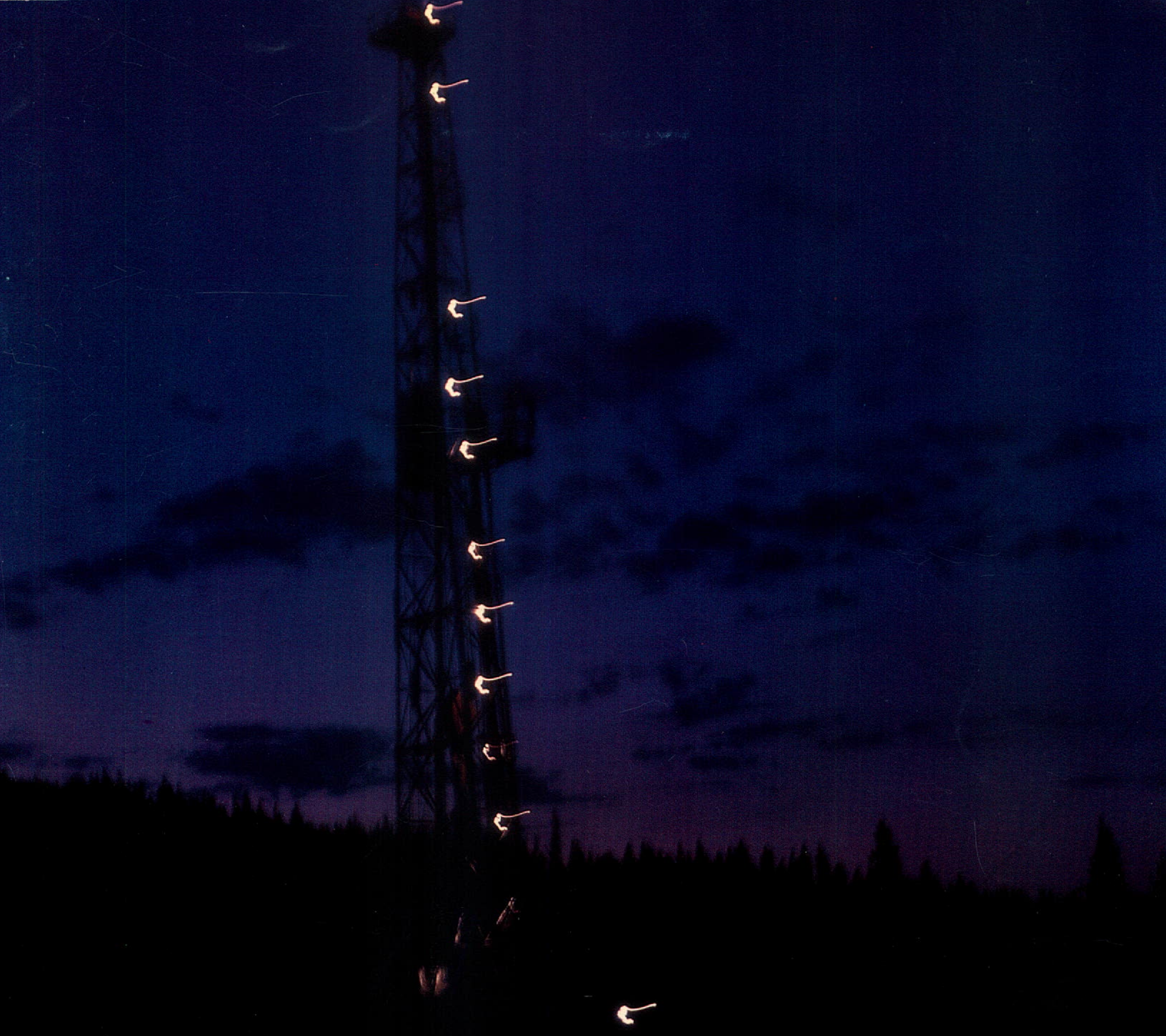


# CANADA SOUTHERN

CANADA SOUTHERN PETROLEUM LIMITED • 1992 ANNUAL REPORT

# CANADA SOUTHERN PETROLEUM LTD.—1992 ANNUAL REPORT

## The Company At A Glance

**In General:** Canada Southern Petroleum Ltd. was incorporated under the Canada Corporations Act in 1954, and has been a Nova Scotia corporation since 1980. Its only business is petroleum exploration and development, principally in northwestern Canada and the Arctic Islands, where it holds property interests now aggregating 500,000 gross acres. Current production and revenue is derived from several mature fields in northeastern B.C. A 38-percent-owned subsidiary, Probe Exploration Inc., has land-holdings and some production in Alberta and Saskatchewan.

**Financial** (year ended June 30)

| | |
|---|---|
| Operating Revenues | $1.5 million |
| Net Loss | $1.4 million |
| Debt | None |
| Line of Credit | $2.0 million |

**Production** (year ended June 30)

| | |
|---|---|
| Natural Gas | 1.17 bcf |
| Oil | 41,000 bbls. |

**Estimated Proved Recoverable Reserves***

| | |
|---|---|
| Natural Gas | 33.75 bcf |
| Oil | 532,000 bbls. |

| | |
|---|---|
| **Number of Shares Outstanding** | 12.3 million |

---

**The company's share of oil and gas reserves in the Arctic Islands are not included in this tabulation since they are not marketable and thus cannot be considered proved.*

*Unless prefaced with U.S., all monetary values in this report are expressed in Canadian dollars.*

***On the cover:***

***The Kotaneelee I-27 discovery well is shown at sunset in a 1963 time exposure photo by H. Anthony Ashton.***

## To Our Shareholders:

In fiscal 1992, ended June 30, our company incurred a net loss of $1.43 million, or 12 cents a share, on gross revenues of $1.86 million. This compares to last year's profit of $426,000 (three cents a share) on gross revenues of $3.13 million.

This year's results were severely impacted by a 42 percent drop in operating revenue, which went from $2.7 million to $1.5 million. This is *in part* attributable to the lower oil prices prevailing during the period, but resulted largely from a substantial decrease in the revenues we receive from our carried-interest properties in British Columbia. That was the unfortunate but unavoidable consequence of capital improvements to the properties—such as the installation of a compressor at Wargen and the recompletion of two Buick Creek gas wells—which, per long-standing agreement, are funded directly out of current operating revenue. We do believe, though, that the benefits from those expenditures should be reflected in this year's results. In addition, we recorded write-downs totaling $365,000 relating to oil and gas properties in Australia and mineral properties in Canada, based on the current potential of those interests.

We also had a $233,000 increase in other costs and expenditures, due in part to the expense of the ongoing litigation involving the Kotaneelee gas field. In connection with that situation, we are pleased to report that, after a one-year delay, our attorneys have received substantive responses from all of the defendants, and are now proceeding to wrap up Canada Southern's discovery. Then, of course, it will be the defendants' turn, and we anticipate their discovery could require as much as four to five months.

Excepting litigation expense, it could be said that this year's results generally reflect the problems being encountered by the oil and gas industry on a worldwide basis. Although oil prices today have reached reasonable levels—which, if maintained, would justify further exploration and development—the uncertainties caused by OPEC's surplus production capacity dictate continued caution. As a result, exploration, in particular, is proceeding at a slower pace than otherwise would be expected given current prices. Moreover, the continuing recession in the industrialized countries also has been a factor.

The gas situation, although affected by the same problems to some extent, is subject to more geographically restricted problems. In the case of western Canada, the North American "gas glut" has kept gas prices low over the past few years; and, now that there is a prospect of a better balance between production and consumption, we are confronted with limited pipeline capacity from the region. This has caused intense price competition, and has kept Canadian wellhead prices much lower than in the U.S. The prevailing view is that this problem will be ameliorated within two years as pipeline capacity is increased.

In anticipation of improving market conditions in the future, Canada Southern has continued with its steady, cautious program to evaluate and acquire new oil and gas prospects on Crown Lands in B.C. and Alberta. We now have an interest in nearly 24,000 "new" acres covering 14 prospects, and are giving special emphasis to those expected to have oil potential. Additional seismic work has been done on several of these prospects, and more is planned for the current year.

Three drilling locations have been selected as a result of this work and one has been drilled, resulting in an oil discovery. The other two wells should be drilled late in 1992 or early in 1993. Earlier drilling had been planned, but access problems and the opportunity to acquire more lands has caused some delays.

We had hoped that we could initiate more drilling by way of farmouts during 1991-2, but, as a consequence of the industrywide downturn, that did not transpire. The leases have a five to ten year life, so further geological and geophysical work is being done to enhance these prospects in anticipation of improved conditions in the future.

Our more mature leases, which account for current production in B.C., are now being re-evaluated by Canada Southern and its partners to determine if production could be increased by new drilling. Several new leads have been found; and a new well has been drilled at the Peejay field, which is now being completed as an oil producer.

Production at Kotaneelee, from the B-38 and I-48 wells, averaged better than 50 million cubic feet per day for the eight month period ended June 30, 1992. We are now beginning to receive more information from the operator, and we hope this will enable us to provide more timely, relevant information to our shareholders as to developments at Kotaneelee.

As to reserves at Kotaneelee, we again emphasize that the field is not fully delineated and is largely undeveloped. However, a report filed with Canada's National Energy Board by the operator in 1989 estimated reserves in-place of approximately 1.6 trillion cubic feet of gas, with estimated proved and probable recoverable reserves of up to 781 billion cubic feet, based on the recovery factors for the Beaver River field (18 percent) to the south and the Pointed Mountain field (over 30 percent) to the north. Although it is not now possible to estimate what the Kotaneelee recovery factor will be, the geological characteristics of the Kotaneelee field appear to be more closely related to Pointed Mountain rather than Beaver River.

We also note that Canada Southern's position as a *carried-interest* partner precludes it from receiving its share of Kotaneelee's production revenue until our share of prior exploration, development, and operating costs have been recouped by the working-interest partners. At present, it is expected that Canada Southern will begin to receive proceeds from Kotaneelee in about eight years, but we emphasize that estimate is based on the *current production rate and current wellhead price.* Obviously, the actual payout period could be shorter or longer than eight years, depending on future market conditions *and* the results of the litigation.

We regret to report the passing of our longtime friend and colleague, James J. Gaughran, an assistant secretary of the company, who handled our shareholder relations and other matters in the U.S. with consummate professionalism for many years.

Respectfully submitted,

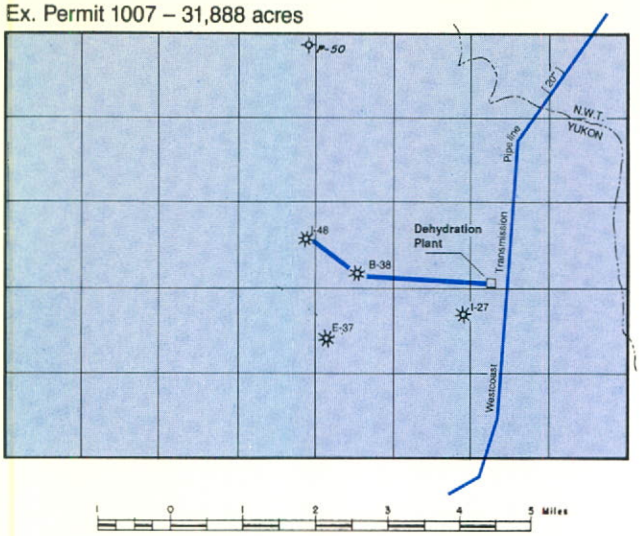
JC Horne

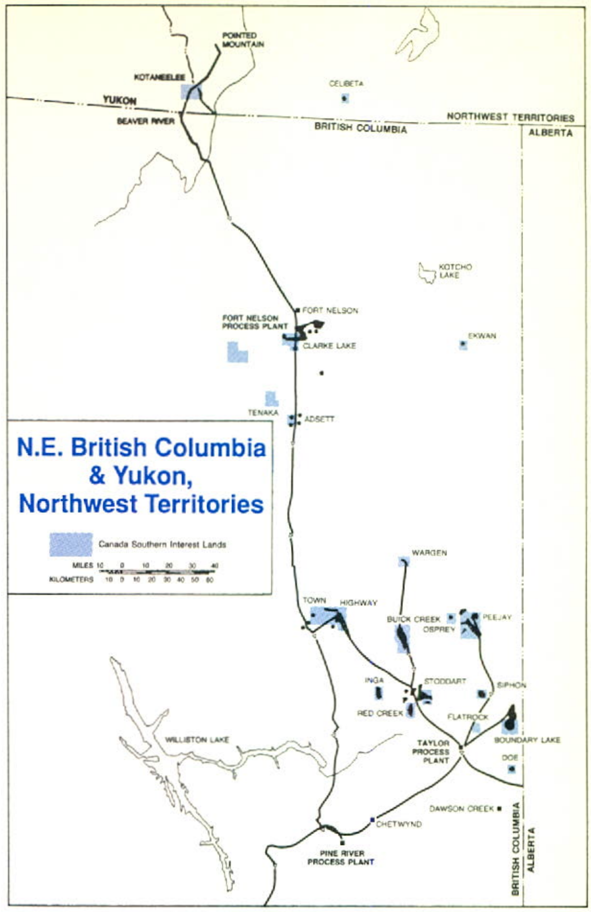
Charles J. Horne
President

Calgary, Alberta
October 23, 1992

## Kotaneelee Field

Ex. Permit 1007 – 31,888 acres




## Gross and Net Petroleum Acreage

as of June 30, 1992

| | Gross Acres | Net Acres |
|---|---|---|
| **Canada:** | | |
| **British Columbia:** | | |
| Carried Interests | 52,539 | 10,626 |
| Working Interests | 62,487 | 17,653 |
| Overriding Royalty Interests | 4,487 | 336 |
| Total British Columbia | 119,513 | 28,615 |
| **Alberta:** | | |
| Working Interests | 15,840 | 7,852 |
| **Yukon & Northwest Territories:** | | |
| Carried Interests | 33,482 | 10,283 |
| **Arctic Islands:** | | |
| Carried Interests | 290,762 | 44,776 |
| Working Interests | 44,577 | 1,795 |
| Total Arctic Islands | 335,339 | 46,571 |
| **Total Canada** | 504,174 | 93,321 |
| **Australia** | 115,645 | 90 |
| **TOTAL** | 619,819 | 93,411 |

## Financial Highlights

| | Year ended June 30, | | | | |
|---|---|---|---|---|---|
| | **1992** | 1991 | 1990 | 1989 | 1988 |
| Operating revenues | **$ 1,545,782** | $ 2,671,570 | $ 1,740,331 | $ 1,450,920 | $ 1,779,853 |
| Total revenues | **$ 1,862,882** | $ 3,132,147 | $ 2,300,628 | $ 2,036,188 | $ 2,282,916 |
| Net income (loss) | **$ (1,431,487)** | $ 426,029 | $ (820,682) | $ (1,181,175) | $ (25,333)** |
| Net income (loss) per share | **$ (.12)** | $ .03* | $ (.07) | $ (.10) | $ —** |
| Working capital | **$ 3,925,857** | $ 4,859,742 | $ 4,649,412 | $ 5,566,844 | $ 6,443,327 |
| Total assets | **$14,593,110** | $16,085,764 | $15,580,704 | $15,376,459 | $16,394,438 |
| Shareholders' Equity: | | | | | |
| Limited Voting Shares | **$12,345,825** | $12,345,825 | $12,272,266 | $11,989,954 | $11,989,954 |
| Contributed surplus | **16,247,717** | 16,247,717 | 16,122,667 | 15,586,274 | 15,586,274 |
| Accumulated deficit | **(14,385,762)** | (12,954,275) | (13,380,304) | (12,559,622) | (11,378,447) |
| | **$14,207,780** | $15,639,267 | $15,014,629 | $15,016,606 | $16,197,781 |
| Average number of outstanding shares | **12,345,825** | 12,294,900 | 12,120,251 | 11,989,954 | 11,298,226 |
| Exchange rates: ($1 Can. expressed in $U.S.): | | | | | |
| Year-end | **$.8340** | $.8757 | $.8593 | $.8357 | $.8245 |
| Average | **$.8606** | $.8660 | $.8505 | $.8317 | $.7805 |
| Range | **$.8929-$.8292** | $.8811-$.8501 | $.8650-$.8288 | $.8475-$.8064 | $.8316-$.7487 |

**Under U.S. generally accepted accounting principles, income before income taxes and extraordinary item would have been $426,029 ($.03 per share), income taxes $299,345 ($.02 per share), extraordinary item (utilization of net operating loss carryforward) $299,345 ($.02 per share) and net income $426,029 ($.03 per share). See Note 6 in Notes to Consolidated Financial Statements.*

***Net income (loss) includes $104,000 ($.01 per share) for the year 1988 for an extraordinary item of tax benefits realized.*

**CANADA SOUTHERN PETROLEUM LTD.**
(Incorporated under the laws of Nova Scotia)

# Consolidated Balance Sheets
(Expressed in Canadian dollars)

| | June 30, 1992 | June 30, 1991 |
|---|---|---|
| **Assets** | | |
| **Current assets:** | | |
| Cash and cash equivalents (Note 2) | **$ 3,568,975** | $ 4,626,103 |
| Accounts and interest receivable | **471,992** | 470,016 |
| Prepaid insurance and other | **206,524** | 210,120 |
| Total current assets | **4,247,491** | 5,306,239 |
| **Investment in and loans to Probe Exploration Inc.** (Note 3) | **1,325,612** | 1,411,832 |
| **Oil and gas properties (full cost method)** (Note 4) | **8,996,535** | 9,198,710 |
| **Other assets** (Note 4) | **23,472** | 168,983 |
| | **$14,593,110** | $16,085,764 |
| **Liabilities and Shareholders' Equity** | | |
| **Current liabilities:** | | |
| Accounts payable | **$ 182,588** | $ 443,201 |
| Accrued liabilities | **139,046** | 3,296 |
| Total current liabilities | **321,634** | 446,497 |
| **Reserve for future restoration costs** | **63,696** | — |
| **Shareholders' equity:** | | |
| Limited Voting Shares, par value $1 per share (Note 5) | | |
| Authorized — 100,000,000 shares | | |
| Outstanding — 12,345,825 shares | **12,345,825** | 12,345,825 |
| Contributed surplus | **16,247,717** | 16,247,717 |
| | **28,593,542** | 28,593,542 |
| Accumulated deficit | **(14,385,762)** | (12,954,275) |
| Total shareholders' equity | **14,207,780** | 15,639,267 |
| **Contingencies and commitments** (Note 8) | | |
| | **$14,593,110** | $16,085,764 |

*See accompanying notes.*

On behalf of the Board:

M. A. Ashton, Director

Charles J. Horne, Director

# Consolidated Statements of Operations and Accumulated Deficit
(Expressed in Canadian dollars)

| | Year ended June 30, | | |
|---|---|---|---|
| | **1992** | 1991 | 1990 |
| **Revenues:** | | | |
| Oil and gas sales | **$ 1,270,498** | $ 1,637,097 | $ 1,598,809 |
| Proceeds under carried interest agreements | **275,284** | 1,034,473 | 141,522 |
| Interest and other income | **317,100** | 460,577 | 560,297 |
| | **1,862,882** | 3,132,147 | 2,300,628 |
| **Costs and expenses:** | | | |
| General and administrative | **2,021,927** | 1,791,649 | 1,581,015 |
| Lease operating costs | **464,943** | 507,800 | 762,417 |
| Depletion and depreciation | **366,566** | 343,376 | 605,283 |
| Foreign exchange losses (gains) | **(96,623)** | 41,585 | 59,397 |
| Abandonments and writedowns | **364,802** | — | — |
| Provision for restoration costs | **63,696** | — | — |
| Rent | **43,293** | 35,146 | 26,149 |
| (Income) loss relating to Probe Exploration Inc. | **65,765** | (13,438) | 87,049 |
| | **3,294,369** | 2,706,118 | 3,121,310 |
| Income (loss) before income taxes | **(1,431,487)** | 426,029 | (820,682) |
| Income taxes (Note 6) | **—** | — | — |
| **Net income (loss)** | **(1,431,487)** | 426,029 | (820,682) |
| Accumulated deficit—beginning of year | **(12,954,275)** | (13,380,304) | (12,559,622) |
| Accumulated deficit—end of year | **$(14,385,762)** | $(12,954,275) | $(13,380,304) |
| Average number of shares outstanding | **12,345,825** | 12,294,900 | 12,120,251 |
| Income (loss) per share based on weighted average number of shares outstanding during the period | **$(.12)** | $ .03 | $(.07) |

*See accompanying notes.*

## Consolidated Statements of Cash Flows

(Expressed in Canadian dollars)

| | Year ended June 30, | | |
|---|---|---|---|
| | **1992** | 1991 | 1990 |
| **Cash Flows from Operating Activities:** | | | |
| Net income (loss) | **$(1,431,487)** | $ 426,029 | $ (820,682) |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: | | | |
| Writedowns | **364,802** | — | — |
| Depreciation and depletion | **366,566** | 343,376 | 605,283 |
| Equity adjustment relating to Probe Exploration Inc. | **65,765** | (13,438) | 87,049 |
| Other | **91,863** | 34,568 | 110 |
| | **(542,491)** | 790,535 | (128,240) |
| Change in assets and liabilities: | | | |
| Accounts and interest receivable | **(1,976)** | (80,347) | 25 |
| Prepaid insurance and other | **3,596** | (16,646) | 3,697 |
| Accounts payable | **(260,613)** | (107,340) | 202,819 |
| Accrued liabilities | **135,750** | (12,238) | 3,403 |
| Net cash provided by (used in) operations | **(665,734)** | 573,964 | 81,704 |
| **Cash Flows from Investing Activities:** | | | |
| Additions to oil and gas properties and other equipment | **(391,394)** | (480,205) | (389,192) |
| Advances to Probe Exploration Inc. | **—** | (100,000) | (400,000) |
| Net cash used in investing activities | **(391,394)** | (580,205) | (789,192) |
| Decrease in cash and cash equivalents | **(1,057,128)** | (6,241) | (707,488) |
| Cash and cash equivalents at beginning of period | **4,626,103** | 4,632,344 | 5,339,832 |
| Cash and cash equivalents at end of period (Note 2) | **$ 3,568,975** | $4,626,103 | $4,632,344 |

*During the past three years there were no charges incurred for interest expense or income taxes.*

## Consolidated Statements of Limited Voting Shares and Contributed Surplus

(Expressed in Canadian dollars)

| | Number of shares | Limited Voting Shares, $1 par value | Contributed surplus | Total |
|---|---|---|---|---|
| Balance at June 30, 1989 | 11,989,954 | $11,989,954 | $15,586,274 | $27,576,228 |
| Shares issued to acquire interest in Probe (Note 3) | 282,312 | 282,312 | 536,393 | 818,705 |
| Balance at June 30, 1990 | 12,272,266 | 12,272,266 | 16,122,667 | 28,394,933 |
| Shares issued to acquire additional interest in Probe (Note 3) | 73,559 | 73,559 | 125,050 | 198,609 |
| Balance at June 30, 1991 and 1992 | 12,345,825 | $12,345,825 | $16,247,717 | $28,593,542 |

*See accompanying notes.*

# Notes to Consolidated Financial Statements

(Expressed in Canadian dollars)
June 30, 1992

## 1. Summary of significant accounting policies

### Accounting principles

The Company prepares its accounts in accordance with accounting principles generally accepted in Canada which conform in all material respects with accounting principles generally accepted in the United States.

### Consolidation

The consolidated financial statements include the accounts of Canada Southern Petroleum Ltd. and its wholly-owned subsidiaries, Canpet Inc. and C.S. Petroleum Limited.

The investment in Probe Exploration Inc. is accounted for by the equity method, under which the investment is carried at cost adjusted by the Company's share of post-acquisition income (losses) and the amortization of the excess of purchase price over the net assets acquired. The Company's share of interest revenue on Probe advances is eliminated under the equity method.

### Cash and cash equivalents

For the purposes of the statement of cash flows, the Company considers all highly liquid investments with a maturity of three months or less to be cash equivalents.

### Oil, gas and mineral properties

The Company, which is engaged primarily in one industry, the exploration for and the development of oil and gas properties principally in Canada, follows the full cost method of accounting for oil and gas properties, whereby all costs associated with the exploration for and the development of oil and gas reserves are capitalized.

The Company periodically reviews the costs associated with undeveloped properties and mineral rights to determine whether they are likely to be recovered. When such costs are not likely to be recovered, such costs are transferred to the depletable pool of oil and gas costs.

The net carrying cost of the Company's oil and gas properties in producing cost centers is limited to an estimated recoverable amount. This amount is the aggregate of future net revenues from proved reserves and the costs of undeveloped properties, net of impairment allowances, less future general and administrative costs, financing costs and income taxes. Future net revenues are calculated using year end prices that are not escalated or discounted.

Gains or losses are not recognized upon disposition of oil and gas properties unless crediting the proceeds against accumulated costs would result in a change in the rate of depletion of 20% or more.

Depletion is provided on costs accumulated in producing cost centers including well equipment using the unit of production method. For purposes of the depletion calculation, gross proved oil and gas reserves as determined by outside consultants are converted to a common unit of measure on the basis of their approximate relative energy content.

Depreciation has been computed for equipment, other than well equipment, on the straight-line method based on estimated useful lives of four to ten years.

Substantially all of the Company's exploration and development activities related to oil and gas are conducted jointly with others and accordingly the consolidated financial statements reflect only the Company's proportionate interest in such activities.

Oil and gas sales are reported net of royalties paid. The amount of royalties for the three years ended June 30, 1990, 1991 and 1992 were $392,576, $411,748 and $301,860, respectively.

### Future site restoration

Estimated future site restoration costs are provided on a unit of production basis. The provision is based on current costs of complying with existing legislation and industry practice for site restoration and abandonment.

### Deferred income taxes

The Company follows the tax allocation method of accounting whereby the income tax provision is based on pre-tax income reported in the accounts. Under this method, full provision is made for deferred income taxes resulting from claiming deductions at the rates permitted by income tax legislation, which may differ from those used in the accounts.

### Foreign currency translation

Transactions for settlement in U.S. dollars have been converted at average monthly exchange rates. Assets and liabilities in U.S. dollars have been translated at the year end exchange rates. Exchange gains or losses resulting from these adjustments are included in costs and expenses.

## 2. Cash and cash equivalents

| | June 30, 1992 | June 30, 1991 |
|---|---|---|
| U.S. Treasury bills | $1,781,180 | $1,679,421 |
| Canadian bankers acceptances | 1,209,460 | 2,363,947 |
| Term deposit—Bermuda | 208,258 | 188,960 |
| | 3,198,898 | 4,232,328 |
| Cash | 370,077 | 393,775 |
| | $3,568,975 | $4,626,103 |

*Note: Cash equivalents are carried at cost which approximates market value.*

## 3. Investment in and loans to Probe Exploration Inc.

A 48 percent interest in Probe Exploration Inc. (Probe) was acquired on January 18, 1990 by issuance of 282,312 Company shares, valued at $818,705. The excess of the consideration paid over the net book value of the assets acquired amounted to $607,755 and has been allocated to oil and gas properties.

The excess of cost over the Company's interest in the net assets of Probe is being amortized over the estimated life of Probe's oil and gas producing properties on the unit of production method.

In March 1991, an additional interest was acquired by issuance of 73,559 Company shares, valued at $198,609. The values at January 1990 and March 1991 were based upon the closing market prices of Company shares on the dates of issuance. At June 30, 1992, the Company had a 38.37 percent (1991-45.79 percent) interest in Probe as a result of the above transactions and share issuances by Probe to others.

The Company's investment in Probe at June 30, 1992 and 1991 is as follows:

| | 1992 | 1991 |
|---|---|---|
| Investment in Probe | $1,017,314 | $1,017,314 |
| Loans to Probe | 500,000 | 500,000 |
| | 1,517,314 | 1,517,314 |
| Less: Equity adjustments (Note 1) | (191,702) | (105,482) |
| | $1,325,612 | $1,411,832 |

As of June 30, 1992, the carrying value of the Company's investment in Probe exceeded the equity in net assets by $286,904, which excess is attributable to oil and gas properties.

The loans to Probe are due on demand and bear interest at the Royal Bank of Canada prime rate (7% at June 30, 1992) plus one percent per annum and are collateralized by a majority of the assets of Probe.

## 4. Oil, gas and mineral properties

| | Cost | Accumulated Provisions and Writedowns | Net Book Value |
|---|---|---|---|
| **1992** | | | |
| Oil and gas properties—developed | $14,119,277 | $5,122,743 | $8,996,534 |
| Oil and gas properties—undeveloped | 223,803 | 223,802 | 1 |
| Equipment | 48,288 | 24,818 | 23,470 |
| Mineral rights | 143,726 | 143,725 | 1 |
| | $14,535,094 | $5,515,088 | $9,020,006 |
| **1991** | | | |
| Oil and gas properties—developed | $13,756,012 | $4,759,128 | $8,996,884 |
| Oil and gas properties—undeveloped | 201,826 | — | 201,826 |
| Equipment | 62,093 | 36,836 | 25,257 |
| Mineral rights | 143,726 | — | 143,726 |
| | $14,163,657 | $4,795,964 | $9,367,693 |

Substantially all gas sales were made to CanWest Gas Supply Inc. and oil sales were made to Petro-Canada.

## 5. Limited Voting Shares and stock options

The Memorandum of Association (Articles of Continuance) of Canada Southern provide that no person (as defined) shall vote more than 1,000 shares.

Under the terms of a stock option plan, the Company is authorized to grant certain key employees and others options to purchase up to an aggregate of 400,000 limited voting shares at prices based on the market price of the shares as determined on the date of the grant. The options are exercisable for five years from the date of grant. At June 30, 1992, the following options were outstanding under the plan and were granted to certain officers, employees, directors and consultants of the Company.

On May 9, 1990, pursuant to the plan, options on 35,000 shares were granted to an officer at a price of $2.25 per share, the market price on the date of grant, exercisable for five years from the date of grant.

Effective March 19, 1991, options on 66,666 shares were granted to consultants to replace an equivalent number which expired. The option price was $2.55, the market price on the date of grant and the options are exercisable for five years from the date of grant.

There were no other changes in stock options during the three years ended June 30, 1992.

| Expiry Date | Option Price per share | Number of shares |
|---|---|---|
| August 4, 1992 | $3.90 | 107,500 |
| May 8, 1995 | 2.25 | 35,000 |
| March 18, 1996 | 2.55 | 66,666 |
| | | 209,166 |

## 6. Income taxes

Income taxes vary from the amounts that would be computed by applying the Canadian federal and provincial income tax rates as follows:

| | 1992 | 1991 | 1990 |
|---|---|---|---|
| Provision for income taxes based on combined basic Canadian federal and provincial income tax rate of 44.34% (1991-43.95%, 1990-43.84%) | $(634,721) | $ 187,282 | $(359,787) |
| Allowable deductions for property costs in excess of related depletion | — | — | 147,672 |
| Utilization of net operating loss carryforward | — | (299,345) | — |
| Federal resource allowance | — | (47,965) | — |
| Non-deductible crown charges | 122,259 | 163,045 | 151,907 |
| (Income) loss of investee company | 29,160 | (5,906) | 38,162 |
| Nondeductible legal fees | — | 3,191 | 13,497 |
| Other | 6,415 | (302) | 8,549 |
| Unrealized tax loss | 476,887 | — | — |
| Actual provision for income taxes | $ — | $ — | $ — |

At June 30, 1992, the Company had net operating losses for financial reporting purposes of approximately $1,544,000 which are available to be carried forward to future periods. In addition, the Company had a net operating loss of approximately $511,000 that may be used to reduce taxable income, if any, and which expires July 1, 1997.

At June 30, 1992, the following oil and gas tax pools are available to reduce future taxable income, subject to a final determination by taxation authorities.

| | |
|---|---|
| Drilling, exploration and lease acquisition costs | $10,025,404 |
| Earned depletion | 2,183,256 |
| Undepreciated capital costs | 625,395 |
| Capital losses (can only be used against future years' capital gains) | 195,698 |
| | $13,029,753 |

The tax benefits attributable to the above accumulated expenditures will not be reflected in the consolidated financial statements until such benefits are realized.

U.S. generally accepted accounting principles under APB 11 require that the carryforward of net operating losses be treated as an extraordinary item when recovered. Accordingly, under U.S. generally accepted accounting principles, the Company would be required to show the utilization of a net operating loss carryforward item as a credit to the income tax provision on the face of the consolidated statements of operations and accumulated deficit.

Income (loss) under U.S. generally accepted accounting principles, in total, and per share based on average number of shares outstanding during the period, for the three years ended June 30 is as follows:

| | 1992 | | 1991 | | 1990 | |
|---|---|---|---|---|---|---|
| | Total | Per share | Total | Per share | Total | Per share |
| Income (loss) before income taxes and extraordinary item | $(1,431,487) | $ (.12) | $ 426,029 | $ .03 | $(820,682) | $ (.07) |
| Income taxes | | — | (299,345) | (.02) | — | — |
| Income (loss) before extraordinary item | (1,431,487) | (.12) | 126,684 | .01 | (820,682) | (.07) |
| Extraordinary item—utilization of net operating loss carryforward | — | — | 299,345 | .02 | — | — |
| Net income (loss) | $(1,431,487) | $ (.12) | $ 426,029 | $ .03 | $(820,682) | $ (.07) |

The Financial Accounting Standards Board issued Statement on Financial Accounting Standard No. 96, "Accounting for Income Taxes," in December 1987. This standard was amended in February 1992 by issuance of Financial Accounting Standard No. 109, effective for fiscal years beginning after December 15, 1992. The objective of the standard is to recognize the amount of taxes payable during the current year and to recognize deferred tax liabilities and assets for the future tax consequences of events which have been recognized in financial statements or tax returns. Management does not expect this standard to have a material impact on the consolidated financial position of the Company.

## 7. Line of credit

The Company has a line of credit with a Canadian chartered bank which provides for a revolving loan of $2 million. The interest rate on borrowing is at 3/4% above the bank's prime lending rate. The line of credit is subject to annual review and is secured by a general assignment of accounts receivable and an undertaking to provide security in the form of assignment of future working interest proceeds. No drawings were made under this line during the years ended June 30, 1992 and 1991.

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## 8. Litigation

The Company believes that the working interest owners in the Kotaneelee gas field have not adequately pursued the attainment of contracts for the sale of Kotaneelee gas; accordingly, legal action was commenced by the Company in 1987 in the United States against Allied Signal Inc. and Allied Corporation (collectively, Allied Signal). This suit was ultimately dismissed in December 1988, and the Company decided to forego its appeals of the dismissal because it appeared to involve costly delays and because alternative courses of action appeared to be available as discussed below.

On October 27, 1989, in the Court of Queens Bench of Alberta, Judicial District of Calgary, Canada (the Canada Court), the Company filed a statement of claim against Amoco Canada Petroleum Company Ltd., Dome Petroleum Limited and Amoco Production Company (collectively, the Amoco-Dome Group), Columbia Gas Development of Canada Ltd., Mobil Oil Canada Ltd. and Esso Resources of Canada Ltd. seeking a declaratory judgment regarding two issues relating to the Kotaneelee field; (1) whether interest accrued on the carried interest account (the Company maintains it does not), and (2) whether expenditures for gathering lines and dehydration equipment are expenditures chargeable to the carried interest account or whether the Company will be assessed a processing fee on gas throughput (the Company maintains the former position). Mobil, Esso and Columbia Gas have filed answers essentially agreeing to the granting of the relief requested by the Company. Amoco-Dome has now admitted one of two claims, i.e., that interest does not accrue on the carried interest account. The Company's position with respect to these two issues has been used as the basis for assessing whether the carrying value (book value) of the Company's oil and gas properties is appropriate.

On March 7, 1990, the Company filed a statement of claim in the Canada Court against the Amoco-Dome Group, Columbia Gas Development of Canada Ltd., Mobil Oil Canada Ltd. and Esso Resources of Canada Ltd. seeking forfeiture of the Kotaneelee field, that the balance of the carried interest account be reduced to zero, damages and other relief for breach of fiduciary duty. If fully successful, the Company could recover a 90 percent interest in the Kotaneelee field and damages. The defendants have contested the claim and the Company is pursuing discovery and trial. Columbia has filed a counter claim seeking, if the Company is successful in its claims, repayment from the Company of all sums Columbia has expended on the Kotaneelee lands before the Company is entitled to its interest.

The Company has notified the defendants that it will apply to the Court to permit amendment of its statement of claim to join other parties and to elaborate on its claim for a reduction of the carried account to zero.

There are two claims still outstanding against the Company as they relate to the initial suit brought against Allied Signal. Allied Signal seek additional relief against the Company to preclude other types of suits by the Company and to recover the costs of the defense of the initial action. If such claims to seek additional relief are successful, such recoveries could have a material adverse effect on the Company's consolidated financial position but counsel advises that such recovery is unlikely.

Effective December 31, 1991, Anderson Exploration Ltd. (Anderson) acquired all of Columbia Gas Development of Canada interests in Canada, including the Columbia interest in the Kotaneelee gas field. Anderson is now the operator of the field. Columbia's previous parent, The Columbia Gas System, Inc., which has filed for bankruptcy in the United States, became contractually liable in the legal proceeding described above.

The working interest partners have entered into contracts under which Kotaneelee gas is being sold. The Company believes that it is too early to determine the impact, if any, that these contracts may have on the status of the above cases.

General and administrative expenses include $863,443, $770,301 and $632,535 for legal fees and expenses for the years ended June 30, 1992, 1991 and 1990, respectively.

## 9. Related party transactions

Directors' fees and other compensation paid to directors who are officers of the Company amounted to $201,090 (1991 - $186,425; 1990 - $181,210). Of these amounts, $46,000 (1991 - $42,000; 1990 - $42,000) were directors' fees.

Fees paid or accrued for legal services rendered to the Company by Reasoner, Davis & Fox of which firm Mr. C. Dean Reasoner, a director of the Company, is a partner amounted to U.S. $138,000 (1991 - $130,000; 1990 - U.S. $127,000).

On January 29, 1991, the Company granted interests amounting to an aggregate of seven and 8/10 percent (7.8%) of any and all benefits to the Company after expenses from the litigation in Canada relating to the Kotaneelee field to certain of its officers, employees, directors, counsel and consultants. The Company has reserved a two and 2/10 percent (2.2%) interest in such net benefits for possible future grants to persons who may include officers and directors of the Company.

## Auditors' Report

To the Shareholders of
**Canada Southern Petroleum Ltd.**

We have audited the accompanying consolidated balance sheets of Canada Southern Petroleum Ltd. as at June 30, 1992 and 1991 and the consolidated statements of operations and accumulated deficit, cash flows, and limited voting shares and contributed surplus for each of the years in the three-year period ended June 30, 1992. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Canada Southern Petroleum Ltd. as at June 30, 1992 and 1991, and the results of operations and the changes in its financial position for each of the years in the three-year period ended June 30, 1992 in conformity with accounting principles generally accepted in Canada.

Ernst + Young
Chartered Accountants

Calgary, Canada
September 2, 1992

## Comments by Auditors for U.S. Readers On Canada – U.S. Reporting Conflict

In the United States, reporting standards for auditors require the addition of an explanatory paragraph (following the opinion paragraph) when the financial statements are affected by significant uncertainties such as that referred to in the attached balance sheets as at June 30, 1992 and 1991 and as described in Note 8 of the consolidated financial statements. The above opinion dated September 2, 1992 is expressed in accordance with Canadian reporting standards which do not permit a reference to such an uncertainty in the auditors' report when the uncertainty is adequately described in the consolidated financial statements.

Ernst + Young
Chartered Accountants

Calgary, Canada
September 2, 1992

# Management's Discussion and Analysis of Financial Condition and Results of Operations

## 1. Liquidity and Capital Resources

A significant proportion of the Company's property interests are covered by carried interest agreements, which provide that expenditures are made by the operator and are recouped solely out of revenues from production. Certain of the properties in which the Company has carried interests have reached payout status. Proceeds from these carried interests plus oil and gas sales are the major continuing sources of working capital for the Company.

The Company's cash and cash equivalents ($3,568,975 at June 30, 1992), its $2,000,000 line of credit with a Canadian bank and operating revenues have been the Company's principal sources of liquidity. These sources are expected to provide adequate liquidity both on a short-term and long-term basis. During the fiscal year, the Company made no drawings under its bank line of credit.

The Company is currently evaluating and expects to continue to evaluate oil and gas properties and may make investments in such properties utilizing cash on hand. The Company anticipates that its capital expenditures for land acquisitions and drilling over the next twelve months will be approximately $300,000. In addition, substantial expenses may be incurred in connection with the litigation involving the Kotaneelee gas field.

## 2. Results of Operations

### Fiscal Year ended June 30, 1992 vs. 1991

The net loss for 1992 was $1,431,487 (12 cents per share) compared to net income of $426,029 (3 cents per share) for 1991. Most of the change is attributable to decreased revenues, particularly proceeds from carried interests, which were adversely affected by expenditures by the operators of the properties. It is expected that benefits from these expenditures will be reflected in fiscal 1993 results.

Operating revenues were 42 percent lower in fiscal 1992 as compared to 1991. Oil and gas sales were down by 22 percent. Oil revenues decreased 29 percent due to a 27 percent decrease in prices and a 3 percent decrease in unit sales. Gas revenues remained unchanged with a 10 percent increase in units sold, offset by a 9 percent decrease in average gas prices.

Interest and other income was 31 percent lower for fiscal 1992 as compared to fiscal 1991, due to reduced amounts invested and lower rates of return on investment.

General and administrative expenses were 12 percent higher than last year, primarily because of Kotaneelee litigation expense. Lease operating costs were 8 percent lower than last year because of lower production levels. Depreciation and depletion expense was 7 percent higher as the effect of these lower production levels were offset by lower estimated reserves.

During the 1992 fiscal year, the Company realized an exchange gain of $96,623 compared to a foreign exchange loss of $41,585 last year. These items reflect the relative weakness or strength of the Canadian dollar versus the U.S. dollar. Certain short term investments are in U.S. treasury bills.

In fiscal 1992, the Company recorded writedowns of $364,802 relating to Australian petroleum properties and Canadian mineral properties.

During 1992, the Company initiated a provision for site restoration costs of $63,696 in accordance with the Canadian Institute of Chartered Accountants requirement to accrue clean-up costs.

The Company recorded a charge of $65,765 to reflect (a) the Company's share of Probe Exploration Inc.'s ("Probe") net loss and (b) the amortization of the excess cost over the Company's interest in Probe's net assets at acquisition dates, which excess is considered attributable to Probe's oil and gas properties. The comparable amount in fiscal 1991 was a credit of $13,438.

### Fiscal Year ended June 30, 1991 vs. 1990

Net income for 1991 was $426,029 (3 cents per share) compared to a loss of $820,682 (7 cents per share) for 1990. The improvement was due in large part to improved revenues, particularly proceeds under carried interest agreements.

Proceeds from carried interests in 1991 benefitted from capital expenditures by the operators in prior years. The Company's share of these expenditures depress revenues until recouped out of production but then revenues generally improve significantly. Thus, proceeds in 1991 were over seven times greater than 1990 proceeds. Due to the nature of carried interests, as discussed above, the Company cannot predict whether this trend will continue.

Oil and gas sales were 2 percent higher in fiscal 1991 as compared to 1990. Unit sales of oil were down 9 percent and oil prices averaged 26 percent higher. Unit gas sales were down 26 percent whereas gas prices were down 1 percent. Interest income was 18 percent lower, due to lower rates of return on investment.

General and administrative expenses increased 13 percent in 1991, primarily due to Kotaneelee litigation expense.

Lease operation costs were 33 percent lower than last year. The costs for 1990 had included charges by operators of Company properties relating to 1988 not received on a timely basis. Depletion and depreciation decreased 43 percent due to reinstatement of Kotaneelee field reserves as proved reserves. These reserves had been eliminated from proved reserves for the purpose of computing depreciation and depletion on April 1, 1988.

During fiscal 1991, the amount of $13,438 was credited to income to reflect (a) the Company's share of Probe net income and (b) the amortization of the excess cost over the Company's interest in Probe's net assets at acquisition dates, which excess is considered attributable to Probe's oil and gas properties. The comparable amount in 1990 was a charge against income of $87,049.

## Supplemental Information on Oil and Gas Activities

(unaudited)

The following information includes estimates which are subject to rapid and unanticipated change. Therefore, these estimates may not accurately reflect future net income to the Company.

The Company has no proved oil and gas reserves in Australia that require disclosure under SEC regulations and no revenues from oil and gas production in that country. All amounts below except for costs, acreage, wells drilled and present activities relate to Canada. Oil and gas reserve data and the information relating to cash flows were provided by Paddock Lindstrom & Associates Ltd., independent consultants.

### 1. Estimated net quantities of proved oil and gas reserves:

| | Oil (bbls) | Gas (bcf) |
|---|---|---|
| Proved reserves: | | |
| June 30, 1989 | 447,949 | 18.614 |
| Revisions of previous estimates | 131,036 | 3.777 |
| Production | (46,034) | (1.322) |
| June 30, 1990 | 532,951 | 21.069 |
| Revisions of previous estimates | 59,738 | 25.647 |
| Production | (41,994) | (1.558) |
| June 30, 1991 | 550,695 | 45.158 |
| Revisions of previous estimates | 22,204 | (10.239) |
| Production | (40,899) | (1.173) |
| June 30, 1992 | 532,000 | 33.746 |
| Proved developed reserves: | | |
| June 30, 1990 | 532,951 | 21.069 |
| June 30, 1991 | 550,695 | 45.158 |
| June 30, 1992 | 532,000 | 33.746 |
| Company share of Probe reserves at | | |
| June 30, 1990 | 57,998 | .801 |
| June 30, 1991 | 49,706 | 1.516 |
| June 30, 1992 | 52,008 | 1.007 |

In 1990 and 1991, oil and gas reserves were revised upward as price increases improved the economics of development of certain areas. Also, in 1991, Kotaneelee field reserves were reinstated as proved reserves.

### 2. Results of oil and gas operations:

| | 1992 | 1991 | 1990 |
|---|---|---|---|
| Income: | | | |
| Oil and gas sales | **$1,270,498** | $1,637,097 | $1,598,809 |
| Proceeds under carried interest agreements | **275,284** | 1,034,473 | 141,522 |
| | **1,545,782** | 2,671,570 | 1,740,331 |
| Costs and expenses: | | | |
| Production costs | | | |
| –lifting costs | **464,943** | 507,800 | 762,417 |
| –wellhead taxes | **—** | — | — |
| Abandonments and writedowns | **221,077** | — | — |
| Depletion and depreciation | **366,566** | 343,376 | 605,283 |
| Income tax expense* | **—** | — | — |
| | **1,052,586** | 851,176 | 1,367,700 |
| Net income (loss) from operations | **$ 493,196** | $1,820,394 | $ 372,631 |
| Company share of Probe results of operations for producing activities | **$ 2,973** | $ 147,478 | $ 45,390 |

**For the purposes of preparing this table only, the Company considered that during the fiscal years ended June 30, 1992, 1991 and 1990, the Company realized tax benefits of $0, $1,091,930 and $111,486, respectively, from carryforward of exploration, development and lease acquisition costs not claimed in prior years.*

### 3. Costs of oil and gas activities*:

| | 1992 | 1991 | 1990 |
|---|---|---|---|
| Exploration | **$295,071** | $365,515 | $268,171 |
| Development | **90,170** | 95,588 | 120,026 |
| Company share of Probe costs of property acquisition, exploration and development | **356,981** | 475,521 | 37,916 |

**Excluding costs relating to carried interests but including $19,252, $23,324 and $18,609 for exploration in Australia in 1992, 1991 and 1990, respectively.*

### 4. Capitalized costs:

See the consolidated balance sheets and footnote 4 for capitalized costs relating to the Company.

The Company's share of Probe's net capitalized costs relating to oil and gas activities was $343,583 at June 30, 1992, $728,844 at June 30, 1991 and $368,556 at June 30, 1990.

### 5. Standardized measure of discounted future net cash flows relating to proved oil and gas reserve quantities during the three years ended June 30:

| | (In thousands of dollars) | | |
|---|---|---|---|
| | **1992** | 1991 | 1990 |
| Future cash inflows | **$ 54,650** | $ 71,292 | $ 39,019 |
| Future development and production costs | **(19,153)** | (17,507) | (16,895) |
| | **35,497** | 53,785 | 22,124 |
| Future income tax expense* | **(8,885)** | (15,384) | (3,530) |
| Future net cash flows | **26,612** | 38,401 | 18,594 |
| 10% annual discount | **(14,748)** | (21,246) | (8,758) |
| Standardized measure of discounted future net cash flows | **$ 11,864** | $ 17,155 | $ 9,836 |
| Company share of Probe's standardized measure of discounted cash flows | **$ 266** | $ 349 | $ 689 |

**Reflects tax benefit for the years ended June 30, 1992, 1991 and 1990 respectively, from carryforward of exploration, development and lease acquisition costs, undepreciated capital costs and book earned depletion of $12,834,055, $12,282,106 and $12,801,476.*

Current prices used in the foregoing estimates were based upon selling prices at the wellhead in June of each fiscal year. Current costs were based upon estimates made by consulting engineers in June of each fiscal year.

### 6. Changes in the standardized measure during the year:

| | (In thousands of dollars) | | |
|---|---|---|---|
| | **1992** | 1991 | 1990 |
| Changes due to: | | | |
| Prices and production costs* | **$ (1,274)** | $ (159) | $ 160 |
| Future development costs | **(99)** | (249) | (159) |
| Sales net of production costs | **(1,081)** | (2,164) | (978) |
| Development costs incurred during the year | **87** | 96 | 120 |
| Net change due to extensions, discoveries and improved recovery | **14** | 0 | 1,379 |
| Revisions of quantity estimates** | **(7,874)** | 12,651 | (276) |
| Accretion of discount | **2,092** | 819 | 856 |
| Net change in income taxes | **2,519** | (3,838) | (123) |
| Other | **325** | 163 | (43) |
| Net change | **$ (5,291)** | $7,319 | $ 936 |

* *The negative revision in 1990 reflects actual current contract prices and reduced spot sales prices.*

** *The revision in 1990 reflects new wells and increased value for Wargen. The major part of the revision in 1991 relates to the reinstatement of Kotaneelee reserves. The revision in 1992 is a result of the increased capital costs at Kotaneelee, which extend the period before payout of the carried interest.*

# Market Information

Canada Southern Petroleum Ltd. has approximately 12.3 million Limited Voting Shares outstanding, held by about 8,500 shareholders of record as of September 30, 1992. This is the Company's sole class of stock, of which 100 million shares are authorized.

The stock, par value $1.00 is listed on the Toronto Stock Exchange and the Pacific Stock Exchange—which are the principal markets in Canada and the United States—and also is traded on several regional exchanges and in the over-the-counter market. The ticker symbol in both countries is CSW.

The Company has never paid a dividend, and future dividends necessarily will be dependent on its earnings, overall financial condition, and business prospects. The Company also is legally restricted from paying dividends or making any other payments to shareholders (except by way of return on capital) until its accumulated deficit—$14.4 million as of June 30, 1992—has been eliminated.

Current Canadian law does not restrict the remittance of dividends to shareholders who are not residents of Canada. However, under the provisions of the current Canadian tax code and the U.S.-Canada tax treaty, any dividends paid to U.S. shareholders would be subject to Canadian withholding tax at a rate of 15 percent.

The quarterly high and low closing prices *(in Canadian dollars)* on The Toronto Stock Exchange during the calendar periods indicated were as follows:

| **1992** | 1st quarter | 2nd quarter | 3rd quarter | 4th quarter |
|---|---|---|---|---|
| High | 5.38 | 4.25 | 3.75 | |
| Low | 3.95 | 3.45 | 3.40 | |

| **1991** | 1st quarter | 2nd quarter | 3rd quarter | 4th quarter |
|---|---|---|---|---|
| High | 2.95 | 2.80 | 4.00 | 5.75 |
| Low | 2.52 | 2.45 | 2.31 | 3.70 |

| **1990** | 1st quarter | 2nd quarter | 3rd quarter | 4th quarter |
|---|---|---|---|---|
| High | 2.95 | 2.90 | 4.00 | 3.80 |
| Low | 2.15 | 2.20 | 2.05 | 2.80 |

The quarterly high and low closing prices *(in United States dollars)* on the Pacific Stock Exchange during the calendar periods indicated were as follows:

| **1992** | 1st quarter | 2nd quarter | 3rd quarter | 4th quarter |
|---|---|---|---|---|
| High | $4\frac{3}{4}$ | $3\frac{9}{16}$ | $3\frac{3}{16}$ | |
| Low | $3\frac{5}{16}$ | $2\frac{7}{8}$ | $2\frac{15}{16}$ | |

| **1991** | 1st quarter | 2nd quarter | 3rd quarter | 4th quarter |
|---|---|---|---|---|
| High | $2\frac{1}{2}$ | $2\frac{1}{2}$ | $3\frac{1}{2}$ | $5\frac{1}{4}$ |
| Low | $2\frac{1}{8}$ | $2\frac{3}{16}$ | 2 | $3\frac{3}{16}$ |

| **1990** | 1st quarter | 2nd quarter | 3rd quarter | 4th quarter |
|---|---|---|---|---|
| High | $2\frac{1}{2}$ | $2\frac{3}{4}$ | $3\frac{1}{2}$ | $3\frac{3}{8}$ |
| Low | $1\frac{13}{16}$ | $1\frac{13}{16}$ | $1\frac{3}{4}$ | $2\frac{3}{16}$ |

All shareholder correspondence relating to stock ownership or address changes, lost stock certificates, and other such matters should be directed to the Company's Transfer Agents in Canada or the U.S., as shown on the adjacent page. Other enquiries may be directed to Canada Southern's Executive Offices in Calgary, or, if more convenient, to the Company, c/o G & O'D Inc., 241 Main Street, Hartford, CT 06106. Telephone: (203) 525-1202.

# CANADA SOUTHERN PETROLEUM LTD.



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