CANADIAN NORTHSTAR
CORPORATION

1986
ANNUAL REPORT

Company Profile

Canadian Northstar Corporation is a diversified energy and investment company headquartered in Calgary, Alberta.

Canadian Northstar participates both directly and on behalf of partners in various energy resource investments and related financial transactions principally in Western Canada. A significant management involvement is maintained in selected operating companies in order to create efficiencies most beneficial to the group.

Through its 80% owned publicly traded subsidiary, Northstar Energy Corporation, the Company participates in petroleum and natural gas exploration and production and has developed a significant position in the ownership of custom gas processing facilities.

The Company's 54% owned oilwell drilling subsidiary, S & T Drilling Ltd., is an Alberta based contractor which currently operates 16 medium depth rigs.

The Company was incorporated under the laws of the Province of Alberta on January 11, 1978 as Northstar Resources Ltd. and changed its name to Canadian Northstar Corporation in December, 1985. The common shares are listed on The Toronto Stock Exchange and The Alberta Stock Exchange under the trading symbol CNX.

CANADIAN NORTHSTAR CORPORATION

Annual Meeting

The annual meeting of shareholders will be held at the Calgary Petroleum Club, 319 - 5th Avenue S.W., Calgary, Alberta at 3:30 P.M., on Wednesday, May 27, 1987.

Contents

		1986	1985
Financial	Gross revenues	**$29,320**	$27,961
(thousands,	Earnings before extraordinary item	**442**	17
except per share data)	per common share	**(0.11)**	0.01
	Net earnings	**1,068**	17
	per common share*	**0.16**	0.01
	Cash flow from operations	**4,574**	4,255
	per common share*	**1.97**	1.83
	Total assets	**89,974**	93,979
	Long term debt	**13,580**	36,501
	Shareholders' equity	**49,533**	19,193
Oil and Gas Operations	Crude oil production (gross BBLS)		
	Annual	**156,000**	126,000
	Per day	**427**	345
	Natural gas production (gross MCF)		
	Annual	**1,461,000**	923,000
	Per day	**4,000**	2,500
	Gross reserves		
	Crude oil and liquids (BBLS)	**1,481,000**	1,375,000
	Natural gas (MMCF)	**51,500**	53,600
	Land holdings		
	Gross acres	**513,000**	830,000
	Net acres	**68,000**	106,000
Drilling Operations	Rig operating days	**2,131**	2,317
	Utilization rate — S & T	**44%**	61%
	— industry	**38%**	55%
Common Share Information	Shares outstanding at December 31	**2,318,669**	11,593,346

In December 1985, shareholders approved a 1 for 5 consolidation of outstanding common shares.

* 1986 and 1985 earnings per share and cash flow per share data shown post-consolidation based on average 2,318,669 common shares outstanding.

Overview

Nineteen eighty six was a disastrous year for the oil industry throughout the world. The severe curtailment of cash flow resulting from the fall in oil prices has impacted dramatically on the survivability of many companies in the industry. This financial crisis, coupled with significant market deregulation for oil and gas, is fundamentally altering the long-term structure of the Canadian oil industry.

With change comes opportunity. 1986 was a year of considerable achievement for Canadian Northstar Corporation. Revenues, earnings, and cash flow from operations exceeded previous years' results. Permanent shareholders' equity increased 150% to approximately $50 million.

The Company is involved in four inter-related sectors of the Canadian energy industry.

Energy Financing and Investments

Canadian Northstar participates both directly and on behalf of venture partners in various energy resource investments and related financial transactions.

In 1987, a wholly-owned subsidiary, Northstar Investment Corporation, was established to pursue financial and investment opportunities. This company is well financed with cash and marketable securities which exceed $17 million.

Oil and Gas Operations

During 1987, Canadian Northstar increased its controlling interest in its renamed oil and gas subsidiary, Northstar Energy (previously Gane Energy), from 54% to 80%.

Exploration efforts centred on:

- Birch-Wavy, Alberta, and the development of low cost Glauconite gas reserves where the Company has a full price gas contract;
- Seal, in northern Alberta, where the Company has now drilled four significant Slave Point oil wells;
- Peerless Lake, Alberta, where a dual zone oil well tested at 2,500 barrels of oil per day has been recently announced.

These exploration projects have resulted in the development of a significant reserve base to be exploited in the immediate future. As a result of these exploration successes, the Company's development expenditures will increase significantly during 1987-1988.

The Federal Government has recently announced an incentive program which will reduce exploration costs by 33%. The grant program, coupled with the Alberta Government's royalty rebate program, makes these projects very economic even with today's energy prices.

Facilities Operations

Two years ago, Northstar Energy began developing a new core business concentrating on ownership of gas plants, pipelines, and processing facilities. Through acquisition and development, this division generated approximately 45% of Northstar Energy's revenues and cash flow in 1986. This business provides a steady, long-term cash flow for the Company which is less susceptible to the vagaries of oil and gas prices.

During 1986, the Company expanded its Turin custom sour gas processing plant to handle a peak capacity in excess of 50 million cubic feet per day (mmcf/d). The Company has recently constructed and operates a 12 mmcf/d gas plant in northern Alberta and has reached agreement in principle to purchase an interest in a 10 mmcf/d sour gas plant in the Birch-Wavy region.

The severe cutback in the availability of conventional bank financing to producers and the anticipated expansion in gas markets should position this division for significant growth in the coming years.

Drilling Operations

The 1986 drilling season has seen many Western Canadian drilling contractors fail and rig utilization rates fall to historic lows.

S & T Drilling continued to operate consistently at utilization rates above industry average and generated a modest contribution to 1986 net cash flow.

Although the future of this business appears troubled at the present time, the rationalization that is occurring will ensure that the survivors will be strong and profitable when recovery occurs. S & T is well positioned to maintain a significant role in the industry.

Financial Results

Gross revenues were $29.3 million in 1986, up modestly from $28.0 million in 1985.

Earnings in 1986, before and after extraordinary items, were up substantially at $442,000 and $1,068,000, respectively, compared to the nominal 1985 earnings of $17,000.

Cash flow from operations was $4.6 million, up from $4.3 million the previous year. On a per share basis, cash flow from operations increased to $1.97 per common share in 1986 as compared to $1.83 in 1985. On a fully diluted basis, cash flow was $1.09 per common share equivalent.

Financial Capability

During 1986, the Company completed approximately $50 million of financings, solidifying its financial health and increasing the Company's ability to pursue its core businesses.

- Private capital of $1 million was utilized to shoot an extensive seismic program in the Birch-Wavy area.
- $6 million was invested into Northstar Energy to increase the Company's shareholding in this subsidiary and to pay down debt.
- Certain processing facilities were sold and leased back with the proceeds of $12 million being utilized to reduce long-term debt.
- $30 million was raised through the issue of floating rate senior preferred shares.

At December 31, 1986, the Company's permanent share capital was approximately $50 million, its debt to equity ratio was a conservative 22%, and cash and marketable securities were $17.6 million.

Outlook — 1987

The Company has weathered the energy storm and has successfully positioned itself to maintain this momentum in all areas of its operations. We are confident that the Company's future financial performance will maintain a pattern of increasing asset values, cash flow, and net income.

We are grateful for the continued support and assistance provided by each of our directors. In particular, we wish to thank the retiring directors. Jim Davidson will still maintain his association through S & T Drilling. Doug Miller will continue his involvement through his new directorship with Northstar Energy.

Anthea Lister, Vice-President and Corporate Secretary, has recently left the Company after an eight year association. Her commitment and contributions have been invaluable.

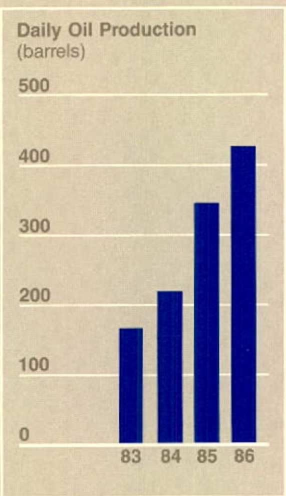
On behalf of the Board,

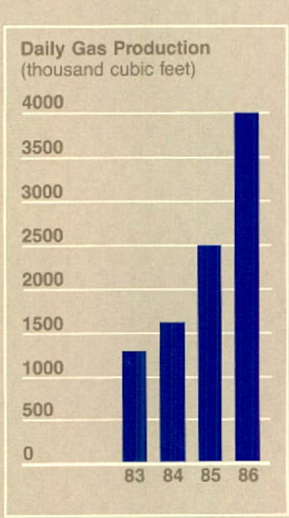
Michael M. Kanovsky
President

John A. Hagg
Chairman

April 15, 1987.

Oil and Gas Operations





All of the Company's exploration, production and processing activities are carried on through Northstar Energy Corporation, an 80% owned subsidiary.

Production and Reserves

During 1986, the Company's daily oil and gas production increased by 32% and 60% respectively, averaging 427 barrels per day of oil and 4.0 million cubic feet per day of gas. Fourth quarter volumes reached record levels at 510 barrels per day of liquids and 5.9 million cubic feet per day of gas.

After correction for production and revisions to previous estimates, the additional 289,000 barrels of net liquid reserves and 4.9 billion cubic feet of gas developed through capital expenditures in 1986 resulted in an 8% increase in the Company's total proven plus probable liquids reserves to 1,481,000 barrels and a marginal decline in gas reserves to 51.5 BCF.

Drilling Activity

Drilling activity through the year involved participation, directly or through farmouts, in 36 locations. With an overall success ratio of 70%, these operations resulted in 15 oil wells, 10 gas wells, and one service well.

The exploration successes in late 1986 in the Seal, Peerless and Birch-Wavy areas, coupled with a general strengthening of oil prices and the recently announced tax incentives, have created a very positive outlook for the Company.

Peerless Lake

The Peerless Lake area will play a major role in the growth of the Company. From its early stages, the potential of this Devonian play has been evident and through several key developments in 1986 and early 1987 our confidence in the play has been strengthened.

- Production from 5-22-89-3W5M, the initial discovery well, had exceeded 24,000 barrels by December with only a 10 psi drop in reservoir pressure.
- Of the four wells drilled in 1986 and early in 1987, the only abandonment, 13-8-89-3W5M, was junked due to downhole problems and redrilled as A13-8-89-3W5M, a dual zone producer tested at 2,500 BPD.
- 9-18-89-3W5M, cased and completed into breakup, is currently being production tested. The excellent correlation of this well with our other wells confirms the large aerial extent of the pool.

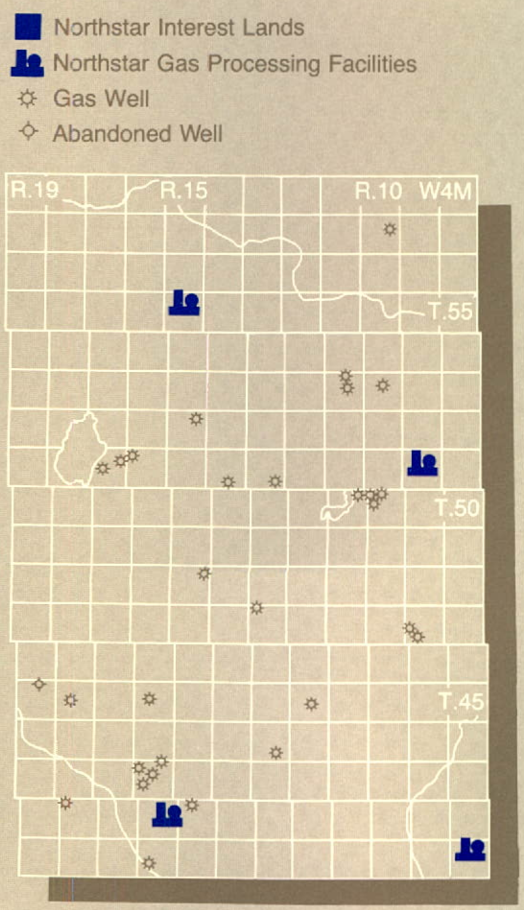
The region is now serviced with all-weather facilities and seismic programs conducted during the late winter have identified 6 or more development offsets and exploratory locations to be drilled through the course of 1987. The Company's acreage position is an average 10.2% interest in 24,640 acres.

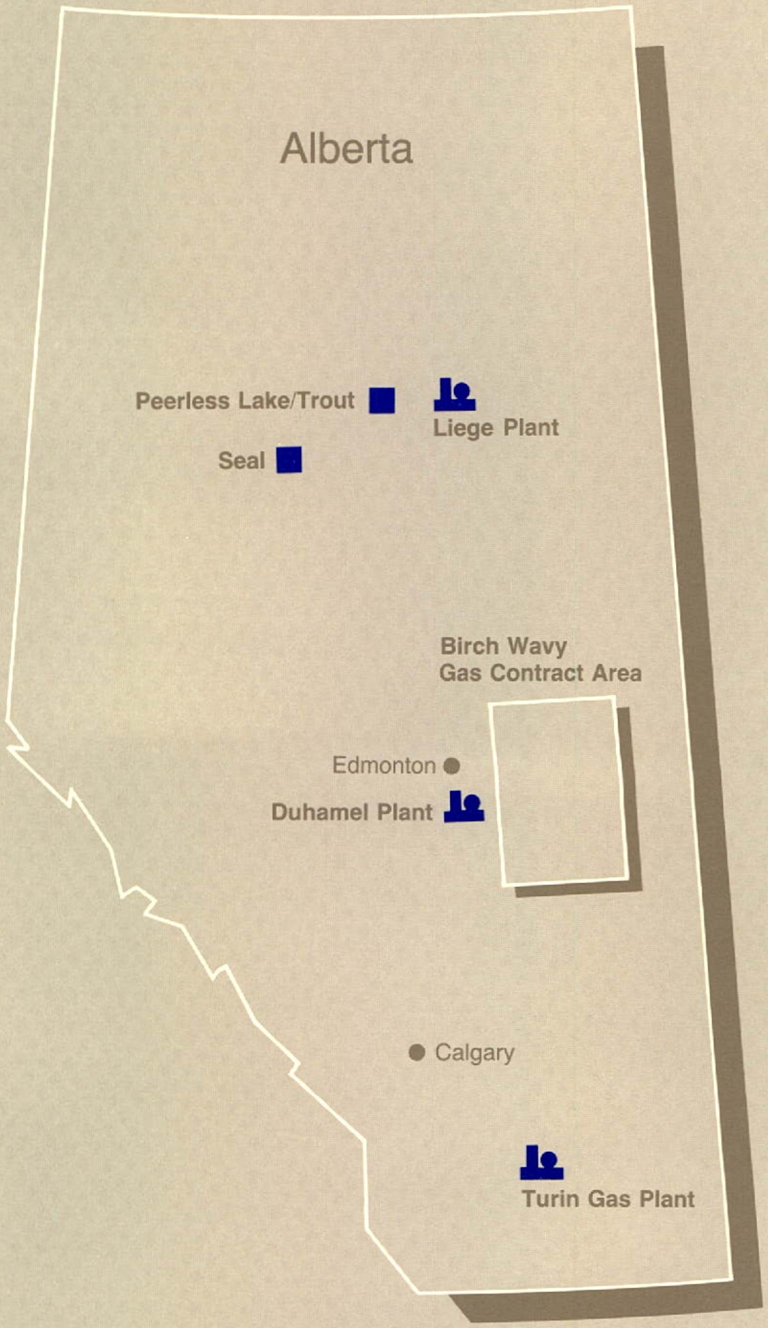
Other

The two most active areas, other than Peerless, were Birch-Wavy and Seal.

In Birch-Wavy, in East Central Alberta, the Company participated in a $1.2 million seismic program late in 1986 keyed to identifying the prolific glauconitic channel sands. That program generated 210 miles of very high quality data and with our innovative interpretation technique has created an exceptional opportunity for 1987. The first of the locations selected using the new data was drilled just prior to breakup and resulted in a successful gas well with gross marketable reserves in excess of 5 BCF on a half section. It is our expectation that we will continue achieving results of a similar nature through 1987 and this program will generate significant reserves with a finding cost approaching 10¢/MCF.

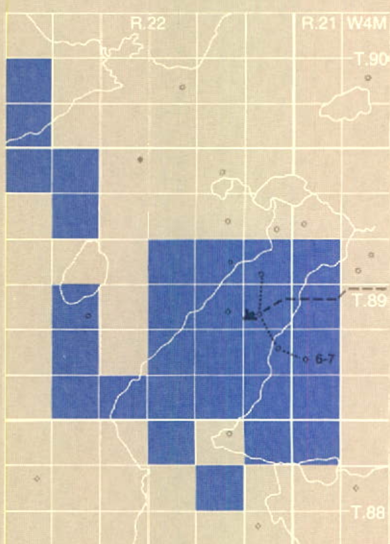
At Seal, in Northern Alberta, the activity in the Slave Point carbonate play accelerated through 1986. Although most of the details remain confidential, due to land deals pending in the area, the Company now has four wells on production and plans for continued drilling through 1987.


Northstar Interest Lands
Northstar Gas Processing Facilities
Gas Well
Abandoned Well
R.19
R.15
R.10
W4M
T.55
T.50
T.45


Alberta
Peerless Lake/Trout
Liege Plant
Seal
Birch Wavy
Gas Contract Area
Edmonton
Duhamel Plant
Calgary
Turin Gas Plant

Turin Gas Plant & Gathering System
Alberta

- Northstar Interest Lands
- Oil Well
- Gas Well
- Abandoned Well
- Plant Site



Liege
Alberta

- Northstar Interest Lands
- Location
- Oil Well
- Gas Well
- Abandoned Well
- Gathering System
- Sales Line
- Plant Site

Turin

The Company's entry into the custom processing business was through the acquisition of a private Alberta company, Turalta Resources, in late 1985. The principal asset involved in that transaction was the Turin Gas Plant located in the Lethbridge area of southern Alberta. When acquired, the plant consisted of a 40 MMSCF/D sour processing facility and an associated network of gathering lines and field compressors.

Through 1986, Northstar spent considerable effort effecting numerous critical additions and modifications to the facility. A major turnaround debottlenecked several process problems and, combined with a solvent replacement program, increased the peak capacity in winter months to in excess of 50 MMSCF/D. Fifteen hundred barrels of additional NGL storage were added and through the installation of two major pipelines 14 MMSCF/D of incremental deliverability connected to the plant.

With these improvements, Turin was able to withstand the general downturn in gas sales associated with poor markets. In spite of the throughput loss created by the two week turnaround, average volumes increased in 1986 to 22 MMSCF/D from 21 MMSCF/D in 1985.

Liege

In an agreement finalized on December 24, 1986, Northstar undertook the construction of a 12 MMSCF/D compression and dehydration facility in a remote area approximately 90 miles west of Fort McMurray. Due to the remote location, the construction of the facility had to be completed before breakup. Initial design began immediately after year end and the facility was commissioned in mid-March 1987, a total elapsed time of less than 10 weeks.

Through its investment in the plant, Northstar was carried to a seven percent working interest position in 24 sections of land, five completed gas wells and approximately eight miles of gathering system. The Company retains a 53% working interest position in, and will operate the plant.

Gas from the field is produced from the Nisku Carbonate zone. Typical of the Liege and adjacent fields, the reservoir pressure is very low but is more than offset by the exceptional porosity and permeability encountered. In fact, the 6-7-89-21W4M well acquired with the acreage tested an absolute open flow potential of 18 MMSCF/D.

Under the terms of the agreement, 53% of the gas produced from the Northstar lands will be processed in the plant on a custom fee basis. The remaining 47% is owned and will be processed by our partner in the plant.

Duhamel

Although not finalized, Northstar has reached an agreement in principle to purchase the interest of several participants in an under-utilized 10 MMSCF/D sour processing plant and associated reserves strategically located in our Birch-Wavy play. We anticipate that operatorship will be transferred to Northstar enabling the Company to maximize this investment.

Market Opportunities

In 1985, Northstar identified a specific opportunity to provide contract processing and facilities services to the oil and gas industry. Turin and Liege represent the first evidence of our entry into that market and we will continue in our dedication to development of stable long-term growth through these investments. Key staff additions in 1986 have added substantial experience in all phases of facility design, construction and operation, and will continue the development of strong technical management to optimize the Company's assets.

35 Years Proud

February 4, 1987 marked the 35th year of continuous service by the Company's oil well drilling subsidiary, S & T Drilling, to the Canadian petroleum business. In three and one half decades, S & T has drilled wells in Western Canada, the United States, the High Arctic and Australia.

From inception, the company has strived to be a leader in the industry, benefitting from the dedication of its long term employees in order to develop new and innovative techniques to improve contract drilling operations. At all times a commitment to "Performance with Safety" and a confidence in the future of Canada's petroleum industry has allowed S & T to maintain a record of achievement of which it is proud.

Progress in 1986

In 1986, the industry experienced the largest decline in its history in the number of wells drilled. In Western Canada the total well count dropped to 6,200 from a peak of 11,300 in 1985.

Early recognition of this changing environment allowed S & T to achieve relatively high rig utilization rates. Even though industry utilization dropped 47% in 1986, S & T declined by only 25%. More importantly, however, rig operating days declined only 8% from 1985 as a result of new rig additions.

S & T was able to consistently operate at the lowest daily costs experienced in years, and concurrently drill record wells in established areas. Planned Preventative Maintenance helped reduce operating costs and downtime for repairs (less than 1%) while also guaranteeing an extremely high level of confidence for meterage, or incentive, drilling.

Aggressive marketing combined with the complete co-operation from all levels of operations to meet our objectives for performance drilling have allowed S & T to continue to outperform the industry.

Rig Additions

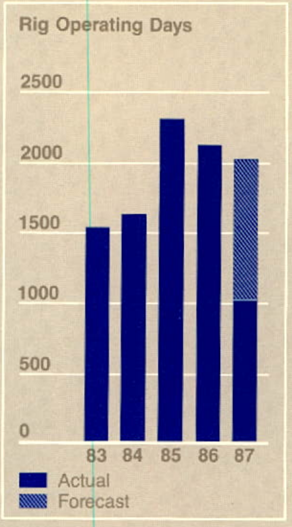
In order to achieve this consistent activity, S & T added four operating units to the fleet on a lease basis with an option to purchase. These rigs included one medium depth rig (Rig 17) and three shallower rigs (Rigs 18, 19 and 20). The lease payments are based on operating days and vary with seasonal demand, while the purchase options are fixed at slightly above current market prices.

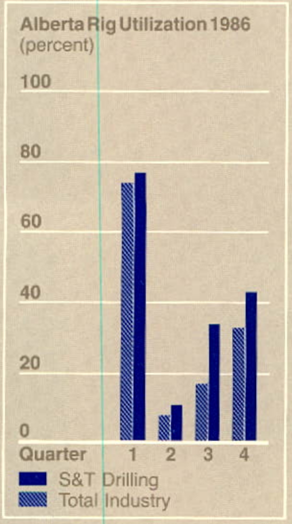
The addition of these rigs complements existing equipment, expands the depth distribution of the drilling fleet, and allows the company to move crews rather than rigs in response to market demand. By locating all the rigs in projected active areas, rig moves are kept to an absolute minimum. The company now operates 18 rigs of which 4 are leased and 14 are owned outright. Two of these are racked at the Nisku, Alberta operations centre pending improvement in market demand.

Forecast

Confidence levels within the industry are beginning to improve as a number of positive indications are surfacing. The combination of Federal government programs to generate investments, Provincial Royalty relief programs for exploratory drilling, continued high success rates for drilling in Canada, and the rationalization of the total drilling fleet should improve the prospects for individual contractors.

Projections of total wells to be drilled in Western Canada in 1987 are in the range of 5,300, with a growth of 15% in the last 3 quarters of 1987 versus 1986. Activity will be concentrated in the areas of development drilling for conventional oil and some deeper drilling for natural gas to build up reserves. With its fleet of well maintained equipment suited to almost all depths of drilling and its tightly knit operations team, S & T Drilling is well positioned to participate fully in today's competitive contract drilling market.





Rig Inventory

#	Rig Equipment	Depth Rating
1	National 55	3700 m
2	National T-32	2000 m
3	Gardener Denver 800	4200 m
4	National 50CA	2450 m
5	National T-45	2900 m
6	National 610	3700 m
7	National 610	3200 m
8	National 55*	3700 m
9	National 370	2750 m
10	Unit 34	1800 m
11	Unit 20*	4000 m
12E	National 50AE	2000 m
14E	Brewster N45E	2200 m
15	National T-32	2000 m
17	National 610	3250 m
18	Superior 350 D	1850 m
19	Failing 3000 HD	1200 m
20	Ideco H30 D	2000 m

* Racked pending improvement in market demand

Operations

Despite the sharp decline in petroleum prices during 1986, cash flow increased $319,000 to $4.6 million, or $1.97 per share. Dividends paid to preferred shareholders amounted to $704,000, resulting in cash flow attributable to common shareholders of $1.84 per share.

Earnings before extraordinary items were $442,000 for the year. The realization of a prior year income tax benefit of $626,000 resulted in 1986 net earnings of $1.1 million or $0.16 per share.

Total revenue for 1986 was $29.3 million, compared to $28.0 million for 1985. Oil and gas revenue declined 10% from the 1985 level. The major drop in oil prices was to a large extent compensated by higher production volumes. The Company's expansion into gas processing was reflected by a $3.9 million increase in revenue to $4.6 million for the year, reflecting a full year of operations for the Turin Gas Plant. Contract drilling revenue was down $1.5 million to $17.5 million, due to the curtailment of drilling activity in response to lower prices.

Oil and gas operating expenses increased 19% to $1.6 million in 1986 as a result of higher production volumes; however, per unit volume expenses fell 17%. Gas processing expenses were reasonable at $2.6 million while contract drilling expenses declined 12% to $14.0 million due to austerity measures undertaken by that division. General and administrative costs declined to $2.7 million, compared to $3.0 million in 1985.

Interest expense was $3.7 million in 1986, compared to $3.2 million in 1985. However, financing charges will be reduced in 1987 due to the substantial reduction of long-term debt completed in December, 1986.

Investment and Financial Capability

Capital expenditures, net of incentives, were $6.5 million in 1986, down sharply from 1985 and reflective of cash flow constraints imposed by lower prices. However, during the month of December, several major financing and investment transactions were completed to improve the Company's overall financial strength:

- $1.1 million was privately raised to finance an extensive seismic program.
- The Company acquired an additional 5 million shares of Northstar Energy Corporation, raising the controlling interest held in that subsidiary from 54% to 80% and reducing Northstar Energy's long-term debt by $6 million.
- The Turin gas plant was sold under a sale-leaseback arrangement for proceeds of $12.2 million, using the cash to reduce long-term debt.
- A further $30 million was raised from the issue of floating rate Senior Preferred Shares. Proceeds were used to significantly reduce long-term debt and provide surplus cash and securities of $17.6 million.

During 1986 shareholder's equity increased by $30 million, long-term debt decreased by $22.9 million to $13.6 million and cash and marketable securities increased to $17.6 million. At December 31, 1986, the debt to equity ratio stood at a very healthy 22%, compared to 66% at the end of 1985, leaving the Company well positioned to develop its core businesses and to selectively pursue future investment opportunities.

Consolidated Balance Sheet

December 31, 1986

Assets

	1986	1985
		(restated)
	(in thousands)	
Current assets		
Cash and marketable securities	**$17,558**	$ 1,417
Accounts receivable (note 6)	**7,058**	11,819
Inventory	**331**	246
	24,947	13,482
Investments (note 4)	**11,209**	10,406
Property and equipment (notes 5 and 6)	**53,818**	70,091
	$89,974	$93,979

Liabilities and Shareholders' Equity

	1986	1985
Current liabilities		
Accounts payable	**$ 7,477**	$13,469
Long-term debt — current portion	**929**	698
	8,406	14,167
Deferred revenue	**4,132**	2,418
Long-term debt (note 6)	**13,580**	36,501
Deferred income taxes	**2,220**	2,060
Minority interest	**12,103**	19,640
	40,441	74,786
Share capital (note 7)	**48,065**	18,089
Retained earnings	**1,468**	1,104
	49,533	19,193
	$89,974	$93,979

Approved on behalf of the Board

, Director , Director

Consolidated Statement of Earnings

Year Ended December 31, 1986

	1986	1985
	(in thousands except per share amounts)	
Revenue		
Oil and gas (net)	$ 5,068	$ 5,642
Processing	4,649	776
Contract drilling	17,521	19,065
Fees, interest, and other	2,082	2,478
	29,320	27,961
Expenses		
Operating — oil and gas	1,562	1,313
— processing	2,618	433
— contract drilling	14,001	15,835
General and administrative	2,706	3,023
Interest	3,671	3,193
Depletion and depreciation	3,143	2,514
	27,701	26,311
Earnings before income taxes	1,619	1,650
Income taxes (note 8)		
Current (recovery)	671	(172)
Deferred	160	1,322
	831	1,150
Earnings before the following	788	500
Minority interest	346	483
Earnings before extraordinary item	442	17
Realization of income tax loss from prior year	626	—
Net earnings	$ 1,068	$ 17
Net earnings (loss) per share		
— before extraordinary item	$ (0.11)	$ 0.01
— after extraordinary item	$ 0.16	$ 0.01
Cash flow from operations (note 9)	$ 4,574	$ 4,255
Cash flow per share	$ 1.97	$ 1.83

Consolidated Statement of Retained Earnings

Year Ended December 31, 1986

	1986	1985
	(in thousands)	(restated)
Retained earnings, beginning of year		
As previously reported	$ 357	$ 340
Adjustment of prior year's deferred income taxes (note 13)	747	747
As restated	1,104	1,087
Net earnings	1,068	17
Dividends	(704)	—
Retained earnings, end of year	$ 1,468	$ 1,104

Consolidated Statement of Changes in Cash Position

Year Ended December 31, 1986

	1986	1985
	(in thousands)	
Provided by (used in) operating activities		
Cash flow from operations (note 9)	**$ 4,574**	$ 4,255
Deferred revenue	**(267)**	21
	4,307	4,276
Provided by (used in) financing activities		
Long term debt, net	**(22,690)**	9,533
Equity — preferred shares	**30,000**	9,362
— common shares of subsidiary	**(78)**	5,002
Preferred share dividends — Company	**(704)**	—
— subsidiary	**(355)**	—
Change in non-cash working capital	**(3,299)**	3,949
	2,874	27,846
Provided by (used in) investing activities		
Property and equipment, net	**(6,487)**	(18,009)
Investments	**833**	(12,341)
Acquisition of Turalta Resources Ltd.	**—**	(9,315)
Sales — facilities	**12,165**	—
— resource properties	**2,074**	2,098
— investments	**375**	5,880
	8,960	(31,687)
Increase in cash	**16,141**	435
Cash, beginning of year	**1,417**	982
Cash, end of year	**$17,558**	$ 1,417

Cash is comprised of cash and marketable securities.

Auditors' Report

To the Shareholders
Canadian Northstar Corporation

We have examined the consolidated balance sheet of Canadian Northstar Corporation as at December 31, 1986 and the consolidated statements of earnings, retained earnings and changes in cash position 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, these consolidated financial statements present fairly the financial position of the Company as at December 31, 1986 and the results of its operations and changes in cash 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
April 24, 1987

Touche Ross & Co.
Chartered Accountants

1. SIGNIFICANT ACCOUNTING POLICIES

(a) **Principles of consolidation**
The consolidated financial statements include the accounts of the Company, its subsidiaries and proportionate interests in various partnerships.

(b) **Marketable securities**

Marketable securities are carried at the lower of cost and net realizable value.

(c) **Inventory**
Inventory is carried at the lower of cost and net realizable value.

(d) **Investments**
Investments are carried at the lower of cost and net realizable value.

(e) **Exploration and development costs**
The Company follows the full cost method whereby exploration and development costs are capitalized on a country by country basis. Such costs include direct acquisition, exploration and development costs together with applicable overhead and carrying charges, net of government incentives and tax credits. Proceeds from disposals are normally deducted from the full cost pool without recognition of gains or losses.

A ceiling test is employed annually to ensure the costs accumulated by cost centre and for the Company as a whole do not exceed future cash flows from estimated proven reserves and the cost of undeveloped properties. For purposes of this test, future cash flows are determined using year-end prices and costs, including deductions for applicable overhead, financing and income tax expenses.

(f) **Depletion and depreciation**
Petroleum and natural gas properties, excluding undeveloped properties, are depleted using the unit-of-production method based on estimated proven reserves before deduction of royalties and after conversion to units of common measure based on relative energy content.

Drilling equipment is depreciated to salvage value based on operating days. Replacement of components and pipe repairs are charged to expense as incurred.

Processing facilities are depreciated using the unit-of throughput method based on estimated total processing volumes over the life of each facility.

(g) **Foreign currency translation**
The accounts of the foreign subsidiary and other foreign operations are translated into Canadian Dollars on the following basis: monetary assets and liabilities at the year-end exchange rate; other assets and liabilities at historical exchange rates; revenue and expense accounts at average exchange rates prevailing during the year except for depletion and depreciation which are translated at the same rates as related assets. Resulting gains or losses are recognized in the statement of earnings.

(h) **Revenue recognition**
Contract drilling revenue is recognized on either a per day or depth drilled basis according to the nature of individual contracts.

Prepayments for undelivered gas are initially deferred and are recognized as revenue when deliveries are made or on expiry of the period allowed for such deliveries.

2. CHANGE IN ACCOUNTING POLICY

Effective January 1, 1986, the Company prospectively adopted the new CICA Full Cost Guideline. This change does not have a material effect on the financial statements for the current or future years.

3. ACQUISITION OF ADDITIONAL SHARES OF SUBSIDIARY

On December 31, 1986, the Company acquired 5,000,000 additional common shares of Northstar Energy Corporation ("NEC") for cash consideration of $6.0 million and thereby raised the Company's interest in NEC from 54% to 80%. As a result of this acquisition, property and equipment and minority interest have each been reduced by $4.4 million.

4. INVESTMENTS

	1986	1985
	(in thousands)	
Floating rate debenture due June 30, 1988	$ 3,000	$ 3,000
Secured notes	4,673	6,308
Investment in associated company	2,500	2,500
Other	1,371	916
	11,544	12,724
Less current portion of secured notes	335	2,318
	$11,209	$10,406

The secured notes are due December 31, 1995, bear interest at the prime rate plus 1% and are secured by an assignment and pledge of certain partnership interests. The notes will be repaid solely out of cash distributions from those partnerships.

5. PROPERTY AND EQUIPMENT

	1986			1985
	Cost or written down value	Accumulated depreciation and depletion	Net book value	Net book value
		(in thousands)		
Petroleum and natural gas properties	$47,326	$ 8,450	$38,876	$47,669
Drilling equipment	15,703	1,843	13,860	12,909
Processing facilities	1,097	15	1,082	9,513
	$64,126	$10,308	$53,818	$70,091

Undeveloped properties not subject to depletion at December 31, 1986 amounted to $2.8 million (1985 - $2.0 million).

Property and equipment with a net book value of approximately $10 million has a zero cost base for income tax purposes.

Overhead capitalized in 1986 amounted to $671,000 (1985 - $514,000).

A gain of $1,960,748 realized from the sale of certain processing facilities, which were subsequently leased back to the Company, is being amortized over the term of the lease.

6. LONG-TERM DEBT

	1986	1985
	(in thousands)	
Bank operating loan	**$ 3,543**	$ 4,169
Production loan	**598**	11,548
Revolving term loan	**5,000**	4,327
Rig loan	**343**	405
Subordinated income debenture	**5,000**	5,000
Bank loans	**25**	623
Notes payable and other	**—**	11,127
	14,509	37,199
Less current portion	**929**	698
	$13,580	$36,501

The bank operating loan is repayable on demand, bears interest at the prime rate plus ½% and is secured by a first fixed charge on certain oil and gas properties and a general assignment of accounts receivable. The loan is repayable from future production revenues and is not expected to require the use of existing working capital; therefore no portion of the loan has been classified as current. The Company had unutilized operating loan facilities aggregating $2.7 million at December 31, 1986 (1985 - $2.3 million).

The production loan is repayable on demand and bears interest at the bank prime rate plus ⅜%. The loan is secured by the Company's interest in certain limited partnerships and the secured notes described in note 4. The loan will be repaid out of cash flow from the partnerships.

The revolving term loan bears interest at the bank prime rate. The loan and the subordinated income debenture described below are secured by a fixed and floating charge against the assets of S & T Drilling Ltd. and a general assignment of accounts receivable. Scheduled repayments are as follows: 1987 — $833,333; 1988 — $1,666,667; 1989 — $2,500,000.

The rig loan bears interest at the bank prime rate plus 1¼% and is secured by certain drilling equipment. Scheduled repayments are as follows: 1987 — $70,000; 1988 — $273,000.

The subordinated income debenture bears interest at one half of the bank prime rate plus 1%, payable annually in arrears to the extent of 30% of adjusted net income of a subsidiary, S & T Drilling Ltd. ("S & T"), if earned. The debenture matures in 1989 at which time S & T may require the bank to convert any unpaid portion to non-voting common shares of S & T. For the period ended October 31, 1986, interest was not accrued due to insufficient profits and cash flow.

7. SHARE CAPITAL

	1986	1985
	(in thousands)	
Senior Preferred Shares, no stated value, authorized — unlimited; issued 1,200,000 cumulative Series A shares having a stated value of $25.00 (1985 — nil)	$30,000	$ —
Junior Preferred Shares, no stated value, authorized — unlimited; issued 1,884,460 cumulative Series A shares having a stated value of $5.00	9,422	9,422
Common Shares, without nominal or par value, authorized — unlimited; issued 2,318,669 shares	8,643	8,666
	$48,065	$18,088

(a) During the year, the Company issued 1,200,000 Senior Preferred Shares, Series A, pursuant to a private placement. Share issue costs totalling $18,000 have been netted against common share capital. The Senior Preferred Shares, Series A, are redeemable at any time and carry a dividend of 75% of the average bank prime rate.

(b) The Junior Preferred Shares, Series A, carry a dividend of 75% of the average bank prime rate and are convertible to Common Shares on a one for one basis until June 30, 1988. Holders are entitled to attend and vote at all meetings of common shareholders and under certain conditions will rank equally with common shareholders in the payment of dividends or in the event of dissolution of the Company.

The Junior Preferred Shares, Series A, carry non-detachable warrants enabling the holder to purchase additional Junior Preferred Shares until January 21, 1989. Two warrants are required to purchase one additional Junior Preferred Share at an exercise price of $5.00 per share; 942,230 Junior Preferred Shares have been reserved for exercise of these warrants.

(c) At December 31, 1986, 22,720 Common Shares were reserved for stock options to senior officers at an exercise price of $5.00 per share. The options expire on June 29, 1994.

(d) On November 7, 1984, the shareholders approved an extraordinary resolution to reduce the common share capital of the Company by $19,719,000 thereby eliminating the deficit as previously reported December 31, 1983.

8. INCOME TAXES

Income tax expense varies from the expected provision obtained from applying the effective income tax rate of 48% (1987 — 47%) to earnings before income taxes.

	1986	1985
	(in thousands)	
Computed "expected" income taxes	**$760**	$ 779
Increases (decreases) resulting from:		
Non-deductible Crown payments	**337**	426
Non-deductible depletion	**38**	156
Resource allowance	**(278)**	(486)
Earned depletion	—	(60)
Alberta royalty tax credit	**(138)**	(120)
Non-taxable dividends	**(106)**	—
Loss carry forward without virtual certainty of recovery	—	383
Provision for taxes on acquisition	**248**	70
Other	**(30)**	2
Actual income tax provision	**$831**	$1,150

The Company and its consolidated subsidiaries have unrecognized non-capital and capital losses carried forward of approximately $2.5 million and $426,000 respectively available for offset against future income for tax purposes. The non-capital losses expire at various dates subsequent to 1989.

9. CASH FLOW FROM OPERATIONS

	1986	1985
	(in thousands)	
Cash flow from operations before the following	**$4,528**	$4,255
Income tax relating to sale of facilities	**(580)**	—
Realization of income tax loss from prior year	**626**	—
	$4,574	$4,255

10. SEGMENTED INFORMATION

The Company is active in Canada in oil and gas exploration and development, contract drilling, and gas processing.

	1986			
	Oil and gas and other	**Contract drilling**	**Processing**	**Total**
	(in thousands)			
Revenue	**$ 7,149**	**$17,521**	**$ 4,650**	**$29,320**
Earnings (loss) before extraordinary items	**$ 369**	**$ 308**	**$ (235)**	**$ 442**
Identifiable assets	**$71,982**	**$16,798**	**$ 1,194**	**$89,974**

	1985			
	Oil and gas and other	Contract drilling	Processing	Total
	(in thousands)			
Revenue	$ 8,120	$19,065	$ 776	$27,961
Earnings (loss) before extraordinary items	$ (516)	$ 352	$ 181	$ 17
Identifiable assets	$65,127	$18,185	$10,667	$93,979

11. LEASE COMMITMENTS

The Company has entered into operating lease agreements covering certain gas processing facilities and office space. Minimum annual lease commitments are as follows: 1987 — $1,801,000; 1988 — $1,929,000; 1989 — $1,936,000; 1990 — $1,936,000; 1991 — $1,936,000.

12. RELATED PARTY TRANSACTIONS

The Company has entered into transactions with affiliated companies and certain senior officers, the terms and conditions of which are in the normal course of business.

13. COMPARATIVE FIGURES

Certain 1985 comparative figures have been reclassified to conform with the current year's presentation. The 1985 financial statements have been adjusted to correct income taxes provided on interest that was forgiven in 1984. As a result, opening retained earnings and minority interest have increased by $747,000 and $639,000 respectively, while deferred taxes have decreased by $1,386,000.

Corporate Information

Head Office
1130 Sunlife Plaza
140 - 4th Avenue S.W.
Calgary, Alberta T2P 3N3
Telephone (403) 261-4830

Principal Subsidiaries
Northstar Energy Corporation
(formerly Gane Energy
Corporation Ltd.)
1130 Sunlife Plaza
140 - 4th Avenue S.W.
Calgary, Alberta T2P 3N3
Telephone (403) 261-4830

Northstar Investment Corporation
1130 Sunlife Plaza
140 - 4th Avenue S.W.
Calgary, Alberta T2P 3N3

S & T Drilling Ltd.
1160 Sunlife Plaza
140 - 4th Avenue S.W.
Calgary, Alberta T2P 3N3
Telephone (403) 234-7361

Auditors
Touche Ross
Calgary, Alberta

Registrar and Transfer Agent
The Canada Trust Company
505 - 3rd Street S.W.
Calgary, Alberta T2P 3E6

Stock Exchange Listings
The Toronto Stock Exchange — CNX
The Alberta Stock Exchange — CNX

Officers
John A. Hagg
Chairman

Michael M. Kanovsky
President

Brian K. Lemke
Treasurer and Corporate Secretary

Directors
John W. Burrows, Calgary (2)
Chairman of the Board,
Novatel Communications Ltd.

James W. Davidson, Edmonton (3)
Chairman (retired),
S & T Drilling Ltd.

Robert A. Dunford, Toronto
Executive Vice President,
Administration
Brascan Limited

John A. Hagg, Calgary (1)
Chairman of the Company

Michael M. Kanovsky, Calgary (1)
President of the Company

David W. Kerr, Toronto (1) (2)
President,
Noranda Inc.

(1) Member of the Executive Committee
(2) Member of the Audit and Compensation Committee
(3) Not standing for reelection

ronalds printing
Printed in Canada

Canadian Northstar Corporation
1130, 140 Fourth Avenue S.W.
Calgary, Alberta
T2P 3N3
Telephone (403) 261-4830