CANADA SOUTHERN PETROLEUM LIMITED

1991 ANNUAL REPORT

CANADA SOUTHERN PETROLEUM LTD.—1991 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 46-percent-owned subsidiary, Probe Exploration Inc., has land-holdings and some production in Alberta and Saskatchewan.

Financial (year ended June 30)

Operating Revenues	$2.7 million
Net Income	$426,000
Debt	None
Line of Credit	$2.0 million

Production (year ended June 30)

Natural Gas	1.56 bcf
Oil	42,000 bbls.

Estimated Proved Recoverable Reserves*

Natural Gas	45.16 bcf
Oil	551,000 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.

To Our Shareholders:

We are pleased to report that your company posted net income of $426,000, or 3 cents a share, on total revenues of $3.1 million in the fiscal year ended June 30, 1991, which compares quite favorably with the $821,000 loss (7 cents a share) on revenues of $2.3 million in the prior year.

This year's improved performance can be attributed largely to the additional revenue we received from the Wargen gas field, in northeastern B.C. That field, in which we have had a 21 percent carried interest for many years, was put in production in April 1990, reached payout the following October, and was instrumental in our dramatic increase in carried-interest revenue.

Although some analysts and other soothsayers continue to predict the imminent deflation of the so-called "gas bubble" and a correlative increase in prices, that certainly did not happen last year. Moreover, wellhead oil prices were best-described as stagnant. We therefore maintained a very conservative posture with respect to exploration drilling last year, and participated in just two Alberta wildcats. Neither of those wells encountered commercial oil or gas reservoirs, but the surrounding acreage nonetheless has good potential.

For the most part, our efforts were directed toward the continued acquisition of prospective Crown Lands in Alberta and B.C. That, too, was a conservative endeavor, but we did acquire interests in about 7,000 gross acres during the year, which brings us to nearly 19,000 "new" acres (covering more than a dozen good prospects) since the program was initiated two years ago. Our objective here is to provide the company with additional oil and gas assets to replace our maturing B.C. production as well as to compensate for the lengthy delay in bringing the Kotaneelee field to payout.

Shareholders will recall that, early last year, Canada Southern acquired a 48 percent equity interest (now 45.7 percent) in Probe Exploration Inc., which then held varying interests in more than 34,000 gross acres in Alberta and Saskatchewan. At the end of fiscal '91, with our help, Probe land-holdings had been increased to approximately 77,000 gross acres, and its net oil-equivalent production was 138 barrels per day. We also have joined with Probe, on a 50-50 basis, to purchase and explore acreage in [illegible] ave been acquired to date.

To a large extent, our plans for the coming year are contingent upon oil and gas prices as well as the outcome of the Kotaneelee litigation, which continues to be a costly business. Nonetheless, we expect to proceed with our acreage expansion program to position ourselves for the inevitable upturn, which will provide increased incentives for exploration drilling on the prospects we have identified.

As to Kotaneelee, our lawsuit against the working-interest partners (Amoco-Canada, *et al*) is proceeding through the discovery process—that is, taking depositions, obtaining documents, and the like—and our attorneys now expect the discovery process to end in early 1992. As you may recall, the suit, filed last year, seeks a return of the defendants' interests in the field as well as recompense and/or other damages for their protracted and deliberate delay in marketing Kotaneelee gas in breach of contract.

One benefit already realized from the lawsuit is that Kotaneelee production began last February. According to a Government agency, cumulative production through July 31 was 2.1 billion cubic feet, *or about 30 million per day when on production*; and, at last report, production was averaging 40 million per day. We believe this production, after so many years of unconscionable delay, is directly attributable to the impact of the lawsuit on the working-interest partners.

We also have learned that the Kotaneelee YT I-48 well, which had been the field's most prolific producer, was shut down shortly after the field was reactivated because the production casing failed at 11,800 feet and could not be repaired. Subsequently, the well was sidetracked, recompleted, and returned to production at mid-summer; and, at last report, was accounting for more than half of the field's output.

Our ability to provide more specific information on Kotaneelee production and revenue is limited because the working-interest partners have not provided us with the timely, pertinent information to which we are entitled. Our lawsuit, we hope, will resolve that problem, but, until then, we can only provide you with information derived from public sources.

According to a Canadian trade journal, three of the working-interest partners, and others, have contracted to deliver 1.2 trillion cubic feet of gas, reportedly worth $2 billion, to B.C. Gas Inc. over a 12-year period. As we understand it, these contracts do not specify the source of the gas to be delivered; but, in light of the fact that the working-interest partners have an affirmative obligation to market Kotaneelee gas, we would hope that they will utilize Kotaneelee as a source for their share of this new market.

Respectfully submitted,

Charles J. Horne
President

Calgary, Alberta
October 25, 1991

In Memoriam

Melton A. Reasoner

1907–1991

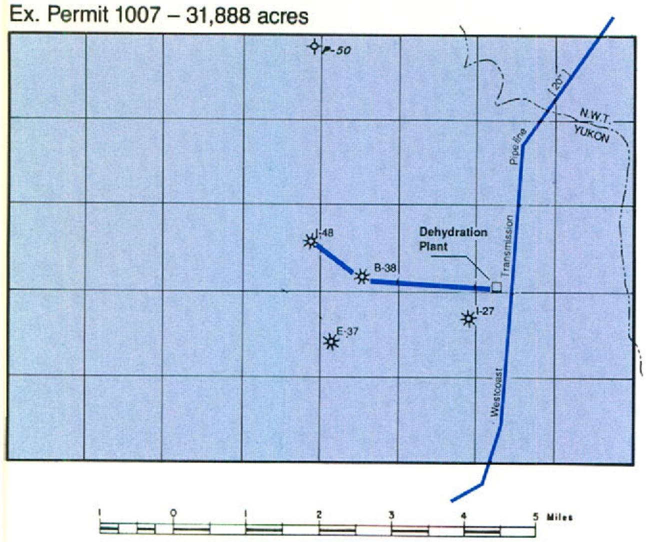
We regret to report the passing of our long-time friend and colleague, Mel Reasoner, on September 26, in Calgary, after a long, colorful, and productive life.

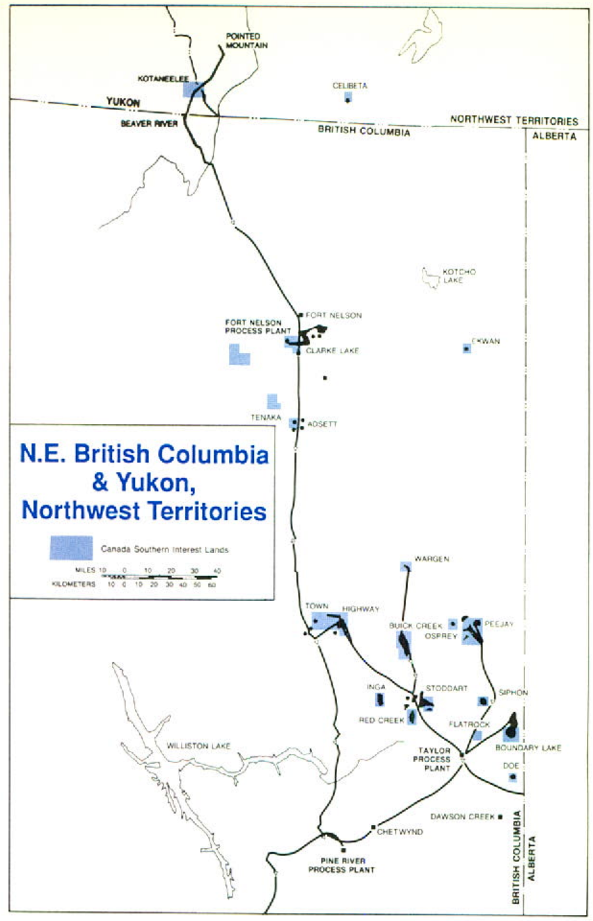
American by birth, a staunch Canadian by choice, Mel came to Calgary 40 years ago as Chief Geologist for the Albercan Oil Company, the predecessor to Canada Southern Petroleum Ltd. When Canada Southern was incorporated, in 1954, he was appointed Vice President & General Manager of the company, and also was elected to its Board of Directors. In 1971, he became a technical advisor to the company, and remained an active member of the Board until his retirement in 1985.

Mel was, first and foremost, an exploration-oriented geologist—a visionary who can be credited for the acquisition of most of Canada Southern's present-day properties, including Kotaneelee. He will be missed by all who were privileged to know him, and we bid him farewell with esteem and friendship.

Kotaneelee Field

Ex. Permit 1007 – 31,888 acres





Petroleum Acreage Summary

as of June 30, 1991

	Gross Acres	Net Acres
Canada:		
British Columbia:		
Carried Interests	57,170	11,347
Working Interests	54,887	14,292
Overriding Royalty Interests	5,184	353
Total British Columbia	117,241	25,992
Alberta:		
Working Interests	14,560	6,008
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	500,622	88,854
Australia	1,483,976	1,046
TOTAL	1,984,598	89,900

Financial Highlights

	Year ended June 30,				
	1991	1990	1989	1988	1987
Operating revenues	**$ 2,671,570**	$ 1,740,331	$ 1,450,920	$ 1,779,853	$ 1,893,575
Total revenues	**$ 3,132,147**	$ 2,300,628	$ 2,036,188	$ 2,282,916	$ 2,071,919
Net income (loss)	**$ 426,029**	$ (820,682)	$ (1,181,175)	$ (25,333)*	$ 143,853*
Net income (loss) per share	**$ .03**	$ (.07)	$ (.10)	$ —*	$ .02*
Working capital	**$ 4,859,742**	$ 4,649,412	$ 5,566,844	$ 6,443,327	$ 2,466,843
Total assets	**$16,085,764**	$15,580,704	$15,376,459	$16,394,438	$12,714,002
Shareholders' Equity:					
Limited Voting Shares	**$12,345,825**	$12,272,266	$11,989,954	$11,989,954	$ 8,992,465
Contributed surplus	**16,247,717**	16,122,667	15,586,274	15,586,274	14,693,788
Accumulated deficit	**(12,954,275)**	(13,380,304)	(12,559,622)	(11,378,447)	(11,353,114)
	$15,639,267	$15,014,629	$15,016,606	$16,197,781	$12,333,139
Average number of shares outstanding	**12,294,900**	12,120,251	11,989,954	11,298,226	8,992,465
Exchange rates: ($1 Can. expressed in $U.S.):					
Year-end	**$.8757**	$.8593	$.8357	$.8245	$.7515
Average	**$.8660**	$.8505	$.8317	$.7805	$.7359
Range	**$.8811-$.8501**	$.8650-$.8288	$.8475-$.8064	$.8316-$.7487	$.7682-$.7158

**Net income (loss) includes $104,000 ($.01 per share) and $148,000 ($.02 per share), for the years 1988 and 1987, respectively, for an extraordinary item of tax benefits realized.*

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

Consolidated Balance Sheet
(Expressed in Canadian dollars)

	June 30,	
	1991	1990
Assets		
Current assets:		
Cash and cash equivalents (Note 2)	**$ 4,626,103**	$ 4,632,344
Accounts and interest receivable	**470,016**	389,669
Prepaid insurance and other	**210,120**	193,474
Total current assets	**5,306,239**	5,215,487
Investment in and loans to Probe Exploration Inc. (Note 3)	**1,411,832**	1,131,656
Oil and gas properties (full cost method) (Note 4)	**9,198,710**	9,073,620
Mineral rights and other assets (Note 4)	**168,983**	159,941
	$16,085,764	$15,580,704
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	**$ 443,201**	$ 550,541
Accrued liabilities	**3,296**	15,534
Total current liabilities	**446,497**	566,075
Shareholders' equity:		
Limited Voting Shares, par value $1 per share (Note 5)		
Authorized — 100,000,000 shares		
Outstanding — 12,345,825 and 12,272,266 shares, respectively	**12,345,825**	12,272,266
Contributed surplus	**16,247,717**	16,122,667
	28,593,542	28,394,933
Accumulated deficit	**(12,954,275)**	(13,380,304)
Total shareholders' equity	**15,639,267**	15,014,629
Contingencies and commitments (Note 8)		
	$16,085,764	$15,580,704

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,		
	1991	1990	1989
Revenues:			
Oil and gas sales	**$ 1,637,097**	$ 1,598,809	$ 1,436,450
Proceeds under carried interest agreements	**1,034,473**	141,522	14,470
Interest	**460,577**	560,297	585,268
	3,132,147	2,300,628	2,036,188
Costs and expenses:			
General and administrative	**1,791,649**	1,581,015	1,691,723
Lease operating costs	**507,800**	762,417	791,276
Depletion and depreciation	**343,376**	605,283	654,613
Foreign exchange losses	**41,585**	59,397	48,260
Abandonments	**—**	—	7,252
Rent	**35,146**	26,149	24,239
Equity adjustment relating to Probe Exploration Inc.	**(13,438)**	87,049	—
	2,706,118	3,121,310	3,217,363
Income (loss) before income taxes	**426,029**	(820,682)	(1,181,175)
Income taxes (Note 6)	**—**	—	—
Net income (loss)	**426,029**	(820,682)	(1,181,175)
Accumulated deficit—beginning of year	**(13,380,304)**	(12,559,622)	(11,378,447)
Accumulated deficit—end of year	**$(12,954,275)**	$(13,380,304)	$(12,559,622)
Average number of shares outstanding	**12,294,900**	12,120,251	11,989,954
Income (loss) per share based on weighted average number of shares outstanding during the period	**$ .03**	$(.07)	$(.10)

See accompanying notes.

Consolidated Statements of Cash Flows

(Expressed in Canadian dollars)

	Year ended June 30, 1991	1990	1989
Cash Flows from Operating Activities:			
Net income (loss)	**$ 426,029**	$ (820,682)	$(1,181,175)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Depreciation and depletion	**343,376**	605,283	654,613
Equity adjustment relating to Probe Exploration Inc.	**(13,438)**	87,049	—
Other	**34,568**	110	884
	790,535	(128,240)	(525,678)
Change in assets and liabilities:			
Accounts and interest receivable	**(80,347)**	25	(128,784)
Prepaid insurance and other	**(16,646)**	3,697	(4,147)
Accounts payable	**(107,340)**	202,819	159,557
Accrued liabilities	**(12,238)**	3,403	3,639
Net cash provided by (used in) operations	**573,964**	81,704	(495,413)
Cash Flows from Investing Activities:			
Additions to oil and gas properties and other equipment	**(480,205)**	(389,192)	(350,805)
Advances to Probe Exploration Inc.	**(100,000)**	(400,000)	—
Net cash used in investing activities	**(580,205)**	(789,192)	(350,805)
Decrease in cash and cash equivalents	**(6,241)**	(707,488)	(846,218)
Cash and cash equivalents at beginning of period	**4,632,344**	5,339,832	6,186,050
Cash and cash equivalents at end of period (Note 2)	**$4,626,103**	$4,632,344	$ 5,339,832

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, 1988 and 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	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, 1991

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 centres 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 centres 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.

Any interest costs incurred that are applicable to oil and gas properties not being depleted currently, and on which exploration or development activities are in progress, are capitalized.

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, 1991	June 30, 1990
Canadian Treasury bill	$ —	$ 1,309,869
U.S. Treasury bills	1,679,421	1,678,511
Canadian bankers acceptances	2,363,947	1,329,565
Term deposit—Bermuda	188,960	168,014
	4,232,328	4,485,959
Cash	393,775	146,385
	$4,626,103	$4,632,344

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 assets acquired and total consideration are summarized as follows:

Working capital	$ (65,696)
Investments	59,260
Oil and gas properties	955,443
Long term debt	(130,302)
	$ 818,705

The excess of cost over the Company's interest in the net assets of Probe is being depleted 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, 1991, the Company had a 45.7 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, 1991 and 1990 is as follows:

	1991	1990
Investment in Probe	$1,017,314	$ 818,705
Loans to Probe	500,000	400,000
	1,517,314	1,218,705
Less: Equity adjustments (Note 1)	(105,482)	(87,049)
	$1,411,832	$1,131,656

As of June 30, 1991, the carrying value of the Company's investment in Probe exceeds the equity in net assets by $879,731, 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 (9.75% at June 30, 1991) plus one percent per annum and are secured by all the assets of Probe.

4. Oil, gas and mineral properties

	Cost	Accumulated Provisions	Net Book Value
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
1990			
Oil and gas properties—developed	$13,318,233	$4,423,115	$8,895,118
Oil and gas properties—undeveloped	178,502	—	178,502
Equipment	49,500	33,285	16,215
Mineral rights	143,726	—	143,726
	$13,689,961	$4,456,400	$9,233,561

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, 1991, 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, 1991.

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:

	1991	1990	1989
Provision for income taxes based on combined basic Canadian federal and provincial income tax rate of 43.952% (1990-43.84%, 1989-43.84%)	$ 187,282	$(359,787)	$(517,827)
Allowable deductions for property costs in excess of related depletion	(299,345)	147,672	285,153
Federal resource allowance	(47,965)	—	—
Non-deductible crown charges	163,045	151,907	122,472
(Income) loss of investee company	(5,906)	38,162	—
Nondeductible legal fees	3,191	13,497	—
Other	(302)	8,549	2,298
Unrealized tax loss	—	—	107,904
Actual provision for income taxes	$ —	$ —	$ —

At June 30, 1991, the Company had net operating losses for financial reporting purposes of approximately $468,000 which are available to be carried forward to future periods. In addition, the Company had a net operating loss of approximately $246,000 that may be used to reduce taxable income, if any, and which expires July 1, 1996.

At June 30, 1991, 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	$ 9,531,936
Earned depletion	2,183,256
Undepreciated capital costs	566,914
Capital losses (can only be used against future years' capital gains)	30,276
	$12,312,382

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 require that the carryforward of net operating losses be treated as an extraordinary item. 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 statement of operations and accumulated deficit. The following summarizes income (loss) per share information under U.S. generally accepted accounting principles for the three years ended June 30:

	1991	1990	1989
Income (loss) per share based on average number of shares outstanding during the period:			
Income (loss) before income taxes and extraordinary item	$ .03	$ (.07)	$ (.10)
Income taxes	(.02)	—	—
Income (loss) before extraordinary item	.01	(.07)	(.10)
Extraordinary item—utilization of net operating loss carryforward	.02	—	—
Net income (loss)	$ .03	$ (.07)	$ (.10)

The Financial Accounting Standards Board issued Statement on Financial Accounting Standard No. 96, "Accounting for Income Taxes," in December 1987. This complex standard requires among other things, the use of a liability method to compute deferred income taxes and permits either prospective or retroactive adoption. The effective date of this standard is currently scheduled for fiscal 1993. 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, 1991 and 1990.

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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 the recoverability of the costs of the Company's oil and gas properties.

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.

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.

The field operator has entered into a one year contract for the sale of Kotaneelee gas. The Company believes that it is too early to determine the impact, if any, that this new contract may have on the status of the above cases.

General and administrative expenses include \$770,301, \$632,535 and \$664,866 for legal fees and expenses for the years ended June 30, 1991, 1990 and 1989, respectively.

9. Related party transactions

Directors' fees and other compensation paid to directors who are officers of the Company amounted to $186,425 (1990 - $181,210; 1989 - $174,445). Of these amounts, $42,000 (1990 - $42,000; 1989 - $69,250) 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. $130,000 (1990 - U.S. $127,000; 1989 - U.S. $124,000).

On January 29, 1991, the Company granted interests amounting to an aggregate of seven and 8/10 percent (7.8%) of any and all net recoveries 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 recoveries for possible future grants to persons who may include officers and directors of the Company.

10. Comparative figures

Certain of the comparative figures have been reclassified to conform with the 1991 presentation.

11. Significant fourth quarter adjustment (unaudited)

Delays in securing markets for Kotaneelee gas increased the anticipated length of the period before payout to the Company of its carried interest in the field. Accordingly, reserves relating to Kotaneelee were eliminated effective April 1, 1988 for the purpose of computing depreciation and depletion. As discussed in Note 8, the field operator has entered into a one year contract for the sale of Kotaneelee gas. Sale of Kotaneelee gas under this contract began in February 1991 and field reserves were reinstated for accounting purposes. The effect of such reinstatement was a reduction to depletion and depreciation expense of $182,791 which was recorded during the fourth quarter of the Company's 1991 fiscal year.

Auditors' Report

The Shareholders
Canada Southern Petroleum Ltd.

We have audited the accompanying consolidated balance sheets of Canada Southern Petroleum Ltd. as of June 30, 1991 and 1990 and the related consolidated statements of operations and accumulated deficit, cash flows, and limited voting shares and contributed surplus for each of the three years in the period ended June 30, 1991. 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 about 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 referred to above present fairly, in all material respects, the consolidated financial position of Canada Southern Petroleum Ltd. at June 30, 1991 and 1990, and the consolidated results of operations and the changes in its financial position for each of the years in the three year period ended June 30, 1991 in conformity with generally accepted accounting principles.

Ernst + Young
Chartered Accountants

Calgary, Alberta
September 6, 1991

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 when the financial statements are affected by significant uncertainties such as those described in Note 8 of the consolidated financial statements. The above opinion is expressed in accordance with Canadian reporting standards which do not permit a reference to such uncertainties in the auditors' report when the uncertainties are adequately described in the consolidated financial statements.

Ernst + Young
Chartered Accountants

Calgary, Alberta
September 6, 1991

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

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 ($4,626,103 at June 30, 1991), 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.

Results of Operations

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 Exploration Inc.'s (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.

Fiscal Year ended June 30, 1990 vs. 1989

The loss for 1990 was $820,682 (7 cents per share) compared to a loss of $1,181,175 (10 cents per share) in fiscal 1989. The reduction in the loss is due to increased operating revenues and reduced expenses.

Operating revenues were up 20 percent in 1990, due mainly to oil prices which were 20 percent higher. Unit sales of oil were up 5 percent in 1990 as compared to 1989. Unit sales of gas were up 5 percent but this was offset by gas prices which were 11 percent lower. Proceeds from carried interests in 1990 increased approximately $127,000, reflecting the 1990 benefit from expenditures made in 1989.

Interest income was four percent lower, reflecting the reduced funds available for investment.

General and administrative expenses were seven percent lower in 1990 due to reduced expenditures relating to the Kotaneelee litigation. There was renewed activity in fiscal 1991 as discussed above.

Depletion and depreciation was eight percent lower as a result of increased estimated proved reserves. Foreign exchange losses, approximately $11,000 higher in 1990 as compared to 1989, relate to United States dollar denominated investments. The increase results from the weakening of the U.S. dollar versus the Canadian dollar.

During 1990, the amount of $87,049 was charged against income reflecting the Company's share of Probe's losses since the date of the Company's investment in Probe plus amortization of the excess cost of net assets acquired, attributable to Probe's oil and gas properties.

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 D & S Petroleum Consulting Group Ltd., independent consultants.

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

	Oil (bbls)	Gas (bcf)
Proved reserves:		
June 30, 1988	489,697	18.527
Revisions of previous estimates	4,232	1.245
Production	(45,980)	(1.158)
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
Proved developed reserves:		
June 30, 1988	489,697	18.527
June 30, 1989	447,949	18.614
June 30, 1990	532,951	21.069
June 30, 1991	550,695	45.158
Company share of Probe reserves at		
June 30, 1990	57,998	.801
June 30, 1991	49,706	1.516

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.

Effective April 1, 1988, Kotaneelee field reserves, were eliminated from estimated net quantities of proved gas reserves based upon the anticipated length of the period before payout to the Company of its carried interest in that field. Sales of Kotaneelee gas under new contracts began in February 1991 and field reserves were reinstated at that time.

2. Results of oil and gas operations:

	1991	1990	1989
Income:			
Oil and gas sales	**$1,637,097**	$ 1,598,809	$ 1,436,450
Proceeds under carried interest agreements	**1,034,473**	141,522	14,470
	2,671,570	1,740,331	1,450,920
Costs and expenses:			
Production costs			
–lifting costs	**507,800**	762,417	791,276
–wellhead taxes	**—**	—	—
Abandonments	**—**	—	7,252
Depletion and depreciation	**343,376**	605,283	654,613
Income tax expense*	**—**	—	—
	851,176	1,367,700	1,453,141
Net income (loss) from operations	**$1,820,394**	$ 372,631	$ (2,221)
Company share of Probe results of operations for producing activities	**$ 147,478**	$ 45,390	$ —

**For the purposes of preparing this table only, the Company considered that during the fiscal years ended June 30, 1991 and 1990, the Company realized tax benefits of $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*:

	1991	1990	1989
Exploration	**$365,515**	$268,171	$178,341
Development	**95,588**	120,026	149,250
Company share of Probe costs of property acquisition, exploration and development	**475,521**	37,916	—

**Excluding costs relating to carried interests but including $23,324, $18,609 and $16,933 for exploration in Australia in 1991, 1990 and 1989, 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 $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)		
	1991	1990	1989
Future cash inflows	**$ 71,292**	$ 39,019	$ 35,157
Future development and production costs	**(17,507)**	(16,895)	(15,032)
	53,785	22,124	20,125
Future income tax expense*	**(15,384)**	(3,530)	(2,943)
Future net cash flows	**38,401**	18,594	17,182
10% annual discount	**(21,246)**	(8,758)	(8,282)
Standardized measure of discounted future net cash flows	**$ 17,155**	$ 9,836	$ 8,900
Company share of Probe's standardized measure of discounted cash flows	**$ 349**	689	—

**Reflects tax benefit for the years ended June 30, 1991, 1990 and 1989 respectively, from carryforward of exploration, development and lease acquisition costs, undepreciated capital costs and book earned depletion of $12,282,106, $12,801,476 and $12,678,345.*

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)		
	1991	1990	1989
Changes due to:			
Prices and production costs*	**$ (159)**	$ (160)	$ (366)
Future development costs	**(249)**	(159)	(141)
Sales net of production costs	**(2,164)**	(978)	(660)
Development costs incurred during the year	**96**	120	157
Net change due to extensions, discoveries and improved recovery	**0**	1,379	255
Revisions of quantity estimates**	**12,651**	(276)	(672)
Accretion of discount	**819**	856	816
Net change in income taxes	**(3,838)**	(123)	56
Other	**163**	(43)	(3)
Net change	**$ 7,319**	$ 936	$ (558)

* *The negative revision in 1989 is due principally to increased operating costs in Peejay. 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.*

Market Information

Canada Southern Petroleum Ltd. has approximately 12.3 million Limited Voting Shares outstanding, held by about 8,700 shareholders of record as of September 30, 1991. 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—$12.9 million as of June 30, 1991—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:

1989	1st quarter	2nd quarter	3rd quarter	4th quarter
High	4.60	4.20	3.65	3.30
Low	3.35	3.05	3.05	2.25

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

1991	1st quarter	2nd quarter	3rd quarter
High	2.95	2.80	4.00
Low	2.52	2.45	2.31

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

1989	1st quarter	2nd quarter	3rd quarter	4th quarter
High	$3\frac{13}{16}$	$3\frac{1}{2}$	3	$2\frac{15}{16}$
Low	$2\frac{3}{4}$	$2\frac{1}{2}$	$2\frac{9}{16}$	$1\frac{15}{16}$

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	$1\frac{13}{16}$	$1\frac{13}{16}$	$1\frac{3}{4}$	$2\frac{3}{16}$

1991	1st quarter	2nd quarter	3rd quarter
High	$2\frac{3}{8}$	$2\frac{1}{2}$	$3\frac{1}{2}$
Low	$2\frac{1}{8}$	$2\frac{1}{8}$	$2\frac{1}{8}$

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 Gherardi & O'Donnell Associates, Inc., 241 Main Street, Hartford, CT 06106. Telephone: (203) 525-1202.

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