

“Canterra will stimulate professional excellence and promote innovation, initiative and responsibility throughout the organization while applying rigorous standards of profitability to achieve financial strength and sustained growth.”



CORPORATE PROFILE

Canterra Energy Ltd., based in Calgary, Alberta, is a major Canadian producer of oil, natural gas, natural gas liquids and sulphur.

The company produces conventional oil and gas in Western Canada, particularly from major oil fields at Rainbow Lake in northern Alberta and major gas fields in the Ram River area of west central Alberta. The company also is a significant producer through enhanced oil recovery methods and operates two heavy oil pilot plants.

Canterra is the second largest producer of sulphur in Canada. Production, purchases and block inventories provide Canterra with an annual supply capability in excess of two million tonnes, making the company the largest Canadian sulphur supplier.

Canterra is an aggressive explorer for oil and gas in Western Canada and in the frontier regions, particularly on the Grand Banks off Newfoundland and on the Scotian Shelf.

In the United States, Canterra explores for and produces natural gas, primarily in the Gulf Coast and produces oil in the Williston Basin. The company is a medium-sized producer of coal in Pennsylvania.

Canterra was formed in 1981 through the merger of Aquitaine Company of Canada Ltd., CDC Oil & Gas Ltd. and the Canadian oil, natural gas and sulphur assets of Texasgulf Inc.

Canada Development Corporation owns 95.4 per cent of Canterra on an undiluted basis.

Canterra became a public company during 1985. The company's shares are listed on the Toronto, Montreal and Alberta stock exchanges and trade under the symbol "CEN."

FINANCIAL OBJECTIVES BY 1989


Annual return on shareholders' equity	15%
Ratio of current value of total assets to total debt	2.5:1
Ratio of cash flow after tax to interest payable	3.0:1

OPERATING STRATEGIES

Replace conventional reserves of oil and gas
Expedite development and marketing of reserves
Exploit enhanced oil recovery potential
Maintain leadership in sulphur production and marketing
Commercialize heavy oil and tar sands pilot projects
Discover major frontier reserves

GLOSSARY

Condensate	A hydrocarbon liquid, like gasoline, recovered from natural gas.
Delineation well	A well drilled to assess the extent of an oil or gas discovery.
Development well	A well drilled with the expectation of producing from a known productive crude oil or natural gas reservoir.
Enhanced oil recovery	An oil recovery technique where various types of fluids such as water, gas and liquified petroleum gases are injected into the reservoir to increase recovery.
Exploratory well	A well drilled in unproved territory or to depths previously unpenetrated to find commercial deposits of crude oil, natural gas or sulphurous gas.
Heavy oil	Heavy crude is more dense and viscous than normal crudes and therefore does not flow as freely. Bitumen, which is also referred to as tar, is denser and more viscous than heavy oil.
Netback	The amount of revenue left to the producer after the deduction of royalties, taxes and other operating costs.
PIP	Petroleum Incentive Program. Enacted as part of the national energy program (NEP) to provide cash incentives for oil and gas exploration and development in Canada.
APIP	Alberta Petroleum Incentive Program. As a result of the Canada/Alberta agreement on energy pricing and taxation, Alberta agreed to administer and fund PIP within the province. Incentive rates and eligibility requirements are the same as the federal program.
Probable reserves	Reserves which may after further drilling or production performance be considered proved.
Proved reserves	Amount of hydrocarbon which is economically recoverable using all technically feasible and economically practical recovery methods.
Reservoir	A body of porous rock containing an accumulation of water, crude oil and/or natural gas (including sulphurous gas).
Resources	An amount of hydrocarbons that is technically recoverable, without consideration of market or economics.
Royalty	A percentage of production which an oil company pays to the owner of the mineral rights. The owner may be a provincial or federal government or a freehold lease owner.
Royalty interest	A company's or mineral lease owner's percentage share of production which is generally received without deduction of any production costs.
Seismic	The measurement of the configuration of rocks beneath the surface of the earth by using a sensitive receiver (geophone) to record the response to a sound or vibration pulse.
Working interest	A company's operating or participating interest percentage under an oil or gas joint venture agreement before the deduction of royalty interests.

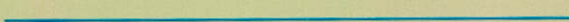

MISSION

Canterra will be a leading force in the Canadian petroleum and sulphur industry.

It will be an aggressive and successful participant in the various facets of the exploration, production and marketing of oil, gas and sulphur in Western Canada and in the offshore regions of Canada.

It will apply its expertise to selective international operations.

Canterra will stimulate professional excellence and promote innovation, initiative and responsibility throughout the organization while applying rigorous standards of profitability to achieve financial strength and sustained growth.



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Corporate Organization

Page 6 **WESTERN CANADA EXPLORATION & PRODUCTION**
Responsible for finding, developing and producing reserves of light and heavy oils, tar sands, natural gas and sulphur in Alberta, Saskatchewan and British Columbia. This is currently the company's major source of earnings and cash flow.

Page 12 **MARKETING**
Responsible for marketing crude oil, natural gas, natural gas liquids and sulphur produced and purchased in Canada.

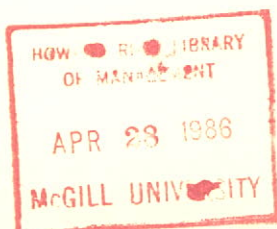
Page 14 **FRONTIER CANADA EXPLORATION & PRODUCTION**
Responsible for finding and developing oil and natural gas on Canada Lands, including offshore Eastern Canada.

Page 17 **U.S. EXPLORATION & PRODUCTION**
Responsible for finding, developing, producing and marketing natural gas and condensate in the Gulf Coast and producing and marketing light oil in the Williston Basin in the northwest.

Page 18 **U.S. COAL**
Responsible for producing and marketing coal from underground and surface mines in Pennsylvania.

Page 19 **CORPORATE RELATIONS**

Page 20 **FINANCE**



Report to Shareholders



Bernard F. Isautier, Chairman and Chief Executive Officer (left); John B. Hague, President and Chief Operating Officer.

The past year marked the fourth consecutive year of improvement in Canterra's operating results. More important for the longer term, the company was almost totally refinanced on advantageous terms and Canterra became a public company.

Changes in federal and provincial government policies implemented in 1985 enhance Canterra's prospects. These changes, more fully described on Page 4, place the oil and gas industry in an environment where market forces are allowed to work freely, capital spending decisions are based on geology and economics, and the success or failure of management decisions will be more accurately measured.

FINANCIAL RESULTS

Markets for Canterra's crude oil and natural gas production were firm throughout 1985. A small increase in sulphur volumes was accompanied by a sharp rise in sulphur prices over the year, as world-wide consumption continued to exceed production. This required further draw downs of Western Canada inventories.

Improvements in the regulatory and market environment, a successful oil exploration program, and continuing cost effectiveness in operations combined to produce a record cash flow of \$535 million before financing charges. That cash flow, the best measure of the company's operating performance, has increased 44 per cent since 1982, Canterra's first full year of operation. Refinancing activities, the pay down of debt and generally lower interest rates throughout 1985 reduced total financing expense, leaving a free cash flow - funds available for capital spending and debt repayment - of \$310.3 million, compared to \$187.1 million in 1984. Net income was \$86.9 million, compared to \$41.4 million in 1984.

During the first half of 1985, Canterra was able to refinance a U.S. \$1.4 billion advance from its parent, Canada Development

Corporation, on a stand-alone unsecured basis. Repayments on this loan are spread over 10 years commencing July 1987 and are broadly in line with expected future cash generating capability. This refinancing, together with much improved operating results, enabled the company to undertake a \$300 million public issue of convertible debentures and common shares in June. Proceeds from this issue were used to reduce debt.

Successful exploration and production activities which add low-cost reserves and productive capacity to Canterra's existing base are considered the best means to build value for Canterra shareholders. Canterra invested \$298.5 million in capital expenditure programs during 1985. Of this amount, \$84.6 million was funded by various government programs, leaving net expenditures of \$213.9 million, compared to \$160.5 million in 1984.

OPERATIONS

In Western Canada, the primary focus during the year was on oil exploration and development. A highly-successful program resulted in a record 11 per cent increase in oil and natural gas liquids reserves. While natural gas exploration continued to be constrained during 1985 due to market uncertainties, net gas reserves increased three per cent. Reserve additions in 1985 replaced approximately 135 per cent of the 1985 production of oil, gas liquids and natural gas on an oil equivalent basis.

Over the past several years, Canterra has been working on the implementation of programs to increase the company's sulphur reserve base. In 1985, sulphur reserve additions were roughly equivalent to production and to one third of sales. The remaining sales are comprised of remelted inventory and purchases.

Technological developments at the company's heavy oil pilot projects near Fort McMurray and North Battleford resulted in increased production volumes for the year. The company will pursue future commercialization of these projects, although expansion will require more supportive fiscal regimes.

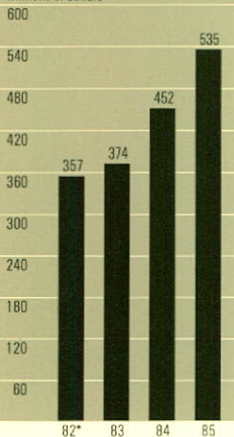
The company's investment in frontier exploration since 1981 has yielded an estimated 400 billion cubic feet of natural gas resources and 23 million barrels of oil and natural gas liquid resources before royalties. Delineation drilling on the Terra Nova oil prospect on the Grand Banks and in the Glenelg, Alma, and Thebaud natural gas prospects offshore Nova Scotia has increased reserve levels close to a point that will permit commercial development when market conditions warrant. This drilling will be continued in 1986.

Canterra Petroleum Inc., the company's operating subsidiary in the United States, again produced good results from its exploration program in 1985. The shift in emphasis from oil exploration in the Williston Basin to finding large gas reserves on the Gulf Coast will continue in 1986.

Canterra Coal Inc., our coal mining subsidiary in Pennsylvania, experienced a difficult year in 1985 due to continuing weak coal markets.

Cash Flow Before Interest Payments

Millions of dollars



*Does not include recovery of 1981 income taxes.

OUTLOOK

As 1985 ended, uncertainties surrounding the industry were increasing. Arrangements which have governed the pricing of crude oil both domestically and internationally for some years have changed and oil now trades on a commodity basis similar to other resource products. The complex set of regulatory and institutional arrangements which have governed the marketing of natural gas in North America are being dismantled and replaced by a free, unregulated market. Future natural gas prices will be established by arm's length negotiations among producer, transporter, distributor and consumer. Sulphur demand is currently so far ahead of production that we anticipate stability in this business.

Prices for crude oil and natural gas, which fell sharply early in 1986, will impact the company's 1986 capital expenditures program. The company will maintain flexibility to implement any deferred capital programs as prices improve.

Canterra's key operating strategies will continue unchanged. Primary among these is the on going need to be even more effective as an explorer for and developer of low-cost reserves. The company has steadily improved operational performance over the past four years, largely by strengthening technical effort, and is well positioned to work effectively and efficiently in a more adverse economic environment. With greater uncertainty, capital investment opportunities will be even more rigorously screened. Selection will be based on providing superior returns both now and in the longer term. Canterra is strengthening marketing skills to better identify customer needs and the ways to most economically serve them.

ACKNOWLEDGEMENTS

The challenges brought about by the new deregulated environment are being met by the innovation, imagination and inventiveness of our staff. We sincerely thank them for their dedication to sustaining improvement in Canterra's performance.

D. Carlton Jones, a director of Canterra and its predecessor companies for seven years, retired at year end. His advice and counsel during Canterra's formative years were invaluable. We are extremely pleased that Dr. Ted Best, who has had a long career in oil and gas, has joined our board. At the beginning of 1986, Bernard F. Isautier, previously president and chief executive officer, became chairman and chief executive officer. John B. Hague, chairman of Canterra for the past three years, was elected president and chief operating officer.

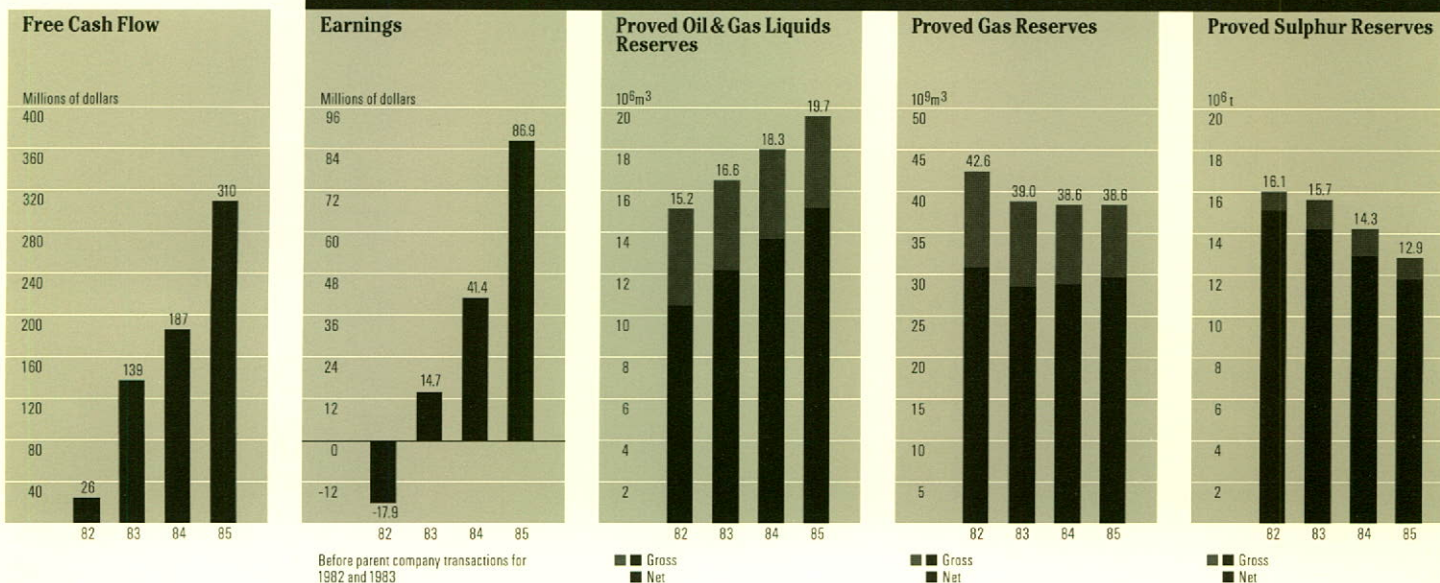
Canterra has experienced four years of building in an environment of change. Change will continue but our commitment to build remains constant.

On behalf of the board,

Bernard F. Isautier
Chairman and
Chief Executive Officer

John B. Hague
President and
Chief Operating Officer

March 7, 1986



Policy Environment

Drilling activity in Western Canada increased 22 per cent in 1985 from the previous year, reflecting positive government policies implemented during the year. While lower prices for oil and natural gas will influence exploratory drilling in 1986, the fundamental changes established by the policies will have positive long-term effects on Canada's oil and gas industry.



Government recognition of the oil and gas industry as a major contributor to employment and economic growth, and the corresponding movement toward deregulation and reduction in royalties and taxes in 1985, created the most positive business climate in the industry in many years. Canterra's expanded 1985 capital expenditures program was largely a function of this new environment.

The changes brought by the new fiscal policies are fundamental and will have far-reaching beneficial effects on the industry over the long term, despite lower prices for oil and natural gas in 1986.

Summary of Major Policy Changes in 1985

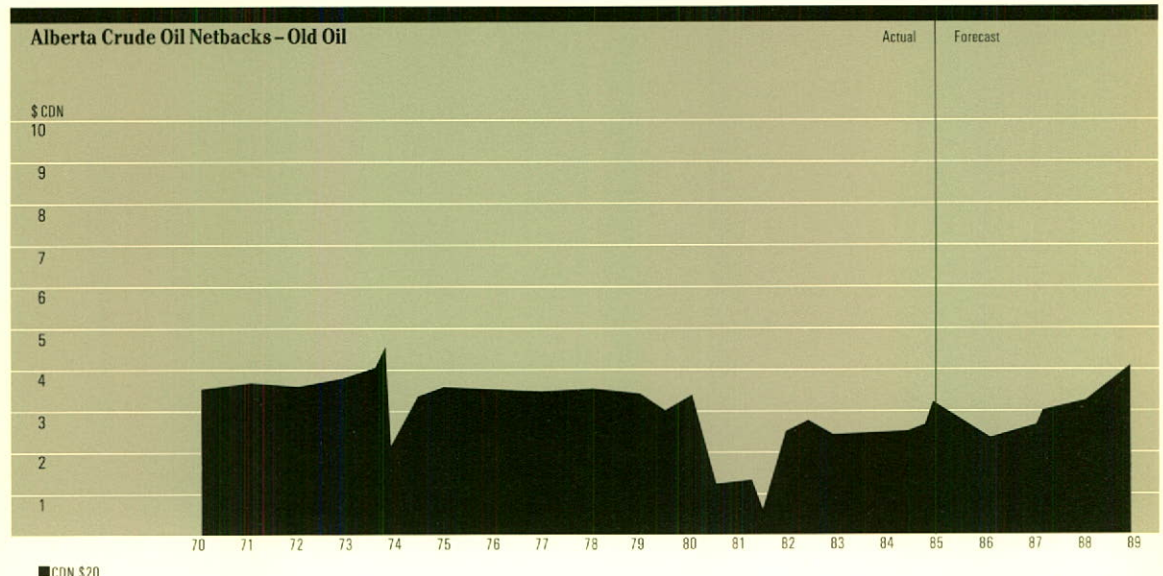
THE ATLANTIC ACCORD

On February 11, the governments of Canada and Newfoundland signed a memorandum of agreement on offshore energy management and revenue sharing. Provisions of the agreement include joint management of offshore resources through a Canada-Newfoundland Offshore Petroleum Board, joint policy direction on industrial and employment benefits and the pace of exploration and development, a resource revenue sharing arrangement similar to land based activities, and an equalization offset payment formula.

THE WESTERN ACCORD

The most significant government policy change occurred with the signing of the Western Accord on March 28 by the federal government and the petroleum producing provinces of Saskatchewan, Alberta and British Columbia. The comprehensive agreement substantially altered the complex pricing, taxation and marketing structures developed over the previous five years. The key elements were: deregulation of crude oil pricing on June 1; movement toward a market-oriented gas pricing system by November 1; complete phase out of the Petroleum and Gas Revenue Tax (PGRT) by January 1989; the immediate removal of numerous upstream and downstream taxes; and termination of the Petroleum Incentive Program by March 28, 1986. The governments agreed to allow the net benefits from decontrol to flow through to the industry.

These charts show the changes in producer netbacks for a high productivity oil well similar to those operated by Canterra in the Rainbow area. Historical values have been adjusted for inflation for comparison with 1985 values and therefore are in "constant" 1985 dollars. The forecast is based on an assumed average wellhead price of CDN \$20 per barrel remaining constant throughout the balance of the decade. Even at these depressed prices, the reductions in royalties and PGRT announced in the Western Accord result in substantial increases in returns from existing production, particularly old oil. Approximately half of Canterra's oil production is considered old oil for royalty purposes.



ALBERTA ROYALTY AND INCENTIVE REVISIONS

Consistent with the spirit of the Western Accord, the Alberta government announced changes on June 24 to oil and gas royalty rates and the Alberta Royalty Tax Credit, and the replacement of exploration and development incentives with a new royalty holiday system.

Starting August 1, 1985, marginal royalty rates on crude oil and natural gas production were reduced in stages over two years from 45 to 40 per cent on old production and from 35 to 30 per cent on new production.

Geophysical and drilling incentive systems, which had been in effect in the province since 1975, were eliminated along with the Alberta Petroleum Incentive Program. In their place the government instituted a royalty holiday system providing, in general, for a 12-month royalty-free period for eligible wells to a maximum of \$1 million per oil well and \$2 million per gas well.

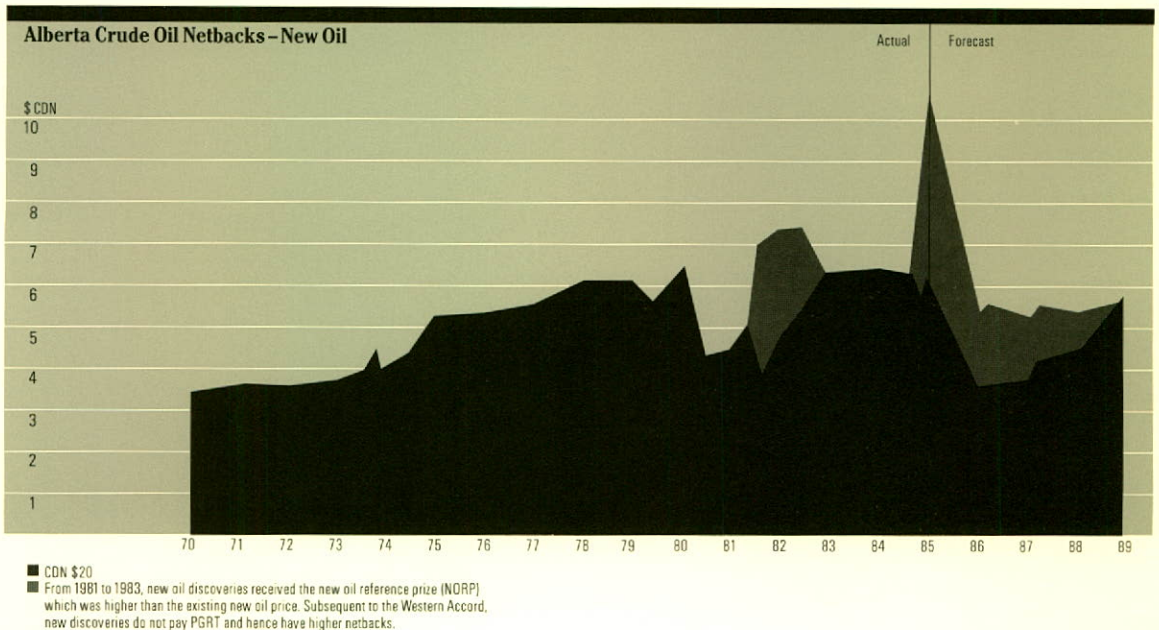
FRONTIER ENERGY POLICY

On October 30, the federal government introduced a new frontier energy policy providing for new petroleum exploration incentives, an improved federal royalty regime and a streamlined regulatory process. Specific changes included: abolition of the Crown share, or 25 per cent "back-in" provision; creation of a refundable 25 per cent Exploration Tax Credit for all exploration expenses above \$5 million per well; a new federal royalty regime similar to the regime for heavy oil and enhanced oil recovery projects in Alberta; a competitive system of land rights issuance based on a single quantifiable bid structure; and an end to the preferential treatment previously accorded to state-owned Petro-Canada.

NATURAL GAS POLICY

In accordance with the Western Accord, on October 31, the governments of Canada, Alberta, British Columbia and Saskatchewan announced an agreement to move toward substantial deregulation of natural gas marketing and pricing. This objective is to be accomplished after a one-year transition period during which the Alberta border and Toronto wholesale prices will be maintained at their current levels. During the transition period, purchasers may negotiate price and volume arrangements directly with the producer in cases where existing contracts expire, or where both parties are in agreement, provided distribution contract carriage arrangements are available. After October 31, 1986 all gas sales will be freely negotiated between producers and distributors or large industrial users.

The single export floor price will be replaced with the export floor prices based on adjacent domestic sales prices. The export flowback system in Alberta will be eliminated after October 31, 1986.



Western Canada Exploration and Production



J. Lindsay Milne, Senior Vice-President, Exploration and Production, Western Canada (front centre); William W. Taylor, Vice-President, Exploration, Western Canada (left); Kenneth J. Fitzgerald, Vice-President, Production, Western Canada (right); Kenneth J. MacRae (far right), Vice-President, Heavy Oil and Tar Sands.

Exploration

The introduction of improved fiscal regimes in 1985 provided a more favourable economic environment for exploration throughout Western Canada. This coincided with Canterra's decision to seek full replacement of produced reserves aggressively through exploratory reserve additions.

The immediate response was an expansion of exploratory expenditures in Western Canada by 30 per cent to \$113.8 million. The majority of the additional expenditures were devoted to the acquisition of new acreage and geophysical data.

LAND

Canterra spent \$30 million on land acquisition during the year, an increase of \$3.5 million over the previous year.

The company acquired 154 000 net hectares of new lands in the western provinces, increasing land holdings to 995 000 net hectares. The competition at Crown sales eased somewhat during the year, making these significant additions possible at attractive prices.

Much of the acreage acquired consisted of large exploration tracts, in keeping with the corporate strategy to broaden the base of exploration acreage and increase the prospect inventory.

The most active areas of acquisition complemented exploration activity at Rainbow, Hinton, Smoky Heights, and Chedderville in Alberta.

SEISMIC

More than \$25 million was spent on geophysical activities, principally on the acquisition of seismic data. Almost 6 900 km of field seismic data was shot, with 60 per cent operated

Western Canada Land Holdings (thousands of hectares)

	1985		1984	
	Gross	Net	Gross	Net
Alberta	1,909	729	1,921	680
British Columbia	440	218	445	213
Saskatchewan	101	47	70	33
Northwest Territories	12	1	12	1
Total	2,462	995	2,448	927

Canterra Net Land Holdings



Major Exploration Areas



- 1 Keg River Basins
- 2 East Peace River Arch
- 3 Peace Coulee-Smoky Heights
- 4 Strachan-Ricinus

by Canterra. In addition, 7700 km of seismic data was purchased. Existing coverage and inventories of gravity and magnetic data were supplemented during the year with a number of small programs in British Columbia and Alberta.

The acquisition of data occurred in all areas of Western Canada, but was concentrated on the flanks of the Peace River Arch, in the Hinton area of western Alberta, and in the Keg

River basins of northern Alberta, where three-dimensional seismic data were increased substantially. Regional seismic surveys were acquired in western Saskatchewan, and several expensive lines of data were recorded in the difficult terrain of the Falls Mountain-Sukunka Valley area of British Columbia.

Seismic Activity

	1985	1984
Kilometres shot	6,852	3,927
Kilometres purchased	7,697	6,797
Total kilometres acquired	14,549	10,724
Total kilometres processed	12,412	11,694

Western Canada Drilling Activity – 1985

	Exploratory Wells		Development Wells	
	Gross	Net	Gross	Net
Oil	41	22.8	119	38.2
Gas	15	6.3	108	11.7
Dry/suspended	58	30.2	25	9.4
Total	114	59.3	252	59.3
Success rate (%)	49.1	49.1	90.1	84.1
Drilling at year end	8	4.5	13	5.0

DRILLING ACTIVITY

The gross number of exploratory test wells decreased to 122 from 149 in 1984; however, net exploratory tests rose to 63.8 from 59.1 underscoring Canterra's strategy to increase the company's interest in joint ventures.

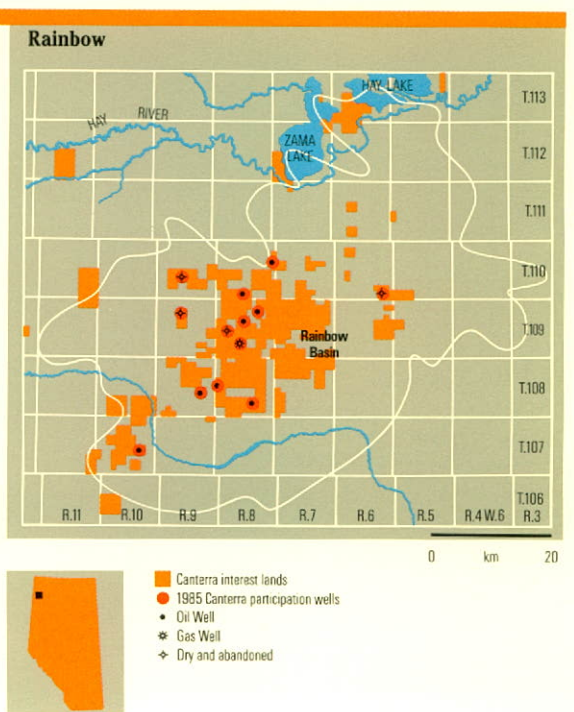
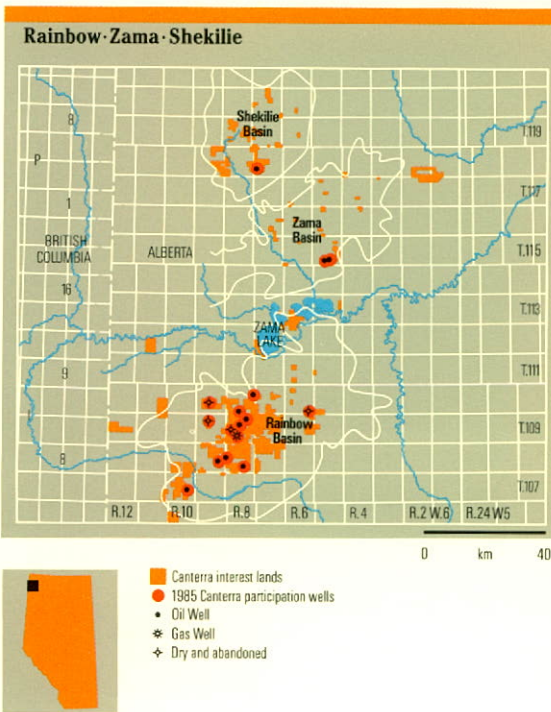
The overall success ratio for exploratory wells in 1985 declined to 49.1 per cent from 56.6 per cent in 1984, reflecting participation in riskier wells that allow for a greater chance of finding large reserves. The success ratio for strictly new field or new pool wildcats was 27 per cent, a level in line with previous years.

Canterra operated 72 (63.2 per cent) of the exploratory tests in which it participated, drilling 103 000 metres compared to 89 500 metres in 1984. As a result, in 1985 the company was the sixth largest exploratory test operator in Canada compared to eleventh last year.

EXPLORATION ACTIVITY

Increased resources were allocated to locating new gas pools, thereby increasing gas and sulphur reserves and moving toward full replacement of produced reserves.

As a result of this strategy, the percentage of expenditures allocated to oil exploration decreased to 50 per cent from 60



per cent in 1984. However, the program was very successful in establishing record volumes of new liquid reserves, replacing almost 80 per cent of the liquids produced in 1985.

Exploratory drilling in the Rainbow, Zama, and Shekile basins was successful in locating new oil bearing reefs, with reserves in one pool reaching 250 000 cubic metres. Closely-gridded seismic surveys in these basins, allowing three-dimensional interpretations of potential reservoirs, have indicated additional anomalies similar to those that have resulted in successful discoveries in 1985.

The Rainbow Basin continued to be a focus of other types of exploratory activity, particularly in an effort to extend the producing area of several shallow oil and gas pools discovered in 1984.

Exploration continued on both the eastern and southern flanks of the Peace River Arch, yielding some successes in the Slave Point and Wabamun formations. The reserves added from oil discoveries in the Slave Point formation at Randell and Driftpile are quite modest, with current data indicating only limited possibility for additional reserves. Land acquisitions and drilling in the Slave area resulted in extensions to the previously established producing area. An oil discovery was made at Bat Lake, but due to difficult, winter-only access, evaluation of this success is incomplete.

A number of oil discoveries were made at scattered locations in central Alberta and western Saskatchewan but, from initial evaluations, they are of modest size.

Exploration for new gas reserves was moderately successful with 39 per cent of gas production replaced by reserve discoveries. Deep tests were conducted in western Alberta and Strachan, Hunter Valley and Sundre. New data acquired during

the year and the re-analysis of existing data have resulted in the development of several new prospects in this promising gas-prone but technically difficult area.

The exploratory Caroline test at Sundre failed to encounter the anticipated highly-sulphurous gas-bearing Leduc formation and was abandoned. However, the failure has not eliminated the potential for gas in the region. Newly-acquired exploratory data are providing leads that may result in additional drilling prospects.

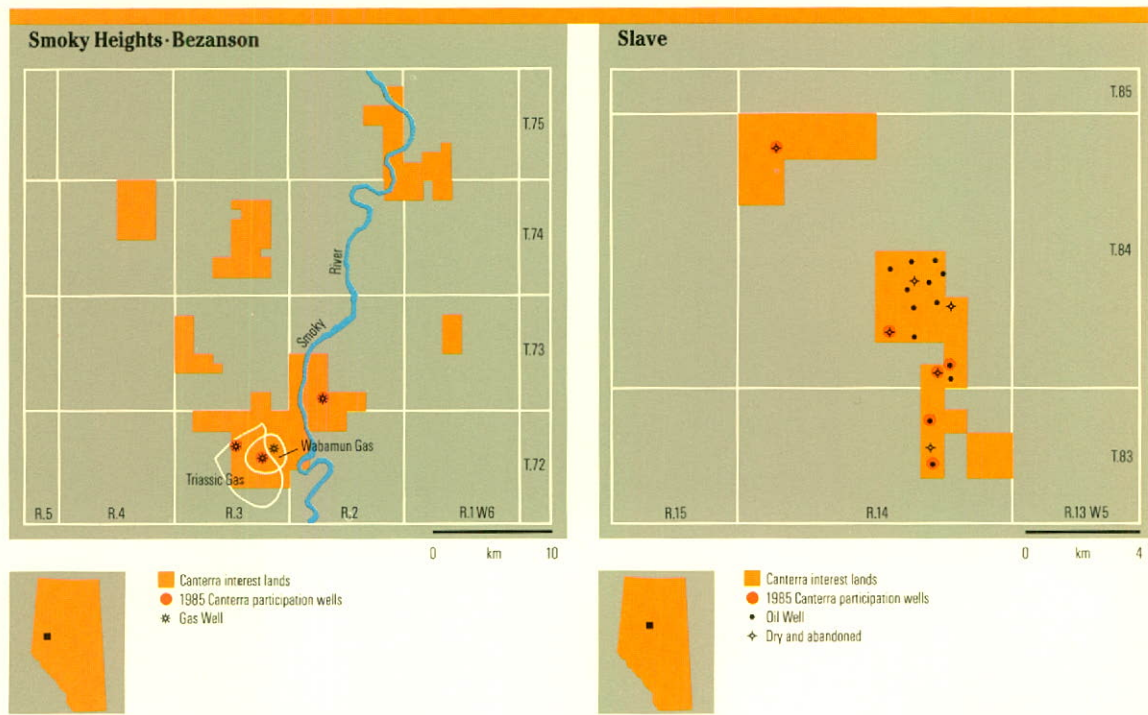
Drilling for shallower gas targets in the Strachan-Ricinus area was successful in extending several existing gas pools. A test at Blackstone was cased as a potential gas well, with strong evidence of very high pressured, sulphurous gas in the Nisku formation. Evaluation of this well is planned for early 1986.

The majority of gas successes occurred in northwestern Alberta where the Kiskatinaw formation provided significant gas reserves at Pouce Coupe and Doe Creek. Continuing geological and geophysical work has resulted in the identification of additional prospects and opportunities that will be evaluated in 1986.

Production

The year was active and highly successful in oil and natural gas production in Western Canada. The positive financial impact of the Western Accord and new royalty regimes were reflected in increased drilling activity with numerous development wells being drilled to take advantage of PGRT and royalty-free opportunities.

Capital spending totalled \$79.0 million, an 80 per cent increase over 1984. While ongoing investments were required to sustain production from existing fields, most of the expen-



ditures were directed at exploiting new discoveries, drilling development wells and enhanced oil recovery schemes, all of

Western Canada Oil and Gas Liquids Sales Volumes and Prices

		1985		1984	
		10 ³ m ³	Average Sales Price Per m ³	10 ³ m ³	Average Sales Price Per m ³
Rainbow Lake	Before royalties	1,069	\$ 228	1,169	\$ 211
	After royalties	802		826	
Other Canada	Before royalties	638	214	563	198
	After royalties	483		414	
Total	Before royalties	1,707		1,732	
	After royalties	1,285		1,240	

Western Canada Gas Sales Volumes and Prices

		1985		1984	
		10 ⁶ m ³	Average Sales Price Per 10 ³ m ³	10 ⁶ m ³	Average Sales Price Per 10 ³ m ³
Ram River	Before royalties	894	\$ 99	1,021	\$ 105
	After royalties	620		713	
Other Canada	Before royalties	923	94	770	100
	After royalties	684		573	
Total	Before royalties	1,817		1,791	
	After royalties	1,304		1,286	

which added significantly to reserves. Canterra's production expenditures in 1985 were through numerous selected small investments, reflecting the maturity of the Western Canadian basin where there is a good infrastructure to service new wells.

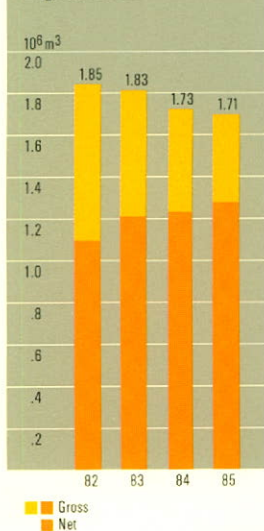
Canterra's exploration and development programs were very successful in 1985. During 1985, Canterra drilled 252 (59 net) development wells, resulting in 119 (38 net) oil and 108 (12 net) gas wells. New exploratory and development wells brought on stream from Canterra and partner-operated properties in Alberta added 530 cubic metres per day of oil and 495 000 cubic metres per day of gas by year end.

Conventional crude oil and natural gas liquids production before royalties decreased 1.4 per cent in 1985; however, volumes after royalties increased 3.6 per cent due to lower royalties on new oil discoveries and tertiary oil production. Production volumes before royalties were 4 678 cubic metres per day.

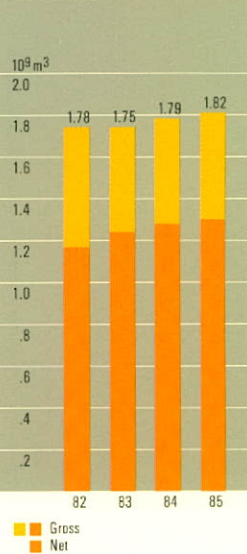
Natural gas sales before royalties increased two per cent during 1985 to nearly five million cubic metres per day. After royalties, gas sales increased 1.4 per cent, but average gas sales prices declined by seven per cent. Deliverability potential was substantially enhanced during 1985 from properties throughout Alberta. Reduced contract sales volumes resulted in a 12.4 per cent decline of Ram River area gas sales. Because of the decreased sour gas throughput at Ram River, sulphur production declined by 11.3 per cent to 1 957 tonnes per day.

Canterra's gas and sulphur production capability was enhanced by the Blackstone 7-5 well (Canterra's interest 36.6 per cent), which is capable of production at rates up to 2.8 million cubic metres of gas per day, making it one of the most prolific natural gas wells in Alberta. Completion of the Rainbow Lake expansion project early in the year significantly increased gas liquids production for use in miscible injection schemes.

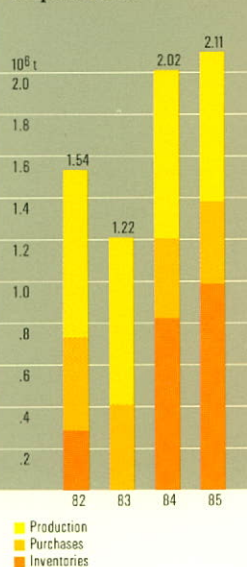
Oil and Gas Liquids Sales



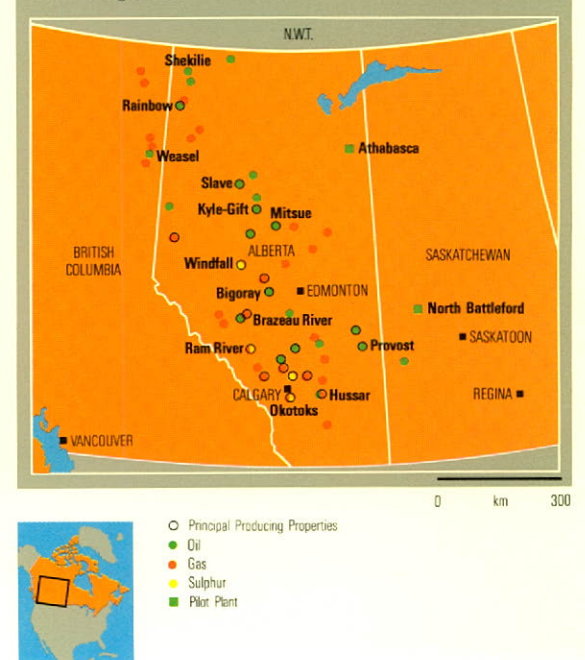
Gas Sales



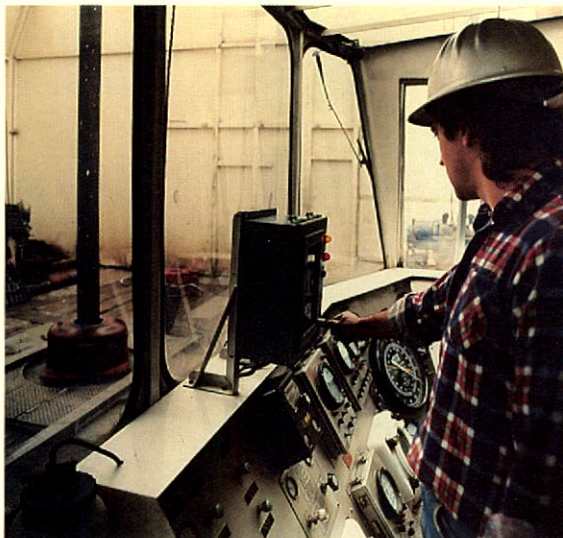
Sulphur Sales



Producing Areas



A rig used to drill an exploratory gas well in south-western Alberta is equipped with state of the art technology that monitors, compiles and transmits drilling data. This equipment results in a highly-efficient and cost-effective operation.



Sulphur

Proved sulphur reserves of 800 000 tonnes were added as a result of performance re-appraisal and inventory adjustments for several properties. This slightly exceeded 1985 sulphur production of 700 000 tonnes but an active marketing program required inventory draw downs of 1.0 million tonnes. The reserve life index for sulphur is 6.1 years.

HEAVY OIL AND TAR SANDS

Production from Canterra's two heavy oil recovery pilot projects increased significantly from 1984.

Total bitumen production from the Athabasca pilot plant, approximately 110 km northeast of Fort McMurray in north-

eastern Alberta, exceeded 21 000 cubic metres, an increase of 155 per cent. The operation, which is on a 19 770 hectare lease, is testing a proprietary modified steam-drive process. Results from the new B pattern (see below) implemented in 1985 have been encouraging.

Canterra holds a 51 per cent interest in the lease on which the pilot project is located. The Alberta Oil Sands Technology and Research Authority (AOSTRA) is financing 25 per cent of the pilot project's expenditures.

The North Battleford pilot project, on joint-interest lands near North Battleford, Saskatchewan, is testing a cyclic steam stimulation process followed by steam drive. In 1985, following completion of the cyclic steam phase, the operation, in which Canterra holds a 33 $\frac{1}{3}$ per cent interest, was converted to steam drive which resulted in a 15 per cent increase in oil production to 37 300 cubic metres.

Outlook

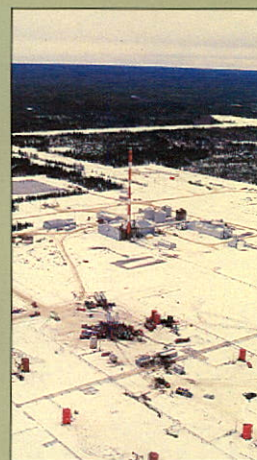
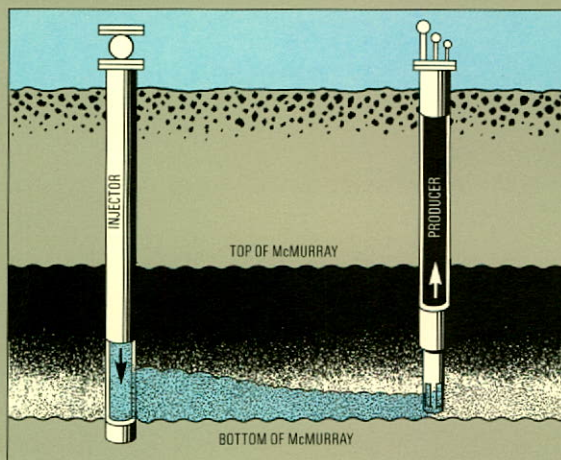
The optimism resulting from the Western Accord and positive royalty regimes has been tempered by declining oil and natural gas prices. Nevertheless, these regimes continue to contribute to favourable economics for new exploration projects. Canterra anticipates that capital spending in 1986 will be below 1985 levels due to uncertainty about product prices.

Until price stability returns, the company will be highly selective in investment projects. Development projects, which are characterized by high rates of return and provide immediate cash flow, are unlikely to be severely affected.

In Western Canada, considerable service cost reductions are anticipated due to excess capacity.

Athabasca

During February, 1985 the second of two test patterns ('B' Pattern) at the Athabasca Pilot was brought on stream. Unlike conventional oil, bitumen in the McMurray Formation is essentially a solid in the ground. To establish a fluid communication path between the central steam injector and the surrounding producers, a major fracture was created by pumping fluids into the reservoir. This allows a path for the steam to heat and move the bitumen to the producing wells.



Bitumen pumped from producing wells surrounding the central steam injector is treated at the plant facility before shipment to market.

Marketing

SULPHUR

Sulphur demand, which had recovered during the second half of 1983 and continued to grow throughout 1984, stabilized in 1985. Despite the leveling off in consumption, demand continues to exceed production on a global basis which will ensure market stability during early 1986.

Contract prices remain stable due to the fundamental global imbalance between consumption and production. This imbalance, which has existed since 1978, necessitates the remelting of Canadian inventories to meet demands.

Marketing

Following strong sulphur sales in 1984, Canterra's sulphur sales volumes increased slightly in 1985, principally due to strong export demand in the offshore markets in the first half. Sales to the United States declined during 1985. This was due to lower consumption and operating rates by the United States phosphate fertilizer industry, and Canterra's marketing strategy of concentrating on offshore sales where netbacks are higher.



D. Michael Stewart,
Vice-President, Corporate
Development and Marketing.

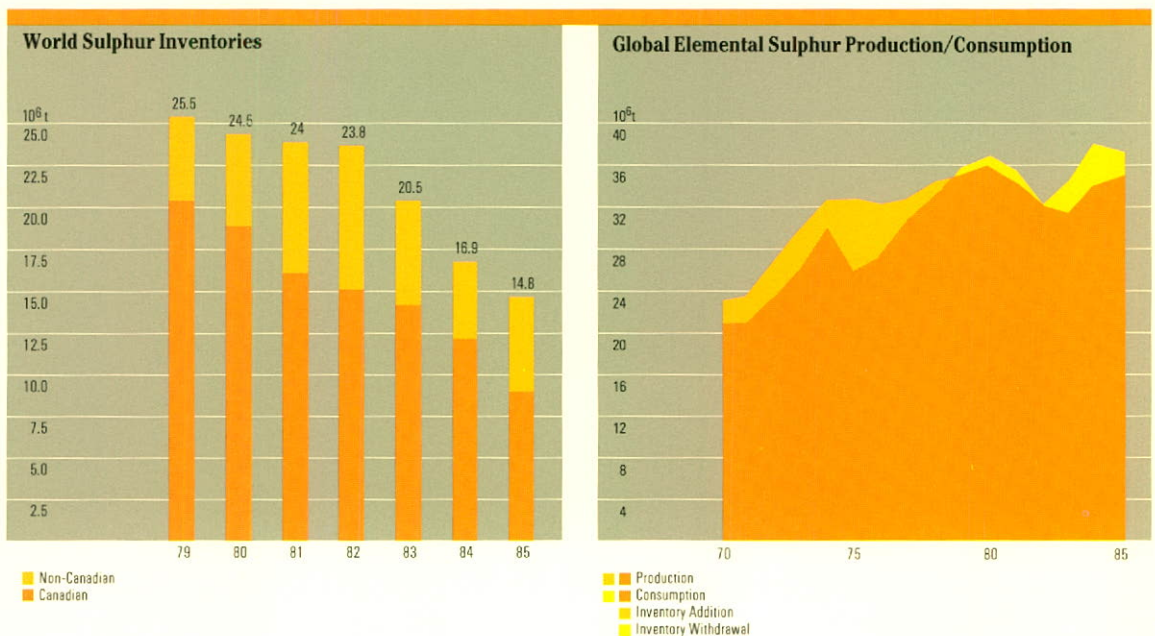
Sales revenues increased by 65.6 per cent primarily because of price increases implemented in the first and second halves of 1985 by Canterra and Cansulex Limited, a marketing company owned by 21 Alberta sulphur producers, including Canterra. The Vancouver base contract price improved from US \$105 per tonne in the second half of 1984 to US \$125 per tonne in the first half of 1985 and US \$135 per tonne in the second half. Canterra increased its prices under its Canadian and U.S. sales contracts in parallel with the higher prices being received in the offshore market.

Supply

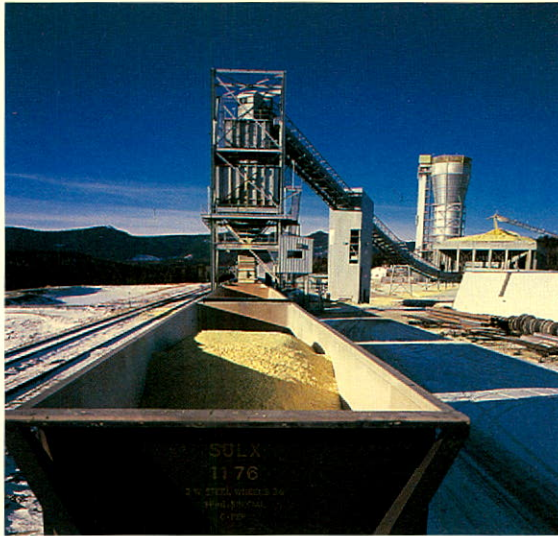
Of the company's 1985 sulphur sales of 2.1 million tonnes, 34 per cent was derived from natural gas production, 19 per cent from purchases and 47 per cent from the company's above-ground inventories. While Canterra's above-ground inventories declined by more than 900 000 tonnes at year end, additions of sour gas reserves during the year replaced production. Canterra continues to expand its drilling program for sour gas which, if successful, will offset future declines in above-ground reserves which now represent 30 per cent of inventories held by Canadian suppliers and 20 per cent of world inventories.

Outlook

Contract prices are expected to remain stable during 1986. Prices should increase as markets expand and continued demand is placed on Canadian and Canterra's above-ground inventories to balance global supply to demand.



Canterra's Ram River plant has the capacity to load more than one sulphur unit train per day for transportation to market. With an annual supply capability of more than two million tonnes, Canterra is the largest sulphur supplier in Canada.



CRUDE OIL

Following deregulation of crude oil marketing on June 1, Canterra effected the transition from a regulated to a decontrolled crude oil market by taking all production in kind. The company has successfully contracted all Canadian oil production since June 1, realizing moderately better netbacks on sales during the last half of 1985 compared to posted prices of Canadian refiners.

To mitigate the effects of oil production prorating in Alberta, which has resulted primarily from pipeline capacity constraints, Canterra selectively entered into supplementary oil sales agreements to reduce shut-in production. This resulted in netbacks at or above those under contract sales.

At year-end 1985, in anticipation of potential significant declines in international crude prices, the company expanded efforts to secure markets in Canada and the United States which would maximize netbacks.

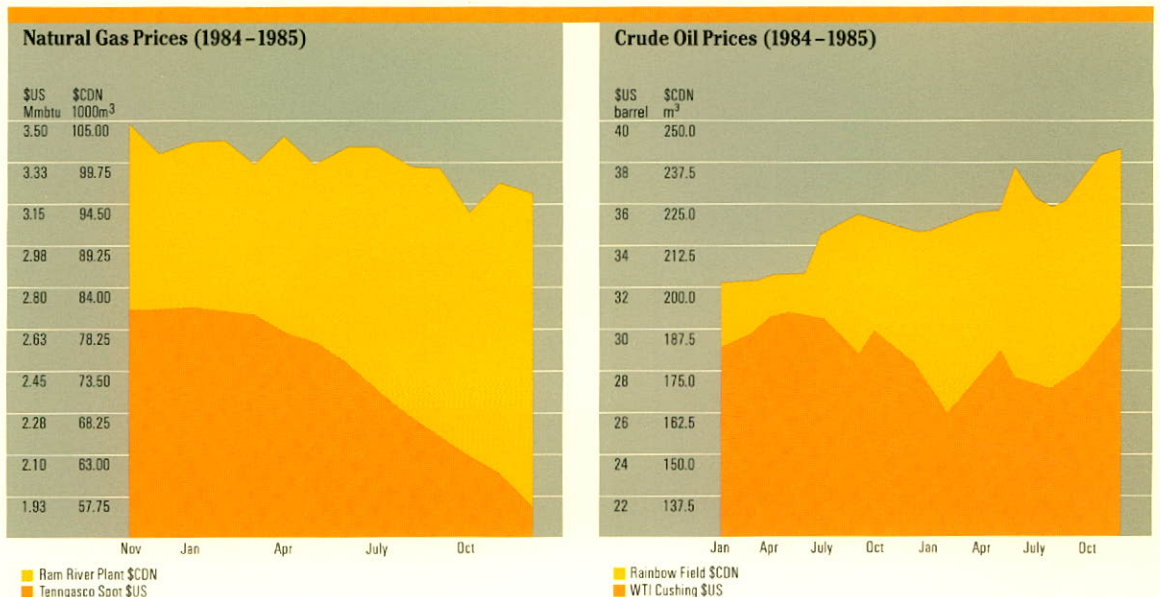
NATURAL GAS

Canterra's 1985 gas sales increased moderately over 1984 following a reduction in the minimum purchase obligation by Canterra's major purchaser. This reduction was offset by increased sales to purchasers with predominantly United States markets.

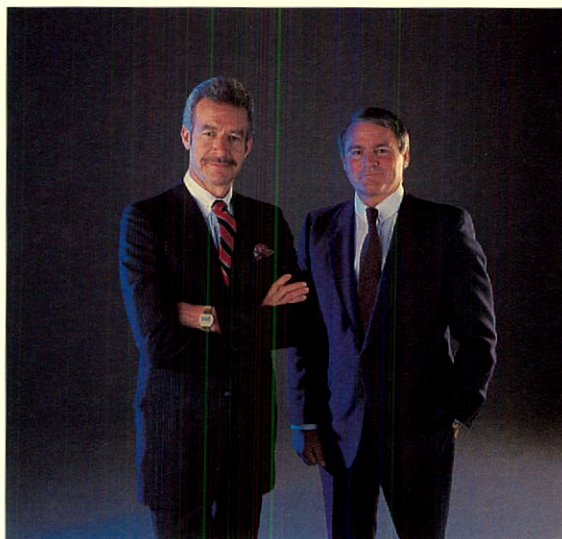
Natural gas sales during 1985 were approximately 55 per cent of Canterra's developed gas capacity. For the year, sales under long-term contracts were 64 per cent of buyers' purchase obligations.

The result of the federal government's October 31 natural gas policy, which calls for a deregulated environment by November 1986, will be restructuring of the marketplace during 1986.

To be able to pursue direct sales opportunities aggressively in the increasingly competitive gas marketplace, Canterra is developing new marketing strategies, upgrading the company's marketing information base and expanding its marketing organization.



Frontier Canada Exploration and Production



William L. Kaufmann, Senior Vice-President, Exploration and Production, Frontier Canada, President, Canterra Petroleum Inc. (left); R. George Scott, Vice-President, Production, Frontier Canada.

During 1985, the last full year of the frontier exploration incentive grant system, the industry's search for Canada's long-term energy resources was at a high level. Canterra's activity level was also high with interests in 24 frontier wells compared to 18 the preceding year. The company's involvement was strongest in the offshore areas of Newfoundland and Nova Scotia with participation in 16 wells. Canterra spent 73 per cent of its frontier exploration capital expenditures off the east coast, in keeping with the objective of concentrating the search for resources where the physical environment allows for an expectation of earlier return on investment.

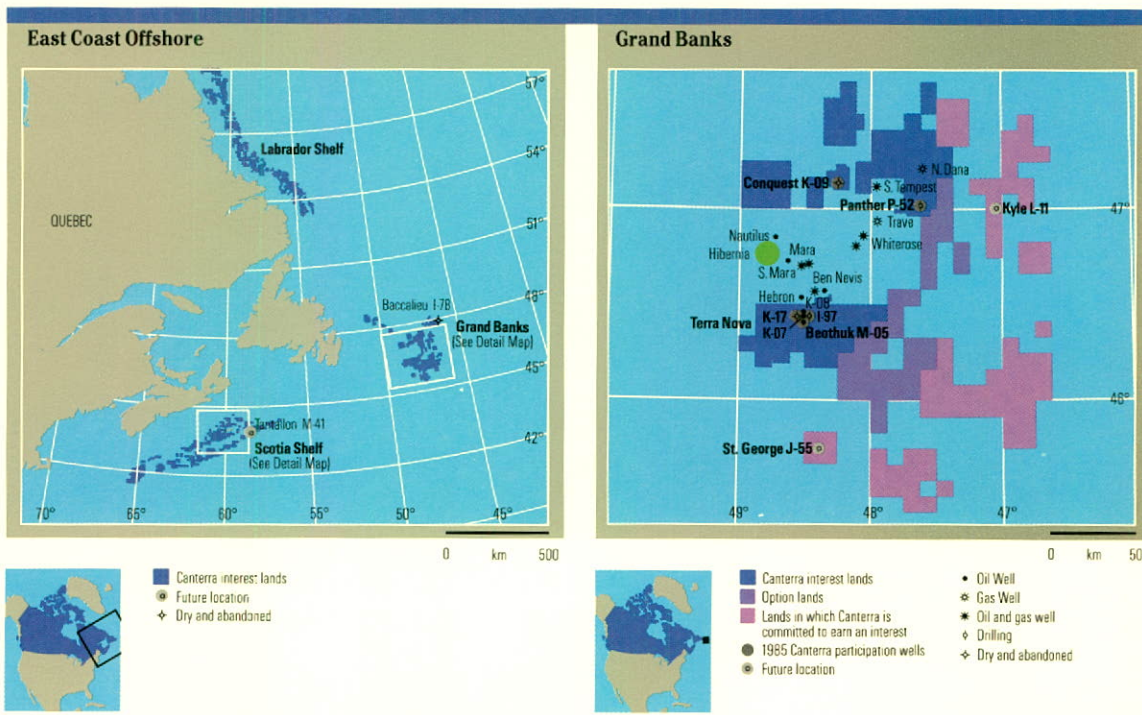
Exploration

Canterra invested \$73.8 million in frontier areas during 1985 and received \$53.1 million in PIP grants. The 24 wells in which the company participated resulted in four oil wells, six gas wells

Frontier Canada Land Holdings (thousands of hectares)

Area Name	1985		1984	
	Gross	Net	Gross	Net
Arctic (incl. Hudson Bay)	667	105	390	[277]
Beaufort	765	178	736	[60]
N.W.T./Yukon	1,280	310	413	[18]
Labrador Sea	3,816	685	3,904	707
Newfoundland offshore	690	[836]	240	[849]
Nova Scotia offshore	338	[2,619]	193	[2,668]
Total	7,556	[3,455]	5,876	[3,872]

[] Approximate land in which Canterra has the right/obligation to earn additional interests.



and 10 abandonments; four wells were still drilling at year end. The exploratory wells table presents basic data on these wells. Canterra acquired, through purchase or partnership operations, 30 000 km of seismic in its preferred exploration areas.

At year end, Canterra held interests in 7.5 million hectares (1.4 million net) of Canada Lands and had obligations, rights and options to earn interests in an additional 4.2 million hectares (500 000 net). Canterra was a successful bidder at the first Crown sale of offshore Nova Scotia Exploration

Agreements, with the acquisition of Exploration Agreement 270 which the company operates on behalf of a group. Through the purchase of all shares of Texas Eastern Exploration of Canada Ltd., Canterra acquired proved reserves in the Thebaud gas field and an interest in gas prospective lands in the general Sable Island area.

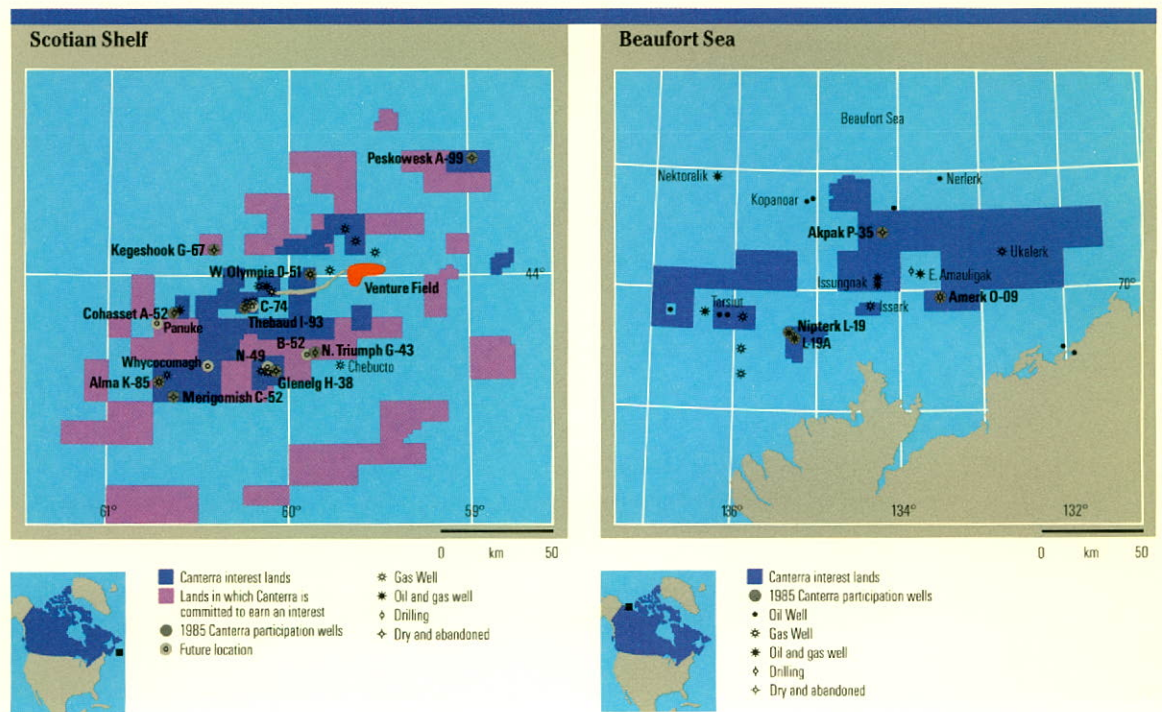
With the objective of finding significant frontier resources, Canterra's strategy has been to take advantage of incentive programs. Since 1981, it has invested \$451 million in frontier exploration (\$104 million after incentive grants), participated

Exploratory Wells at year end 1985

Well Name	Cost Interest %	Net Interest %	Status/ Results	Well Name	Cost Interest %	Net Interest %	Status/ Results
Shell Glenelg H-38	28.0	19.0	D & A	Esso Baccalieu I-78	11.0	5.5	D & A
Shell Alma K-85	22.0	12.8	Gas	Petro-Canada Terra Nova K-07	8.3	8.3	Oil
Shell Peskowsk A-99	17.5	8.8	D & A	Canterra Terra Nova K-17	8.3	8.3	D & A
Shell Kegeshook G-67	8.8	8.8	D & A	Petro-Canada Terra Nova I-97	50.0	17.5	Drilling
Shell Merigomish C-52	11.0	11.0	D & A	Esso Amerk 0-09	4.3	2.1	Gas
Shell N. Triumph G-43	30.0	15.0	Drilling	Esso Nipterk L-19	4.3	2.1	Oil
Mobil Thebaud I-93	9.0	9.0	Gas	Esso Nipterk L-19A	2.1	2.1	Oil
Mobil W. Olympia 0-51	12.6	6.3	Gas	Gulf Akpak P-35/2P-35	7.7	17.6	D & A
Petro-Canada Cohasset A-52	9.0	9.0	Drilling	Petro-Canada Tweed Lake M-47	50.0	25.0	Gas
Canterra Beothuk M-05	25.0	12.0	Oil	Petro-Canada Tweed Lake A-67	25.0	25.0	Gas
Husky Conquest K-09	10.0	5.0	D & A	Trillium Beluga 0-23	5.0	2.5	D & A
Husky Panther P-52	12.5	6.3	Drilling	ICG Netsiq N-01	5.0	2.5	D & A

Total Wells

4 oil	.25 net
6 gas	.80 net
10 D & A	.89 net
4 drilling	.48 net
24 wells	2.42 net





Canterra operated four offshore wells in 1985. During 1986, the company will concentrate on delineation and development of discoveries where the physical environment allows for an expectation of earlier return on investments.

in 50 (5.8 net) wells of which 7 (.5 net) resulted in oil wells and 13 (1.6 net) in gas wells. From an initial position of no representation in the Grand Banks and Scotian Shelf, Canterra now has varying interests in one million hectares of federal Exploration Agreements in these areas. The company is a partner in the Terra Nova oil discoveries southeast of Hibernia and the Scotian Shelf gas discoveries Glenelg, Alma, Uniacke and North Triumph. In addition, in 1985 the company acquired a position in the Thebaud gas and Cohasset oil fields.

The company has built a substantial technical data base and established itself as an efficient off-shore operator.

NOVA SCOTIA OFFSHORE

Delineation drilling was carried out to assess the size of previous discoveries. An easterly offset well at Glenelg H-38 encountered poor reservoir development and was abandoned, while the first delineation well at Alma (K-85) tested gas and condensate in five drillstem tests. The upper three tests flowed gas at rates from 272 000 to 856 000 cubic metres per day. Canterra also participated through a farm-in in delineation drilling at West Olympia 0-51 which flowed gas at a maximum rate of 595 000 cubic metres on drillstem test. Drilling at Thebaud I-93, a project which was part of the purchase of Texas Eastern Exploration Canada assets, yielded gas flows of 782 000 cubic metres per day.

Wildcat wells at Peskowesk A-99, Kegeshook G-67 and Merigomish C-52 were less successful and were abandoned. A well at North Triumph G-43 encountered excellent gas pay in the Missisauga reservoir sands at year end, which was confirmed early in 1986 by two separate drillstem test flows of approximately one million cubic metres per day each.

Drilling is under way at Cohasset A-52, an offset to a previous light oil discovery in which Canterra acquired an interest through the Texas Eastern acquisition.

GRAND BANKS

In the area of the Terra Nova oil discovery, delineation drilling took place in 1985. The Canterra-operated Beothuk M-05 well tested oil on three drillstem tests with the largest flow being 228 cubic metres per day. A western offset at Terra Nova K-17, also Canterra-operated, was dry but a well at K-07 recorded flows of 656 and 628 cubic metres per day respectively. A further delineation well, I-97, to the east, was drilling at year-end and has since been tested at rates up to 790 cubic metres per day, the largest recorded to date in the Terra Nova field. Canterra has taken an additional farm-in on this well to increase its earned interest to 17.5 per cent in 18 000 hectares. Other Canterra interest wells in the Grand Banks area were Conquest K-09 which was abandoned and Panther P-52 on which operations are still continuing. Canterra holds small interests in these exploratory ventures.

OTHER AREAS

Two wells were drilled in the Tweed Lake area, north of Norman Wells, where a 1984 farm-in agreement has earned Canterra a 25 per cent interest in an Exploration Agreement. Both wells were suspended as potential gas wells. Further drilling in the area is under way.

In the Beaufort Sea, Canterra took part in the drilling of the Nipterk L-19 oil discovery well and its successful directional delineation well L-19A. Two of the oil zones in L-19 each tested maximum flows of more than 500 cubic metres per day and the L-19A well had similar results. The nearby Amerk O-09 well discovered gas at rates of 510 000 cubic metres per day. Canterra has a 2.14 per cent interest in these wells. The company farmed out most of its interest in the Akpak P-35/2P-35 well which failed to find any encouraging results.

In Hudson Bay, the company acted as manager/operator on the Beluga O-23 and Netsiq N-01 wells on behalf of two groups of companies. The company had a five per cent cost interest in both wells which were abandoned.

In the Flemish Pass area off Newfoundland, Canterra participated in the Baccalieu I-78 well which yielded important geologic information but which was abandoned without testing.

Production

Canterra's frontier production department conducts economic and technical feasibility studies on frontier development prospects and offshore drilling operations. Four offshore wells were operated by Canterra in 1985.

The company is investigating the feasibility of economic production from its offshore discoveries at Terra Nova and on the Scotian Shelf. Systems currently being used in the North Sea indicate that pools such as Terra Nova, which are of modest proportions, can be economically exploited.

On the Scotian Shelf, it is becoming apparent that pools such as Alma, Glenelg and North Triumph may provide incremental reserves which could make the Venture development scheme economically successful. Through its nine per cent interest in the Thebaud pool, Canterra is now a participant in the Venture pre-development process.

Outlook

Further delineation drilling is planned offshore Nova Scotia for 1986 at Glenelg and North Triumph, while off Newfoundland further delineation and extension drilling is likely to take place at Terra Nova. Exploratory wells are planned for St. George, to be operated by Canterra 75 km southeast of Terra Nova, and in the Flemish Pass at the Kyle location and on the Scotian Shelf.

The company's emphasis in the post-PIP era will be on delineation and development of discoveries, continuing to work on lowering development costs and on expanding Canterra's activities in the MacKenzie Valley corridor.

U.S. Exploration and Production

Note: All dollar amounts in the report are in Canadian dollars unless stated otherwise.

The United States oil and gas industry continued to operate in a very competitive and uncertain environment in 1985. Sharply reduced industry activity during the year was the result of three factors: financial restructuring of the industry, lower natural gas prices and expected oil price decreases, and anticipated tax

reforms. Natural gas spot prices declined approximately 30 per cent over the year and the active drilling rig count declined from an average of 2 525 in 1984 to 1 981 in 1985.



Douglas K. Thompson,
Executive Vice-President,
Canterra Petroleum Inc.

U.S. Drilling Activity

	Exploratory Wells		Development Wells	
	Gross	Net	Gross	Net
Working interest				
Oil	11	2.39	-	-
Gas	7	1.58	2	0.51
Abandoned	16	5.03	1	0.35
Drilling/suspended (at year end)	4	0.81	-	-
Total	38	9.81	3	0.86
Royalty interest				
Oil	3			
Gas	-			
Abandoned	9			
Drilling/suspended (at year end)	3			
Total	15			

Exploration

The company had an active exploratory drilling year in 1985 with a total of 38 wells, a 23 per cent increase from the previous year. Of these, 11 (2.4 net) were oil and 7 (1.6 net) were gas discoveries. In addition, 12 exploratory wells, drilled on farmout lands at no cost to the company, resulted in three oil wells.

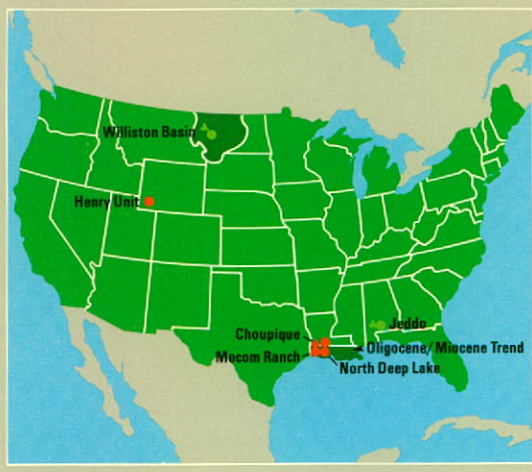
Most of the U.S. \$13.9 million capital expenditures was invested on the Oligocene/Miocene Trend in the Gulf Coast region where Canterra's operations are directed toward the finding and producing of natural gas and condensates. This region affords the best opportunity for reserve growth and economic return.

Exploration for oil in the Williston Basin declined in 1985, as land holdings expired, and was eventually discontinued in early 1986. The company will concentrate all its exploration efforts in the Gulf Coast which affords the best opportunity for major reserve growth and above-average economic growth.

A successful natural gas exploration program increased natural gas reserves by 14 per cent. This was largely the result of gas discoveries on the Mecom Ranch and at North Deep Lake in Cameron Parish, Louisiana and a gas condensate discovery in Calcasieu Parish at Choupique.

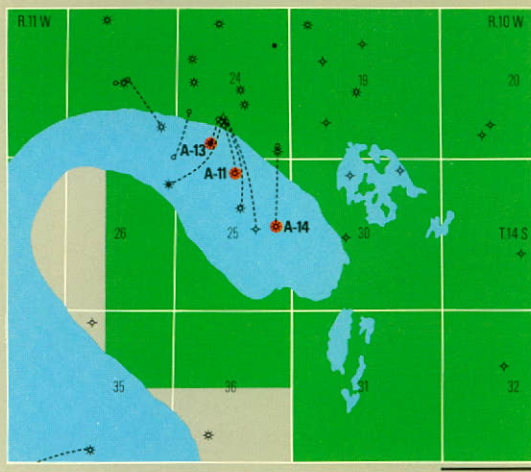
Oil and gas liquids reserve additions and revisions of 133 000 cubic metres slightly exceeded production of 130 000 cubic metres. A major contributor to the year's production was an oil discovery in southern Louisiana on the Jeddo Prospect.

Major Areas of Activity



Principal Producing Properties ● Oil ● Gas
Major Areas of Exploration ▲ Oil ▲ Gas

Mecom Ranch



● Canterra interest lands
● 1985 Canterra participation wells
● Oil Well
* Gas Well
* Oil and gas well
○ Location
◇ Dry and abandoned

0 km 1

Production

While the company's working interest production of oil and natural gas liquids decreased by some five per cent to a daily

U.S. Proved Reserves

	Oil & Gas Liquids 10 ⁶ m ³		Natural Gas 10 ⁹ m ³	
	Gross	Net	Gross	Net
Reserves at 31/12/1984	0.468	0.386	1.274	0.904
Revisions	0.001	-	(0.022)	(0.012)
Discoveries/extensions	0.133	0.104	0.332	0.246
Production	0.130	0.107	0.141	0.107
Reserves at 31/12/1985	0.472	0.383	1.443	1.031

rate of 357 cubic metres, natural gas production increased by approximately 40 per cent as a result of aggressive marketing and new discoveries in the Gulf Coast area.

Despite the average decline of 15 per cent in the industry price of oil and natural gas liquids, the reduction of revenue from operations was held to seven per cent because of the substantial increase in gas sales.

Outlook

Reduced activity in oil and gas in the United States is expected to extend into 1986 as industry awaits clarification of fiscal and market uncertainties.

Canterra will take advantage of the current downturn by seeking sound investments to capitalize on anticipated longer term opportunities, especially in natural gas on the Gulf Coast.

U.S. Coal

Weak coal markets resulting from a low rate of consumption growth, combined with increased productivity in non-unionized underground coal mines, has resulted in an almost permanent excess productive capacity in the United States. This oversupply of coal has created the most persistent market slump in years.

At the surface mines, shipments were also affected by the weak markets. The impact of fixed costs on much-reduced production volumes resulted in higher unit costs despite productivity gains.

The overall effect for Canterra was an almost 50 per cent reduction in shipments which, combined with stagnant selling prices and higher unit costs, resulted in a loss of \$5.5 million.

Operations

No shipments have been made from Canterra Coal's underground subsidiary since May, following the termination of an 18-year sales agreement. Workers at the subsidiary belonging to the United Mine Workers of America have been on strike since August. Salaried personnel have continued to operate the mines since September and have achieved high productivity gains.

Outlook

The company intends to continue the reorganization of its underground mine and redevelop the operation as market and labour conditions permit.

The productivity gains achieved to date demonstrate the ability of Canterra Coal to successfully compete in the marketplace under appropriate labour conditions.



Jean-Jacques Pascal,
President, Canterra Coal Inc.

Coal Operations*

	1985	1984
Shipments thousands of tonnes	470	887
Average selling price per tonne	\$ 48.73	\$ 45.68
Operating expenses** per tonne	\$ 63.18	\$ 43.45
Operating profits (loss) million \$	(5.5)	2.4

*Canterra Coal Inc. - Consolidated

**Includes depletion, depreciation and amortization

Coal Reserves (Proved clean recoverable)

(millions of tonnes)	1985	1984
Reserves at 31/12/1984	51.1	55.4
Purchases	.1	.3
Revisions of previous estimates	(.3)	(3.7)
Termination of coal lease	(16.2)	
Sales	(.5)	(.9)
Reserves at 31/12/1985	34.2	51.1
Land holdings (gross surface hectares)	12,911	14,900

Corporate Relations



John H. Currie, Senior Vice-President, Administration (left); Lawrence M. MacLeod, Assistant Secretary; W. Stewart Wright, General Counsel and Corporate Secretary (right).

Canterra's corporate affairs activities are integral in the pursuit of operational goals. These activities include recruiting well-trained employees with demonstrated ability and continuing to develop employee skills through appropriate training programs; implementing appropriate safety and environmental programs; maximizing national and regional benefits generated by operations, and keeping communities in which the company operates aware of activities.

HUMAN RESOURCES

The company continued its efforts in 1985 to improve productivity by conducting organizational reviews to develop more effective work procedures, organization and employee commitment.

A recruiting and training program was implemented during the year specifically for new graduate geologists and geophysicists. Selected managers participated in an executive development program. Overall training was increased during the year to ensure employees are equipped to handle their jobs effectively.

At year end Canterra had a total of 1,337 employees in Canada and the United States, a slight decrease from 1984 due to staff cutbacks in the U.S. coal operation.

SAFETY

Operating safe facilities is a cost-effective way of doing business and ensures protection of the company's highly-trained work force. The company's objective is to operate accident-free throughout its operation.

Canterra's management safety advisory group continued active monitoring of the company's safety performance through regular safety audits of company facilities. The audits resulted in a number of valuable suggestions to improve operating procedures.

As a result of the combined effort of supervisors and staff, all 17 Canterra plants received awards from both the Alberta Petro-Chemical Safety Council and the Canadian Gas Processors Association (CGPA) for a full year without a lost time accident. For the third consecutive year, the company's Ram River plant staff was awarded the CGPA's most prestigious award for the industry's safest large plant.

COMMUNITY RELATIONS

At Sundre in west central Alberta, a major program was conducted during a three-month sour gas well drilling operation. Canterra maintained an information office in Sundre throughout the program. Local residents served as communication co-ordinators to keep their neighbours informed daily of drilling progress and to ensure rapid evacuation in the event of an emergency. The program achieved positive results in gaining local understanding and will serve as a guide for future Canterra community communication activities.

Canterra conducts local information programs for all drilling wells designated as "critical" by regulatory authorities. Activities include notification of residents close to well sites of impending drilling programs and the establishment of communication and emergency procedures.

ENVIRONMENT

Canterra's environmental programs are directed at preserving the environment where the company operates and consulting with interested parties on potential environmental effects of Canterra's operations.

During a well test at Panther River, in a remote area of the Rocky Mountain foothills, local users and environmental interest groups participated in programs to ensure wildlife protection, access control and maintenance of water and vegetation quality.

In the frontier region, environmental protection was a key factor during the company's drilling program in Hudson Bay. Meetings were held with a committee representing regional native associations to address the protection of marine life. A wildlife monitoring program was carried out at the drill sites.

CANADA BENEFITS

In support of the company's drilling program in Hudson Bay, Canadian workers were employed on the drilling vessel, businesses from communities around the Bay were approached to support the operation, and employment and training programs were developed to provide local workers with job opportunities. Nunasi Corporation, the Inuit-controlled company responsible for native business interest in the region, provided local manpower services and logistical facilities and 27 local workers were hired for onshore and offshore activities.

Off the east coast, Canterra continued its activities designed to optimize the use of Canadian workers and further the development of Canadian supply capability.

Financial Review



T. Sean Ahern,
Vice-President, Finance (left);
Clarence E. Glessing,
Controller (centre);
Richard P. Norris, Treasurer.

Nineteen eighty-five was a successful year for Canterra in building financial strength and creating value for shareholders. These objectives were achieved by internal growth through selective high return capital expenditures which improved financial ratios and increased cash flow, earnings and asset values.

The Company's interest coverage increased to 2.4 times from 1.7 in 1984, reflecting improved cash flow from operations and lower interest rates and debt levels.

Net earnings for the year increased 110% to \$86.9 million, with earnings per share of \$1.10, continuing the positive growth trend in earnings since 1982.

Free cash flow – the amount available for capital expenditures and debt repayment after deducting all expenses including capitalized charges – continued to strengthen, increasing 66%

to \$310.3 million. On a per share basis, free cash flow was \$3.94, up from \$2.47 in 1984.

The Company materially improved its debt structure during the year by syndicating a 12-year U.S. \$1.4 billion loan and through the issue of common stock and convertible subordinated debentures. The proceeds of the equity issue, combined with internally-generated cash flow enabled the company to make payments on debt of \$130.4 million in 1985. In addition, the Company held cash and short-term investments of \$62.1 million at year end. As a result of these actions, the company has increased its equity base and reduced debt, thereby providing greater financial flexibility to pursue operational strategies.

Public ownership in Canterra is now 4.6% on an undiluted basis and 13.3% after allowing for conversion of debentures to common stock.

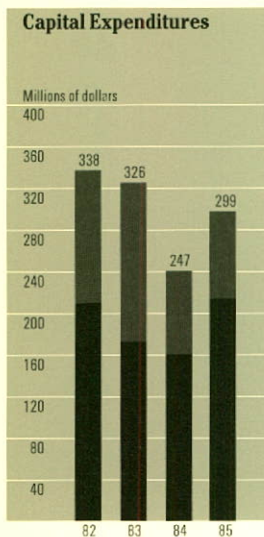
In the medium term, the Company will not pay dividends on its common shares. Earnings instead will be reinvested to generate growth in the value of shareholders' equity.

Canterra's financial objectives over the next five years are ambitious. The Company believes the following objectives are attainable in the medium-term:

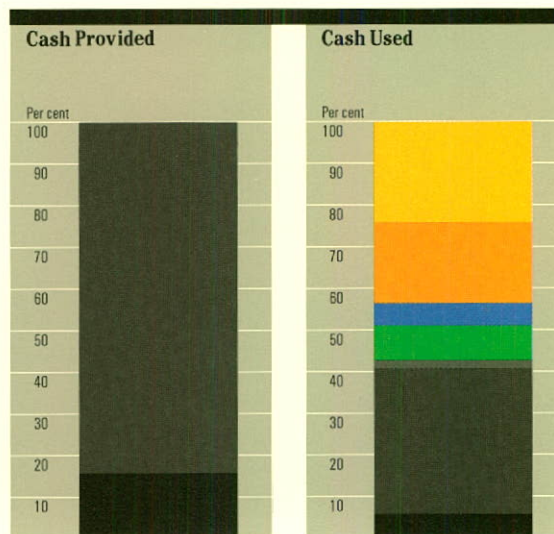
	Target for 1989	Achieved in 1985
Annual return on shareholders' equity	15 per cent	11.7 per cent
Current value of total assets to total debt*	2.5 times	1.6 times
Coverage of financial charges by cash flow after tax	3.0 times	2.4 times

*The current value of total assets to total debt calculation uses standard engineering practices to determine the present value of reserves over the remaining established life using price forecasts in effect at December 31, 1985, discounted at an appropriate rate and before income tax.

Additional discussion is incorporated with the financial statements to improve the usefulness of the financial review section.



■ Gross
■ Net



■ Operating Activities
■ Financing Activities

■ Western Canada Exploration Capital Expenditures
■ Western Canada Production Capital Expenditures
■ Frontier Capital Expenditures
■ U.S. and Other Capital Expenditures
■ Other Transactions
■ Debt Repayments
■ Increase in Cash

Management's Responsibility for Financial Statements

The accompanying consolidated financial statements of the Company were prepared by management in accordance with accounting principles generally accepted in Canada and consistently applied. The significant accounting policies, which management believes are appropriate for the Company, are described in the accompanying "Summary of Significant Accounting Policies." The financial information contained elsewhere in this annual report is consistent with that in the financial statements.

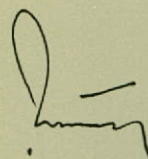
Management is responsible for the integrity and objectivity of the financial statements. In the preparation of these statements, estimates are sometimes necessary when transactions affecting the current accounting period cannot be finalized with certainty until future periods. Such estimates are based on careful judgements and have been properly reflected in the financial statements. Management has established systems of internal control which are designed to provide reasonable assurance that assets are safeguarded from loss or unauthorized use and to produce reliable accounting records for the preparation of financial information.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal control. The board exercises its responsibilities through the Audit Committee of the board, comprising direc-

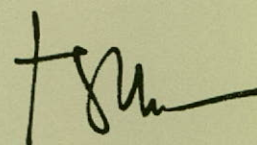
tors who are not employees of the Company. The committee meets with management as well as with the internal and external auditors to satisfy itself that each group is properly discharging its responsibilities and to review the financial statements and the external auditors' report. The Audit Committee reports its findings to the board for consideration in approving the financial statements for issuance to the shareholders.

In management's opinion, the financial statements fairly present the financial position, the operations and cash resources of the Company.

Management recognizes its responsibility for conducting the Company's affairs in compliance with established financial standards and applicable laws and maintains proper standards of conduct for its activities.



B.F. Isautier
Chairman and
Chief Executive Officer



T.S. Ahern
Vice-President, Finance

Auditors' Report

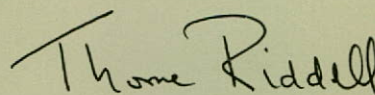
To the Shareholders of Canterra Energy Ltd.

We have examined the consolidated balance sheet of Canterra Energy Ltd. as at December 31, 1985 and the consolidated statements of earnings, retained earnings and cash resources for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, the consolidated financial statements referred to above (pages 22, 23, 24, 26, 28 and 30 to 37) present fairly the financial position of the Company as at December 31, 1985 and the results of its operations and the

changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Calgary, Alberta
February 14, 1986



Chartered Accountants

Summary of Significant Accounting Policies

Canterra Energy Ltd. (the Company) follows accounting policies generally accepted in Canada. The following significant policies are presented to assist the reader in evaluating these financial statements and together with the following notes should be considered an integral part of the consolidated financial statements.

PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of the Company, subsidiary companies and a limited partnership, all of which are wholly owned.

A wholly-owned subsidiary providing certain insurance coverage to the Company is accounted for by the equity method and is included in investments and other assets. The Company's 33 $\frac{1}{3}$ % interest in Rainbow Pipe Line Company, Ltd. is also accounted for by the equity method.

The Company has an equity interest in Cansulex Limited, a producer-owned company that markets sulphur outside North America. The ownership in this company is reallocated annually depending on annual volume commitments by the respective owners. The Company's proportionate interest in sales and accounts receivable are accounted for as incurred.

FOREIGN EXCHANGE TRANSLATION

All foreign subsidiaries are considered to be integrated. Accordingly, monetary assets and monetary liabilities of such subsidiaries are translated at the rate of exchange in effect at the balance sheet date. Non-monetary assets and liabilities together with revenues and expenses are translated at rates in effect at the time of the transactions. Provisions for depletion, depreciation and deferred income are translated at the same rates as the related items. Exchange gains or losses resulting from this translation method are included in the determination of earnings for the year in which realized.

The Company's U.S. dollar denominated debt is translated at the exchange rate in effect at the balance sheet date. To the extent that the Company's U.S. dollar denominated debt is hedged by future U.S. dollar revenue streams, the resulting foreign exchange exposure is deferred and charged to earnings in the period in which debt repayments occur. Any unhedged foreign exchange exposure is amortized to earnings over the life of the debt.

INVENTORIES

Inventories include materials, supplies, purchased sulphur and coal and are stated at the lower of cost or net realizable value.

PROPERTY, PLANT AND EQUIPMENT

The Company follows the full cost method of accounting whereby all costs of acquiring properties, exploring for and developing oil, natural gas and sulphur and related reserves are capitalized and accumulated in country-by-country cost centres. Such expenditures include land acquisition costs, geological and geophysical expenses, capitalized financing costs and other carrying charges of undeveloped properties, costs of drilling productive and non-productive wells and overhead expenses directly related to exploration and development activities.

Maintenance and repairs are charged against earnings and renewals and betterments which extend the economic life of the properties, plant and equipment are capitalized.

Gains or losses are not recognized upon disposition of oil and natural gas properties unless such a disposition would significantly alter the relationship between capitalized costs and proved reserves of oil and gas. Gains or losses are recognized upon disposition of other assets.

CEILING TEST

The Company places a limit on the aggregate costs which may be carried forward for amortization against revenues of future periods (the Ceiling Test). This test is a cost recovery test whereby the capitalized costs less accumulated depletion and depreciation in each cost centre are limited to an amount equal to the estimated value of future net revenues from proved reserves (based on current prices and costs as at the balance sheet date) plus unproved properties at cost less impairment. The aggregate of such estimated future value for all cost centres is further reduced for recurring general and administrative costs, future financing costs associated with long-term debt and income taxes. Any costs carried on the balance sheet in excess of the ceiling test limit will be charged to earnings.

DEPLETION AND DEPRECIATION

The provision for depletion and depreciation for oil, natural gas and sulphur operations is calculated on the unit of production method based on gross proved reserves in each cost centre. Reserves are estimated by the Company's petroleum engineers and are converted to equivalent units on the basis of approximate relative energy content.

Costs of acquiring and evaluating unproved properties are excluded from the calculation of depletion and depreciation until it is determined that proved reserves are attributable to the properties or that impairment has occurred. On this basis the costs of acquiring and evaluating unproved properties in Western Canada and in Canadian Frontier areas, including exploration drilling in the Canadian Frontier, have been excluded from capitalized costs subject to depletion until determination of whether or not reserves have been proved or impairment has occurred. All dry hole costs are included in costs subject to depletion. Details of excluded costs are presented in Note 2 to the consolidated financial statements.

CAPITALIZED FINANCING COSTS

Financing costs are capitalized on costs incurred during the construction of major facilities and on unproved properties. Financing costs are charged to earnings when constructed facilities commence operations and when the exploration of unproved properties is completed.

ADVANCES UNDER NATURAL GAS SALES CONTRACTS

Amounts received for annual contracted natural gas volumes not taken by pipeline purchasers are deferred. Revenue will be recognized as deliveries are completed over a ten-year period ending in 1994.

JOINT VENTURE

The Company conducts substantially all of its oil, natural gas and sulphur exploration and production activities on a joint venture basis and the accounts reflect the Company's proportionate interest in such activities.

COMPARATIVE ACCOUNTS

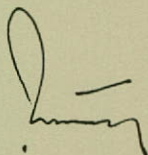
Certain of the comparative accounts have been reclassified to conform with the financial statement presentation adopted in 1985.

Consolidated Balance Sheet

Canterra Energy Ltd., December 31, 1985

(millions)		1985	1984
Assets			
Current assets	Cash and short-term investments	\$ 62.1	\$ 33.8
	Accounts receivable	101.1	80.1
	Petroleum Incentive Program grants receivable (Note 11)	26.5	13.4
	Inventories (Note 1)	71.8	94.4
	Prepaid expenses	3.6	7.9
		265.1	229.6
Investments and other assets		61.4	48.6
Property, plant and equipment (Note 2)		3,149.8	3,012.7
Deferred foreign exchange		308.6	202.7
		\$ 3,784.9	\$ 3,493.6
Liabilities			
Current liabilities	Bank indebtedness	\$ 22.9	\$ 16.1
	Accounts payable and accrued liabilities	121.3	82.4
	Due to parent company	-	27.5
	Current portion of advances under natural gas sales contracts	3.6	3.1
	Current portion of long-term debt	.3	1.3
		148.1	130.4
Long-term debt (Note 3)		2,131.2	2,359.1
Convertible subordinated debentures (Note 4)		222.5	-
Advances under natural gas sales contracts		33.8	38.2
Deferred petroleum and gas revenue taxes		24.3	-
Deferred income taxes		397.7	301.6
		2,957.6	2,829.3
Shareholders' equity	Capital (Note 5)	734.1	658.0
	Retained earnings	93.2	6.3
		827.3	664.3
		\$ 3,784.9	\$ 3,493.6

Approved by the Board:



B.F. Isautier, Director



H.G. Pearce, Director

Discussion of Consolidated Balance Sheet

WORKING CAPITAL

Working capital, which indicates the ability to meet short-term obligations, increased 18% in 1985 to \$117.0 million. An 84% increase in cash and short-term investments places Canterra in the position of having cash available for debt repayment or capital investment purposes. The net PIP grants receivable increased due to a substantial decrease in the year-end PGRT liability resulting from higher PGRT-exempt oil and gas revenues and a significant deferral of PGRT into future periods. A 24% decrease in inventories resulted from the sale of purchased sulphur from inventory. This sulphur was previously purchased from other producers with which Canterra has long-term purchase contracts.

INVESTMENTS AND OTHER ASSETS

Investments and other assets includes Canterra's equity investment in two companies, Penmore, S.A. (100% owned and based in Switzerland) and Rainbow Pipe Line Company, Ltd. (33 $\frac{1}{3}$ % owned). Penmore is an insurance company insuring the employees of Canterra's coal operation against occupational health disease. The Rainbow pipeline is a strategic oil pipeline from Northern Alberta to Edmonton.

PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment includes all capital investments related to acquiring properties, exploring for, and developing hydrocarbons and sulphur. During 1985, \$160.7 million of frontier costs was transferred to the depletable asset base, leaving \$439.5 million of frontier costs not subject to depletion. In line with proposed full-cost accounting guidelines, Canterra will transfer more frontier assets to the depletion base when proved reserves are established or a loss of value occurs. Unproved properties in Western Canada are transferred to the depletion base over a six-year period. For further details, refer to the summary of significant accounting policies and Note 2.

FOREIGN EXCHANGE

The Company's long-term foreign currency debt is converted to Canadian dollars at the exchange rate in effect at year end. Canterra has a U.S. dollar-related revenue stream which effectively acts as a hedge against the company's U.S. dollar denominated debt. Fluctuations in the exchange rate will affect both the debt and the revenue stream in a similar manner. A one-cent drop in the relative value of the Canadian dollar adds

\$27 million to long-term debt but also adds approximately \$90 million to after-tax cash flow over the life of the Company's reserves. Any foreign exchange exposure is charged to earnings as debt repayments occur or is amortized on a straight line basis over the life of the debt. The balance of unamortized foreign exchange is deferred and reported as Deferred Foreign Exchange on the balance sheet.

LONG-TERM DEBT

While debt payments of \$130.4 million were made during the year, 1985 debt levels are in line with 1984 levels because of a weakened Canadian dollar relative to the U.S. dollar. Canterra benefitted from the weakened Canadian dollar in cash flow due to the U.S. dollar-based product prices. (See Financial Sensitivities page 40).

In addition to the long-term debt drawn as of December 31, 1985, the Company has \$204.5 million of unutilized bank lines. These available credit facilities, along with internally-generated cash flow plus short-term investments, provide the Company with the financial flexibility to meet its capital program, manage its debt repayments commencing in 1987, and cope with an uncertain market environment.

ADVANCES UNDER NATURAL GAS SALES CONTRACTS

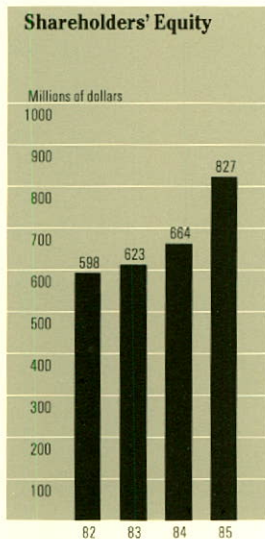
Advances under natural gas sales contracts are amounts received under various contracts such as Topgas which provide for payments from pipeline purchasers unable to take delivery of the minimum contract amount. Physical deliveries of the gas under this program started November 1, 1984 and will be completed by 1994. Advances are reduced and revenue is recognized as deliveries are made under the program.

DEFERRED PETROLEUM AND GAS REVENUE TAXES

In 1985, the Company was able to defer PGRT liability as a result of new legislation permitting PGRT liability to be offset with exploration and development expenditures not needed to reduce taxable income. The Deferred Petroleum and Gas Revenue Taxes will become payable at a future date when the Company utilizes these expenditures to reduce taxable income.

SHAREHOLDERS' EQUITY

Shareholders' equity of \$827.3 million increased 24.5% from 1984, largely due to the equity issue and increased earnings. The Company achieved a return to shareholders of 11.7% in 1985 (defined as earnings divided by average equity) compared to the Company's medium term objective of 15%.



Consolidated Statement of Earnings

Canterra Energy Ltd., Year Ended December 31, 1985

(millions)	1985	1984
Revenues		
Sales (Note 6)	\$ 767.3	\$ 647.2
Investment and other income	23.5	22.4
	790.8	669.6
Expenses		
Operating	179.9	109.2
Financing costs	158.9	165.3
Administrative	45.6	40.0
Foreign exchange	18.1	(3.7)
Depletion and depreciation	148.8	142.2
	551.3	453.0
Earnings before undernoted items	239.5	216.6
Income and other taxes (Note 7) Current	(2.1)	(1.1)
Deferred	105.6	120.2
Petroleum and gas revenue and other production taxes	24.8	56.1
Deferred petroleum and gas revenue taxes	24.3	-
	152.6	175.2
Net earnings	\$ 86.9	\$ 41.4
Earnings per common share (Note 12)		
Basic	\$ 1.10	\$ 0.55
Fully diluted	\$ 1.07	\$ 0.55

Consolidated Statement of Retained Earnings

Canterra Energy Ltd., Year Ended December 31, 1985

(millions)	1985	1984
Retained earnings (deficit) at beginning of year	\$ 6.3	\$ (35.1)
Net earnings	86.9	41.4
Retained earnings at end of year	\$ 93.2	\$ 6.3

Discussion of Consolidated Statement of Earnings

REVENUES

Consolidated revenue after deducting royalties increased to \$790.8 million, up 18% from 1984, largely attributable to increases in oil and sulphur prices combined with benefits of deregulation from the Western Accord and an improved royalty regime for crude oil and natural gas. Oil and natural gas products accounted for 40% and 21%, respectively of net revenue and sulphur contributed 36%. Refer to Note 6 for more details.

OPERATING COSTS

Operating costs increased 64.7% to \$179.9 million, primarily because of selling a higher proportion of purchased sulphur during 1985.

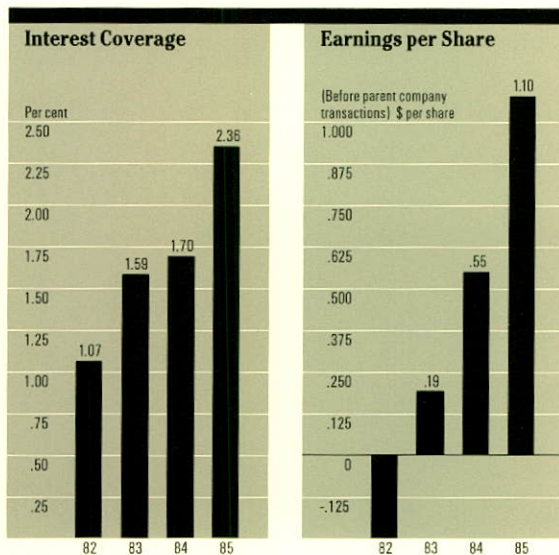
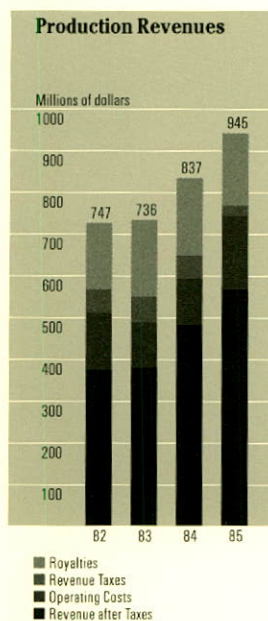
The cost of sulphur purchased and resold in 1985 was \$65.7 million compared with \$2.3 million in 1984. Oil and gas operating costs increased 17%, due to numerous new properties being brought on stream as a result of Canterra's exploration success.

FINANCING COSTS

Total interest paid in 1985 was \$224.5 million, down \$40.2 million (15.2%) from 1984. Capitalized interest decreased 34.0% to \$65.6 million. The interest coverage ratio (cash flow before interest divided by interest payments) of 2.4 has dramatically improved over the past four years because of higher cash flow, reduced interest rates and lower debt levels. The average U.S. rate of interest paid in 1985 was 9.12% compared to 11.16% in 1984.

INCOME AND OTHER TAXES

Income and other taxes decreased 13% in 1985 compared with 1984. The Company's effective tax rate declined from 80.9% in 1984 to 63.7% in 1985 and is reconciled to the expected corporate tax rate of 47% in Note 7. Deferred income taxes arise because the amortization rates of certain costs for income tax purposes (capital cost allowance, Canadian exploration expense) are in excess of the amortization rates for financial reporting purposes (depletion and depreciation). Income taxes are expected to continue to be deferred as a result of the Company's capital expenditure programs.



Consolidated Statement of Cash Resources

Canterra Energy Ltd., Year Ended December 31, 1985

(millions)		1985	1984
Cash provided from (used for):			
Operating activities	Net earnings	\$ 86.9	\$ 41.4
	Non-cash items, financing costs and capitalized exploration overhead	447.9	410.4
	Cash flow before interest payments	534.8	451.8
	Interest payments	(224.5)	(264.7)
	Free cash flow*	310.3	187.1
	Change in working capital other than cash	4.7	(10.5)
	Cash provided from operations	315.0	176.6
Investing activities	Expenditures on property, plant and equipment	(213.9)	(160.5)
	Other investments	(8.2)	5.3
	Cash used for investing	(222.1)	(155.2)
Financing activities	Share capital issue	77.9	-
	Convertible subordinated debenture issue	222.5	-
	Share capital and debenture issue costs	(8.1)	-
	Syndicated loan proceeds	1,935.9	-
	Repayment of parent company note	(1,935.9)	-
	Refinancing costs	(10.8)	-
	Convertible subordinated debenture proceeds applied to syndicated loan	(222.5)	-
	Cash provided from financing	59.0	-
	Increase in cash available for repayment of debt	\$ 151.9	\$ 21.4
Cash applied to (funded by):			
	Cash net of short-term indebtedness	\$ 21.5	\$ 29.5
	Long-term debt including current portion	130.4	(8.1)
		\$ 151.9	\$ 21.4

Refer to Note 9.

*Free cash flow represents funds available for capital expenditures and debt repayment after deducting all expenses and including capitalized charges.

Discussion of Consolidated Statement of Cash Resources

This statement relates the consolidated statement of earnings to changes during the year in the consolidated balance sheet. It discloses the Company's operating cash flow activities, investing activities, financing activities, and the amount of debt reduction.

OPERATING ACTIVITIES

Cash flow before interest payments reached a record level of \$534.8 million, up \$83.0 million or 18.4%. After deducting all interest payments, the Company's free cash flow of \$310.3 million was available for capital expenditures and debt repayment.

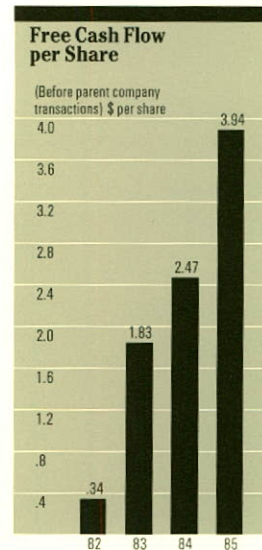
INVESTING ACTIVITIES

The Company spent \$222.1 million on petroleum-related investments for the purposes of building reserves to generate future operating cash flows. Capital expenditures were 69% of free cash flow.

FINANCING ACTIVITIES

The combination of free cash flow generated and equity raised provided sufficient funds for capital expenditures of \$213.9 million, debt repayments of \$130.4 million, and an increase in short term investments of \$21.5 million.

The financial and operating activities in 1985 demonstrated the Company's ability to attract new equity investors, refinance debt on favourable terms, and generate internal cash flow sufficient to meet all cash requirements, including capital investment and debt servicing.



Notes to Consolidated Financial Statements

(tabular dollar amounts shown in millions of dollars)

1. Inventories		1985	1984
Materials and supplies			
	Oil, natural gas and sulphur	\$ 10.8	\$ 10.7
	Coal	2.9	3.1
Purchased sulphur		56.2	79.2
Coal		1.9	1.4
		\$ 71.8	\$ 94.4

2. Property, plant and equipment				1985	1984
		Cost	Accumulated Provisions	Net	Net
Oil, natural gas and sulphur					
	Canada	\$ 3,249.8	\$ 401.6	\$ 2,848.2	\$ 2,707.2
	United States	288.3	134.1	154.2	158.3
		3,538.1	535.7	3,002.4	2,865.5
Coal	United States	81.4	16.1	65.3	66.0
Office buildings	Canada	67.1	4.7	62.4	62.2
Other	United States	20.5	.8	19.7	19.0
		\$ 3,707.1	\$ 557.3	\$ 3,149.8	\$ 3,012.7

Costs of unproved properties excluded from depletion after the December 31 transfer to the depletion base are as follows:

				1985	1984
	Western Canada	Frontier	Tar Sands	Total	Total
Balance at beginning of year	\$ 201.1	\$ 529.0	\$ 33.1	\$763.2	\$ 913.7
Acquisitions	33.8	-	-	33.8	30.0
Exploration	-	20.7	.9	21.6	14.0
Capitalized financing costs	15.1	50.5	-	65.6	99.4
Transfers to depletion base*	(69.5)	(160.7)	-	(230.2)	(293.9)
Balance at end of year	\$ 180.5	\$ 439.5	\$ 34.0	\$654.0	\$ 763.2

*Transferred costs are subject to depletion in subsequent years.

3. Long-term debt

	1985	1984
Syndicated term loan (U.S. \$1,192.5 million)	\$ 1,666.5	\$ -
Notes payable to parent company (U.S. \$1,412.0 million)	-	1,865.8
Floating rate notes and bank loans:		
Payable in Canadian funds due 1986 to 1991 with average interest of 9.88% (1984-11.28%)	37.3	90.8
Payable in U.S. funds due 1987 to 1992 with average interest of 8.60% (1984-10.53%) (1985 - U.S. \$275.5 million; 1984 - U.S. \$242.4 million)	385.0	320.3
5.75% notes due in 1986 (Swiss francs 50.0 million)	28.4	28.4
11.25% notes due in 1985 (U.S. \$30.0 million)	-	39.6
Other	14.3	15.5
	2,131.5	2,360.4
Less current portion	(.3)	(1.3)
Long-term debt at current rates	\$ 2,131.2	\$ 2,359.1

(a) Syndicated Term Loan

The syndicated term loan is payable to a group of international banks. The loan bears interest at a rate equal to the London Inter-Bank Offer Rate (LIBOR) plus $\frac{5}{8}$ of 1%, increasing to LIBOR plus $\frac{3}{4}$ of 1% in 1987, with provision for a reduction in such rates by $\frac{1}{8}$ of 1% in certain circumstances.

The loan agreement contains certain restrictive covenants. The primary covenants require the Company to maintain a specified ratio of current assets to current liabilities, a specified fixed charge coverage and a specified ratio of debt to the value of proved reserves. Certain other covenants include a limitation on the payment of dividends on the common shares relative to the ratio of debt to the value of proved reserves.

The loan is repayable in semi-annual instalments commencing July 1987 and ending December 1997 and is unsecured.

(b) Long-term Debt Repayments

Repayments of long-term debt for the next five years are as follows:

1986 - \$.3 million; 1987 - \$72.2 million; 1988 - \$163.2 million; 1989 - \$181.4 million; and 1990 - \$270.9 million.

The Company has cash, short-term investments and undrawn committed credit facilities of \$266.6 million which may be applied to these repayments.

4. Convertible subordinated debentures

The convertible subordinated debentures bear interest at 8.5% per annum and mature June 15, 2000. The debentures are direct unsecured obligations of the Company and are subordinated to all other indebtedness of the Company. The debentures are convertible at the holder's option into common shares of the Company any time prior to June 15, 1995 at a conversion price of \$17.00 per share. The debentures may be redeemed by the Company after December 15, 1988 at a reducing premium until June 15, 1994 at which time they are redeemable at par. A sinking fund will be established in the years 1996 to 2000 inclusive in a sufficient amount to retire in each of such years 10% of the aggregate principal amount of debentures outstanding on June 15, 1995.

5. Capital

Authorized: Unlimited number of preferred and common shares without par value.
 Issued: Common shares

	Shares	Amount
Balance at beginning of year	27,566,193	\$ 658.0
Stock split (see (a) below)	48,240,837	-
Issued	5,562,500	76.1
Balance at end of year	81,369,530	\$ 734.1

- (a) The Company subdivided its issued and outstanding common shares on a 2.75-for-1 basis effective on April 26, 1985.
- (b) The Company redesignated its authorized preferred shares as first preferred shares and created a new class of an unlimited number of shares designated second preferred shares effective on April 26, 1985.
- (c) The Company has reserved a maximum of 4% of its total issued and outstanding common shares for issuance to officers and key employees of the Company and its principal U.S. subsidiary pursuant to the terms of its Stock Option Plan. At December 31, 1985, options to purchase 1,618,432 common shares had been granted by the Company at an exercise price of \$8.75 per share. Options to purchase one half of these common shares vest in and become exercisable by the participants in the plan on January 1, 1986 and the remaining one half will vest on January 1, 1988. The options expire on January 1, 1992.
- (d) The Company has reserved for issuance 13,088,235 common shares for purposes of the conversion privileges for the convertible subordinated debentures more fully discussed in Note 4.

6. Sales

The Company's sales comprise oil, natural gas, sulphur and coal. Details of sales by product are as follows:

					1985	1984
	Oil	Natural Gas	Sulphur	Coal	Total	Total
Gross sales						
Produced	\$ 408.1	\$ 194.5	\$ 177.9	\$ 22.9	\$803.4	\$ 808.5
Purchased	-	-	120.4	-	120.4	4.1
Processed	-	21.3	-	-	21.3	24.4
	408.1	215.8	298.3	22.9	945.1	837.0
Royalties	99.6	53.6	24.6	-	177.8	189.8
Net sales	\$ 308.5	\$ 162.2	\$ 273.7	\$ 22.9	\$767.3	\$ 647.2

Sulphur sales are made from production and are supplemented by buying sulphur from other producers. Cost of sulphur purchased and resold was \$65.7 million in 1985 (1984 - \$2.3 million) and is included in operating costs.

7. Income and other taxes The effective rate of income and other taxes was 63.7% (1984-80.9%) on earnings before income and other taxes. A reconciliation of effective tax rates is set out below:

	1985	1984
Expected income tax rate	47%	47%
Computed "expected" income tax expense	\$ 112.6	\$ 101.8
Increase (decrease) in income tax resulting from:		
Non-deductible Crown charges less resource allowance and provincial rebates	8.3	11.3
Non-allowable depletion and depreciation	26.3	21.1
Tax deductions allowed in excess of available book amounts	(9.8)	-
Earnings of subsidiaries	(5.7)	(7.7)
Processing tax credit	(17.2)	-
Other	(11.0)	(7.4)
Income tax expense	103.5	119.1
Petroleum and gas revenue and other production taxes	49.1	56.1
Total income and other taxes	\$ 152.6	\$ 175.2

Included in the above are petroleum and gas revenue taxes of \$49.1 million (1984 - \$56.1 million) and deferred income taxes of \$105.6 million (1984 - \$120.2 million). Deferred income taxes result from timing differences in recognition of income and expenses for income tax and financial statement purposes. The source of these differences and the tax effect of each were as follows:

	1985	1984
Capital cost allowance deducted for income tax purposes in excess of (less than) depreciation	\$ (7.3)	\$ 12.1
Exploration expenditures deducted for income tax purposes in excess of provision for depletion	2.3	49.2
Capitalized interest deducted for income tax purposes	30.8	46.7
Net capital loss	(4.5)	-
Non-capital loss	51.3	21.2
Income deferred for income tax purposes	40.6	-
Other	(7.6)	(9.0)
Deferred income tax expense	\$ 105.6	\$ 120.2

Certain U.S. subsidiary companies have tax loss carry forwards available for income tax purposes at December 31, 1985 of U.S. \$79.6 million and investment tax credits of U.S. \$8.0 million which expire from 1992 to 2000. The realization of these tax benefits is dependent upon the future taxable incomes of these subsidiaries. No recognition of the potential tax benefits has been taken into account.

8. Business segments				1985				1984			
				Canada	United States	Other Foreign	Total	Canada	United States	Other Foreign	Total
Revenues											
Oil, natural gas and sulphur	\$ 689.0	\$ 55.4	\$ -	\$ 744.4	\$ 542.5	\$ 64.2	\$ -	\$ 606.7			
Coal	-	22.9	-	22.9	-	40.5	-	40.5			
Office buildings	6.6	-	-	6.6	8.2	-	-	8.2			
Other	9.2	6.0	1.7	16.9	10.1	1.2	2.9	14.2			
	\$ 704.8	\$ 84.3	\$ 1.7	\$ 790.8	\$ 560.8	\$ 105.9	\$ 2.9	\$ 669.6			
Operating profits											
Oil, natural gas and sulphur	\$ 388.2	\$ 12.8	\$ -	\$ 401.0	\$ 351.8	\$ (9.0)	\$ -	\$ 342.8			
Coal	-	(5.5)	-	(5.5)	-	2.4	-	2.4			
Office buildings	2.6	-	-	2.6	4.7	-	-	4.7			
Other	9.2	6.0	1.7	16.9	10.1	1.2	2.9	14.2			
	\$ 400.0	\$ 13.3	\$ 1.7	415.0	\$ 366.6	\$ (5.4)	\$ 2.9	364.1			
Administrative				(45.6)				(40.0)			
Foreign exchange				(18.1)				3.7			
Financing costs				(158.9)				(165.3)			
Earnings before income taxes				192.4				162.5			
Income taxes				(105.5)				(121.1)			
Net earnings				\$ 86.9				\$ 41.4			
Depletion and depreciation											
Oil, natural gas and sulphur	\$ 117.8	\$ 25.1	\$ -	\$ 142.9	\$ 97.5	\$ 38.7	\$ -	\$ 136.2			
Coal	-	4.7	-	4.7	-	4.3	-	4.3			
Office buildings and other	1.2	-	-	1.2	1.7	-	-	1.7			
	\$ 119.0	\$ 29.8	\$ -	\$ 148.8	\$ 99.2	\$ 43.0	\$ -	\$ 142.2			
Identifiable assets											
Oil, natural gas and sulphur	\$3,311.2	\$ 304.6	\$.5	\$3,616.3	\$3,033.1	\$ 289.3	\$.2	\$3,322.6			
Coal	-	72.7	-	72.7	-	77.0	-	77.0			
Office buildings	62.4	-	-	62.4	62.2	-	-	62.2			
Other	-	-	33.5	33.5	-	-	31.8	31.8			
	\$3,373.6	\$ 377.3	\$ 34.0	\$3,784.9	\$3,095.3	\$ 366.3	\$ 32.0	\$3,493.6			

9. Consolidated statement of cash resources

The consolidated statement of cash resources has been prepared on the basis of changes in cash available for repayment of debt.

(a) Operating activities

	1985	1984
Non-cash items, financing costs and capitalized exploration overhead		
Financing costs	\$ 158.9	\$ 165.3
Depletion and depreciation	148.8	142.2
Deferred income and other taxes	129.9	120.2
Foreign exchange	18.1	(3.7)
Capitalized exploration overhead	(7.8)	(13.6)
	\$ 447.9	\$ 410.4

(b) Investing activities

	1985	1984
(I) Expenditures on property, plant and equipment		
Frontier Canada	\$ 73.8	\$ 92.0
Western Canada exploration	113.8	87.3
Western Canada production	79.9	46.3
U.S. and other	31.0	21.0
	298.5	246.6
Less Petroleum Incentive Program and provincial grants	84.6	86.1
	\$ 213.9	\$ 160.5

The above capital expenditures do not include capitalized financing costs and exploration overhead of \$73.4 million in 1985 (1984 - \$113.0 million).

	1985	1984
(II) Changes in working capital		
(Bracketed items reflect decreases in working capital.)		
Accounts receivable	\$ 21.0	\$ 16.6
Petroleum Incentive Program grants receivable	13.1	(33.8)
Inventories	(22.6)	22.3
Prepaid expenses	(4.3)	.6
Accounts payable and accrued liabilities	(38.9)	3.5
Due to parent company	27.5	2.9
Current portion of advances under natural gas sales contracts	(.5)	(1.6)
	(4.7)	10.5
Cash net of short-term indebtedness		
Cash and short-term investments	28.3	27.7
Bank indebtedness	(6.8)	1.8
	21.5	29.5
Current portion of long-term debt	1.0	-
	\$ 17.8	\$ 40.0

10. Related party transactions

- (a) Sulphur sales after royalties by the Company through Cansulex Limited were \$247.5 million (1984 - \$124.1 million). At December 31, 1985 and 1984, Cansulex Limited was indebted to the Company for \$25.4 million and \$16.7 million respectively.
- (b) During the year the Company sold \$72.5 million of convertible subordinated debentures and 1,812,500 common shares to its parent company and replaced its notes payable to the parent company from the proceeds of a syndicated term bank loan.
Included in financing costs are \$95.0 million in 1985 (1984 - \$210.4 million) paid to the parent company in respect of a U.S. \$1,412.0 million note payable and also in respect of the debentures issued to the parent company.

11. Other information (a) Pensions

The Company contributes to pension plans and coal union health and retirement benefit plans for employees. The plans maintained by the Company are funded based on determinations by the Company's independent actuarial consultant and costs were \$1.2 million in 1985 (1984 - \$1.1 million). In addition, costs of contributions to the coal union health and retirement plans were \$.6 million in 1985 (1984 - \$1.5 million).

In the case of pension plans covering Canadian employees, the present value based on an interest factor of 7.5% of vested and non-vested benefits was \$18.7 million, determined as at January 1, 1985, the date of the latest triennial actuarial valuation of the plan as required under Canadian pension legislation. The plan earned an effective net annual rate of return of 14%. The pension plan covering United States employees not covered by coal union health and retirement plans had present values of vested and non-vested benefits of \$2.3 million computed using a rate of return of 8.5% and determined as at August 28, 1985, the date of the latest actuarial valuation. The assets of these plans are approximately equal to plan liabilities.

Under the provisions of the coal union agreements, the companies have guaranteed the benefits provided during the terms of the contract. Vested benefits under these plans may be underfunded and the companies may have future liabilities under the provisions of the U.S. pension legislation. It is not anticipated that the Company's share of such liabilities will have a material effect on the Company's financial position.

(b) Rental Obligations

The annual rental obligations for buildings and equipment under long-term leases are: 1986 - \$4.9 million; 1987 - \$4.4 million; 1988 - \$7.6 million; 1989 - \$14.8 million; 1990 - \$14.4 million.

(c) Building Commitment

The Company has committed to lease space in a new office tower which is scheduled to be completed in 1988. The lease is for a period of 15 years at an average lease cost of \$8.0 million per year over the term of the lease and provides for certain renewal provisions.

(d) Petroleum Incentive Program Grants

Petroleum Incentive Program grants receivable at December 31, 1985 and 1984 are \$26.5 million and \$13.4 million, respectively. These amounts are reported net of Petroleum and Gas Revenue taxes payable of \$11.4 million and \$26.1 million, respectively.

12. Earnings per common share

Earnings per common share have been calculated on the basis of the weighted average number of common shares outstanding for the year ended December 31, 1985, after giving effect to the 2.75-for-1 stock split on April 26, 1985, as if the shares were outstanding on January 1, 1984 (refer to Note 5). Fully diluted earnings per share have been calculated assuming the conversion of all convertible subordinated debentures at date of issue.

	1985	1984
Weighted average number of shares	78,809,257	75,807,030
Fully diluted number of shares	86,294,554	75,807,030

13. Quarterly financial information (unaudited)

	1st Quarter		2nd Quarter		3rd Quarter		4th Quarter	
	1985	1984	1985	1984	1985	1984	1985	1984
Revenues	\$ 211.0	\$ 155.0	\$ 201.2	\$ 158.2	\$ 180.4	\$ 164.8	\$ 198.2	\$ 191.6
Expenses	(128.6)	(107.3)	(145.3)	(102.7)	(135.0)	(111.3)	(142.4)	(131.7)
Income and other taxes	(60.2)	(43.9)	(37.3)	(42.2)	(29.2)	(42.8)	(25.9)	(46.3)
Net earnings	\$ 22.2	\$ 3.8	\$ 18.6	\$ 13.3	\$ 16.2	\$ 10.7	\$ 29.9	\$ 13.6
Free cash flow	\$ 90.1	\$ 39.7	\$ 70.3	\$ 40.6	\$ 60.8	\$ 41.2	\$ 89.1	\$ 65.6
Earnings per share								
Basic	\$ 0.29	\$ 0.05	\$ 0.25	\$ 0.18	\$ 0.19	\$ 0.14	\$ 0.37	\$ 0.18
Fully diluted	\$ 0.29	\$ 0.05	\$ 0.24	\$ 0.18	\$ 0.19	\$ 0.14	\$ 0.35	\$ 0.18
Free cash flow per share								
Basic	\$ 1.19	\$ 0.52	\$ 0.92	\$ 0.54	\$ 0.73	\$ 0.54	\$ 1.10	\$ 0.87
Fully diluted	\$ 1.19	\$ 0.52	\$ 0.89	\$ 0.54	\$ 0.62	\$ 0.54	\$ 0.98	\$ 0.87

Four-Year Financial Summary

Canterra Energy Ltd.

The Company was formed in 1981. However, as 1982 was the first full year of Company operations, all summarized historical data are shown for four years.

Earnings (millions)		1985	1984	1983	1982
Revenues (net after royalties)					
Sales	Oil and natural gas liquids	\$ 308.5	\$ 280.3	\$ 271.1	\$ 231.1
	Natural gas	140.9	144.7	135.4	131.8
	Sulphur	273.7	157.3	85.8	142.2
	Coal	22.9	40.5	34.7	43.3
	Processing income	21.3	24.4	22.3	18.6
	Investment and other income	23.5	22.4	34.2	33.9
Total revenues		790.8	669.6	583.5	600.9
Expenses					
Production	Oil, natural gas and sulphur	89.2	72.7	60.7	60.9
	Sulphur cost of sales	65.7	2.3	22.0	32.1
	Coal	25.0	34.2	28.1	40.4
Administrative		45.6	40.0	41.0	42.3
Financing costs		158.9	165.3	148.2	229.6
Foreign exchange		18.1	(3.7)	-	-
Depletion and depreciation		148.8	142.2	127.6	123.0
Total expenses		551.3	453.0	427.6	528.3
Earnings before undernoted items		239.5	216.6	155.9	72.6
Income and other taxes					
	Current	(2.1)	(1.1)	(3.5)	(20.7)
	Deferred	105.6	120.2	86.1	53.0
	Petroleum and gas revenue and other taxes	24.8	56.1	58.6	58.2
	Deferred petroleum and gas revenue taxes	24.3	-	-	-
		152.6	175.2	141.2	90.5
Net earnings (loss) before parent company transactions		86.9	41.4	14.7	(17.9)
Parent company transactions		-	-	10.1	(42.0)
Net earnings (loss)		\$ 86.9	\$ 41.4	\$ 24.8	\$ (59.9)
Earnings by Lines of Business (millions)					
Oil, natural gas and sulphur					
	Canada	\$ 388.2	\$ 351.8	\$ 259.4	\$ 248.0
	United States	12.8	(9.0)	(3.1)	15.0
Coal	United States	(5.5)	2.4	3.1	1.3
Office buildings		2.6	4.7	5.4	5.0
Other	Canada	9.2	10.1	13.3	13.0
	United States	6.0	1.2	2.1	1.9
	Other foreign	1.7	2.9	10.3	6.7
Unallocated expenses		(222.6)	(201.6)	(189.2)	(271.9)
Income taxes		(105.5)	(121.1)	(86.6)	(36.9)
Parent company transactions		-	-	10.1	(42.0)
Net earnings (loss)		\$ 86.9	\$ 41.4	\$ 24.8	\$ (59.9)

Financial Position (millions)	1985	1984	1983	1982
Current assets	\$ 265.1	\$ 229.6	\$ 196.2	\$ 247.0
Investments and other assets	61.4	48.6	66.7	42.7
Property, plant and equipment (net)	3,149.8	3,012.7	2,869.7	2,729.7
Deferred foreign exchange	308.6	202.7	62.4	37.7
	\$ 3,784.9	\$ 3,493.6	\$ 3,195.0	\$ 3,057.1
Current liabilities	\$ 148.1	\$ 130.4	\$ 137.0	\$ 126.9
Long-term debt	2,353.7	493.3	457.3	463.6
Notes payable to parent company	-	1,865.8	1,757.1	1,735.9
Advances under natural gas sales contracts	33.8	38.2	39.3	37.3
Deferred petroleum and gas revenue taxes	24.3	-	-	-
Deferred income taxes	397.7	301.6	181.4	95.3
Shareholders' equity	827.3	664.3	622.9	598.1
	\$ 3,784.9	\$ 3,493.6	\$ 3,195.0	\$ 3,057.1
Property, Plant and Equipment (millions)				
Gross investment				
Oil, natural gas and sulphur				
Canada	\$ 3,249.8	\$ 2,991.7	\$ 2,726.3	\$ 2,487.5
United States	288.3	267.5	256.2	227.7
Coal United States	81.4	79.2	75.5	75.3
Office buildings Canada	67.1	67.1	67.1	67.1
Other	20.5	19.7	17.8	17.7
	\$ 3,707.1	\$ 3,425.2	\$ 3,142.9	\$ 2,875.3
Net investment				
Oil, natural gas and sulphur				
Canada	\$ 2,848.2	\$ 2,707.2	\$ 2,538.5	\$ 2,391.0
United States	154.2	158.3	184.2	187.3
Coal United States	65.3	66.0	65.7	68.4
Office buildings Canada	62.4	62.2	63.9	65.7
Other	19.7	19.0	17.4	17.3
	\$ 3,149.8	\$ 3,012.7	\$ 2,869.7	\$ 2,729.7
Average Prices (dollars)(gross)				
Oil and natural gas liquids (per m ³)				
Canada	222	207	197	158
United States	218	234	233	249
Gas (per 10 ³ m ³) Canada	96	103	101	100
United States	142	166	145	164
Sulphur (per t) Consolidated	142	89	74	100
Coal (per t) United States	49	46	43	47

*Capital expenditures do not include capitalized financing costs and exploration overhead of \$73.4 million in 1985, \$113.0 million in 1984, \$89.6 million in 1983 and \$132.3 million in 1982.

Capital Expenditures* (millions)		1985	1984	1983	1982	
Exploration	Frontier Canada	\$ 73.8	\$ 92.0	\$ 165.3	\$ 119.8	
	Less PIP grants	(53.1)	(71.3)	(130.5)	(82.0)	
		20.7	20.7	34.8	37.8	
	Western Canada	113.8	87.3	87.8	107.6	
	Less PIP grants	(22.2)	(19.5)	(20.7)	(45.6)	
		91.6	67.8	67.1	62.0	
	United States	19.5	10.2	14.6	25.1	
		\$ 131.8	\$ 98.7	\$ 116.5	\$ 124.9	
	Production	Western Canada	\$ 79.0	\$ 43.8	\$ 49.0	\$ 52.2
		Less PIP grants	(9.2)	(2.9)	(2.0)	1.8
		69.8	40.9	47.0	54.0	
United States		Oil, natural gas and sulphur	3.6	4.1	4.0	15.4
		Coal	3.7	4.7	1.9	1.7
		\$ 77.1	\$ 49.7	\$ 52.9	\$ 71.1	
Heavy oil and tar sands		\$.9	\$ 2.5	\$ 1.4	\$ 8.9	
Less PIP grants		(.1)	(.4)	(.2)	(2.1)	
		\$.8	\$ 2.1	\$ 1.2	\$ 6.8	
Adjustment of prior year PIP claims		-	\$ 8.0	-	-	
Other	\$ 4.2	\$ 2.0	\$ 2.3	\$ 7.2		
Total expenditures	\$ 298.5	\$ 246.6	\$ 326.3	\$ 337.9		
Petroleum Incentive Program and provincial grants	(84.6)	(86.1)	(153.4)	(127.9)		
Net capital expenditures	\$ 213.9	\$ 160.5	\$ 172.9	\$ 210.0		

Financial Sensitivities (millions of dollars)	Change	Effect on Free Cash Flow	Effect on Earnings
Interest rate (U.S.)	1%	23.0	8.8
Oil price	\$1 Cdn/BBL (\$6.29/m ³)	8.8	4.3
Gas price	\$.10/MCF (\$3.55/10 ³ m ³)	5.2	1.9
Sulphur	\$1 cdn/tonne	1.9	1.2
Exchange rate †	1¢ decline	7.4	3.6

† A strengthening U.S. dollar relative to the Canadian dollar (e.g. from \$.74 to \$.73) has a positive impact on the company's cash flow and earnings.

Four-Year Operating Summary

Canterra Energy Ltd.

Sales Volumes		1985	1984	1983	1982
Oil and natural gas liquids (m ³ per day)					
Before royalties	Canada	4,678	4,734	5,003	5,074
	United States	357	375	444	463
After royalties	Canada	3,519	3,388	3,323	3,378
	United States	293	308	363	378
Natural gas (10 ³ m ³ per day)					
Before royalties	Canada	4,978	4,894	4,802	4,863
	United States	387	275	265	312
After royalties	Canada	3,572	3,513	3,419	3,225
	United States	293	209	201	233
Sulphur (10 ³ t)					
Before royalties	Canada	1,968	1,704	1,096	1,388
	United States	137	313	121	153
After royalties	Canada	1,776	1,420	1,003	1,247
	United States	137	313	121	153
Coal (10 ³ t)	United States	470	887	804	924
Net Land Holdings (thousands of hectares)					
Oil and natural gas					
	Western Canada	995	927	1,012	1,142
	Frontier Canada	1,386	1,295	2,571	2,510
	United States	81	226	268	370
Coal	United States	13	15	15	15
Proved Reserves					
Oil and natural gas liquids (10 ⁶ m ³)					
Before royalties	Canada	19.2	17.8	16.2	14.7
	United States	.5	.5	.4	.5
After royalties	Canada	14.8	13.3	11.8	10.1
	United States	.4	.4	.4	.4
Natural gas (10 ⁹ m ³)					
Before royalties	Canada	37.2	37.3	37.7	41.8
	United States	1.4	1.3	1.3	.8
After royalties	Canada	28.7	27.9	27.7	30.3
	United States	1.0	.9	.9	.6
Sulphur (10 ⁶ t)					
Before royalties	Canada	12.9	14.3	15.7	16.1
	Canada	11.8	12.9	14.2	15.1
Coal (10 ⁶ t)	United States	34.2	51.1	55.4	55.4

Wells Drilled	1985		1984		1983		1982	
	Gross	Net	Gross	Net	Gross	Net	Gross	Net
Western Canada – Exploratory								
Oil	41	22.8	58	22.5	34	13.9	22	12.4
Gas	15	6.3	19	3.5	27	10.0	54	24.8
Dry and abandoned/suspended	58	30.2	59	25.7	47	27.5	27	12.5
Total	114	59.3	136	51.7	108	51.4	103	49.7
Western Canada – Development								
Oil	119	38.2	95	21.5	65	15.7	56	13.1
Gas	108	11.7	9	5.7	10	3.5	13	5.2
Dry and abandoned/suspended	25	9.4	7	1.4	3	.9	3	.8
Total	252	59.3	111	28.6	78	20.1	72	19.1
Frontier Canada								
Oil	4	.3	1	.1	-	-	2	.1
Gas	6	.8	4	.5	1	.2	2	.1
Dry and abandoned/suspended	10	.9	8	.8	8	1.1	4	.9
Total	20	2.0	13	1.4	9	1.3	8	1.1
United States – Exploratory								
Oil	11	2.4	9	2.2	4	.8	10	3.7
Gas	7	1.6	5	1.2	8	1.3	2	.5
Dry and abandoned/suspended	20	5.8	13	3.0	14	6.1	17	4.5
Total	38	9.8	27	6.4	26	8.2	29	8.7
United States – Development								
Oil	-	-	2	.3	3	.4	6	.6
Gas	2	.5	1	.5	-	-	6	.9
Dry and abandoned/suspended	1	.4	-	-	-	-	6	2.2
Total	3	.9	3	.8	3	.4	18	3.7
Government Taxes and Royalties (millions)								
Property taxes	\$	2.7	\$	2.7	\$	2.6	\$	2.5
Petroleum and gas revenue tax								
Current		21.6		52.4		54.0		51.9
Deferred		24.3		-		-		-
Windfall profits tax and severance taxes								
		3.2		3.8		4.6		6.3
Income taxes								
Current		(2.1)		(1.1)		(3.5)		(20.7)
Deferred		105.6		120.2		86.1		15.7
Royalties								
		161.2		175.7		171.7		163.8
	\$	316.5	\$	353.7	\$	315.5	\$	219.5

Seismic Activity (10 ³ km)	1985	1984	1983	1982
Western Canada	14.5	10.7	9.5	10.8
Frontier Canada	30.4	67.7	15.4	126.3
United States	1.8	.6	.9	.6
Ratios				
Current ratio (1)	1.8	1.8	1.4	1.9
Debt to equity (2), (3)	2.8	3.6	3.6	3.7
Debt to equity plus deferred taxes (4)	1.9	2.4	2.8	3.2
Interest coverage (5)	2.4	1.7	1.6	1.1
Reinvestment of cash flow (6)	.7	.9	1.2	8.1
Sulphur Operations (10 ³ t)				
Sulphur volumes (gross)				
Canada	85	178	109	139
United States	137	313	121	153
Offshore	1,883	1,526	987	1,249
	2,105	2,017	1,217	1,541
Source of supply				
Production	714	805	820	800
Purchases	395	382	416	448
Inventories	996	830	(19)	293
	2,105	2,017	1,217	1,541
Year-end inventories	3,038	3,954	4,631	4,650
Number of Employees				
Canada	1,063	1,100	1,089	1,071
United States - oil and gas	60	59	63	75
United States - coal	214	241	232	340
	1,337	1,400	1,384	1,486

(1) CURRENT RATIO = Current assets divided by current liabilities.

(2) DEBT = Long term debt, convertible subordinated debentures, syndicated loan and current portion of long term debt.

(3) EQUITY = Shareholders' equity.

(4) DEFERRED TAXES = Deferred PGR taxes and deferred income taxes.

(5) INTEREST COVERAGE = Cash flow before interest payments divided by interest payments.

(6) REINVESTMENT OF CASH FLOW = Net capital expenditures divided by free cash flow.

Corporate Information

DIRECTORS

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Consultant
Foster Research
Calgary, Alberta

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President and
Chief Operating Officer
Canterra Energy Ltd.
Calgary, Alberta

H. ANTHONY HAMPSON
President and
Chief Executive Officer
Canada Development Corp.
Toronto, Ontario

BERNARD F. ISAUTIER
Chairman of the Board and
Chief Executive Officer
Canterra Energy Ltd.
Executive Vice-President
Canada Development Corp.
Toronto, Ontario

JOHN R. McCAIG
Chairman of the Board and
Chief Executive Officer
Trimac Limited
Calgary, Alberta

JOHN O. O'BRIEN
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J. O'Brien Petroleum Inc.
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DANIEL P. OWEN
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Canada Development Corp.
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H. GORDON PEARCE
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Gordon Pearce Research Ltd.
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STANLEY G.B. PEARSON
President
S.G.B. Pearson Holdings Ltd.
Cremona, Alberta

JOHN D. REDFERN
Chairman
Lafarge Corporation
Montreal, Quebec

ALLAN F. WATERS
President
CHUM Limited
Toronto, Ontario

COMMITTEES OF THE BOARD

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H. GORDON PEARCE
(Chairman)
John O. O'Brien
Daniel P. Owen
Allan F. Waters

Compensation Committee

JOHN R. McCAIG
(Chairman)
Bernard F. Isautier
H. Anthony Hampson
John D. Redfern

Executive Committee

BERNARD F. ISAUTIER
(Chairman)
Edward W. Best
John B. Hague
John O. O'Brien
Stanley G.B. Pearson

OFFICERS

BERNARD F. ISAUTIER
Chairman of the Board and
Chief Executive Officer

JOHN B. HAGUE
President and
Chief Operating Officer

JOHN H. CURRIE
Senior Vice-President
Administration

W. STEWART WRIGHT
General Counsel and
Corporate Secretary

LAWRENCE M. MacLEOD
Assistant Secretary

OFFICERS (cont.)

WILLIAM F. KAUFMANN
Senior Vice-President
Frontier Canada
Exploration and Production
President
Canterra Petroleum Inc.

R. GEORGE SCOTT
Vice-President Production
Frontier Canada

*DOUGLAS K. THOMPSON
Executive Vice-President
Canterra Petroleum Inc.

J. LINDSAY MILNE
Senior Vice-President
Western Canada
Exploration and Production

KENNETH J. FITZGERALD
Vice-President
Production
Western Canada

KENNETH J. MacRAE
Vice-President
Heavy Oil and Tar Sands

WILLIAM W. TAYLOR
Vice-President
Exploration
Western Canada

T. SEAN AHERN
Vice-President
Finance

CLARENCE E. GLESSING
Controller

RICHARD P. NORRIS
Treasurer

JEAN-JACQUES PASCAL
President
Canterra Coal Inc.

D. MICHAEL STEWART
Vice-President
Corporate Development and
Marketing

AUDITORS

THORNE RIDDELL
Chartered Accountants
12th Fl., Bow Valley Sq. Two
205-5 Avenue S.W.
Calgary, Alberta T2P 2V7

CORPORATE OFFICES

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CANTERRA COAL INC.
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U.S.A. 15220
Phone: (412) 923-4100
Telex: 866-387

CANTERRA SULPHUR INC.
Three Parkway Center
Pittsburgh, Pennsylvania
U.S.A. 15220
Phone: (412) 928-8626

*Officer of Canterra
Petroleum Inc.

Shareholder Information

REGISTRARS AND TRANSFER AGENT

The Royal Trust Company offices at Calgary, Halifax, Montreal, Toronto, Winnipeg, Regina and Vancouver.

ANNUAL GENERAL MEETING

The Annual General Meeting of Shareholders will be held on Thursday, May 15, 1986 at the Aquitaine Tower Auditorium, 540-5 Avenue S.W., Calgary, Alberta.

1985 SHARE PRICES

Toronto Stock Exchange: High \$12 $\frac{1}{2}$, Low \$8 $\frac{1}{2}$
December 31, 1985 \$9 $\frac{7}{8}$

Canterra shares were listed for trading on the Toronto Stock Exchange in June 1985.

ADDITIONAL INFORMATION

Shareholders with questions regarding share certificates, registration and change of address, share valuation, dividends, proxies and other related shareholder business, please contact: Canterra Energy Ltd. Shareholder Services Department
William H. Murphy, Director
200, 444 Yonge Street
Toronto, Ontario M5B 2H4

For information on Canterra or to obtain additional copies of this report contact:

Public Relations Department
Canterra Energy Ltd.
P.O. Box 1051
Calgary, Alberta T2P 2K7
(403) 267-9111

CONVERSION TABLE

To Convert From	To	Multiply by
metres (m)	feet (well depths)	3.2808
kilometres (km)	miles (distance)	0.6214
hectares (ha)	acres (land)	2.47
1,000 cubic metres (10 ³ m ³)	thousand cubic feet (mcf gas)	35.494
cubic metres (m ³)	barrels (oil)	6.29
tonnes (t)	long tons (sulphur)	0.9842
tonnes (t)	short tons (coal)	1.10231
gigajoules (GJ)	Millions of British Thermal Units (Mmbtu - gas)	0.948



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