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Canada Southern Petroleum Ltd.

1987 Annual Report

Canada Southern Petroleum Ltd.

Directors

John W. Bush
Consultant
Naples, Florida

Benjamin W. Heath
President
Magellan Petroleum Corporation
Newport Beach, California

Charles J. Horne
President
Canada Southern Petroleum Ltd.
Calgary, Alberta

Eugene C. Pendery
President
Car Care Investments, Inc.
Denver, Colorado

C. Dean Reasoner, Esq.
Partner
Reasoner, Davis & Fox
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Officers

Charles J. Horne
President

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Vice President

Evelyn D. Scott
Secretary-Treasurer

Executive Offices

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First Jersey National Bank
P.O. Box 960
Jersey City, New Jersey 07303

First Interstate Bank
P.O. Box 3667, Terminal Annex
Los Angeles, California 90051

Auditors

Arthur Young, Clarkson,
Gordon & Co.
20 Church Street
Hartford, Connecticut 06103

Shareholder Relations

Howell Public Relations, Inc.
2224 Liberty Street
Allentown, Pennsylvania 18104
(215) 437-0211

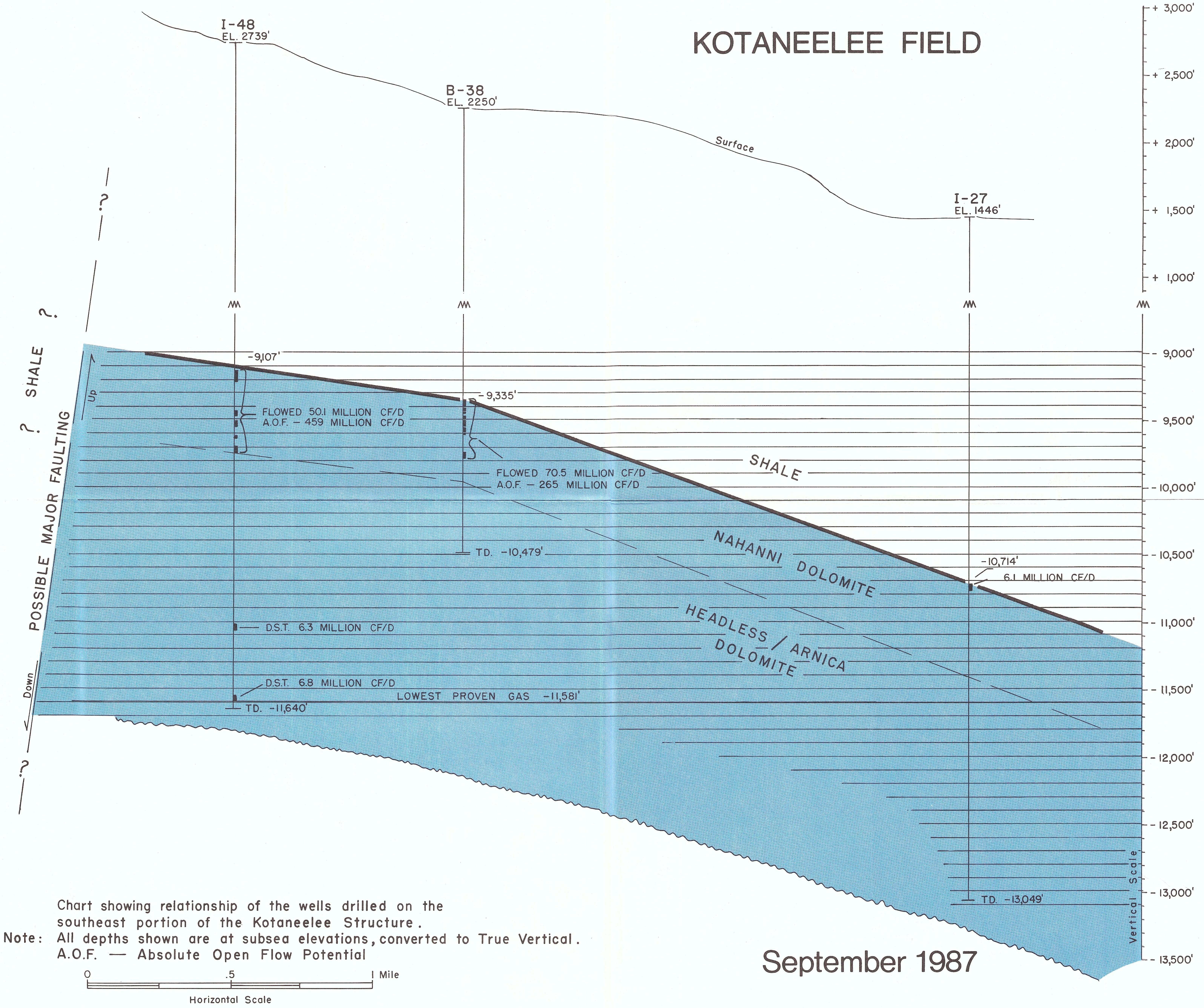
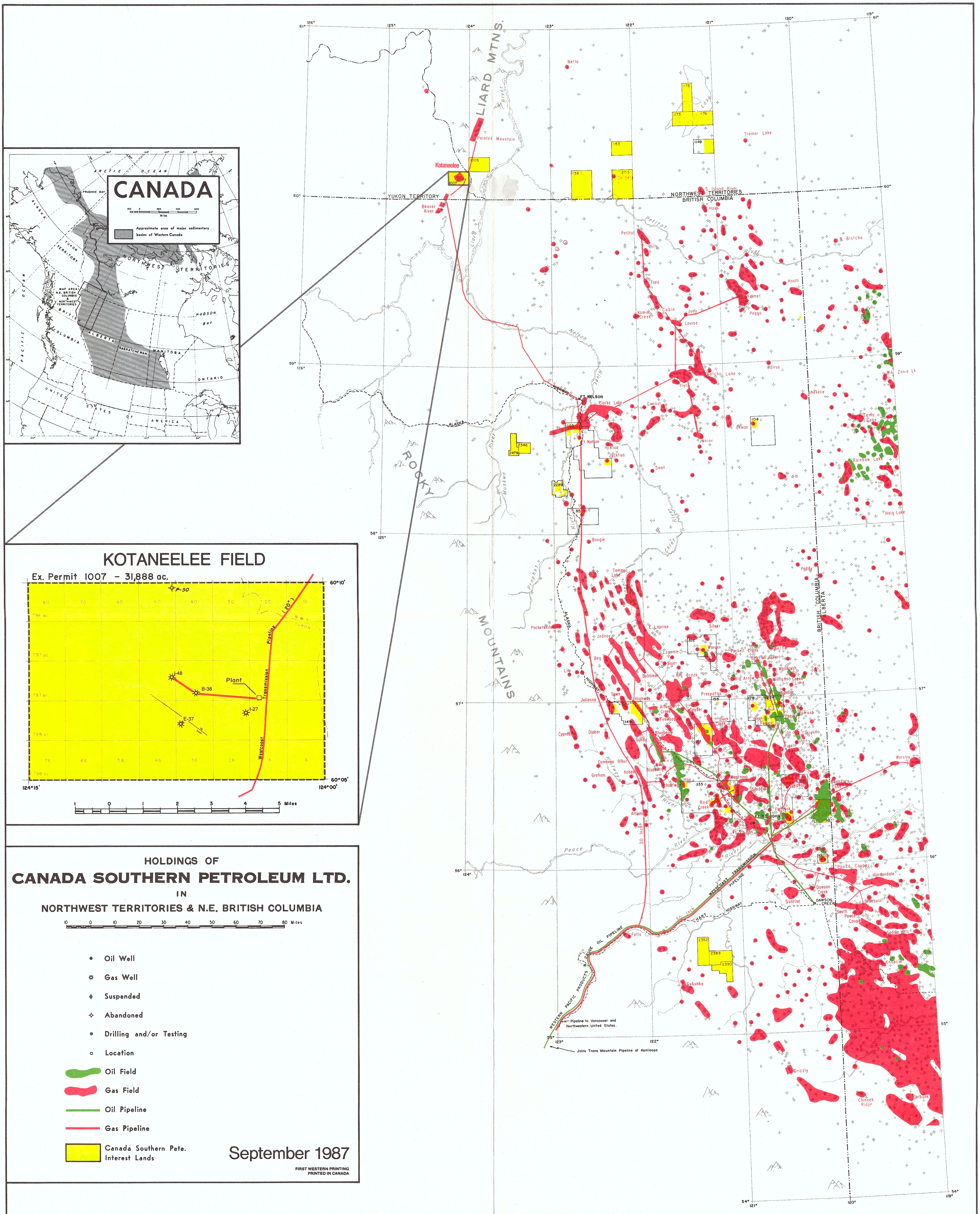


Chart showing relationship of the wells drilled on the southeast portion of the Kotaneelee Structure.

Note: All depths shown are at subsea elevations, converted to True Vertical.

A.O.F. — Absolute Open Flow Potential



HOLDINGS OF
CANADA SOUTHERN PETROLEUM LTD.
IN
NORTHWEST TERRITORIES & N.E. BRITISH COLUMBIA
Oil Well
Gas Well
Suspended
Abandoned
Drilling and/or Testing
Location
Oil Field
Gas Field
Oil Pipeline
Gas Pipeline
Canada Southern Pete. Interest Lands
September 1987
FIRST WESTERN PRINTING
PRINTED IN CANADA
KOTANEELEE FIELD
Ex. Permit 1007 - 31,888 ac.
Plant
Transmission
Pipeline
Westcoast
CANADA
Approximate area of major sedimentary basins of Western Canada
NORTHWEST TERRITORIES
BRITISH COLUMBIA
ALBERTA
YUKON TERRITORY
LIARD MTNS.
ROCKY
MOUNTAINS
FT. NELSON
Kotaneelee
Pipeline to Vancouver and Northwestern United States.
Joins Trans Mountain Pipeline at Kamloops

To Our Shareholders:

Canada Southern continues to report profitable operations despite the difficulties experienced by the petroleum industry during the past few years. The fiscal year ended June 30, 1987 was the Company's fifth consecutive profitable year, with net income of $143,853, or 2 cents a share. More importantly, the fourth quarter was our best quarter of the year, hopefully a harbinger of results for fiscal 1988.

The Board of Directors appreciates your participation in the Company's recent rights offering in which 2,997,489 shares of limited voting stock were purchased by our shareholders. The response was outstanding, with the result that the total subscriptions requested aggregated approximately 3.9 million shares. Net proceeds of $3.7 million have been added to working capital. Canada Southern remains free of both short and long term debt, and now has working capital in excess of $6 million.

As reported in last year's Annual Report, the Canadian Federal Government has designated Hecla, Whitefish, Drake Point, Roche Point, Kristoffer, Romulus and Bent Horn as significant discovery areas in the Arctic. Our interests therein (192,794 gross acres, 41,417 net acres) will be retained indefinitely pending development. In addition, the Company has retained approximately 258,703 gross acres (50,087 net acres) in the Whitefish and Cameron Island areas. All other Company interests in the Arctic Islands, amounting to 3,537,987 gross acres (589,023 net acres), were relinquished during the period from July 1, 1986 to September 30, 1987 since the drilling requirements were not fulfilled prior to expiration dates of the pertinent exploration agreements.

As you are aware, one of the Company's principal assets is its 30 percent carried interest in the Kotaneelee gas field, located in the southeastern corner of Canada's Yukon Territory. Year after year, our Annual Reports to shareholders have continued to stress the importance of this field to the future success of the Company. Generally, such reports carried a message to the effect that "we have been advised by Columbia Gas Development of Canada, Ltd. (Columbia), the current operator at Kotaneelee, that the field is expected to go on stream next year". In many instances, references were made to "the following November or early next fall".

As an example, following is an excerpt from a portion of our 1980 Annual Report:

"On August 6 of this year, Columbia Gas Development of Canada Ltd., as operator of the Kotaneelee gas field in the Yukon Territory, announced that stimulation and production testing programs had been completed on the third development well in the field, YT I-48. The well was flowed at a stabilized rate of 50 million cubic feet per day from 233 feet of perforations between 11,988 feet and 12,598 feet.

Based on the results of a series of flow rates, an absolute open flow rate for this well was calculated at 459 million cubic feet per day.

At the same time, Columbia advised that following stimulation of the first Kotaneelee field development well, YT B-38, was flowed at a stabilized rate of 70 million cubic feet per day from 192 feet of perforations made between the interval of 11,641 feet and 12,080 feet. Based on the results of a series of flow rates, the absolute open flow for this well was calculated at 265 million cubic feet per day.

Completion of the YT I-48 indicates a significant increase in proved reserves of the Kotaneelee field. Such conclusion is based on the well's indicated productivity and its 2,474 feet of gross pay section, pointing to a material increase in the potentially productive acres of the field, both horizontally and vertically.

As previously reported, Columbia received approval of the Canadian National Energy Board several months ago to export 84.5 billion cubic feet of Kotaneelee gas to the United States over the next eight years. In view of the understandings reached earlier this year between Canadian and United States energy agencies with respect to the pricing mechanism for Canadian gas, it is anticipated that United States import authorizations will be granted before the end of this year or early in 1981. Kotaneelee gas currently is priced at $4.47 (U.S.) per thousand

All monetary values in this report are expressed in Canadian dollars.

cubic feet at the United States border.

In order to better appreciate the magnitude of the gas reservoir at Kotaneelee, the cross-section on page 2 is designed to graphically portray the field's Dolomitic producing formation as established to date by the wells I-27, B-38, and I-48. This diagram includes specific information on drill stem and production tests of the section tested in each of these wells.

Please note that well B-38, the first to be drilled by Columbia Gas as operator of the property, tested only the interval of 445 feet from the top of the section, although it actually penetrated an additional 699 feet of the section to a total depth of 10,479 feet (sub-sea) without establishing a water level. In the case of I-48, this well was drilled 2,533 feet into the producing formation and drill stem tested significant volumes of gas at a depth of 11,581 feet (sub-sea). It thereby established a gross productive zone for this well of 2,474 feet, again without encountering the water level.

The horizontal line appearing on the cross-section at 11,581 feet (sub-sea) establishes the lowest depth that gas has been proven for production. Therefore, the portion above this line can be assumed to be the gross pay zone. It should be noted that the vertical scale of this cross-section is exaggerated on a 2:1 basis."

In addition to the above information on the progress at Kotaneelee for fiscal 1980, and the expressed anticipation for early production, the 1980 report also included a schematic cross-section of the field, which is reproduced on the reverse side of the pull-out map accompanying this report. It graphically demonstrates the impressive thickness of the producing section at Kotaneelee and the remarkable testing performance of the three wells that are illustrated.

Since 1980, we have faithfully passed along to you the latest information on the status of Kotaneelee. Invariably, and much to our chagrin, we were forced to report our hopes for production to commence "next year."

A continuing obligation to "assure the earliest feasible development and marketing of oil and/or gas found on the properties" was a major commitment to the Company and its partners by the parties that acquired a one-half interest in the properties in 1959. The major party of that group was Signal Oil and Gas Company, the corporate successor of which is Allied-Signal Inc. Your Company has filed a lawsuit against Allied-Signal, Inc. in a United States Federal Court for failure to carry out or cause to be carried out "the earliest feasible development and marketing" of the Kotaneelee gas field. The obligation still continues, and damages are being asked for such failure. Mitigation of future damages would occur, of course, from carrying out or causing to be carried out the obligation undertaken, which we remain hopeful will be done.

Respectfully submitted,

J. Horne

Charles J. Horne, President

Calgary, Alberta,
October 9, 1987

Financial Highlights

	Year ended June 30,				
	1987	1986	1985	1984	1983
Operating revenues	**$ 1,893,575**	$ 2,557,635	$ 2,728,013	$ 2,968,580	$ 1,673,373
Total revenues	**$ 2,071,919**	$ 2,720,668	$ 2,836,476	$ 2,983,098	$ 1,846,292
Net income	**$ 143,853**	$ 589,757*	$ 895,000*	$ 1,344,351*	$ 455,412*
Net income per share	**$ .02***	$ .07*	$ .10*	$ .15*	$ .05*
Working capital (deficit)	**$ 2,466,843**	$ 2,489,956	$ 1,858,026	$ 1,114,684	$ (122,864)
Total assets	**$12,714,002**	$12,703,616	$12,003,486	$11,097,050	$10,228,028
Shareholders' Equity:					
Limited voting stock	**$ 8,992,465**	$ 8,992,465	$ 8,992,465	$ 8,992,465	$ 8,992,465
Capital in excess of par value	**14,693,788**	14,982,543	14,982,543	14,982,543	14,982,543
Accumulated deficit	**(11,353,114)**	(11,496,967)	(12,086,724)	(12,981,724)	(14,326,075)
	$12,333,139	$12,478,041	$11,888,284	$10,993,284	$ 9,648,933
Average number of outstanding shares	**8,992,465**	8,992,465	8,992,465	8,992,465	8,992,465

*Includes $148,000 ($.02 per share), $361,000 ($.04 per share), $535,000 ($.06 per share), $804,000 ($.09 per share) and $338,000 ($.04 per share) for the years 1987, 1986, 1985, 1984 and 1983 respectively, for an extraordinary item of tax benefits realized.

CANADA SOUTHERN PETROLEUM LTD.
(A Nova Scotia corporation)

Consolidated Balance Sheet

(Expressed in Canadian dollars)

	June 30, 1987	June 30, 1986
Assets		
Current assets:		
Cash	$ 313,311	$ 71,727
Term deposits	2,040,194	2,208,042
Accounts receivable	269,717	276,293
Prepaid insurance and other	224,484	159,469
Total current assets	2,847,706	2,715,531
Oil and gas properties:		
Costs being depleted	12,438,610	12,263,222
Less accumulated depletion	(2,871,584)	(2,577,813)
	9,567,026	9,685,409
Costs not being depleted	142,612	142,612
	9,709,638	9,828,021
Other	156,658	160,064
	$12,714,002	$12,703,616
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	$ 283,996	$ 195,459
Accrued liability re abandoned well	40,000	—
Accrued liabilities — other	56,867	30,116
Total current liabilities	380,863	225,575
Shareholders' equity:		
Limited voting stock, par value $1 per share Authorized 15,000,000 shares Outstanding 8,992,465 shares	8,992,465	8,992,465
Capital in excess of par value	14,693,788	14,982,543
	23,686,253	23,975,008
Accumulated deficit	(11,353,114)	(11,496,967)
Total shareholders' equity	12,333,139	12,478,041
	$ 12,714,002	$ 12,703,616

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,		
	1987	1986	1985
Revenues:			
Oil and gas sales	**$ 1,783,319**	$ 2,242,040	$ 2,298,753
Proceeds under carried interest agreements	**110,256**	315,595	429,260
Interest	**178,344**	163,033	108,463
	2,071,919	2,720,668	2,836,476
Costs and expenses:			
General and administrative	**1,074,629**	1,255,194	1,118,702
Lease operating costs	**523,028**	524,705	602,779
Depletion and depreciation	**299,448**	170,224	109,074
Abandonments	**43,143**	88,644	—
Petroleum and gas revenue tax	**(40,476)**	52,272	71,384
Rent	**28,294**	39,872	39,537
	1,928,066	2,130,911	1,941,476
Income before income taxes and extraordinary item	**143,853**	589,757	895,000
Income taxes	**148,000**	361,000	535,000
Income (loss) before extraordinary item	**(4,147)**	228,757	360,000
Extraordinary item—Tax benefit realized from carryforward of exploration, development and lease acquisition costs not claimed in prior years	**148,000**	361,000	535,000
Net income	**143,853**	589,757	895,000
Accumulated deficit—beginning of year	**(11,496,967)**	(12,086,724)	(12,981,724)
Accumulated deficit—end of year	**$ (11,353,114)**	$ (11,496,967)	$ (12,086,724)
Average number of shares outstanding	**8,992,465**	8,992,465	8,992,465
Income (loss) per share based on average number of shares outstanding during the period:			
Income (loss) before extraordinary item	**$. —**	$.03	$.04
Extraordinary item	**.02**	.04	.06
Net income	**$.02**	$.07	$.10

See accompanying notes.

Consolidated Statement of Changes in Financial Position
(Expressed in Canadian dollars)

	Year ended June 30,		
	1987	1986	1985
Operating Activities:			
Income (loss) before extraordinary item	**$ (4,147)**	$ 228,757	$ 360,000
Charges to income not involving outlay of cash:			
Depreciation and depletion	**299,448**	170,224	109,074
Abandonments	**—**	88,644	—
Other	**2,223**	3,462	8,206
	297,524	491,087	477,280
Extraordinary item—tax benefit realized from carryforward of exploration, development and lease acquisition costs not claimed in prior years	**148,000**	361,000	535,000
	445,524	852,087	1,012,280
Increase (decrease) in working capital other than cash and cash equivalents:			
Accounts receivable and other current assets	**58,438**	158,952	(155,729)
Current liabilities	**(155,288)**	(110,373)	(11,436)
Cash and cash equivalents provided by operations	**542,374**	803,508	1,179,445
Investment Activities:			
Additions to oil and gas properties and other equipment	**179,883**	220,157	268,938
Expense of rights offering	**288,755**	—	—
Increase in cash and short-term investments	**73,736**	583,351	910,507
Cash and short-term investments at beginning of period	**2,279,769**	1,696,418	785,911
Cash and short-term investments at end of period	**$ 2,353,505**	$ 2,279,769	$ 1,696,418

See accompanying notes.

Notes to Consolidated Financial Statements—June 30, 1987
(Expressed in Canadian dollars)

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. Until March 31, 1986, expenditures incurred in the Arctic Islands had been excluded from the capitalized costs in the Canada cost center to be depleted pending the commencement of pay-outs, if any, of the Company's interests in this major development project. On April 1, 1986, costs of $4,881,981 relating to the Arctic Islands were transferred to the Canada cost center and included in the cost depletion pool because the decline in petroleum prices has caused an indeterminate delay in the commencement of pay-outs of the Company's Arctic interests.

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 or 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.

For fiscal 1987, the Company has prospectively adopted the guideline issued by the Canadian Institute of Chartered Accountants for petroleum and natural gas companies using the full cost method of accounting. In determining the limitation on the carrying value of petroleum and natural gas properties, the Company previously discounted the future net revenues from estimated production of petroleum and natural gas reserves using year end prices and costs at a rate of 10 percent. This change in accounting has had no effect on the results of operations for the year ended June 30, 1987.

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.

Interest costs incurred which 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 rate. During the three years ended June 30, 1987, exchange gains and losses have not been significant.

During fiscal 1987, the Company provided $40,000 representing the Alberta Energy Resources Conservation Board's estimate of the cost of reabandoning a well drilled in the 1950's. In 1986 costs of $88,644 relating to mineral properties abandoned were charged to expense.

2. Properties

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

At June 30, 1987, 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, 1987, for the carried interest areas that have not reached payout status, the Company would have been required to pay approximately $22,000,000, 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. Approval has been granted by the Canadian National Energy Board to export gas from the Kotaneelee field at the rate of 10 million cubic feet per day increasing to 51.2 million cubic feet per day when necessary authorizations and facilities are in place. The operator of the field has advised the Company that they are seeking U.S. purchasers for this gas.

Oil and gas properties and mineral properties, aggregating $286,338 at June 30, 1987 and 1986, respectively, are substantially unexplored or undeveloped. The amount relating to mineral properties was $143,726.

2. Properties (Cont.)

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

	Cumulative to June 30, 1987	Activity for years ended June 30, 1986 and 1987	Activity for years ended June 30, 1985	Cumulative to June 30, 1984
Australia (all exploration costs)	$142,162	$ –	$4,409	$138,203

At June 30, 1987, the Company's carried and working interest in the Arctic Islands ranged from 3% to 100% in 2,097,752 gross acres (679,873 net acres).

The Company has an interest in 1,519,696 gross (983 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.

3. Line of credit

The Company has a line of credit for a production loan with a Canadian chartered bank which provides for a revolving loan of $2 million. The interest rate on borrowings 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, 1987.

4. Capital stock and stock options

On August 3, 1987, the Company completed a rights offering to shareholders of 2,997,489 shares of its limited voting stock at a subscription price of $1.34 (Canadian) or $1.00 (U.S.). All of the shares offered by the Company were sold and the Company realized approximately $3,650,000 after deducting approximately $336,000 of related expenses. Of the $336,000, expenses of $288,755 had been accrued at June 30, 1987.

A stock option plan was adopted at the Annual General Meeting of Shareholders on December 3, 1985 reserving 400,000 Company 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 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.

During fiscal 1985, options on 75,000 shares and during fiscal 1986, options on 10,000 shares expired by their terms. On January 20, 1987, an option on 15,000 shares expired by its terms.

There were no other changes in stock options during the three years ended June 30, 1987.

Stock options outstanding at June 30, 1987 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
Director	3/19/86	3/18/91	25,000	$3.85	$ 96,250	$3.85	$ 96,250
Consultants	3/19/86	3/18/91	50,000	3.85	192,500	3.85	192,500
			75,000		$288,750		$288,750

On August 5, 1987, pursuant to the plan, options on 35,000 shares were granted to an officer, 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 exercisable for five years from the date of grant.

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.

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

5. 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 $13,607, $16,201 and $24,587, for the years ended June 30, 1987, 1986 and 1985, respectively.

Compensation of directors in all forms, for the years ended June 30, 1987, 1986 and 1985 amounted to $112,983, $182,371 and $193,433, respectively. Of these amounts, for the same periods, $40,248, $62,855 and $46,374, 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 fiscal year ended June 30, 1987 amounted to $96,500 (U.S.).

6. Income taxes and extraordinary item

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

	1987		1986		1985	
	Amount	Percent of pretax earnings	Amount	Percent of pretax earnings	Amount	Percent of pretax earnings
Statutory tax expense	$ 73,638	51.19%	$302,486	51.29%	$461,373	51.55%
Tax effect of permanent differences between financial statements and tax return income:						
B.C. deemed income	—	—	—	—	86,799	9.70
PGRT and resource royalty taxes	(20,720)	(14.40)	26,810	4.55	36,798	4.11
Crown royalties	183,798	127.77	215,137	36.48	191,120	21.35
Resource allowance	(72,388)	(50.32)	(123,982)	(21.02)	(146,309)	(16.34)
Earned depletion	(17,647)	(12.27)	(58,181)	(9.87)	(96,370)	(10.77)
	1,319	.91	(1,270)	(.22)	1,589	.18
Provision for income tax	$148,000	102.88%	$361,000	61.21%	$535,000	59.78%

At June 30, 1987, the following amounts remained to be carried forward indefinitely to reduce future taxable income:

Drilling, exploration and lease acquisition costs	$9,942,090
Earned depletion	2,183,256
Undepreciated capital costs	584,012
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 financial statements until such benefits are realized.

During fiscal 1987, the Company recorded credits of $40,476 relating to PGRT taxes paid in prior years which had been received or were receivable at June 30, 1987.

Report of Independent Public Accountants

The Shareholders
Canada Southern Petroleum Ltd.

We have examined the accompanying consolidated balance sheet of Canada Southern Petroleum Ltd. at June 30, 1987 and 1986 and the related consolidated statements of operations and accumulated deficit and changes in financial position for each of the three years in the period ended June 30, 1987. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements mentioned above present fairly the consolidated financial position of Canada Southern Petroleum Ltd. at June 30, 1987 and 1986, and the consolidated results of operations and changes in financial position for each of the three years in the period ended June 30, 1987, in conformity with generally accepted Canadian accounting principles applied on a consistent basis during the period.

ARTHUR YOUNG, CLARKSON, GORDON & CO.

Hartford, Connecticut
September 23, 1987

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

Liquidity and Capital Resources

At June 30, 1987, the Company had working capital of $2,466,843.

Most 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 pay-out status. Proceeds from these carried interests plus oil and gas sales are the major sources of working capital for the Company.

The Company's term deposits of $2,040,194, its $2,000,000 line of credit with a Canadian bank and operating revenues have been the Company's principal sources of liquidity. In addition, on August 3, 1987, the Company completed a rights offering to shareholders. An aggregate of 2,997,489 shares of limited voting stock were sold with net proceeds to the Company of approximately $3,650,000.

During fiscal 1988, the Company does not expect to make any significant expenditures on any of its properties.

Results of Operations

1987 vs. 1986

Revenues for fiscal 1987 were 24 percent lower than fiscal 1986 revenues due to lower oil and gas prices. However, in the fourth quarter of fiscal 1987, revenues improved and were higher than in the same quarter last year as oil prices strengthened. Interest income increased due to the availability of additional funds for investment.

General and administrative expenses were lower due principally to reduced salary expense and shareholders' reports expenses.

Depletion and depreciation increased as the transfer of costs relating to Arctic Islands properties which was effective March 31, 1986 was reflected for the full fiscal year 1987.

During fiscal 1987, the Company recorded credits of $40,476 relating to petroleum and gas revenue tax refunds.

The 1987 charge to abandonments relates to the Alberta Energy Resources Conservation Board's estimated cost of reabandoning a well drilled in the 1950s.

1986 vs. 1985

Total revenues for 1986 were 4 percent below fiscal 1985 revenues as the result of the drop in oil prices in the latter half of fiscal 1986. Revenues from gas sales were strong throughout fiscal 1986 and partially made up for the reduced oil revenues. Carried interest income declined because of certain capital expenditures by the operator of the properties. Interest income continued to increase due to additional funds available for investment.

General and administrative expenses increased 12 percent over fiscal 1985 due principally to increased insurance and shareholders expenses and a severance payment to a retired employee.

Depletion and depreciation increased as the result of the transfer of costs relating to Arctic Islands properties to the Canada cost center subject to depletion.

The 1986 charge to abandonments relates to certain Northwest Territories mineral properties.

Supplementary Oil & Gas Information (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 and acreage relate to Canada. Oil and gas reserve data and the information relating to cash flows were provided by D & S Petroleum Consulting Group Ltd.

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

	Oil (bbls)	Gas (bcf)
Proved reserves:		
June 30, 1984	344,767	64.946
Revisions of previous estimates	16,689	(6.631)
Production	(51,639)	(1.306)
June 30, 1985	309,817	57.009
Revisions of previous estimates	94,656	(17.222)
Production	(48,092)	(.870)
June 30, 1986	356,381	38.917
Revisions of previous estimates	133,241	4.575
Production	(49,157)	(1.088)
June 30, 1987	440,465	42.404
Proved developed reserves:		
June 30, 1984	344,767	64.946
June 30, 1985	309,817	57.009
June 30, 1986	356,381	38.917
June 30, 1987	440,465	42.404

In 1986, the oil reserves were revised upward due to the inclusion of natural gas liquids as a consequence of changes in British Columbia regulations. During the same year, gas reserves were revised downward due to the price declines which made development of certain reserves uneconomic.

In 1987, oil and gas reserves were revised upward as price increases improved the economics of development of certain areas.

2. Capitalized costs relating to oil and gas producing activities:

See Note 2 to the Financial Statements.

3. Costs of oil and gas activities*:

	1987	1986	1985
Exploration	**$ 95,800**	$ 94,905	$ 150,868
Development	**79,588**	125,252	100,275

**Excluding costs relating to carried interest but including $4,409 for exploration in Australia in the year 1985.*

4. Results of oil and gas operations:

	1987	1986	1985
Income:			
Oil and gas sales	**$1,783,319**	$2,242,040	$2,298,753
Proceeds under carried interest agreements	**110,256**	315,595	429,260
	1,893,575	2,557,635	2,728,013
Costs and expenses:			
Production costs -lifting costs	**523,028**	524,705	602,779
-wellhead taxes	**(40,476)**	52,272	71,384
Abandonments	**43,143**	—	—
Depletion and depreciation	**299,448**	170,224	109,074
Income tax expense*	**—**	—	—
	825,143	747,201	783,237
Net income from operations	**$1,068,432**	$1,810,434	$1,944,776

**For the purposes of preparing this table only, the Company considered that during the fiscal years ended June 30, 1987, 1986 and 1985, the Company realized tax benefits of $621,293, $987,086, and $1,078,845, respectively, from carryforward of exploration, development and lease acquisition costs not claimed in prior years.*

5. Standardized measure of discounted future net cash flows relating to proved oil and gas reserve quantities during the three years ended June 30, 1987:

	1987	1986	1985
	(In thousands of dollars)		
Future cash inflows	**$61,526**	$54,429	$169,572
Future development and production costs	**(22,426)**	(19,236)	(24,023)
	39,100	35,193	145,549
Future income tax expense*	**(11,854)**	(10,634)	(59,239)
Future net cash flows	**27,246**	24,559	86,310
10% annual discount	**(16,183)**	(13,832)	(51,639)
Standardized measure of discounted future net cash flows	**$11,063**	$10,727	$ 34,671

**Reflects tax benefit for the years ended June 30, 1987, 1986 and 1985, respectively, from carryforward of exploration, development and lease acquisition costs, undepreciated capital costs and book earned depletion of $12,709,358, $13,057,875 and $13,972,863, respectively.*

Current prices used in the foregoing estimates were based upon selling prices at the wellhead in June 1987. Current costs were based upon estimates made by consulting engineers in June 1987. Cash flows are predicated upon timely approval by U.S. authorities of the importation of gas from the Kotaneelee field. The amounts of estimated future net revenues by years is significantly different from previous projections because of a decline in the price expected to be realized from the sale of Kotaneelee gas. The above amounts were calculated based upon a start-up date of January 1, 1988 for fiscal 1985 and 1986 and a start-up date of January 1, 1989 for fiscal 1987 for sales of Kotaneelee gas. The Company has no assurance that the January 1, 1989 date will be met.

6. Changes in the standardized measure during the year:

	1987	1986	1985
	(In thousands of dollars)		
Changes due to:			
Prices, production costs, development costs*	**$ (1,975)**	$(55,795)	$ 6,331
Sales net of production costs	**(1,406)**	(1,981)	(2,054)
Development costs incurred during the year	**80**	170	100
Revisions of previous quantity estimates**	**5,695**	(15,804)	(21,555)
Accretion of discount***	**(838)**	861	(4,108)
Net change in income taxes	**(1,220)**	48,605	17,198
Net change	**$ 336**	$(23,944)	$ (4,088)

**In 1987, 1986 and 1985, respectively, export prices of $1.99 (U.S.), $1.50 (U.S.) and $3.15 (U.S.) per mcf were used.*

***The negative revision in 1985 is due principally to changes in British Columbia legislation whereby royalties are now due the government. Previously, all sales were made to a government corporation at a reduced price but the producer was assessed no royalty.*

****The negative accretions in 1985 and 1987 were due principally to the change in the assumed start-up date for Kotaneelee production: November 1, 1985 was used in fiscal 1984, January 1, 1988 was used in fiscal 1985, and January 1, 1989 was used in fiscal 1987.*

Market Information

Canada Southern Petroleum Ltd. has approximately 12 million shares of limited voting stock outstanding (15 million are authorized), held by about 10,000 shareholders of record as of September 30, 1987. The stock, par value $1.00, is listed on The Toronto Stock Exchange and the Pacific Stock Exchange—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 on its capital stock. Any future dividends will be dependent on the Company's earnings, financial condition, and business prospects. The Company is legally restricted from paying any dividends or making any other payment to shareholders (except by way of return of capital) on the limited voting stock until its accumulated deficit ($11,353,114 at June 30, 1987) is eliminated.

Current Canadian law does not restrict the remittance of dividends to persons not residents of Canada. Under current Canadian tax law *and* the U.S.–Canada tax treaty, any dividends paid to U.S. shareholders would be subject to withholding.

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

1985	1st quarter	2nd quarter	3rd quarter	4th quarter
High	5.50	5.25	5.13	4.60
Low	4.75	3.90	4.10	3.80

1986	1st quarter	2nd quarter	3rd quarter	4th quarter
High	4.00	4.75	4.60	3.85
Low	2.75	3.00	3.50	3.25

1987	1st quarter	2nd quarter	3rd quarter
High	6.25	5.88	4.35
Low	3.20	3.95	3.40

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

1985	1st quarter	2nd quarter	3rd quarter	4th quarter
High	$4\frac{1}{8}$	$3\frac{15}{16}$	$3\frac{7}{8}$	$3\frac{7}{16}$
Low	$3\frac{1}{16}$	$2\frac{7}{8}$	$2\frac{15}{16}$	$2\frac{3}{4}$

1986	1st quarter	2nd quarter	3rd quarter	4th quarter
High	$2\frac{15}{16}$	$3\frac{9}{16}$	$3\frac{3}{8}$	$2\frac{15}{16}$
Low	2	$2\frac{1}{4}$	$2\frac{9}{16}$	$2\frac{5}{16}$

1987	1st quarter	2nd quarter	3rd quarter
High	$4\frac{5}{8}$	$4\frac{3}{8}$	$3\frac{5}{16}$
Low	$2\frac{1}{2}$	$2\frac{3}{4}$	$2\frac{1}{2}$

Petroleum Acreage Summary

As of October 1, 1987

	Gross Acreage	Net Acreage
Canada		
British Columbia:		
Carried Interests	130,873	14,324
Working Interests	51,042	10,972
Overriding Royalty Interests	5,184	143
Total British Columbia	187,099	25,439
Alberta:		
Working Interests	640	40
Yukon & Northwest Territories:		
Carried Interests	127,960	32,076
Working Interests	466,556	31,003
Total Yukon & Northwest Territories	594,516	63,079
Arctic Islands		
Panarctic Agreements:		
Carried Interests	368,991	50,332
Working Interests	82,506	41,172
Total Arctic Islands	451,497	91,504
Total Canada	1,233,752	180,062
Australia	1,519,696	983
TOTAL	2,753,448	181,045

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