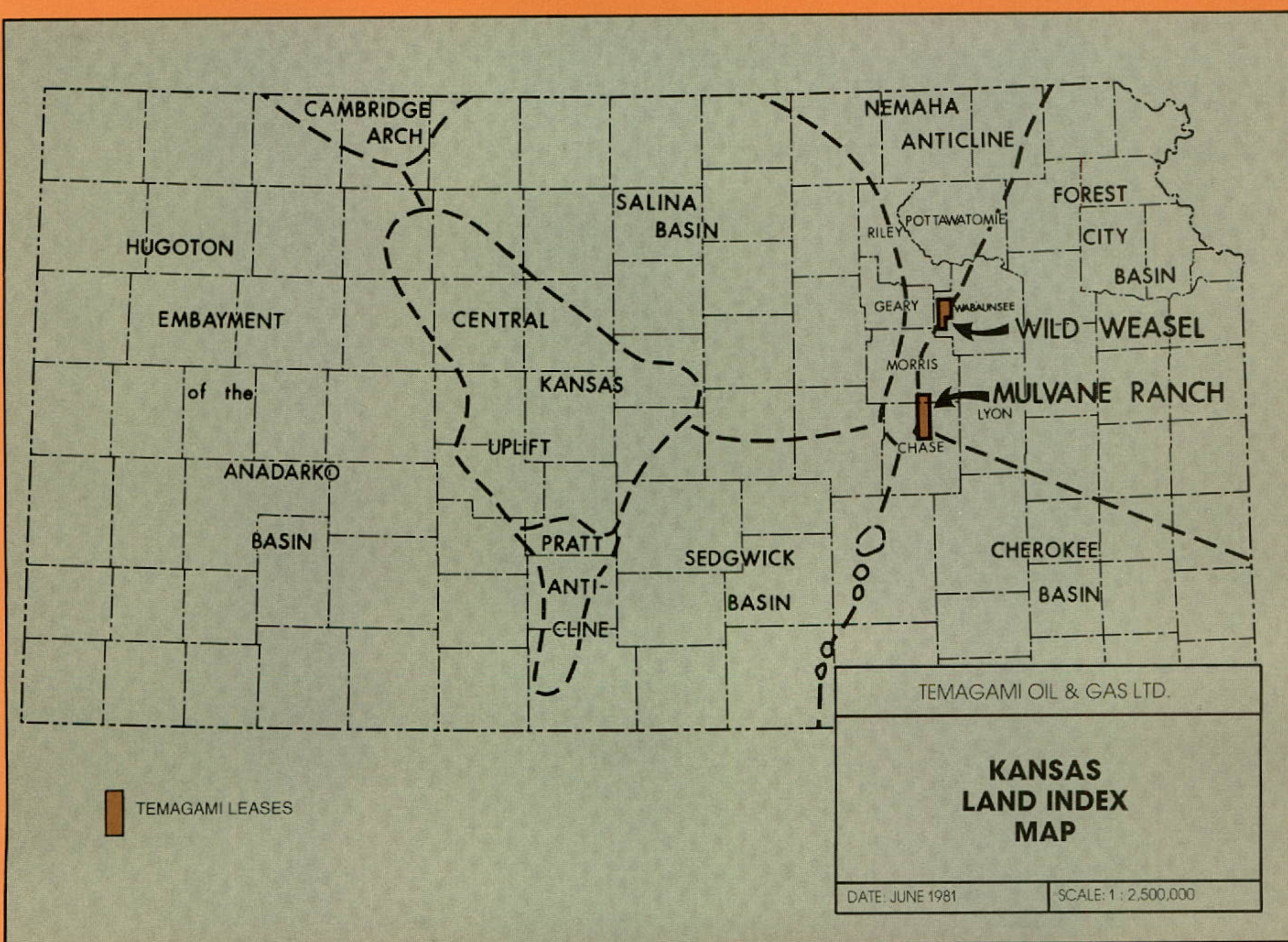


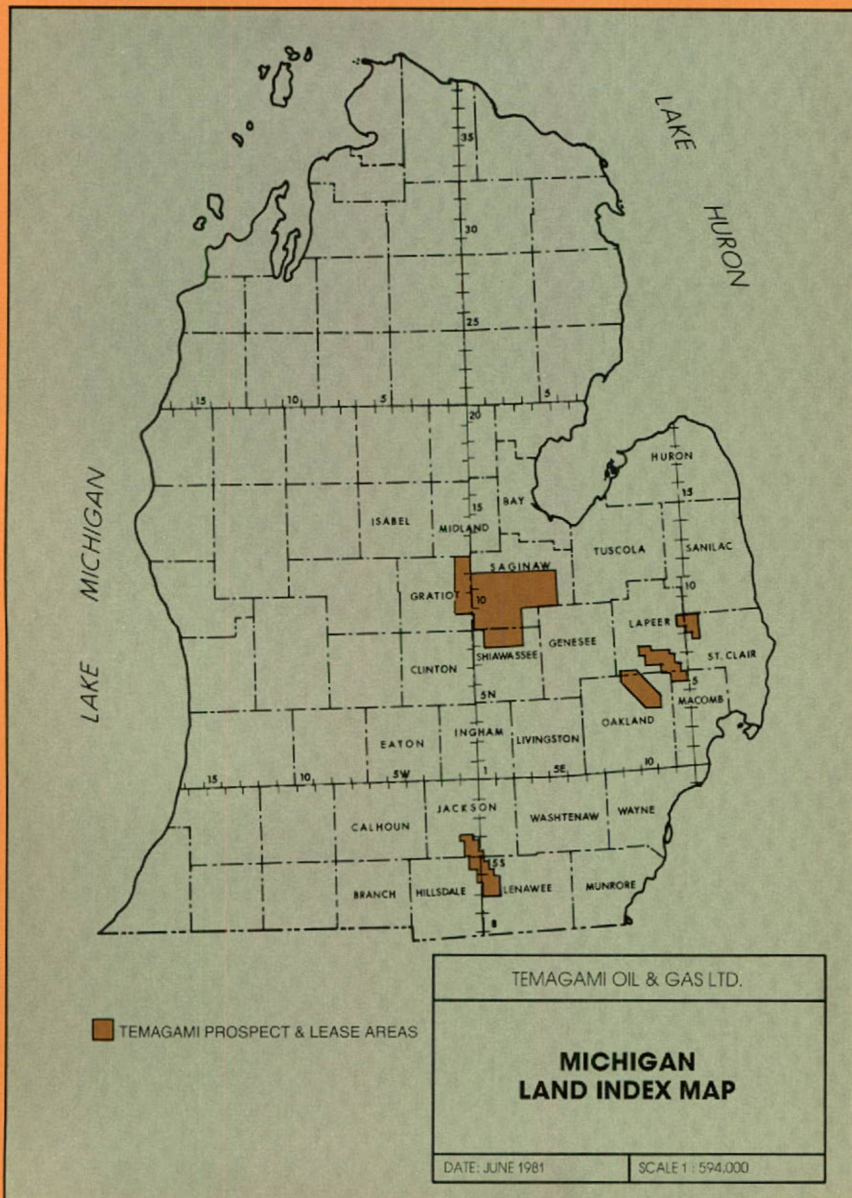


KANSAS

The initial three exploratory wells on the 11,000 acre Mulvane Ranch have been drilled and abandoned after encountering excellent reservoir rocks and some oil and gas shows. Two to four more wells will be drilled later this year, in addition to the one or two wells to be drilled on the 6000 acre Wild Weasel leases to the north. The Company interest is 28.125 per cent.

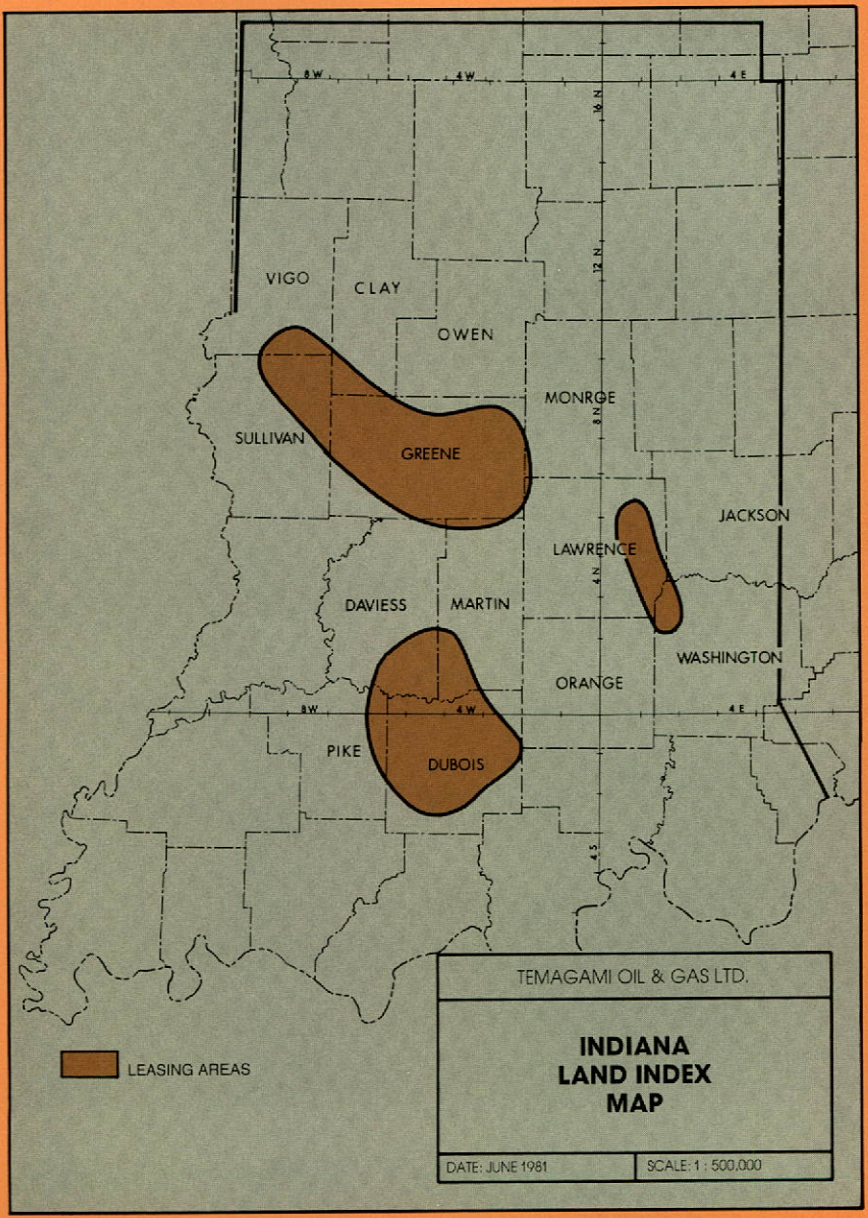
In West Kansas, the Company owns a small carried working interest in a five well exploratory program to be conducted on 22,000 acres of leases. The initial seismic surveys have revealed numerous anomalies which will require testing.





MICHIGAN

The Company owns a 12½ per cent interest in 26,000 acres of leases in southern Michigan, on which five drillable prospects have been identified. Farmout negotiations on the first prospect are underway.



INDIANA

The Company is engaged in an aggressive leasing program in south central Indiana and at the time of writing has acquired approximately 100,000 acres of leases. Numerous shallow, multi zone anomalies exist under these lands and when the leasing program is closer to completion, a series of exploration programs will be prepared for drilling. The Company interest in these lands is 25 per cent.

CANADA

The Company's interests in Canadian exploration are essentially limited to the Liard and the Turner Valley prospects, where the company has maintained its interests because of the potentially large sized reservoirs which are anticipated. The Liard project will be farmed out, but in the Turner Valley prospect, one of the two wells drilled in early 1980 has been re-entered and is being redrilled in a more advantageous direction.

COMPARATIVE STATISTICS

The following summary tabulation presents the current and prior year's acreage, drilling and production statistics.

	FISCAL 1980/81				FISCAL 1979/80			
	Canada		U.S.A.		Canada		U.S.A.	
	Gross	Net	Gross	Net	Gross	Net	Gross	Net
Acreage	77,260	4,320	117,481	27,517	73,060	2,342	14,708	6,553
Wells drilled								
Oil	—	—	3	1.699	4	.094	9	2.655
Gas	2	.043	—	—	2	.110	—	—
Suspended	—	—	2(1)	.975(1)	1	.012	1	.860
Abandoned	—	—	4	.464	3	.063	—	—
Drilling at Year End	—	—	2	.864	2	.158	1	.125
Oil Production BBL	—	—	369,077	132,338	—	—	137,065	26,975
Gas Production MMCF	—	—	71,252	11,462	—	—	35,900	9,600

(1) Indicated Oil Wells
Standing Cased — Awaiting Completion

AUDITORS' REPORT

To the Shareholders
Temagami Oil & Gas Ltd.

We have examined the consolidated balance sheet of Temagami Oil & Gas Ltd. as at May 31, 1981 and the consolidated statements of earnings, retained earnings 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 May 31, 1981 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.

Calgary, Canada
July 24, 1981
(except as to note 9
which is dated August 20, 1981)

COLLINS BARROW,
Chartered Accountants

TEMAGAMI OIL & GAS LTD.
(Incorporated under the laws of British Columbia)

CONSOLIDATED BALANCE SHEET

MAY 31, 1981

ASSETS

	1981	1980
Current assets		
Cash	**$ 1,312,938**	$ 635,754
Accounts receivable	**2,634,406**	1,567,609
Prepaid expenses	**36,416**	37,187
Total current assets	**3,983,760**	2,240,550
Notes receivable (note 2)	**970,500**	1,038,000
Properties and equipment (note 3)	**12,796,415**	6,890,659
Other assets (note 4)	**299,264**	396,634
	$18,049,939	$10,565,843

LIABILITIES

	1981	1980
Current liabilities		
Accounts payable and accrued liabilities	**$ 3,252,125**	$ 1,808,506
Dividends payable	**60,059**	12,726
Obligations under capital leases — current portion	**31,000**	20,804
Total current liabilities	**3,343,184**	1,842,036
Long-term debt (note 5)	**9,284,574**	5,208,978
Deferred income taxes	**1,379,010**	325,538

SHAREHOLDERS' EQUITY

	1981	1980
Share capital (note 6)	**1,997,000**	1,944,500
Contributed surplus (note 6)	**853,500**	906,000
Retained earnings	**1,192,671**	338,791
	4,043,171	3,189,291
	$18,049,939	$10,565,843

Approved on behalf of the Board,

Director

Carl Q. Jousson Director

The accompanying notes are an integral part of these financial statements

TEMAGAMI OIL & GAS LTD.

CONSOLIDATED STATEMENT OF EARNINGS

YEAR ENDED MAY 31, 1981

	1981	1980
Revenue		
Oil and gas sales	**$5,265,305**	$1,167,402
Other	**92,435**	39,001
	5,357,740	1,206,403
Expenses		
Production	**285,167**	36,323
Windfall profit tax and production tax	**717,548**	114,046
General and administrative	**596,184**	168,338
Mineral claims surrendered	**87,125**	—
Depletion	**1,460,000**	118,000
Depreciation and amortization	**244,305**	82,077
	3,390,329	518,784
Earnings before income taxes	**1,967,411**	687,619
Deferred income taxes	**1,053,472**	325,538
Net earnings	**$ 913,939**	$ 362,081
Earnings per share (after giving effect to a 3-for-1 stock split)		
Basic	**$ 0.127**	$ 0.055
Fully diluted	**$ 0.085**	$ 0.035
Pro forma basic	**$ 0.087**	

The accompanying notes are an integral part of these financial statements.

TEMAGAMI OIL & GAS LTD.

CONSOLIDATED STATEMENT OF RETAINED EARNINGS

YEAR ENDED MAY 31, 1981

	1981	1980
Retained earnings (deficit), beginning of year	**$ 338,791**	$(10,564)
Add: Net earnings	**913,939**	362,081
	1,252,730	351,517
Deduct: Dividends on Preferred Shares		
Series A	**16,439**	3,794
Series B	**20,760**	4,242
Series C	**22,860**	4,690
	60,059	12,726
Retained earnings, end of year	**$1,192,671**	$338,791

The accompanying notes are an integral part of these financial statements

TEMAGAMI OIL & GAS LTD.

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION

YEAR ENDED MAY 31, 1981

	1981	1980
Working capital was provided from		
Operations	$3,864,735	$ 836,696
Obligations under capital leases	75,596	208,978
Bank production loan	4,000,000	—
Decrease in notes receivable	67,500	—
Other	178,821	—
Issue of shares — common	—	322,500
— preferred	—	1,038,000
Issue of debenture	—	5,000,000
	8,186,652	7,406,174
Working capital was used for		
Acquisition of property and equipment	7,884,531	5,509,535
Increase in other assets	—	332,478
Notes receivable	—	1,038,000
Preferred share dividends	60,059	12,726
	7,944,590	6,892,739
Increase in working capital	242,062	513,435
Working capital (deficiency), beginning of year	398,514	(114,921)
Working capital, end of year	$ 640,576	$ 398,514

The accompanying notes are an integral part of these financial statements

TEMAGAMI OIL & GAS LTD.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

MAY 31, 1981

1. Significant accounting policies

The consolidated financial statements of the company have been prepared by management in accordance with generally accepted accounting principles consistently applied. These financial statements have, in management's opinion been properly prepared within reasonable limits of materiality and in light of information available up to July 24, 1981. The principal accounting policies are summarized as follows:

(a) Principles of consolidation

The consolidated financial statements include, in addition to the accounts of the company, the accounts of its wholly-owned subsidiary, Temagami Oil & Gas Inc.

(b) Exploration and development costs

The company follows the full cost method of accounting for exploration and development expenditures, wherein all costs related to the exploration for and the development of oil and gas reserves are initially capitalized. Costs capitalized include land acquisition costs, geological and geophysical expenditures, rentals on undeveloped properties, costs of drilling productive and non-productive wells together with overhead and interest directly related to exploration and development activities. Proceeds on minor property sales are credited to the net book value of the property and equipment. Gains or losses on major property sales are normally recognized in the statement of earnings.

Exploration and development costs are allocated to one cost centre, namely, North America (Canada and the United States).

Costs capitalized in the cost centre are depleted on the composite unit-of-production method based on estimated proven oil and gas reserves as determined by independent and company engineers.

(c) Mining properties

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

(d) Depreciation

Depreciation of production equipment is provided for on the composite unit-of-production method. Depreciation of other equipment is computed on the declining balance method at rates varying from 20 to 30 percent per annum.

(e) Joint venture

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

(f) Unamortized deferred financing charges

Deferred financing charges included in other assets in respect of the issuance of shares and a debenture are being amortized using the straight line method over six and five years respectively.

(g) Translation of foreign currencies

The accounts of the foreign subsidiary have been translated to Canadian dollars on the following basis: Current assets and current liabilities at the rate of exchange in effect at the year end. Other assets and liabilities at the rate of exchange in effect at the date of settlement. Revenue and expense items are translated using average rates of exchange prevailing throughout the year.

(h) Earnings per share

Basic earnings per share is based on the weighted average number of common shares outstanding during the year.

Fully diluted earnings per share is calculated assuming the conversion of the convertible debenture and the preferred shares.

Pro forma basic earnings per share is calculated taking into consideration the conversion of debenture referred to in note 9. It is calculated as though the issue of the common shares on the conversion of the debenture had taken place at the beginning of the current year.

2. Notes receivable

Notes receivable in the amount of $970,500 bearing interest at a rate of 6% per annum are due from three employees of the company. These loans were made to enable the employees to purchase preferred shares of the company.

3. Property and equipment

Property and equipment consists of the following:

	1981			1980
	Cost	**Accumulated Depletion and Depreciation**	**Net**	Net
Oil and gas properties including exploration and development costs thereon	**$12,306,621**	**$1,599,899**	**$10,706,722**	$5,915,000
Mining properties	**—**	**—**	**—**	87,025
Production equipment	**1,927,010**	**246,075**	**1,680,935**	673,602
Other	**482,046**	**73,288**	**408,758**	215,032
	$14,715,677	**$1,919,262**	**$12,796,415**	$6,890,659

4. Other assets

Other assets consist of the following:

	1981	1980
Unamortized deferred finance charges in connection with the issue of a convertible debenture	**$249,503**	$331,686
Unamortized deferred finance charges in connection with the issue of common shares	**48,153**	63,340
Organization costs	**1,608**	1,608
	$299,264	$396,634

5. Long-term debt

Long-term debt consists of the following:

	1981	1980
Bank production loan	**$4,000,000**	$ —
Obligations under capital leases — net of current portion	**284,574**	208,978
Convertible debenture	**5,000,000**	5,000,000
	$9,284,574	$5,208,978

a) The bank production loan is secured by certain petroleum and natural gas properties. The loan bears interest at 1% over a Canadian bank's prime lending rate and is repayable out of future production proceeds and accordingly is not expected to require the use of existing working capital; therefore, no portion of this loan has been reclassified to current liabilities. It is anticipated that the loan will be repaid at regular intervals from future production proceeds. There is no requirement for any fixed terms of repayment.

b) Obligations under capital leases

The following is a schedule of future minimum lease payments under capital leases expiring in 1986 and 1987.

Year ending May 31, 1982	$ 84,588
1983	84,588
1984	84,588
1985	84,588
1986	69,090
1987	82,500
Total minimum lease payments	489,942
Less: Amount representing interest at rates varying from 13 - 20%	174,368
Balance of obligations before current portion	315,574
Current portion	31,000
Balance of obligations	$284,574

c) Convertible debenture

The debenture bears interest at 2% below the Canadian prime rate and is secured by a fixed charge on all of the company's property and equipment and a floating charge on all other assets. The debenture is due November 15, 1984.

The debenture is convertible in whole or in part into common shares of the company on the following basis (after giving effect to a three-for-one stock split):

$1.333 per share up to November 15, 1981
$1.500 per share between November 16, 1981 and November 15, 1982
$1.667 per share between November 16, 1982 and November 15, 1983
$2.000 per share between November 16, 1983 and November 15, 1984

The company may redeem the debenture at 115% of the principal amount after November 15, 1981, subject to the exercise of any conversion privileges.

6. Share capital and contributed surplus

a) Authorized and issued share capital consist of the following:

	1981	**1980**
Authorized		
100,000 Preferred Shares Series A with a par value of $1 each		
100,000 Preferred Shares Series B with a par value of $1 each		
100,000 Preferred Shares Series C with a par value of $1 each		
15,000,000 Common Shares without par value		
Issued		
29,000 Convertible Preferred Shares Series A (1980 — 44,000 shares)	**$ 29,000**	$ 44,000
44,000 Convertible Preferred Shares Series B	**44,000**	44,000
44,000 Convertible Preferred Shares Series C	**44,000**	44,000
6,720,000 Common Shares (1980 - 6,675,000 shares)	**1,880,000**	1,812,500
	$1,997,000	$1,944,500

b) During the year the following Common Shares were issued:

Number of Shares		Amount
45,000	Shares issued upon conversion of 15,000 Convertible Preferred Shares, Series A	$67,500

c) The Preferred Shares Series A, B and C issued are in respect of a key employee share purchase plan and are all convertible into Common Shares on a three-for-one basis (after giving effect to a three-for-one stock split). Loans in the amount of $970,500 have been made to certain key employees to enable them to purchase the shares (see note 2). The shares are held in trust pending repayment of the loans by the employees. The shares pay dividends equal to the income earned by the company on the notes due from the employees.

d) Effective November 12, 1980, the shareholders of the company approved an increase in the authorized share capital of the Company from 5,000,000 Common Shares without par value to 15,000,000 Common Shares without par value.

e) Effective November 12, 1980, the directors approved the subdivision of shares of the company on a three-for-one basis.

f) There are 3,750,000 Common Shares (after giving effect to a three-for-one stock split) reserved at May 31, 1981 for issuance upon the conversion of the convertible debenture (see note 5).

g) Contributed surplus represents the excess of cash received on the issue of Preferred Shares over their par value.

7. Segmented information

	Canada	United States	Total
Petroleum and natural gas sales	$ 4,663	$ 5,260,642	$5,265,305
Operating profit	$ 94,591	$ 4,260,434	$4,355,025
General and administrative expenses			596,184
Mineral claims surrendered			87,125
Depletion			1,460,000
Depreciation and amortization			244,305
			2,387,614
Earnings before income taxes			$1,967,411
Identifiable assets	$5,471,922	$12,578,017	

8. Remuneration of directors and officers

The total remuneration paid to directors and officers of the company amounts to $374,250 (1980 -$140,000).

9. Subsequent event

Effective August 20, 1981, the convertible debenture of $5,000,000 referred to in note 5 was converted to fully paid and non-assessable common shares of the company.

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