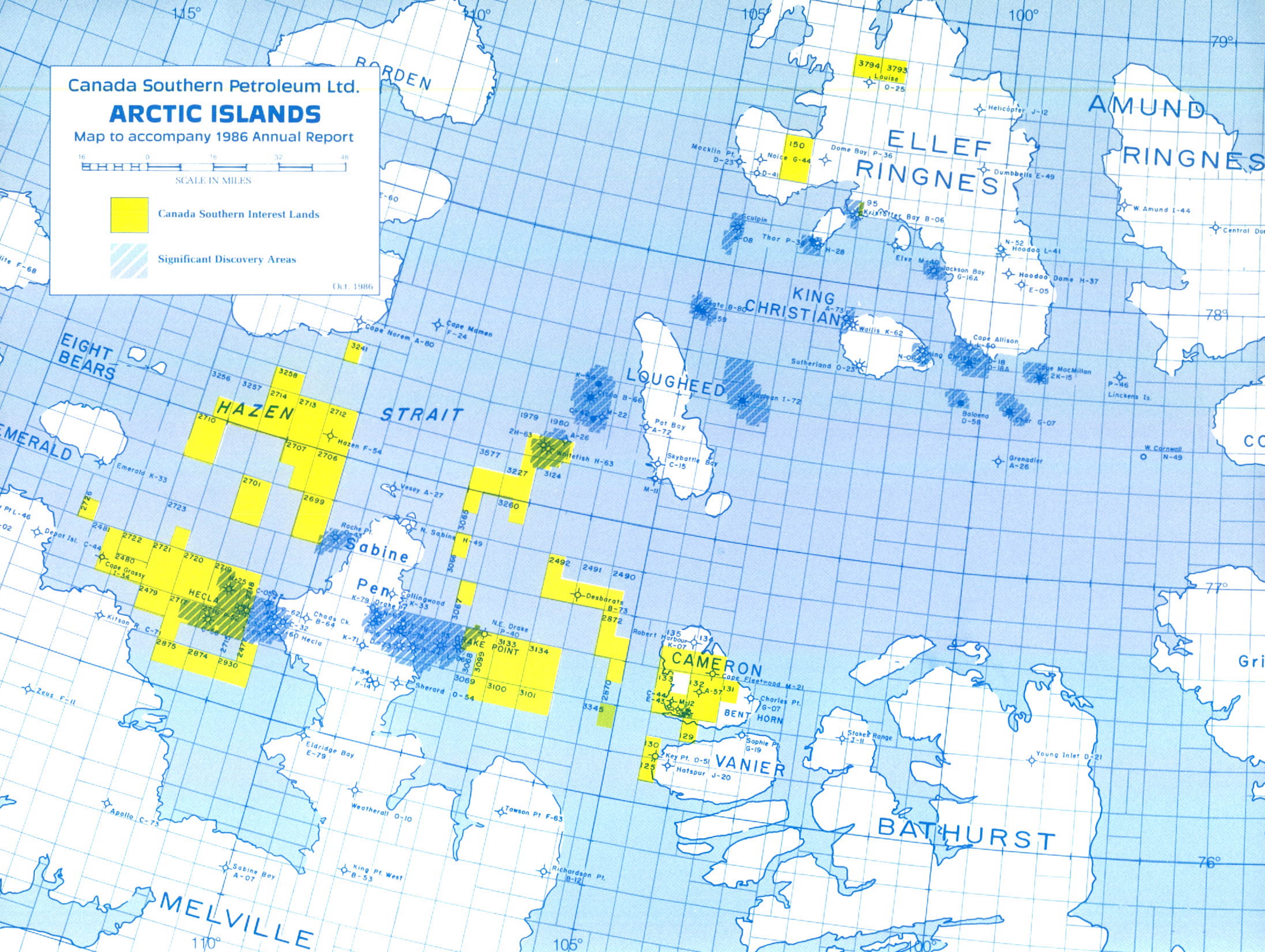
Canada Southern Petroleum Ltd.

1986 Annual Report


Canada Southern Petroleum Ltd.
ARCTIC ISLANDS
Map to accompany 1986 Annual Report
16 0 16 32 48
SCALE IN MILES
Canada Southern Interest Lands
Significant Discovery Areas
Oct. 1986
115°
110°
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BORDEN
ELLEF RINGNES
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EIGHT BEARS
EMERALD
Sabine Pen
HECLA
DRAKE POINT
CAMERON
BENT HORN
VANIER
BATHURST
MELVILLE
Helicopter J-12
Dome Bay P-36
Noice G-44
Mocklin Pt. D-23
Dumbbells E-49
W. Amund I-44
Hoodoo L-41
Hoodoo Dome H-37
E-05
Jackson Bay G-16A
Elve M-40
Kristoffer Bay B-06
Thor P-38
H-28
Sculpin
Cape Allison
Wallis K-62
Sutherland O-23
Cape MacMillan 2K-15
P-46
Linckens Is.
Balaena D-58
Char G-07
W. Cornwall N-49
Grenadier A-26
Cape Norem A-80
Cape Mamen F-24
Cisco B-66
Pat Bay A-72
Skybattle Bay C-15
M-11
Whitefish H-63
A-26
Vesey A-27
N. Sabine H-49
Roche Pt.
Collingwood K-33
Chads Ck. B-64
Hecla
Sherard O-54
N.E. Drake P-40
Desbarats B-73
Robert Harbour K-07
Cape Fleetwood M-21
Charles Pt. G-07
Sophie Pt. G-19
Key Pt. O-51
Hotspur J-20
Stokes Range J-11
Young Inlet D-21
Emerald K-33
Depot Isl. C-44
Cape Grassy I-34
Kitson R. C-71
Zeus F-11
Eldridge Bay E-79
Weatherall O-10
Towson Pt F-63
Apollo C-73
King Pt. West B-53
Richardson Pt. B-12
Sabine Bay A-07
Hazen F-54
3794
3793
Louise O-25
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To Our Shareholders:

It is a pleasure to advise you that the fiscal year ended June 30, 1986 was Canada Southern's fourth consecutive profitable year, with net income of $589,757, or 7 cents a share. Our company remains free of both short- and long-term debt, and has working capital in excess of $2.4 million.

During the third and fourth quarters of fiscal 1986, the revenues from our producing properties in British Columbia decreased about 12 percent as a consequence of the decline in world oil prices coupled with a new provincial royalty on natural gas. In all probability, those factors will continue to depress our income throughout fiscal 1987.

Our Kotaneelee field, in the southeastern Yukon Territory, represents the most likely source of a significant increase in revenues for Canada Southern. As of this writing, the operator for the field, Columbia Gas Development of Canada Ltd., has not yet negotiated a contract for the sale of Kotaneelee gas—in spite of diligent efforts toward that end—primarily because the permissable border crossing price has been too high to allow the gas to be competitive in the U.S. market. The good news is that the Canadian Government has deregulated natural gas pricing as of November 1. This will create a free market environment—*allowing direct negotiations and flexible pricing arrangements between buyer and seller—and should result in increased Canadian gas exports to the United States.*

In light of the fact that Kotaneelee already has a gas treatment plant in place, and is connected to a major pipeline system, it should be among the first fields to benefit from deregulation. However, four to six months will be required to "demothball" the treatment plant and other field facilities.

Although so-called "spot sales" certainly would not be unwelcome, Columbia Canada quite properly is giving primary emphasis to a firm, uninterruptible contract for at least 25 to 30 million cubic feet per day, subject to provisions for flexible pricing. But, whatever the terms may be, it is important to recognize that Canada Southern, as a *carried interest* holder, is not entitled to share in the field's operating revenues until the working interest partners have recovered their exploration, development, and operating costs, which aggregate about $62 million to date. On that basis, and considering the very low prices now being paid for natural gas, it could take several years for the working interest partners to recover their costs. On the other hand, increased quantities of gas sold or increased gas prices could significantly shorten this payout period. In any event, once payout has been reached, Canada Southern will receive a 30 percent share of Kotaneelee's revenues net of operating costs.

On July 18, 1986, Panarctic Oils Ltd., the operator for our Arctic Island properties, was required to relinquish approximately 16 million acres, or 50 percent, of its exploration area to the Canadian Oil and Gas Lands Administration (i.e., the Crown) pursuant to the Canada Oil & Gas Act of 1981.

This statutory acreage relinquishment reduced Canada Southern's *gross* Arctic acreage by about 57 percent, from approximately 4.7 to 2 million acres. But, because Panarctic also returned certain lands to Canada Southern, our *net* Arctic acreage is relatively undiminished, now standing at 756,630 acres as compared to 781,410 acres in the prior year. Moreover, our interests in the significant discovery areas—*Hecla, Drake Point, Whitefish, Roche Point, Kristoffer,* and *Bent Horn*—will be continued indefinitely, thus preserving our share (about 780 billion cubic feet) of the proved and probable gas reserves established in those areas.

Respectfully submitted:

J. Horne

Charles J. Horne
President

Calgary, Alberta
November 3, 1986

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

Financial Highlights

	Year ended June 30,				
	1986	1985	1984	1983	1982
Operating revenues	**$ 2,557,635**	$ 2,728,013	$ 2,968,580	$ 1,673,373	$ 1,213,497
Total revenues	**$ 2,720,668**	$ 2,836,476	$ 2,983,098	$ 1,846,292	$ 1,306,313
Net income (loss)	**$ 589,757***	$ 895,000*	$ 1,344,351*	$ 455,412	$ (515,106)
Net income (loss) per share	**$ .07***	$ .10*	$ .15*	$ .05*	$ (.06)
Working capital (deficit)	**$ 2,489,956**	$ 1,858,026	$ 1,114,684	$ (122,864)	$ (365,641)
Total assets	**$12,703,616**	$12,003,486	$11,097,050	$10,228,028	$10,347,813
Shareholders' Equity:					
Limited voting stock	**$ 8,992,465**	$ 8,992,465	$ 8,992,465	$ 8,992,465	$ 8,992,465
Capital in excess of par value	**14,982,543**	14,982,543	14,982,543	14,982,543	14,982,543
Accumulated deficit	**(11,496,967)**	(12,086,724)	(12,981,724)	(14,326,075)	(14,781,487)
	$12,478,041	$11,888,284	$10,993,284	$ 9,648,933	$ 9,193,521
Average number of outstanding shares	**8,992,465**	8,992,465	8,992,465	8,992,465	8,992,465

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

Consolidated Balance Sheet

(Expressed in Canadian dollars)

	June 30, 1986	June 30, 1985
Assets		
Current assets:		
Cash	$ 71,727	$ 71,418
Term deposits	2,208,042	1,625,000
Accounts receivable	276,293	265,565
Prepaid insurance and other	159,469	11,245
Total current assets	2,715,531	1,973,228
Oil and gas properties:		
Costs being depleted	12,263,222	7,220,499
Less accumulated depletion	(2,577,813)	(2,412,839)
	9,685,409	4,807,660
Costs not being depleted	142,612	4,965,178
	9,828,021	9,772,838
Other	160,064	257,420
	$12,703,616	$12,003,486

Liabilities and Shareholders' Equity

	1986	1985
Current liabilities:		
Accounts payable	$ 195,459	$ 75,697
Accrued liabilities	30,116	39,505
Total current liabilities	225,575	115,202
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	14,982,543	14,982,543
	23,975,008	23,975,008
Accumulated deficit	(11,496,967)	(12,086,724)
Total shareholders' equity	12,478,041	11,888,284
	$12,703,616	$12,003,486

See accompanying notes.

Consolidated Statement of Operations and Accumulated Deficit

(Expressed in Canadian dollars)

	Year ended June 30,		
	1986	1985	1984
Revenues:			
Oil and gas sales	**$ 2,242,040**	$ 2,298,753	$ 1,838,795
Proceeds under carried interest agreements	**315,595**	429,260	1,129,785
Interest	**163,033**	108,463	14,518
	2,720,668	2,836,476	2,983,098
Costs and expenses:			
General and administrative	**1,255,194**	1,118,702	864,610
Lease operating costs	**524,705**	602,779	417,664
Depletion and depreciation	**170,224**	109,074	109,276
Abandonments	**88,644**	—	—
Petroleum and gas revenue tax	**52,272**	71,384	207,273
Rent	**39,872**	39,537	39,924
	2,130,911	1,941,476	1,638,747
Income before income taxes and extraordinary item	**589,757**	895,000	1,344,351
Income taxes	**361,000**	535,000	804,000
Income before extraordinary item	**228,757**	360,000	540,351
Extraordinary item—Tax benefit realized from carryforward of exploration, development and lease acquisition costs not claimed in prior years	**361,000**	535,000	804,000
Net income	**589,757**	895,000	1,344,351
Accumulated deficit—beginning of year	**(12,086,724)**	(12,981,724)	(14,326,075)
Accumulated deficit—end of year	**$(11,496,967)**	$(12,086,724)	$(12,981,724)
Average number of shares outstanding	**8,992,465**	8,992,465	8,992,465
Income per share based on average number of shares outstanding during the period:			
Income before extraordinary item	$.03	$.04	$.06
Extraordinary item	.04	.06	.09
Net income	$.07	$.10	$.15

See accompanying notes.

Consolidated Statement of Changes in Financial Position

(Expressed in Canadian dollars)

	Year ended June 30,		
	1986	1985	1984
Operating Activities:			
Income before extraordinary item	**$ 228,757**	$ 360,000	$ 540,351
Charges to income not involving outlay of cash:			
Depreciation and depletion	**170,224**	109,074	109,276
Abandonments	**88,644**	—	—
Other	**3,462**	8,206	11,378
	491,087	477,280	661,005
Extraordinary item—tax benefit realized from carryforward of exploration, development and lease acquisition costs not claimed in prior years	**361,000**	535,000	804,000
	852,087	1,012,280	1,465,005
Increase (decrease) in working capital other than cash and cash equivalents:			
Accounts receivable and other current assets	**158,952**	(155,729)	123,067
Current liabilities	**(110,373)**	(11,436)	475,329
Cash and cash equivalents provided by operations	**803,508**	1,179,445	866,609
Investment Activities:			
Additions to oil and gas properties	**220,157**	268,938	227,457
Increase in cash and short-term investments	**583,351**	910,507	639,152
Cash and short-term investments at beginning of period	**1,696,418**	785,911	146,759
Cash and short-term investments at end of period	**$2,279,769**	$1,696,418	$ 785,911

See accompanying notes.

Notes to Consolidated Financial Statements—June 30, 1986

(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 inactive subsidiaries, Canpet Inc. and C.S. Petroleum Limited, hereafter referred to collectively as the Company. The financial statements are in conformity with both Canadian and United States generally accepted accounting principles.

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 oil and gas properties is limited to the amount determined by estimating the present value of future net revenues from proved properties together with the value of unproved properties at the lower of cost or net realizable value.

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, 1986, exchange gains and losses have not been significant.

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 Australia.

At June 30, 1986, 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, 1986, for the carried interest areas that have not reached payout status, the Company would have been required to pay $22,001,660, 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 four gas wells 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 is seeking U.S. purchasers for this gas.

Oil and gas properties and mineral properties, aggregating $286,338 and $5,197,548 at June 30, 1986 and 1985, respectively, are substantially unexplored or undeveloped. Amounts relating to mineral properties were $143,726 at June 30, 1986 and $232,370 at June 30, 1985.

Most of the Company's interests in the Arctic Islands are subject to carried interest agreements with Panarctic Oils Ltd. under which the Company's participation percentages range from 3% to 30%.

The Company has an interest in 3,051,943 gross (1,974 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.

2. Properties (Cont.)

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

	Cumulative to June 30, 1986	Activity for years ended June 30, 1986	1985	1984	Cumulative to June 30, 1983
Australia (all exploration costs)	$142,612	$ —	$4,409	$1,278	$136,925

Costs of Arctic Islands properties excluded from the depletion computation until March 31, 1986 were as follows:

	Cumulative to March 31, 1986	Nine months ended March 31, 1986	Activity for years ended June 30, 1985	1984	Cumulative to June 30, 1983
Acquisition costs	$ 970,721	$ —	$ —	$ —	$ 970,721
Exploration costs	3,700,975	59,415	75,698	119,783	3,446,079
Capitalized interest	210,285	—	—	25,588	184,697
	$4,881,981	$59,415	$75,698	$145,371	$4,601,497

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 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 year ended June 30, 1986.

4. Capital and stock options

Stock options outstanding at June 30, 1986 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	1/21/82	1/20/87	15,000	$5.78	$ 86,700	$5.25	$ 78,750
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
			90,000		$375,450		$367,500

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.

All options became exercisable on the date of grant. During fiscal 1984, options on 7,500 shares expired as a result of termination of employment. During fiscal 1985, options on 75,000 shares and during fiscal 1986, options on 10,000 shares expired by their terms.

There were no other changes in stock options during the three years ended June 30, 1986.

Upon exercise of options, the excess of the

4. Capital and stock options (Cont.)

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 letters patent, as supplemented, 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 $16,201, $24,587, and $30,364 for the years ended June 30, 1986, 1985 and 1984, respectively.

Compensation of directors in all forms, for the years ended June 30, 1986, 1985 and 1984 amounted to $182,371, $193,433 and $118,508, respectively. Of these amounts, for the same periods, $62,855, $46,374, and $44,613, 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, 1986 amounted to $82,300 (U.S.).

6. Income taxes and extraordinary item

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

	1986		1985		1984	
	Amount	Percent of pretax earnings	Amount	Percent of pretax earnings	Amount	Percent of pretax earnings
Statutory tax expense	$302,486	51.29%	$461,373	51.55%	$637,895	47.45%
Tax effect of permanent differences between financial statements and tax return income:						
B.C. deemed income	—	—	86,799	9.70	87,536	6.51
PGRT and resource royalty taxes	26,810	4.55	36,798	4.11	98,352	7.32
Crown royalties	215,137	36.48	191,120	21.35	140,729	10.47
Resource allowance	(123,982)	(21.02)	(146,309)	(16.34)	(162,041)	(12.05)
Earned depletion	(58,181)	(9.87)	(96,370)	(10.77)	—	—
Other	(1,270)	(.22)	1,589	.18	1,529	.11
Provision for income tax	$361,000	61.21%	$535,000	59.78%	$804,000	59.81%

At June 30, 1986, the following amounts remained to be carried forward indefinitely to reduce future taxable income:

Drilling, exploration and lease acquisition costs	$10,341,411
Earned depletion	2,183,256
Undepreciated capital costs	533,208
Capital losses (can only be used against future years' capital gains)	30,276

In addition, noncapital losses expiring in 1987 amount to $46,813:

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

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, 1986 and 1985 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, 1986. 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, 1986 and 1985, the consolidated results of operations and changes in financial position for each of the three years in the period ended June 30, 1986 in conformity with generally accepted Canadian accounting principles applied on a consistent basis during the period.

ARTHUR YOUNG, CLARKSON, GORDON & CO.

Hartford, Connecticut
September 22, 1986

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

Liquidity and Capital Resources

At June 30, 1986, the Company had working capital of $2,489,956. Although production from the Company's properties continues to decline, expected revenues should be more than sufficient to meet the Company's working capital requirements for the next year.

Some 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 sources of working capital for the Company.

The Company's term deposits of $2,208,042, its $2,000,000 line of credit with a Canadian bank and operating revenues are the Company's principal sources of liquidity.

During fiscal 1987, the Company does not expect to make any significant expenditures on any of its properties.

Inflation is not expected to have a significant effect on operating results for fiscal 1987 and has not had a significant effect for the three years ended June 30, 1986.

Results of Operations

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.

Results of Operations (Cont.)

1985 vs. 1984

Total revenues were down about 5 percent in 1985 from the high reached in 1984 due to reduced volume of gas and oil sold. The average per unit sale price of gas was also lower while gas production (lease operating) costs were significantly higher. As the result of conversion of certain carried interests to working interests in 1984, the proceeds from carried interests decreased and oil and gas sales increased. Interest income increased due to the additional funds available for investment.

General and administrative expenses for the 1985 fiscal year were higher than in the previous year principally as the result of increased expenses relating to shareholders.

Supplementary Oil and Gas Information (Unaudited)

The following information consists only of estimates that 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, relate to Canada. Oil and gas reserve data and the information relating to cash flows was 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, 1983	562,604	66.003
Revisions of previous estimates	(164,874)	.309
Production	(52,963)	(1.366)
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
Proved developed reserves:		
June 30, 1983	562,604	66.003
June 30, 1984	344,767	64.946
June 30, 1985	309,817	57.009
June 30, 1986	356,381	38.917

The 1984 revision of previous estimates for oil reserves relates principally to unitized fields in British Columbia. These are mature waterflood projects experiencing steep production declines.

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.

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

See Note 2 to the Financial Statements.

3. Costs of oil and gas activities*:

	1986	1985	1984
Exploration	**$ 94,905**	$150,868	$201,459
Development	**125,252**	100,275	25,998

**Excluding costs relating to carried interests but including $4,409 and $1,278 for exploration in Australia in the years 1985 and 1984, respectively.*

4. Results of oil and gas operations:

	1986	1985	1984
Income:			
Proceeds under carried interest agreements	**$ 315,595**	$ 429,260	$1,129,785
Oil and gas sales	**2,242,040**	2,298,753	1,838,795
	2,557,635	2,728,013	2,968,580
Costs and expenses:			
Production costs —lifting costs	**524,705**	602,779	417,664
—wellhead taxes	**52,272**	71,384	207,273
Depletion and depreciation	**170,224**	109,074	109,276
Income tax expense*	**—**	—	—
	747,201	783,237	734,213
Net income from operations	**$1,810,434**	$1,944,776	$2,234,367

**For the purpose of preparing this table only, the Company considered that during the years ended June 30, 1986, 1985 and 1984, the Company realized tax benefits of $1,108,167, $1,078,845 and $1,226,311, 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, 1986:

	(In thousands of dollars)		
	1986	1985	1984
Future cash inflows	**$ 54,429**	$169,572	$202,325
Future development and production costs	**(19,236)**	(24,023)	(39,570)
	35,193	145,549	162,755
Future income tax expense*	**(10,634)**	(59,239)	(76,493)
Future net cash flows	**24,559**	86,310	86,262
10% annual discount	**(13,832)**	(51,639)	(47,503)
Standardized measure of discounted future net cash flows	**$ 10,727**	$ 34,671	$ 38,759

**Reflects tax benefit for the years ended June 30, 1986, 1985 and 1984, respectively, from carryforward of exploration, development and lease acquisition costs, undepreciated capital costs and book earned depletion of $13,057,875, $13,972,863 and $15,058,718.*

Current prices used in the foregoing estimates were based upon selling prices at the wellhead in June 1986. Current costs were based upon estimates made by consulting engineers in June 1986. Cash flows are predicated upon timely approval by U.S. authorities of import 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 November 1, 1985 for fiscal 1984 figures and January 1, 1988 for fiscal 1985 and 1986 figures for sales of Kotaneelee gas. The Company has no assurance that the January 1, 1988 date will be met.

6. Changes in the standardized measure during the year:

	(In thousands of dollars)		
	1986	1985	1984
Changes due to:			
Prices, production costs, development costs(1)	**$(55,795)**	$ 6,331	$(2,012)
Sales net of production costs	**(1,981)**	(2,054)	(2,343)
Development costs incurred during the year	**170**	100	26
Revisions of previous quantity estimates(2)	**(15,804)**	(21,555)	(1,000)
Accretion of discount(3)	**862**	(4,108)	2,640
Net change in income taxes	**48,605**	17,198	(1,966)
Net change	**$(23,944)**	$(4,088)	$(4,655)

(1) In 1983, the price of gas to be exported, such as Kotaneelee gas, at the U.S.-Canadian border was $4.40 (U.S.) per mcf for the first 50 percent of full contract volumes and volumes of gas in excess of that level were priced at $3.40 (U.S.) per mcf. For purposes of making these calculations for the year 1984, the 1983 prices were used. In 1985 and 1986, respectively, export prices of $3.15 (U.S.) and $1.50 (U.S.) per mcf were used.

(2) 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.

(3) The negative accretion in 1985 is due principally to the change in the assumed start-up date for Kotaneelee production: November 1, 1985 was used in fiscal 1984 and January 1, 1988 was used in fiscal 1985.

Petroleum Acreage Summary

As of October 1, 1986

	Gross Acres	Net Acres
Northwestern Canada		
Alberta:		
Working Interests	640	40
British Columbia:		
Carried Interests	132,217	14,620
Working Interests	51,171	10,942
Overriding Royalty Interests	5,533	389
	188,921	25,951
Yukon & Northwest Territories:		
Carried Interests	118,019	29,839
Working Interests	466,556	31,003
	584,575	60,842
Arctic Islands		
Carried Interests	370,116	129,439
Working Interests	1,681,774	627,191
	2,051,890	756,630
Total Canada	2,826,026	843,463
Australia	3,051,943	1,974
Grand Total	5,877,969	845,437

Market Information

Canada Southern Petroleum Ltd. has approximately 9 million shares of limited voting stock outstanding (15 million are authorized), held by about 10,000 shareholders of record as of September 15, 1986. 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 the Boston Stock Exchange. The ticker symbol in both countries is CSW. To date, no dividends have been declared by the company.

The quarterly high and low closing prices *(in Canadian dollars)* on The Toronto Stock Exchange during the past two fiscal years were as follows:

1984			3rd quarter	4th quarter
High			5.00	5.75
Low			3.75	4.10
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		
High	4.00	4.75		
Low	2.75	3.00		

The quarterly high and low closing prices *(in U.S. dollars)* on the Pacific Stock Exchange during the past two fiscal years were as follows:

1984			3rd quarter	4th quarter
High			3 7/8	4 7/16
Low			2 13/16	3
1985	1st quarter	2nd quarter	3rd quarter	4th quarter
High	4 1/8	3 15/16	3 7/8	3 7/16
Low	3 1/16	2 7/8	2 15/16	2 3/4
1986	1st quarter	2nd quarter		
High	2 15/16	3 9/16		
Low	2	2 1/4		

Canada Southern Petroleum Ltd.

Corporate Profile, 1986

Canada Southern Petroleum Ltd. was incorporated under the Canada Corporations Act in 1954 as the successor to Canada Southern Oils Ltd., and has been a Novia Scotia corporation since 1980.

The company's only business is petroleum exploration and development—principally in northwestern Canada and the Arctic Islands—where it has acquired substantial interests in largely undeveloped properties now aggregating approximately 2.8 million acres.

Some of the company's acreage is covered by *carried interest agreements* with other companies. These enable Canada Southern to participate in oil and gas ventures in which its share of the exploration, development, and operating costs is advanced by the others, and is repaid out of operating income on an interest-free basis.

The company's operating income, at present, is derived primarily from its interests in eight producing oil and gas fields in British Columbia. Its principal asset, however, is its 30 percent carried interest in the Kotaneelee gas field in the southeastern Yukon Territory. This partially developed field, now shut-in, has proved and probable reserves of 390 billion cubic feet, is capable of producing 120 million cubic feet per day, and has been connected to a major pipeline system. When in production, this field eventually will generate significant revenues for the company.

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

C. Dean Reasoner, Esq.
Partner
Reasoner, Davis & Fox
Washington, D.C.

Shareholder Relations

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

Officers

Charles J. Horne
President

F. Betsy Shaw
Vice President

Evelyn D. Scott
Secretary-Treasurer

Executive Offices

Suite 1410, One Palliser Square
125 Ninth Avenue, S.E.
Calgary, Alberta T2G 0P6

Transfer Agents

The Montreal Trust Company
15 King Street West
Toronto, Ontario M5H 1B4

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

Canada Southern's Arctic Island property interests were reduced from 4.7 to 2 million gross acres by statutory acreage relinquishments in 1986. However, the company's interests in the significant discovery areas—notably Hecla and Whitefish—were unaffected, and will be retained indefinitely. Canada Southern's share of the proved and probable gas reserves in these areas is estimated at 776 billion cubic feet.

Canada Southern also has a small (.04 percent) working interest in the Amadeus Joint Venture, an Australian exploration consortium which has drilled 11 wells including one well in a potentially commercial gas field.

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