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CANADA SOUTHERN PETROLEUM LTD.

ANNUAL REPORT
1990

The Company and its Properties

Canada Southern Petroleum Ltd. is a petroleum exploration and production company whose activities are principally in western Canada, where its recoverable reserves are equivalent to about 24 million barrels of oil. It also has substantial interests in about 335,000 gross acres (currently nonproducing) in the Arctic Islands, where its share of the estimated oil and gas reserves established to date are equivalent to 130 million barrels of oil.

More than half of the company's properties in northwestern Canada, and in most of the Arctic areas, are covered by longstanding *carried interest* agreements with other companies. Under the terms of these covenants, Canada Southern's share of the exploration, development, and operating costs is advanced by the working interest partners and is repaid out of operating revenue when production commences. (Subsequent to that "payout period," the company receives its *pro rata* share of the revenues net of operating costs.)

Producing Properties—B.C.

In recent years, virtually all of Canada Southern's operating revenue has been provided by oil and gas production from eight mature fields in northeastern British Columbia. These are the Boundary Lake, Buick Creek, Flatrock, Inga, Peejay, Siphon, Stoddard, and Town fields—all located generally within an 80-mile radius of Fort St. John—which generated revenues of $1.74 million for the company in fiscal 1990. Another field in this area, Wargen, was brought into production during the year, but has not yet reached payout.

Kotaneelee

The Kotaneelee gas field, located in the southeastern corner of the Yukon Territory, was discovered by Canada Southern in 1964; and the company's 30 percent carried interest in the field is one of its principal assets. Only partially developed, this field is capable of producing 120 million cubic feet per day from two wells on a sustained basis, and the operator's consultants have estimated that the field's reserves are 390 billion cubic feet.

Although it has been connected to a major pipeline system for the past 16 years, Kotaneelee has yet to produce any significant amount of gas, which has deprived Canada Southern of substantial current revenues. Unable to otherwise resolve that situation, the company has been compelled to bring suit against the working interest partners; and a discussion of that lawsuit may be found on page 3.

Arctic Island Properties

Canada Southern has both working and carried interests in five Government-designated "significant discovery areas"—*Drake Point, Hecla, Kristoffer, Roche Point, Whitefish*—in the western Sverdrup Basin to the north of Melville Island. Although this is a remote region that is ice-bound for nine months a year, major gas reserves have been established in these areas, and the company's share is about 780 billion cubic feet.

Another potentially valuable property is the company's five percent carried interest in the *Bent Horn* oilfield on Cameron Island. Unlike the other areas, Bent Horn has been partially developed and is in limited production during the summer months when the island is not ice-bound. (Year-round production has been considered but thus far not implemented.) The field's reserves, although thought to be *very* substantial, cannot be quantified until a meaningful production history has been established.

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

Financial Highlights

	Year ended June 30,				
	1990	1989	1988	1987	1986
Operating revenues	**$ 1,740,331**	$ 1,450,920	$ 1,779,853	$ 1,893,575	$ 2,557,635
Total revenues	**$ 2,300,628**	$ 2,036,188	$ 2,282,916	$ 2,071,919	$ 2,720,668
Net income (loss)	**$ (820,682)**	$ (1,181,175)	$ (25,333)*	$ 143,853*	$ 589,757*
Net income (loss) per share	**$ (.07)**	$ (.10)	$ —*	$ .02*	$ .07*
Working capital	**$ 4,649,412**	$ 5,566,844	$ 6,443,327	$ 2,466,843	$ 2,489,956
Total assets	**$15,580,704**	$15,376,459	$16,394,438	$12,714,002	$12,703,616
Shareholders' Equity:					
Limited Voting Shares	**$12,272,266**	$11,989,954	$11,989,954	$ 8,992,465	$ 8,992,465
Capital in excess of par value	**16,122,667**	15,586,274	15,586,274	14,693,788	14,982,543
Accumulated deficit	**(13,380,304)**	(12,559,622)	(11,378,447)	(11,353,114)	(11,496,967)
	$15,014,629	$15,016,606	$16,197,781	$12,333,139	$12,478,041
Average number of outstanding shares	**12,120,251**	11,989,954	11,298,226	8,992,465	8,992,465
Exchange rates: ($1 Can. expressed in $U.S.):					
Year-end	**$.8593**	$.8357	$.8245	$.7515	$.7216
Average	**$.8505**	$.8317	$.7805	$.7359	$.7222
Range (high–low)	**$.8650-$.8288**	$.8475-$.8064	$.8316-$.7487	$.7682-$.7158	$.7427-$.6937

**Net income (loss) includes $104,000 ($.01 per share), $148,000 ($.02 per share) and $361,000 ($.04 per share), for the years 1988, 1987 and 1986, respectively, for an extraordinary item of tax benefits realized.*

To Our Shareholders:

Canada Southern posted a net loss of $821,000, or 7 cents a share, on total revenues of $2.3 million in fiscal 1990, ended June 30, as compared to the loss of $1.2 million, or 10 cents a share, on revenues of $2.0 million in fiscal 1989. This was due largely to our continuing dispute with the working interest partners in the Kotaneelee field, which is discussed hereinafter.

Although a loss of any magnitude is regrettable, there were several very positive aspects to the year-end results that bode well for 1991, specifically:

* operating revenues were up 20 percent due to increases in proceeds from carried interest agreements as well as improved oil prices.
* we were able to reduce general and administrative expense by 7 percent this year.
* the oil prices we used at fiscal year-end to calculate our proved reserves (see page 14) obviously did *not* reflect recent increases in crude oil prices. Nonetheless, the improved economics evident at year-end resulted in a 29 percent increase in proved oil reserves. Based on current prices, this appears to have been a somewhat conservative estimate.

As noted in last year's report, your company has taken a more active role in the acquisition of oil and gas assets to replace the maturing production from our British Columbia properties and to compensate for the long delay in marketing Kotaneelee gas; and we are pleased to advise you that considerable progress was made during the past year.

First and foremost has been our program to evaluate and bid on Crown Lands in Alberta and British Columbia. This technical work is both time-consuming and expensive, and we have proceeded cautiously but with some success. In Alberta, we have acquired interests ranging from 10 to 100 percent in more than 8,000 gross acres on eight different oil and gas prospects. Four of these have been drilled to date, resulting in two potential oil wells, a potential gas well, and one dry hole.

In addition, we have acquired 100 percent interests in three prospects encompassing 1,850 acres in northeastern British Columbia, where we intend to continue to bid on prospective acreage as it becomes available. While there are no immediate plans to drill the other six prospects, we hope that at least two of them will be drilled next year, given the improving climate for petroleum exploration.

Our other approach—involving the acquisition of producing properties—has been even more cautious, but here, too, we feel we enjoyed considerable success with the cash-free acquisition of a 48 percent equity interest (3.67 million shares) of Probe Exploration Inc. in exchange for 282,000 shares of Canada Southern stock.

Probe, a small public company on the Alberta Stock Exchange, has producing properties in Alberta and Saskatchewan and a small but competent staff with geological and operating experience in those provinces. This acquisition complements Canada Southern's principal areas of involvement in northeastern B.C., the Yukon, and the Northwest Territories; and we believe this relationship will be of mutual benefit to both companies. We expect to advance about $100,000 to Probe to augment its exploration efforts in fiscal '91 in addition to the $400,000 already advanced.

As the result of a pending acquisition, Probe will increase its gross land-holdings to over 34,000 acres and its net oil-equivalent production to 145 barrels per day in mid-October. We also are pleased to report that Probe recently took over as operator at Sylvan Lake, and is now retesting this potential gas well to ascertain why it has not yet responded properly to remedial work that should produce a constant flow.

Although most of our acreage in northwestern Canada already has been surveyed and drilled, we know there is some remaining potential for further exploration and/or development when oil and gas prices have improved enough to justify the expenditure. Earlier this year, for example, the operator for the Wargen Field (75 miles northwest of Fort St. John) built compression and dehydration facilities to bring three previously shut-in gas wells into production. Based on initial production rates, and the anticipated increased demand for natural gas, Canada Southern's share of the income from this field—in which we have a 21.25 percent carried interest—could have a significant impact on our cash flow after payout. Assuming there are no unanticipated capital expenditures, which would adversely affect the carried interest account, Wargen should reach payout during 1991.

The Kotaneelee dispute, by way of background, first began in mid-1987 with Canada Southern's U.S. lawsuit against Allied-Signal. This was a breach-of-contract action in which we sought damages for their failure to fulfill their obligation "to assure the earliest feasible development and marketing" of gas from the Kotaneelee field.

Subsequently, Allied-Signal filed a lawsuit in Calgary against its assignees at Kotaneelee—i.e., Amoco Canada and its affiliates—seeking indemnification for any damages that might be awarded to our company in the U.S. case. The Amoco group, in response, filed a counterclaim in which, among other things, it asked the Calgary Court to issue an injunction that would prevent Canada Southern from proceeding with the U.S. case, which had been docketed for trial.

Unfortunately the Canadian Court did issue such an injunction in December 1988; and the U.S. Court dismissed our case a few days later. Appeals in the U.S. and Canada were abandoned on the advice of counsel. It then became apparent that, if we were to pursue our claims, we would have to do so in the Calgary Court.

Before initiating such an action, however, we agreed to have confidential discussions with some of the parties to the Kotaneelee dispute, hoping that this could lead to an out-of-court settlement. However, it became evident that no meaningful progress was being made, and the discussions were discontinued.

Thus it was that, in March 1990, Canada Southern filed a suit in Calgary against the working interest partners in Kotaneelee—*Amoco Canada* (and its Dome Petroleum unit), *Esso Canada, Mobil Canada,* and the operator, *Columbia Gas Development of Canada*—seeking a surrender of their interests in the field for breach of fiduciary duty and for failing to fulfill their obligation to assure the earliest feasible marketing of gas from the field. This suit *also* seeks damages and/or other relief from their breach of fiduciary duty in failing to market gas, including specific refusals to market gas, from the field.

Several months after our suit was filed, Columbia Canada informed us that *British Columbia Petroleum Corporation has signed a one-year contract to purchase Kotaneelee gas, and that deliveries are expected to begin this November.* (To date, Columbia Canada has not responded to our request for information on the price and volume parameters of this contract.) Although we view this long-awaited commencement of production as a positive development, this sale does *not* remedy the damages inflicted upon Canada Southern by the defendants' protracted and deliberate delay in marketing Kotaneelee gas, and we are proceeding with the lawsuit. Pre-trial discovery is now in progress; and we anticipate that the case *should* proceed to trial in 1991.

We trust shareholders will recognize it is not our intent to give undue emphasis to, or over-dramatize, this litigation. Indeed, we wish it had never become necessary in the first place, for it is an exceedingly time-consuming and costly business. But there is no getting around the fact that, until it becomes economic to develop and market our oil and gas reserves in the high Arctic, the Kotaneelee field is a *major* asset and a potential source of very substantial revenue after payout. We feel, therefore, that any developments affecting Kotaneelee are deserving of comment.

While there is no question that the past few years have been difficult for the smaller, exploration-oriented companies in the industry, Canada Southern not only has weathered the storm but is in *excellent* position to take advantage of the upturn in the oil and gas markets. On an energy-equivalent basis, natural gas is still very underpriced relative to oil, but, as pipeline capacity is increased, the unquestionable advantage of a stable, *uninterruptible* supply of Canadian gas will be realized. There also is no question that, as a company with large proved reserves of gas in North America, we will see those reserves become increasingly desirable as the real cost of so-called "cheap" offshore oil becomes apparent.

Respectfully submitted,

Charles J. Horne
President

Calgary, Alberta
October 12, 1990

Petroleum Acreage Summary

as of June 30, 1990

	Gross Acres	Net Acres
Canada		
Alberta:		
Working Interests	8,320	2,824
British Columbia:		
Carried Interests	122,416	13,433
Working Interests	52,285	11,690
Overriding Royalty Interests	5,184	353
Total British Columbia	179,885	25,476
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	557,026	85,154
Australia	1,483,976	1,046
TOTAL	2,041,002	86,200

CANADA SOUTHERN PETROLEUM LTD.
(A Nova Scotia corporation)

Consolidated Balance Sheet
(Expressed in Canadian dollars)

	June 30, 1990	June 30, 1989
Assets		
Current assets:		
Cash and cash equivalents	**$ 4,632,344**	$ 5,339,832
Accounts receivable and interest receivable	**389,669**	389,694
Prepaid insurance and other	**193,474**	197,171
Total current assets	**5,215,487**	5,926,697
Investment in and advances to Probe Exploration Inc.	**1,131,656**	—
Oil and gas properties (full cost method):		
Costs being depleted	**13,318,233**	12,948,646
Less accumulated depletion	**(4,423,115)**	(3,823,735)
	8,895,118	9,124,911
Costs not being depleted	**178,502**	159,892
	9,073,620	9,284,803
Mineral rights and other assets	**159,941**	164,959
	$15,580,704	$15,376,459
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	**$ 550,541**	$ 347,724
Accrued liabilities	**15,534**	12,129
Total current liabilities	**566,075**	359,853
Shareholders' equity:		
Limited Voting Shares, par value $1 per share		
Authorized — 100,000,000 shares		
Outstanding — 12,272,266 shares and 11,989,954 shares, respectively	**12,272,266**	11,989,954
Capital in excess of par value	**16,122,667**	15,586,274
	28,394,933	27,576,228
Accumulated deficit	**(13,380,304)**	(12,559,622)
Total shareholders' equity	**15,014,629**	15,016,606
	$15,580,704	$15,376,459

See accompanying notes.

CANADA SOUTHERN PETROLEUM LTD.
(A Nova Scotia corporation)

Consolidated Statement of Operations and Accumulated Deficit

(Expressed in Canadian dollars)

	Year ended June 30,		
	1990	1989	1988
Revenues:			
Oil and gas sales	**$ 1,598,809**	$ 1,436,450	$ 1,591,337
Proceeds under carried interest agreements	**141,522**	14,470	188,516
Interest	**560,297**	585,268	503,063
	2,300,628	2,036,188	2,282,916
Costs and expenses:			
General and administrative	**1,581,015**	1,691,723	1,356,685
Lease operating costs	**762,417**	791,276	451,254
Depletion and depreciation	**605,283**	654,613	309,346
Foreign exchange losses	**59,397**	48,260	128,583
Abandonments	**—**	7,252	41,607
Rent	**26,149**	24,239	20,774
Equity adjustment relating to Probe Exploration Inc. (Probe) since date of acquisition	**87,049**	—	—
	3,121,310	3,217,363	2,308,249
Loss before income taxes and extraordinary item	**(820,682)**	(1,181,175)	(25,333)
Income taxes	**—**	—	104,000
Loss before extraordinary item	**(820,682)**	(1,181,175)	(129,333)
Extraordinary item—Tax benefit realized from carryforward of exploration, development, and lease acquisition costs not claimed in prior years	**—**	—	104,000
Net loss	**(820,682)**	(1,181,175)	(25,333)
Accumulated deficit—beginning of year	**(12,559,622)**	(11,378,447)	(11,353,114)
Accumulated deficit—end of year	**$(13,380,304)**	$(12,559,622)	$(11,378,447)
Average number of shares outstanding	**12,120,251**	11,989,954	11,298,226
Loss per share based on average number of shares outstanding during the period:			
Loss before extraordinary item	**$(.07)**	$(.10)	$(.01)
Extraordinary item	**—**	—	.01
Net loss	**$(.07)**	$(.10)	$ —

See accompanying notes.

CANADA SOUTHERN PETROLEUM LTD.
(A Nova Scotia corporation)

Consolidated Statement of Cash Flows

(Expressed in Canadian dollars)

	Year ended June 30,		
	1990	1989	1988
Cash Flows from Operating Activities:			
Loss before extraordinary item	**$ (820,682)**	$(1,181,175)	$ (129,333)
Adjustments to reconcile net loss to net cash provided by operating activities:			
Depreciation and depletion	**605,283**	654,613	309,346
Equity adjustment relating to Probe	**87,049**	—	—
Other	**110**	884	2,221
	(128,240)	(525,678)	182,234
Extraordinary item*	—	—	104,000
	(128,240)	(525,678)	286,234
Change in assets and liabilities:			
Accounts receivable and interest receivable	**25**	(128,784)	8,807
Other current assets	**3,697**	(4,147)	31,460
Accounts payable	**202,819**	159,557	(95,829)
Accrued liabilities	**3,403**	3,639	(88,377)
Cash and cash equivalents provided by (used in) operations	**81,704**	(495,413)	142,295
Cash Flows from Investing Activities:			
Additions to oil and gas properties and other equipment	**(389,192)**	(350,805)	(199,725)
Advances to Probe	**(400,000)**	—	—
Net cash used in investing activities	**(789,192)**	(350,805)	(199,725)
Cash Flows from Financing Activities:			
Proceeds of sales of Limited Voting Shares less expenses	—	—	3,889,975
Net cash provided by financing activities	—	—	3,889,975
Increase (decrease) in cash and cash equivalents	**(707,488)**	(846,218)	3,832,545
Cash and cash equivalents at beginning of period	**5,339,832**	6,186,050	2,353,505
Cash and cash equivalents at end of period	**$4,632,344**	$ 5,339,832	$6,186,050

Tax benefit realized from carryforward of exploration, development and lease acquisition costs not claimed in prior years.

Consolidated Statement of Limited Voting Shares and Capital in Excess of Par Value

Expressed in Canadian dollars—Three years ended June 30, 1990

	Number of shares	Limited Voting Shares, $1 par value	Capital in excess of par value	Total
Balance at June 30, 1987	8,992,465	$ 8,992,465	$14,693,788	$23,686,253
Sales of shares less related fiscal 1988 expenses	2,997,489	2,997,489	892,486	3,889,975
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	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

See accompanying notes.

CANADA SOUTHERN PETROLEUM LTD.
(A Nova Scotia corporation)

Notes to Consolidated Financial Statements

(Expressed in Canadian dollars)
June 30, 1990

1. Summary of significant accounting policies

The accompanying consolidated financial statements include the accounts of Canada Southern Petroleum Ltd. (Canada Southern) and its wholly-owned subsidiaries, Canpet Inc. and C.S. Petroleum Limited, hereafter referred to collectively as the Company. The financial statements are in conformity with Canadian generally accepted accounting principles. There would have been no material differences had United States generally accepted accounting principles been followed.

The Company, which is engaged primarily in one industry, exploration for and 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. Proceeds received from disposal of properties are credited against accumulated costs. Depletion of net costs accumulated in the Canada cost center is provided on the composite unit-of-production method, which is based on estimated recoverable proved reserves. The Canada cost center includes all of the Company's costs but does not include costs associated with Probe properties.

The carrying value of the Company's petroleum and natural gas properties within each cost center is limited to the aggregate of (i) the cost of properties not being amortized, (ii) the lower of amortized cost and estimated fair value of unproved properties and (iii) future net revenues from estimated production of proved petroleum and natural gas reserves using either year-end prices or average prices for a period not exceeding twelve months. The carrying value of petroleum and natural gas properties on a consolidated basis is limited to the aggregate of the carrying value of each cost center less future general and administrative costs, financing costs and income taxes.

Under Canadian generally accepted accounting principles (G.A.A.P.), a ceiling test was conducted in two parts:

(1). The net book value of each cost center was compared to future net revenues plus the net cost of major development projects and unproved properties.

(2). The net book value of the two Company cost centers, net of related deferred taxes, was compared to the future net revenues plus the net cost of major development projects and unproved properties, less future general and administrative expenses, financing costs, and income taxes.

Under U.S. G.A.A.P., a ceiling test was conducted using a discount rate of 10 percent but excluding a deduction for future general and administrative expenses.

No excess carrying amounts requiring a write-off were established using either Canadian or U.S. G.A.A.P. for the three years ended June 30, 1990.

Depreciation has been computed for equipment, other than well equipment, by the straight-line method based on estimated useful lives of four to ten years. Depreciation of well equipment and depletion of leasehold acquisition and intangible drilling costs pertaining to producing wells are computed by the unit-of-production method.

Effective as of April 1, 1988, reserves relating to the Kotaneelee Field have been eliminated for the purpose of computing depreciation and depletion, based upon the anticipated length of the period before payout to the Company of its carried interest in this field. This change resulted in an increase in depreciation and depletion of $50,139 in fiscal 1988.

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.

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. During the years ended June 30, 1990, 1989 and 1988, respectively, the Company recorded exchange losses of $59,397, $48,260 and $128,583 as a result of an investment in U.S. Treasury bills.

For the purposes of the statement of cash flows, the Company considers all highly liquid investments with short-term maturities to be cash equivalents.

Cash and cash equivalents are as follows:

	June 30, 1990	June 30, 1989
Canadian Treasury bill	$ 1,309,869	$ —
U.S. Treasury bills	1,678,511	1,723,309
Bankers acceptances	1,329,565	3,335,413
Term deposit—Bermuda	168,014	149,745
	4,485,959	5,208,467
Cash	146,385	131,365
	$ 4,632,344	$ 5,339,832

Cash equivalents are carried at cost, which approximates market value.

2. Acquisition of Probe Exploration Inc. (Probe)

A 48 percent interest in Probe Exploration Inc. was acquired on January 18, 1990 by issuance of 282,312 Company shares, valued at $818,705 based upon the closing market price of Company shares on that date. The investment in Probe is accounted for on the equity method, and the excess ($607,755) of cost over the Company's interest in the net assets of Probe on January 18, 1990 will be depleted over the life of the Probe oil and gas producing properties based on the unit of production method. In fiscal 1990, the Company advanced $400,000 to Probe. The advances bear interest per annum at the Royal Bank of Canada prime rate (14.75% at June 30, 1990) plus one percent.

3. Properties

The Company's property interests are located in Alberta, British Columbia, the Yukon and Northwest Territories, and the Arctic Islands in Canada, and in the Northern Territory of Australia.

At June 30, 1990, a substantial portion of the acreage located in British Columbia and the Yukon and Northwest Territories was covered by carried interest agreements. These carried interest agreements provide that revenues are not payable to the Company until expenditures by the operators have been recouped from production. Also, the Company may at any time elect to convert from a carried interest to a working interest by paying its share of the expenditures not recouped from revenues from production. At June 30, 1990, for the carried interest areas that have not reached payout status, the Company would have been required to pay approximately $22,000,000 if it had elected to convert all of the carried interests to working interests.

The Company has a 30% carried interest in the Kotaneelee field in the Yukon Territory where three gas wells capable of production have been completed. The operator had incurred development costs of approximately $62,000,000 at June 30, 1990. It is expected that the Company will begin to receive proceeds from the carried interest approximately ten years after commencement of production from the field, assuming a graduated build-up and based upon June 1990 prices. There has been no significant change in prices since year-end. See also Note 8.

Charges to abandonments of $41,607 in fiscal 1988 related to the cost associated with a previously abandoned well drilled in the 1950's.

Oil and gas properties and mineral properties, aggregating $322,228 and $303,618 at June 30, 1990 and 1989, respectively, are substantially unexplored or undeveloped. The amount relating to mineral properties was $143,726 at June 30, 1990 and 1989.

At June 30, 1990, the Company's carried and working interest in the Arctic Islands ranged from 3% to 30% in 335,339 gross acres (46,571 net acres).

The Company has an interest in 1,483,976 gross (1,046 net) acres in the Amadeus Basin in the Northern Territory in Australia. It was a minor participant in a five year exploration program begun in 1980 and completed in 1985. To date, eleven wells have been drilled resulting in one potentially commercial gas field and two uneconomic gas accumulations.

Costs of oil and gas properties excluded from the depletion computation are as follows:

	Cumulative to	Activity for years ended June 30,			Cumulative to
	June 30, 1990	1990	1989	1988	June 30, 1987
Australia (all exploration costs)	$178,502	$18,609	$16,933	$348	$142,612

4. Line of credit

The Company has a line of credit with a Canadian chartered bank that provides for a revolving loan of $2 million. The interest rate on borrowing is at ¾% 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 year ended June 30, 1990.

5. Limited Voting Shares and stock options

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

A stock option plan was adopted at the Annual General Meeting of Shareholders on December 3, 1985 reserving 400,000 limited voting shares for issuance under the Plan. On March 19, 1986, pursuant to the plan, options on 25,000 shares were granted to a director and options on 50,000 shares were granted to consultants, one of whom is an officer of the Company, at a price of $3.85, the market price on the date of grant. The options are exercisable for five years from the date of grant. On October 5, 1987, these options were increased to 33,333 and 66,665, respectively, at a price of $3.30, the market price on that date, to offset the dilution resulting from the 1987 rights offering.

On August 5, 1987, pursuant to the plan, options on 35,000 shares were granted to the President, options on 50,000 shares were granted to directors and options on 22,500 shares were granted to officers and employees, all at a price of $3.90, the market price on the date of grant, and all are exercisable for five years from the date of grant.

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.

There were no other changes in stock options during the three years ended June 30, 1990.

Stock options outstanding at June 30, 1990 are summarized as follows:

Optionee	Date of grant	Expiration date	Number of shares	Option price Per share	Option price Aggregate	Market price at date of grant Per share	Market price at date of grant Aggregate
Former director	3/19/86	3/18/91	33,333	$3.30	$109,999	$3.30	$109,999
Consultants	3/19/86	3/18/91	66,665	3.30	219,994	3.30	219,994
Directors, officers and employee	8/5/87	8/4/92	107,500	3.90	419,250	3.90	419,250
Officer	5/9/90	5/8/95	35,000	2.25	78,750	2.25	78,750
			242,498		$827,993		$827,993

Upon exercise of options, the excess of the proceeds over the par value of the shares issued is credited to capital in excess of par value. No charges are made against income in accounting for options.

6. Compensation

The Company has a contributory pension plan for all employees, which is administered by an insurance company. Benefits payable on retirement to employees are guaranteed by annuities purchased from the insurance company. The Company's policy is to fund pension cost currently. Contributions by the Company to the pension plan were $5,112, $5,569, and $14,148 for the years ended June 30, 1990, 1989 and 1988, respectively.

Directors' fees and other compensation paid to directors who are officers of the Company for the years ended June 30, 1990, 1989 and 1988 amounted to $181,210, $174,445 and $135,865, respectively. Of these amounts, for the same periods, $42,000, $69,250 and $61,500, respectively, 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, during the years ended June 30, 1990, 1989 and 1988 amounted to $127,000 (U.S.), $124,000 (U.S.) and $111,500 (U.S.), respectively.

7. Income taxes and extraordinary item

The following table reconciles the statutory Canadian income tax rate and provision with the recorded 1988 income tax rate and expense:

Statutory tax expense	$ (12,522)
Tax effect of permanent differences between financial statements and tax return income:	
Crown royalties	155,606
Resource allowance	(40,902)
Other	1,818
Provision for income tax	$ 104,000

At June 30, 1990, the Company had net operating losses for financial reporting purposes of approximately $1,265,000 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. This carryforward expires July 1, 1996.

At June 30, 1990, the following oil and gas tax pools of deductions were available to reduce future taxable income, subject to a final determination by taxation authorities:

Drilling, exploration and lease acquisition costs	$10,076,146
Earned depletion	2,183,256
Undepreciated capital costs	542,074
Capital losses (can only be used against future years' capital gains)	30,276

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

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.

8. Litigation

The Company believes that the working interest owners in the Kotaneelee gas field (Note 3) 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 ultimately was 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 (the Company maintains they are). 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.

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, 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 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. Such claims 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 and the impact, if any, on the determination of the Company's proved reserves.

General and administrative expenses include $632,535, $664,866 and $471,314 for legal fees and expenses for the years ended June 30, 1990, 1989 and 1988, respectively.

Report of Independent Auditors

The Shareholders
Canada Southern Petroleum Ltd.

We have audited the accompanying consolidated balance sheet of Canada Southern Petroleum Ltd. as of June 30, 1990 and 1989, and the related consolidated statements of operations and accumulated deficit, cash flows, and limited voting shares and capital in excess of par value for each of the three years in the period ended June 30, 1990. 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 the 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. We believe that our audits provide a reasonable basis for our opinion.

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, 1990 and 1989, and the consolidated results of its operations and its cash flows for each of the three years in the period ended June 30, 1990, in conformity with generally accepted Canadian accounting principles.

As discussed in Note 8 to the consolidated financial statements, Canada Southern Petroleum Ltd. is involved in certain litigation, the eventual outcome of which is uncertain. Accordingly, no provision for any liability that may result has been made in the consolidated financial statements.

Ernst + Young

Hartford, Connecticut
September 21, 1990

Management's Discussion and Analysis of Financial Condition

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 ($4,632,344 at June 30, 1990), 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 it 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 $500,000, and it expects to advance approximately $100,000 to Probe Exploration Inc. In addition, substantial expenses may be incurred in connection with the litigation involving the Kotaneelee gas field.

Allied-Signal has filed an amended statement of claim against the Company in the Canada Court to recover Allied-Signal's costs of defense of the claims brought by the Company in Florida. The Company has filed a motion to dismiss the Allied-Signal claims. If Allied-Signal were successful in its efforts to recover such unspecified costs, that recovery could have a material adverse effect on the Company's financial condition, but counsel advises that such recovery is unlikely.

The operator of the Kotaneelee field has entered into a one-year contract for sale of Kotaneelee gas beginning in November 1990. The Company has requested further details, but, because the operator and the Company are in litigation, no additional details are available.

The crisis in the Middle East has caused many energy consuming countries, including the United States, to realize the vulnerability to disruption of energy supplies from OPEC countries. The Company anticipates this should result in increased interest in producing areas such as western Canada.

Results of Operations

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 unchanged in 1990 as compared to 1989. Unit sales of gas were up 14 percent but this was offset by gas prices which were 10 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, discussed elsewhere.

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 to reflect (a) the Company's share of Probe's losses since the date of the Company's investment in Probe, and (b) the amortization of the excess cost of net assets acquired attributable to Probe's oil and gas properties.

Fiscal Year ended June 30, 1989 vs. 1988

The Company incurred a loss of $1,181,175 (10 cents per share) in fiscal 1989 compared to a loss of $25,333 (less than one cent per share) in fiscal 1988. The increased loss is due to a combination of decreased revenues from operations and increased costs.

Operating revenues were down 18 percent, principally because of lower oil prices in the first half of fiscal 1989. Oil unit sales were virtually identical in 1989 and 1988. Proceeds under carried interests were lower because of significant capital expenditures, which are recouped by the operator before any amounts are paid over to the Company.

The 25 percent increase in general and administrative expense resulted from the cost of litigation relating to the Kotaneelee field. Lease operating costs recorded in fiscal 1989 were significantly higher than in fiscal 1988 due to the following reasons. The Company relies on data submitted by the field operator (Petro-Canada) in determining certain of the lease operating data. The operator adjusted the method of billing for these costs effective January 1, 1988. Due to this change, the Company underestimated lease operating costs for fiscal 1988, and recorded $90,000 of such costs in fiscal 1989. In addition, the overall operating costs levels have increased by 29 percent in 1989 as compared to 1988.

Interest income increased by 16 percent, mostly due to higher rates on funds invested. Depletion and depreciation charges for 1989 were more than double 1988 charges because of the exclusion of Kotaneelee field reserves.

Foreign exchange losses, which were $48,260 in fiscal 1989 as compared to $128,583 in the prior year, relate to United States dollar-denominated investments. The reduced loss relates to the strengthening of the U.S. dollar versus the Canadian dollar.

Supplemental Information on Oil and Gas Activities

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, 1987	440,465	42.404
Revisions of previous estimates	94,867	(22.960)
Production	(45,635)	(.917)
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
Proved developed reserves:		
June 30, 1987	440,465	42.404
June 30, 1988	489,697	18.527
June 30, 1989	447,949	18.614
June 30, 1990	532,951	21.069
Company share of Probe reserves at June 30, 1990	57,998	.801

In 1990, oil and gas reserves were revised upward as price increases improved the economics of development of certain areas.

Effective April 1, 1988, Kotaneelee field reserves, amounting to approximately 23 bcf, 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.

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2. Results of oil and gas operations:

	1990	1989	1988
Income:			
Oil and gas sales	**$1,598,809**	$1,436,450	$1,591,337
Proceeds under carried interest agreements	**141,522**	14,470	188,516
	1,740,331	1,450,920	1,779,853
Costs and expenses:			
Production costs			
lifting costs	**762,417**	791,276	451,254
wellhead taxes	—	—	—
Abandonments	—	7,252	41,607
Depletion and depreciation	**605,283**	654,613	309,346
Income tax expense*	—	—	—
	1,367,700	1,453,141	802,207
Net income (loss) from operations	**$ 372,631**	$ (2,221)	$ 977,646
Company share of Probe results of operations for producing activities	**$ 45,390**	$ —	$ —

**For the purposes of preparing this table only, the Company considered that during the fiscal years ended June 30, 1990 and 1988, respectively, the Company realized tax benefits of $111,486 and $571,118 from carryforward of exploration, development and lease acquisition costs not claimed in prior years.*

3. Costs of oil and gas activities*:

	1990	1989	1988
Exploration	**$268,171**	$178,341	$ 82,906
Development	**120,026**	149,250	116,819
Company share of Probe costs of property acquisition, exploration and development	**37,916**	—	—

Excluding costs relating to carried interests but including $18,609, $16,933 and $348 for exploration in Australia in 1990, 1989 and 1988, respectively.

4. Capitalized costs:

Please refer to the Consolidated Balance Sheet and Footnote 2 and 3 for capitalized costs relating to the Company. The Company's share of Probe's net capitalized costs relating to oil and gas activities was $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, 1990:

	(In thousands of dollars)		
	1990	1989	1988
Future cash inflows	**$ 39,018**	$ 35,158	$ 35,340
Future development and production costs	**(16,887)**	(15,036)	(15,121)
	22,131	20,122	20,219
Future income tax expense*	**(3,529)**	(2,836)	(2,867)
Future net cash flows	**18,602**	17,286	17,352
10% annual discount	**(8,766)**	(8,338)	(7,894)
Standardized measure of discounted future net cash flows	**$ 9,836**	$ 8,948	$ 9,458
Company share of Probe's standardized measure of discounted cash flows	**$ 689**	$ —	$ —

Reflects tax benefit for the years ended June 30, 1990, 1989, and 1988 respectively, from carryforward of exploration, development and lease acquisition costs, undepreciated capital costs and book earned depletion of $12,801,476, $12,678,345 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 three years ended June 30, 1990:

	(In thousands of dollars)		
	1990	1989	1988
Changes due to:			
Prices, production costs, development costs*	**$(3,076)**	$ (984)	$ 18,098
Sales net of production costs	**(978)**	(660)	(1,329)
Development costs incurred during the year	**120**	149	117
Revisions of previous quantity estimates**	**5,308**	1,428	(29,890)
Accretion of discount	**207**	(474)	2,412
Net change in income taxes	**(693)**	31	8,987
Net change	**$ 888**	$ (510)	$ (1,605)

The positive revision in 1988 is due principally to the increased natural gas price and reduced operating costs. The negative revision in 1989 is due principally to increased operating costs in Peejay. The negative revision in 1990 reflects actual current contact prices and reduced spot sales prices.

**The negative value in 1988 is due principally to the reclassification of Kotaneelee reserves. The revision in 1990 reflects new wells and increased value for Wargen.*

Market Information

Canada Southern Petroleum Ltd. has approximately 12.3 million Limited Voting Shares outstanding, held by about 9,100 shareholders of record as of September 30, 1990. This is the Company's sole class of stock, of which 15 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—$13.4 million as of June 30, 1990—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.

The quarterly high and low closing prices *(in Canadian dollars)* on The Toronto Stock Exchange over the past 33 months were as follows:

1988	1st quarter	2nd quarter	3rd quarter	4th quarter
High	5.62	9.25	7.62	7.50
Low	2.25	4.90	5.75	3.80

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
High	2.95	2.90	4.00
Low	2.15	2.20	2.05

The quarterly high and low closing prices *(in U.S. dollars)* on the Pacific Stock Exchange over the past 33 months were as follows:

1988	1st quarter	2nd quarter	3rd quarter	4th quarter
High	4 11/16	7 1/2	6 1/8	6 1/4
Low	1 3/4	4	4 15/32	3 3/16

1989	1st quarter	2nd quarter	3rd quarter	4th quarter
High	3 13/16	3 1/2	3	2 15/16
Low	2 3/4	2 1/2	2 9/16	1 15/16

1990	1st quarter	2nd quarter	3rd quarter
High	2 1/2	2 3/4	3 1/2
Low	1 13/16	1 13/16	1 13/16

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

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