# Canada Southern Petroleum Ltd.
## 1985 Annual Report



# Canada Southern Petroleum Ltd.

## Directors

**John W. Bush**
Consultant
Naples, Florida

**David Goodwill**
Petroleum Consultant
Petroleum Industry Consultants, Inc.
Westminster, California

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

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

**M.A. Reasoner**
Technical Advisor
Calgary, Alberta

## U.S. Investor 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

505 Eighth Avenue, S.W.
Calgary, Alberta T2P 1G2

## 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.
One Corporate Center
20 Church Street
Hartford, Connecticut 06103

On the cover:
*The **M.V. Arctic**, a converted, ice-strengthened, 28,000-ton bulk ore carrier, is shown at anchor off Cameron Island, where it took on 100,000 barrels of crude oil from the Bent Horn oilfield in September 1985. (See Page 4). This winter, the vessel will be upgraded to give it unrestricted access to Cameron Island and to increase its oil cargo capacity by 25%.*

Photo courtesy of
Canarctic Shipping Company Ltd.
Ottawa, Ontario

## Corporate Profile, 1985

Canada Southern Petroleum Ltd., a Nova Scotia corporation, is the successor to Canada Southern Oils, Ltd., which was founded 34 years ago. The company has no short or long-term debt, has working capital in excess of $1.8 million, and posted gross revenues of $2.84 million in fiscal 1985.

Over the years, the company has been an active participant in Canadian petroleum exploration ventures, and has acquired substantial interests in the Arctic Islands as well as northwestern Canada. *(See Petroleum Acreage Summary, Page 6.)* Of the estimated proved and probable reserves established to date, Canada Southern's share is 922 billion cubic feet of natural gas and 1.91 million barrels of oil and natural gas liquids.

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

Company properties in northwestern Canada (783,000 gross acres) include interests in eight producing oil and gas fields in British Columbia, located, for the most part, within an 80-mile radius of Fort St. John. The Company's net income of $895,000 in fiscal 1985 can be attributed principally to these producing properties.

Also in northwestern Canada, but not yet in production, is the huge Kotaneelee gas field, in which the company has a 30 percent carried interest. Originally discovered by Canada Southern, this field has been partially developed in partnership with Columbia Gas Development of Canada Ltd. and three other, major Canadian oil companies. It has proved and probable reserves of 390 billion cubic feet; is capable of an estimated output of 120 million cubic feet per day; and is connected to a major pipeline system. Columbia Canada, as operator, is actively seeking U.S. markets for Kotaneelee gas; however, it is not now determinable when this field will be brought into production. *(See page 3.)*

The company's Arctic Island property interests (4.7 million gross acres) are located, for the most part, in the western Sverdrup Basin—most notably, the Hecla and Whitefish gas fields—where Canada Southern's share of proved and probable reserves is estimated at 776 billion cubic feet of gas. The company's major working interest partner, Panarctic Oils Ltd. (which is 53 percent Government-owned), has been actively exploring the Arctic Islands for nearly 20 years; and thus far has established recoverable reserves of 17.3 trillion cubic feet of gas and 250–500 million barrels of oil.

As is the case in northwestern Canada, the Arctic Islands acreage is predominately in the *carried interest* position. Moreover, these carried interest lands are subject to prior agreements with Panarctic that divide the properties into seven geographic areas, or "blocks," which have been structured as separate economic entities. Thus, the expenses incurred in exploring an area that is not commercially viable cannot be charged against the revenues derived from a successful area.

Canada Southern is listed on the Toronto, Boston, and Pacific Stock Exchanges under the ticker symbol CSW. For additional market data, please refer to page 17.

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

# 1985 IN REVIEW

Canada Southern Petroleum Ltd. earned a net profit of $895,000, or .10 per share during fiscal 1985 (ended June 30), which was the company's third consecutive profitable year. The company remains free of both short and long-term debt, and has increased its working capital to $1.8 million.

As in years past, the company's earnings were generated by its interests in eight producing oil and gas fields in British Columbia, on permits that originally were acquired by Canada Southern. According to the company's consultants, these mature fields should remain productive for at least 10 more years.

## New Directors

At last year's Annual Meeting, shareholders overwhelmingly ratified the Board of Directors' nomination of David Goodwill to succeed the late Thomas W. Donlon, who had been a Director since 1978. Mr. Goodwill, 64, has been associated with the oil and gas industry for nearly 40 years, and has held petroleum engineering and production positions with Standard Oil of California and the Champlin Petroleum Company. Prior to his retirement, in 1983, he was Champlin's Vice President-Pacific Division, with overall responsibility for producing the company's 22,000 barrel-per-day Wilmington oilfield as well as all exploration and production (onshore and offshore) in the West Coast states and Alaska. He now is a California-based petroleum consultant.

On December 11, 1984, Charles J. Horne was elected by the Board of Directors to complete the term of the late John W. Buckley, Canada Southern's first President, who died suddenly in Toronto on December 1. A Director since 1954, Mr. Buckley had been re-elected to a five year term in 1983; and hence Mr. Horne will serve as a Director until the 1988 Annual Meeting. Mr. Horne has been associated with Canada Southern and its predecessor company since 1950, and was elected President of the company in 1980.

More recently, the Board has nominated James S. Brown to succeed M. A. Reasoner, 78, who has served the company as a Director and in other capacities since 1954. Mr. Brown, 63, has been associated with the Union Oil Company of California ("Unocal") for the past 37 years, during which he has held various management positions in the company's research and refining divisions as well as in oil and gas production. He currently is Unocal's Vice President-Natural Gas & Gas Liquids—a position he has held for five years—and is serving as President of the U.S. Gas Processors Association for 1984-85. He intends to retire in November to become a consultant to the gas industry.

### Kotaneelee

Canada Southern's largest, readily accessible gas reserve is the Kotaneelee field—located in the southeastern corner of the Yukon Territory—which has a gathering system and dehydration plant in place, is capable of an estimated output of 120 million cubic feet per day, and is connected to a major pipeline system. However, this prolific field (along with many others in Canada) remains shut-in as a consequence of Canadian Government gas pricing policies and the current "gas glut" in North America.

Early in 1985, Columbia Gas Development of Canada Ltd. ("Columbia Canada"), the operator for the field, was advised by Texas Gas Transmission Corp. that it had exercised its right to terminate the 1982 agreement under which it was to have purchased about 18 billion cubic feet of Kotaneelee gas per year. Notwithstanding that setback, Columbia Canada was able to obtain a one-year extension to the applicable gas export license from the Canadian National Energy Board, and is continuing its efforts to sell Kotaneelee gas.

It should be noted that Canada Southern's 30 percent stake in Kotaneelee is in the carried interest position, and that Columbia Canada, as operator for the field, is vested with the responsibility for selling Kotaneelee gas. In addition to Columbia Canada, *all* the carrying (i.e., working interest) partners—which include Amoco Canada, Dome Petroleum, and Esso Resources—have a contractual obligation to assure the earliest feasible development and marketing of the field. Thus, *four of Canada's largest oil companies* share a common interest with Canada Southern in bringing Kotaneelee gas to market as soon as possible. Also notable is the fact that Canada Southern's new Director, David Goodwill, has been actively working with Columbia Canada in the effort to market Kotaneelee gas.

To summarize the situation, Canada Southern and its carrying partners are by no means alone in having a large reserve of shut-in gas in northwestern Canada, as Government pricing policies and the gas glut have combined to make Canadian gas non-competitive in U.S. markets. There are some indications that the gas glut is starting to dissipate; and it is hoped that the pricing situation will be remedied by the Government's new gas export policy, which is anticipated later this year. Kotaneelee thus represents a substantial, long-term supply of gas that would be immediately available to potential U.S. customers as soon as Canadian gas becomes economically viable to them.

## Bent Horn

The great bulk of Canada Southern's reserves *(see table, page 6)* are located in the Arctic Islands; and shareholders therefore should be pleased to learn of the successful completion of the *Bent Horn Pilot Project* on September 11, 1985 when a tanker arrived in Montreal with 100,000 barrels of Bent Horn crude oil. This marks the first shipment of Arctic petroleum; generates the first production-derived income for the operator, Panarctic Oils Ltd.; and demonstrates that Arctic petroleum *can* be safely shipped to market in ice-strengthened tankers. Hopefully, this project will pave the way for substantially larger production—possibly on a year-round basis—at Bent Horn, in which Canada Southern has a five percent carried interest.

## Drake Point

Another significant development in the Arctic during 1985 was the successful completion of Panarctic's offshore stepout well, *East Drake L-06,* only three-quarters of a mile from Canada Southern acreage to the east. *(See map, inside back cover.)* According to Panarctic, the Drake Point field already contained 5.14 trillion cubic feet of gas; and the L-06 well—which flowed 25.5 million cubic feet of gas per day on an extended production test—is said to have tapped a new gas pool that will add considerably to the field's reserves. Moreover, the gas-bearing structure is believed to extend about eight miles further eastward onto company-interest lands.

## Arctic Reserves in Perspective

Canada Southern's share of estimated Arctic gas reserves is now 779 billion cubic feet; and an eastward expansion of the Drake Point field *could* add significantly to that total. Panarctic, moreover, is actively continuing its Arctic exploration program. In any event, the existing 779 billion cubic feet alone is an enormous reserve of gas—equivalent to about 70 million cubic feet per day for 30 years—and, although development of these fields may be years away, the rewards could be quite handsome when production is realized.

## Summary

There no longer is any significant doubt that Canada has more than enough gas to meet its present and future needs; and thus a significant increase in U.S. consumption of Canadian gas would benefit *both* countries. For those reasons, Canadian gas producers generally believe that a pragmatic Government policy will enable Canada to become a major energy supplier to the U.S. And, small though it may be, Canada Southern is ideally positioned to reap substantial benefits from that situation, with an experienced and active Board of Directors, a portfolio of properties that is the envy of many, larger companies, mostly carried interest positions with major working interest partners, and no debt. Canada Southern, in short, is a stable and mature company; and, looking to the future, there will be many opportunities to enhance shareholders' equity.

CANADA SOUTHERN PETROLEUM LTD.

Calgary, Alberta
October 15, 1985

## Petroleum Acreage Summary

As of June 30, 1985

| | GROSS ACRES | NET ACRES |
|---|---|---|
| **Northwestern Canada** | | |
| ***Alberta:*** | | |
| Working Interests | 640 | 40 |
| ***British Columbia:*** | | |
| Carried Interests | 141,110 | 15,904 |
| Working Interests | 51,171 | 10,942 |
| Overriding Royalty Interests | 5,533 | 389 |
| | 197,814 | 27,235 |
| ***Yukon and Northwest Territories:*** | | |
| Carried Interests | 118,019 | 29,839 |
| Working Interests | 466,556 | 31,003 |
| | 584,575 | 60,842 |
| **Arctic Islands** | | |
| ***Panarctic Agreements:*** | | |
| Carried Interests | 3,101,793 | 702,459 |
| Working Interests | 1,628,812 | 78,951 |
| | 4,730,605 | 781,410 |
| TOTAL CANADA | 5,513,634 | 869,527 |
| AUSTRALIA | 3,051,943 | 1,974 |
| GRAND TOTAL: | 8,565,577 | 871,501 |

## Estimated Oil & Gas Reserves, 1985

| | OIL & NATURAL GAS LIQUIDS (million bbls.) | GAS (billion cu. ft.) |
|---|---|---|
| **Northwestern Canada** | | |
| Alberta and British Columbia | .31 | 26 |
| Kotaneelee | | 117 |
| **Arctic Islands** | | |
| Hecla | | 668 |
| Whitefish | 1.60 | 108 |
| Kristoffer | | 3 |
| TOTAL: | 1.91 | 922 |

*The reserves shown herein are classified as proved & probable by independent consultants. No estimate has been made for the Bent Horn oilfield, as it is not now possible to accurately determine the magnitude of the recoverable reserves from that field. See page 15 for estimated net quantities of proved oil and gas reserves pursuant to SEC regulations.*

# Financial Highlights

| | Year ended June 30, | | | | |
|---|---|---|---|---|---|
| | **1985** | 1984 | 1983 | 1982 | 1981 |
| Operating revenues | **$ 2,728,013** | $ 2,968,580 | $ 1,673,373 | $ 1,213,497 | $ 1,381,523 |
| Total revenues | **$ 2,836,476** | $ 2,983,098 | $ 1,846,292 | $ 1,306,313 | $ 1,541,866 |
| Net income (loss) | **$ 895,000*** | $ 1,344,351* | $ 455,412* | $ (515,106) | $ (250,125) |
| Net income (loss) per share | **$ .10*** | $ .15* | $ .05* | $ (.06) | $ (.03) |
| Working capital (deficit) | **$ 1,858,026** | $ 1,114,684 | $ (122,864) | $ (365,641) | $ 1,386,841 |
| Total assets | **$ 12,003,486** | $ 11,097,050 | $ 10,228,028 | $ 10,347,813 | $ 9,992,710 |
| Stockholders' Equity: | | | | | |
| Capital 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 | **(12,086,724)** | (12,981,724) | (14,326,075) | (14,781,487) | (14,266,381) |
| | **$ 11,888,284** | $ 10,993,284 | $ 9,648,933 | $ 9,193,521 | $ 9,708,627 |
| Average number of outstanding shares | **8,992,465** | 8,992,465 | 8,992,465 | 8,992,465 | 8,971,234 |

*Includes $535,000 ($.06 per share), $804,000 ($.09 per share) and $338,000 ($.04 per share) for the years 1985, 1984 and 1983, respectively, for tax benefits realized as the result of carryforward of exploration, development, and lease acquisition costs.

# Consolidated Balance Sheet

(Expressed in Canadian dollars)

| | June 30, 1985 | June 30, 1984 |
|---|---|---|
| **Assets** | | |
| **Current assets:** | | |
| Cash | **$ 71,418** | $ 35,911 |
| Term deposits | **1,625,000** | 750,000 |
| Accounts receivable and other | **276,810** | 432,539 |
| Total current assets | **1,973,228** | 1,218,450 |
| **Oil and gas properties:** | | |
| Costs being depleted | **7,220,499** | 7,049,463 |
| Less accumulated depletion | **(2,412,839)** | (2,309,158) |
| | **4,807,660** | 4,740,305 |
| Costs not being depleted | **4,965,178** | 4,885,071 |
| | **9,772,838** | 9,625,376 |
| **Other** | **257,420** | 253,224 |
| | **$12,003,486** | $11,097,050 |
| **Liabilities and Shareholders' Equity** | | |
| **Current liabilities:** | | |
| Accounts payable and accrued liabilities | **$ 115,202** | $ 103,766 |
| Total current liabilities | **115,202** | 103,766 |
| **Shareholders' equity:** | | |
| Capital 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 | **(12,086,724)** | (12,981,724) |
| Total shareholders' equity | **11,888,284** | 10,993,284 |
| | **$12,003,486** | $11,097,050 |

See accompanying notes.

## Consolidated Statement of Operations and Accumulated Deficit

(Expressed in Canadian dollars)

| | Year ended June 30, | | |
|---|---|---|---|
| | **1985** | 1984 | 1983 |
| **Income:** | | | |
| Oil and gas sales | **$ 2,298,753** | $ 1,838,795 | $ 174,695 |
| Proceeds under carried interest agreements | **429,260** | 1,129,785 | 1,498,678 |
| Interest | **108,463** | 14,518 | 22,714 |
| Other | **—** | — | 150,205 |
| | **2,836,476** | 2,983,098 | 1,846,292 |
| **Costs and expenses:** | | | |
| General and administrative | **1,118,702** | 864,610 | 929,583 |
| Depletion and depreciation | **109,074** | 109,276 | 118,081 |
| Petroleum and gas revenue tax | **71,384** | 207,273 | 219,648 |
| Lease operating costs | **602,779** | 417,664 | 60,031 |
| Rent | **39,537** | 39,924 | 63,537 |
| | **1,941,476** | 1,638,747 | 1,390,880 |
| Income before income taxes and extraordinary item | **895,000** | 1,344,351 | 455,412 |
| Income taxes | **535,000** | 804,000 | 338,000 |
| Income before extraordinary item | **360,000** | 540,351 | 117,412 |
| **Extraordinary item—** | | | |
| Tax benefit realized from carryforward of exploration, development and lease acquisition costs not claimed in prior years | **535,000** | 804,000 | 338,000 |
| **Net income** | **895,000** | 1,344,351 | 455,412 |
| Accumulated deficit—beginning of year | **(12,981,724)** | (14,326,075) | (14,781,487) |
| Accumulated deficit—end of year | **$(12,086,724)** | $(12,981,724) | $(14,326,075) |
| Average number of shares outstanding | **8,992,465** | 8,992,465 | 8,992,465 |
| Income per share based on average number of shares outstanding during the period: | | | |
| Income before extraordinary item | **$.04** | $.06 | $.01 |
| Extraordinary item | **.06** | .09 | .04 |
| Net income | **$.10** | $.15 | $.05 |

See accompanying notes.

# Consolidated Statement of Changes in Financial Position

(Expressed in Canadian dollars)

| | Year ended June 30, | | |
|---|---|---|---|
| | **1985** | 1984 | 1983 |
| **Source of working capital:** | | | |
| Income before extraordinary item | **$ 360,000** | $ 540,351 | $ 117,412 |
| Charges to income not involving outlay of working capital: | | | |
| Depreciation and depletion | **109,074** | 109,276 | 118,081 |
| Other | **8,206** | 11,378 | 11,379 |
| Working capital provided by operations | **477,280** | 661,005 | 246,872 |
| Extraordinary item—Tax benefit realized from carryforward of exploration, development and lease acquisition costs not claimed in prior years | **535,000** | 804,000 | 338,000 |
| | **1,012,280** | 1,465,005 | 584,872 |
| **Disposition of working capital:** | | | |
| Additions to oil and gas properties | **268,938** | 232,283 | 364,402 |
| Less Government Petroleum Incentive Grants | **—** | (4,826) | (22,306) |
| | **268,938** | 227,457 | 342,096 |
| Increase in working capital | **$ 743,342** | $1,237,548 | $ 242,776 |
| **Increase in working capital by component:** | | | |
| Cash | **$ 35,507** | $ (110,848) | $ (70,842) |
| Term deposits | **875,000** | 750,000 | (240,000) |
| Accounts receivable and other | **(155,729)** | 128,817 | 80,461 |
| Government Petroleum Incentive Grants receivable | **—** | (5,750) | (102,039) |
| Bank loan | **—** | 400,000 | 449,000 |
| Accounts payable and accrued liabilities | **(11,436)** | 75,329 | 126,196 |
| Increase in working capital | **$ 743,342** | $1,237,548 | $ 242,776 |

See accompanying notes.

# Notes to Consolidated Statements—June 30, 1985
(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 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 (excluding the Arctic Islands) is provided on the composite unit-of-production method which is based on estimated recoverable proved reserves. Expenditures incurred in the Arctic Islands have 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 (see Note 2).

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 and 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 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. Interest costs for the years ended June 30, 1984 and 1983 amounted to $25,588, and $135,697, respectively, all of which were capitalized. There were no interest costs in 1985.

Amounts received or receivable from the Canadian Government as Petroleum Incentive Grants are applied as a reduction in the carrying value of the related oil and gas properties.

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, 1985, 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, 1985, 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 by revenues from production. At June 30, 1985, 1984, and 1983, for the carried interest areas that have not reached payout status, the Company would have been required to pay $21,981,659, $21,953,498 and $21,907,188, respectively, to convert all of the carried interests to working interests. Two blocks, in which the Company's interest is 27.75%, have reached payout status. The Company's share of profits from these blocks was $1,295,527 for the year ended June 30, 1983, which amount has been credited to income. On November 1, 1983, these blocks were converted to working interests. During the period July 1, 1983 to October 31, 1983, the Company's share of profits from these blocks was $404,887.

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. In 1984, government agencies in the United States and Canada issued new policy guidelines with respect to the export of Canadian gas to the United States.

Oil and gas properties in the Arctic Islands and Australia and mineral properties, aggregating $5,197,548 and $5,117,441 at June 30, 1985 and 1984, respectively, are substantially unexplored or undeveloped. The amount relating to mineral properties was $232,370 at June 30, 1985 and 1984.

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 is 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

## 2. Properties (Cont.)

one potentially commercial gas field and two uneconomic gas accumulations.

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

| | Balance June 30, 1985 | Year ended June 30, 1985 | 1984 | 1983 | Cumulative to June 30, 1982 |
|---|---|---|---|---|---|
| **Arctic Islands** | | | | | |
| Acquisition costs | $ 970,721 | $ — | $ — | $ — | $ 970,721 |
| Exploration costs | 3,641,560 | 75,698 | 119,783 | 165,206 | 3,280,873 |
| Capitalized interest | 210,285 | — | 25,588 | 135,697 | 49,000 |
| | 4,822,566 | 75,698 | 145,371 | 300,903 | 4,300,594 |
| **Australia** (all exploration costs) | 142,612 | 4,409 | 1,278 | 4,502 | 132,423 |
| | $4,965,178 | $ 80,107 | $146,649 | $ 305,405 | $4,433,017 |

## 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.

## 4. Litigation

On November 2, 1981 the Securities and Exchange Commission (SEC) filed a civil action in the United States District Court for the District of Columbia against the Company, Benjamin W. Heath and John W. Buckley, directors of the Company, C. Dean Reasoner, special counsel to the Company and certain other public companies. All the parties named in the action have consented to the entry of final judgments of permanent injunction against violations of securities laws and other equitable relief.

The SEC's complaint alleged that The Catawba Corporation (Catawba), a privately held corporation, provided management services to the corporate defendants from early in the 1950's until May, 1978 during which time Mr. Buckley, Mr. Reasoner and Mr. Heath were the principal operating directors of Catawba and beneficial owners of minority interests in Catawba. The complaint alleged that certain filings made by the corporate defendants under the Securities Exchange Act of 1934 and the Securities Act of 1933 were materially inadequate and incomplete concerning transactions which accrued to the benefit of Catawba and its shareholders.

All the claims between the Company and Catawba, and the Company and its prior SEC counsel, were settled during 1983 and resulted in the receipt of net settlement proceeds of $106,000 (U.S.) by the Company. Such amount was included in other income in fiscal 1983.

## 5. Capital and stock options

Stock options outstanding at June 30, 1985 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 | 6/9/81 | 6/8/86 | 10,000 | 12.50 | 125,000 | 12.50 | 125,000 |
| Director | 1/21/82 | 1/20/87 | 15,000 | 5.78 | 86,700 | 5.25 | 78,750 |
| | | | 25,000 | | $211,700 | | $203,750 |

### 5. Capital and Stock Options (Cont.)

All options were excercisable 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 expired by their terms.

There were no other changes in stock options during the three years ended June 30, 1985.

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 letters patent, as supplemented, of the Company provide that no person (as defined) shall vote more than 1,000 shares.

### 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 $24,587, $30,364 and $30,785 for the years ended June 30, 1985, 1984 and 1983, respectively.

A former secretary-treasurer was granted early retirement effective July 1, 1983 under an agreement whereby he was paid at an annual rate of $37,259 until his normal retirement date, October 1, 1984.

Compensation of directors in all forms, for the years ended June 30, 1985, 1984 and 1983 amounted to $193,433, $118,508 and $118,226, respectively. Of these amounts, for the same periods, $46,374, $44,613, and $44,336 were directors' fees.

### 7. Income taxes and extraordinary item

For the years ended June 30, 1985, 1984 and 1983, respectively, the Company realized tax benefits of $535,000, $804,000 and $338,000 for Canadian income tax purposes from carryforward of exploration, development and lease acquisition costs not claimed in prior years.

The following reconciles the statutory Canadian income tax rate to recorded income tax expense:

| | 1985 | | 1984 | | 1983 | |
|---|---|---|---|---|---|---|
| | Amount | Pretax earnings | Amount | Pretax earnings | Amount | Pretax earnings |
| Expected tax expense | $461,373 | 51.55% | $637,895 | 47.45% | $222,241 | 48.80% |
| Tax effect of permanent differences between financial statements and tax return income: | | | | | | |
| B.C. deemed income | 86,799 | 9.70 | 87,536 | 6.51 | 12,051 | 2.65 |
| PGRT and resource royalty taxes | 36,798 | 4.11 | 98,352 | 7.32 | 107,188 | 23.53 |
| Crown royalties | 191,120 | 21.35 | 140,729 | 10.47 | 1,901 | .42 |
| Resource allowance | (146,309) | (16.34) | (162,041) | (12.05) | — | — |
| Earned depletion | (96,370) | (10.77) | — | | — | — |
| Other | 1,589 | .18 | 1,529 | .11 | (5,381) | (1.18) |
| | $535,000 | 59.78% | $804,000 | 59.81% | $338,000 | 74.22% |

At June 30, 1985, the following amounts remained to be carried forward indefinitely to reduce future taxable income:

| | |
|---|---|
| Drilling, exploration and lease acquisition costs | $11,270,791 |
| Undepreciated capital costs | 518,816 |
| Capital losses (can only be used against future year's capital gains) | 30,276 |

In addition, noncapital losses expiring in 1987 amounted 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, 1985 and 1984 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, 1985. 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, 1985 and 1984, the consolidated results of operations and changes in financial position for each of the three years in the period ended June 30, 1985 in conformity with generally accepted Canadian accounting principles applied on a consistent basis during the period.

ARTHUR YOUNG, CLARKSON, GORDON & CO.

Hartford, Connecticut
September 20, 1985

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

### Liquidity and Capital Resources:

At June 30, 1985, the Company had working capital in the amount of $1,858,026. Expected revenues should be more than sufficient to meet the Company's working capital requirements for the next year.

Most of the Company's property interests are covered by carried interest agreements, which provide that expenditures are made by the carrying partners 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 revenues from oil and gas sales are the major sources of working capital for the Company.

The Company has a $2,000,000 line of credit with a Canadian bank. Operating revenues and this line of credit are the Company's principal sources of liquidity.

During fiscal 1986, the Company does not expect to make any significant expenditures on any of its properties, nor does it expect any pay-out from the Kotaneelee Field.

Inflation is not expected to have a significant effect on operating results for fiscal 1986.

### Results of Operations:

**1985 vs. 1984**

Total revenues were down about 5 percent in 1985 from the high reached in 1984 due to reduced sales of gas and oil. 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 fiscal 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 current year were higher than in the previous year principally as the result of increased expenses relating to shareholders.

**1984 vs. 1983**

Total revenues were significantly higher in fiscal 1984 than in fiscal 1983 due to improved prices and the conversions from carried interests to working interests. As the result of conversion of certain carried interests to working interests in fiscal 1984, the proceeds from carried interests decreased and oil and gas sales increased. That conversion also accounted for the increase in lease operating costs.

General and administrative expenses and rent expense for fiscal 1984 were lower because of continued efforts to reduce expenses.

# 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, 1982 | 596,845 | 65.035 |
| Revisions of previous estimates | 29,184 | 2.343 |
| Production | (63,425) | (1.375) |
| 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 |
| Proved developed reserves: | | |
| June 30, 1982 | 596,845 | 65.035 |
| June 30, 1983 | 562,604 | 66.003 |
| June 30, 1984 | 344,767 | 64.946 |
| June 30, 1985 | 309,817 | 57.009 |

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.

### (2.) Costs of oil and gas activities:*

| | 1985 | 1984 | 1983 |
|---|---|---|---|
| Property acquisition—unproved | **$ —** | $ — | $ — |
| Exploration | **150,868** | 201,459 | 339,778 |
| Development | **100,275** | 25,998 | 2,318 |

*Excluding costs relating to carried interests but including $4,409, $1,278 and $4,502 for exploration in Australia in the years 1985, 1984 and 1983, respectively.

### (3.) Results of oil and gas operations:

| | 1985 | 1984 | 1983 |
|---|---|---|---|
| Income: | | | |
| Proceeds under carried interest agreements | **$ 429,260** | $1,129,785 | $1,498,678 |
| Oil and gas sales | **2,298,753** | 1,838,795 | 174,695 |
| | **2,728,013** | 2,968,580 | 1,673,373 |
| Costs and expenses: | | | |
| Production costs —lifting costs | **602,779** | 417,664 | 60,031 |
| —wellhead taxes | **71,384** | 207,273 | 219,648 |
| Depletion and depreciation | **109,074** | 109,276 | 118,081 |
| Income tax expense* | **—** | — | — |
| | **783,237** | 734,213 | 397,760 |
| Results of oil and gas operations from producing activities | **$1,944,776** | $2,234,367 | $1,275,613 |

*For the purposes of preparing this table only, the Company considered that during the years ended June 30, 1985, 1984 and 1983, the Company realized tax benefits of $1,078,845, $1,226,311, and $738,258, respectively, from carryforward of exploration, development and lease acquisition costs not claimed in prior years.

### (4.) Standardized measure of discounted future net cash flows relating to proved oil and gas reserve quantities during the three years ended June 30, 1985:

| | (In thousands of dollars) 1985 | 1984 | 1983 |
|---|---|---|---|
| Future cash inflows. | **$169,572** | $202,325 | $220,159 |
| Future development and production costs.......... | **(24,023)** | (39,570) | (43,567) |
| | **145,549** | 162,755 | 176,592 |
| Future income tax expense* ...... | **(59,239)** | (76,493) | (72,907) |
| Future net cash flows ......... | **86,310** | 86,262 | 103,685 |
| 10% annual discount....... | **(51,639)** | (47,503) | (60,271) |
| Standardized measure of discounted future net cash flows .. | **$ 34,671** | $ 38,759 | $ 43,414 |

*Reflects reduction of $11,270,791, $12,392,412, and $14,145,418 for the years ended June 30, 1985, 1984 and 1983, respectively, from carryforward of exploration, development and lease acquisition costs.

Current prices used in the foregoing estimates were based upon selling prices at the wellhead in June 1985. Current costs were based upon estimates made by consulting engineers in June 1985. 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 January 1, 1988 for sales of Kotaneelee gas, but the Company has no assurance that that date will be met.

### (5.) Changes in the standardized measure during the year:

| | (In thousands of dollars) 1985 | 1984 | 1983 |
|---|---|---|---|
| Changes due to: | | | |
| Prices, production costs, development costs*......... | **$ 6,331** | $ (2,012) | $ (28,110) |
| Sales net of production costs | **(2,054)** | (2,343) | (1,394) |
| Development costs incurred during the year ....... | **100** | 26 | 2 |
| Revisions of previous quantity estimates** .... | **(21,555)** | (1,000) | 5,335 |
| Accretion of discount***.... | **(4,108)** | 2,640 | (7,723) |
| Net change in income taxes ... | **17,198** | (1,966) | 8,609 |
| Net change ...... | **$ (4,088)** | $ (4,655) | $ (23,281) |

*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 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 years 1983 and 1984, the 1983 prices were used. In 1985, the export price of $3.15 (U.S.) per mcf was used.

**The negative revision in 1985 is due principally to the change 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.

***This negative accretion is due principally to the change in the assumed start-up date for Kotaneelee production: November 1, 1985 was used in fiscal 1983 and fiscal 1984 and January 1, 1988 was used in fiscal 1985.

## Market Information

Canada Southern Petroleum Ltd. has approximately 9 million shares of common stock outstanding (15 million are authorized), held by about 10,600 shareholders of record. 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. 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:

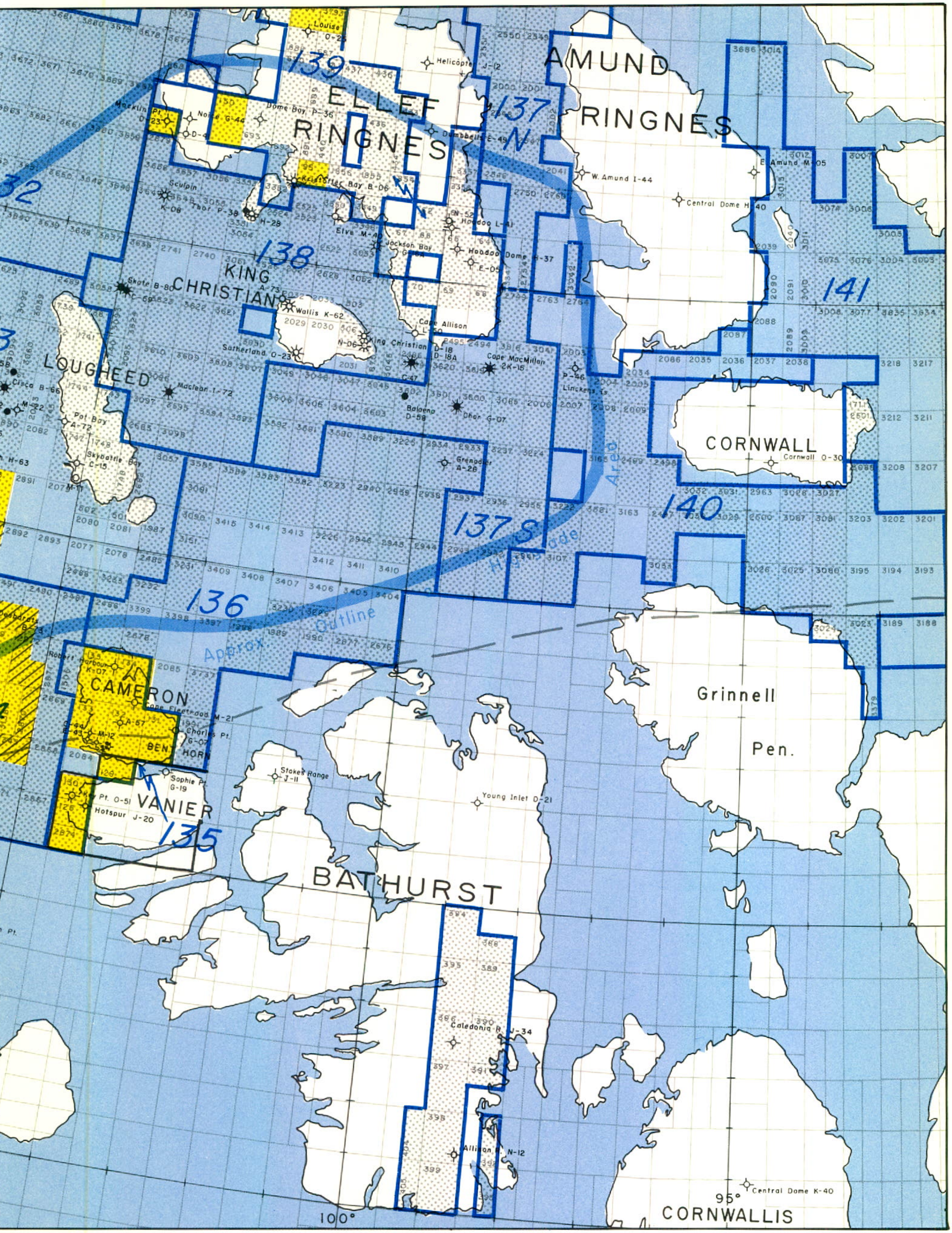
| **1983** | | | 3rd quarter | 4th quarter |
|---|---|---|---|---|
| High... | | | 5.50 | 4.80 |
| Low ... | | | 4.60 | 3.40 |
| **1984** | 1st quarter | 2nd quarter | 3rd quarter | 4th quarter |
| High... | 4.50 | 4.65 | 5.00 | 5.75 |
| Low ... | 3.30 | 3.50 | 3.75 | 4.10 |
| **1985** | 1st quarter | 2nd quarter | | |
| High... | 5.50 | 5.25 | | |
| Low ... | 4.75 | 3.90 | | |

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:

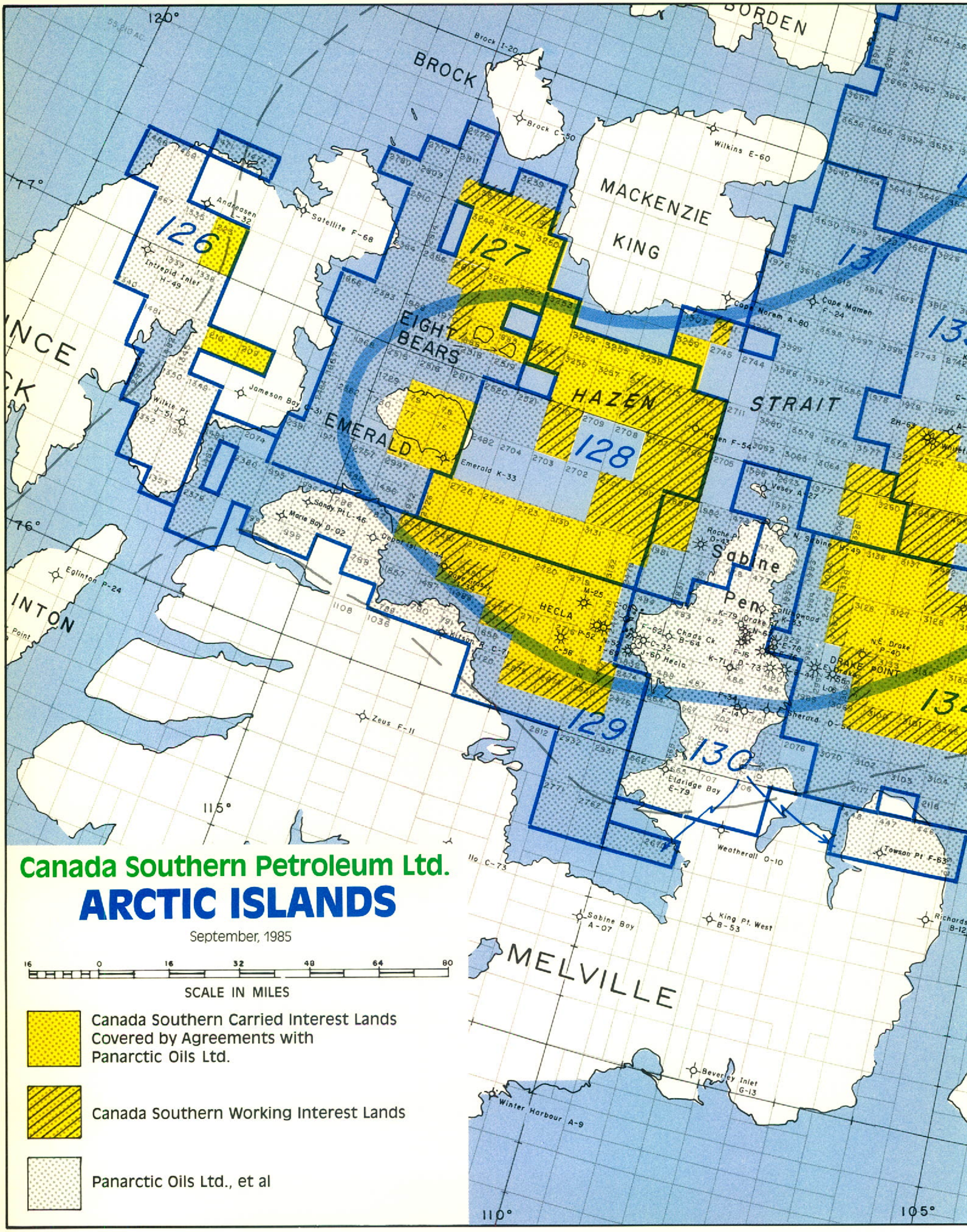
| **1983** | | | 3rd quarter | 4th quarter |
|---|---|---|---|---|
| High... | | | 4 3/16 | 4 1/8 |
| Low ... | | | 3 5/8 | 2 11/16 |
| **1984** | 1st quarter | 2nd quarter | 3rd quarter | 4th quarter |
| High... | 3 5/8 | 3 5/8 | 3 7/8 | 4 7/16 |
| Low ... | 2 11/16 | 2 11/16 | 2 13/16 | 3 |
| **1985** | 1st quarter | 2nd quarter | | |
| High... | 4 1/8 | 3 15/16 | | |
| Low ... | 3 1/16 | 2 7/8 | | |

**Ticker Symbol: CSW**

New shareholders and other interested parties may wish to obtain a pamphlet entitled "Shareholders: Know Your Company," which contains a comprehensive review of the company's property interests in northwestern Canada and the Arctic Islands. Copies are available from the company's executive offices in Calgary or from its U.S. investor relations representative, for which addresses are shown on the inside front cover of this report.



ELLEF
RINGNES
AMUND
RINGNES
KING
CHRISTIAN
LOUGHEED
CORNWALL
CAMERON
VANIER
BENT
HORN
BATHURST
Grinnell
Pen.
CORNWALLIS
Louise O-25
Helicopter J-12
Dome Bay P-36
Noice G-44
Macklin Pt. O-23
Dumbbells E-49
Kristoffer Bay B-06
Sculpin K-06
Thor P-38
H-28
Elve M-40
Jackson Bay G-04
Hoodoo L-41
Hoodoo Dome H-37
E-05
W. Amund I-44
E. Amund M-05
Central Dome H-40
Skate B-80
Wallis K-62
Satherland O-23
King Christian N-06
Cape Allison L-50
Cape MacMillan 2K-15
Maclean I-72
Balaena D-58
Char G-07
Pat Bay A-72
Skybattle Bay C-15
Cisco B-66
Grenadier A-26
Linckens Is. P-46
Cornwall O-30
Robert Harbour K-07
Cape Fleetwood M-21
Charles Pt.
Sophie Pt. G-19
Hotspur J-20
Stokes Range J-11
Young Inlet O-21
Caledonia R. J-34
Allison C. N-12
Central Dome K-40
95°
100°
139
137 N
138
132
136
137 S
135
140
141
Approx. Outline Hingeline Area


Canada Southern Petroleum Ltd.
ARCTIC ISLANDS
September, 1985
SCALE IN MILES
16 0 16 32 48 64 80
Canada Southern Carried Interest Lands Covered by Agreements with Panarctic Oils Ltd.
Canada Southern Working Interest Lands
Panarctic Oils Ltd., et al
BORDEN
BROCK
MACKENZIE KING
EIGHT BEARS
EMERALD
HAZEN STRAIT
HECLA
Sabine Pen
DRAKE POINT
MELVILLE
120°
115°
110°
105°
77°
76°
126
127
128
129
130
131
134
Brock I-20
Brock C-50
Wilkins E-60
Satellite F-68
Intrepid Inlet H-49
Jameson Bay C-31
Wilkie Pt. J-51
Emerald K-33
Sandy Pt. L-46
Marie Bay D-02
Eglinton P-24
Cape Norem A-80
Cape Mamen F-24
Hazen F-54
Vesey A-27
Roche Pt. O-43
N. Sabine H-49
Chads Ck. B-64
Zeus F-11
Eldridge Bay E-79
Weatherall O-10
Towson Pt. F-63
Sabine Bay A-07
King Pt. West B-53
Beverley Inlet G-13
Winter Harbour A-9
N.E. Drake P-40
Sherard O-54
Collingwood K-33

Printed in U.S.A.