



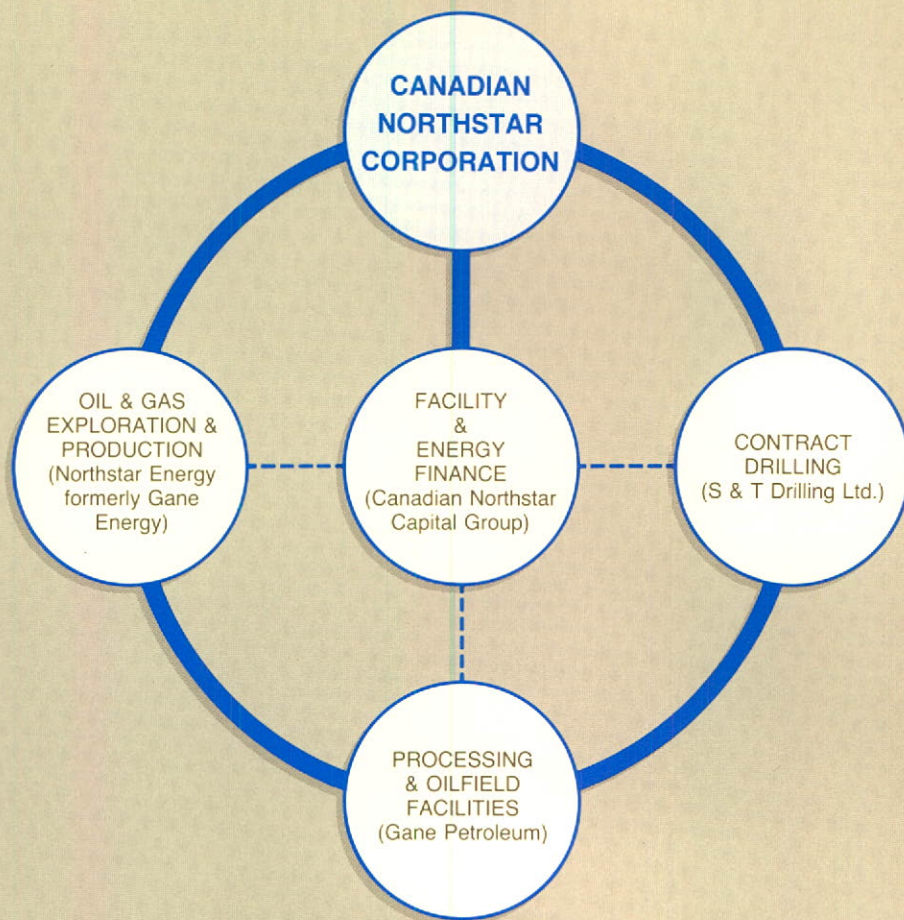
CANADIAN NORTHSTAR CORPORATION ANNUAL REPORT 1985



Company Profile

Canadian Northstar Corporation is a Canadian integrated resource company headquartered in Calgary, Alberta. The Company engages in petroleum and natural gas exploration, production and processing principally in Canada. The Company also owns an Alberta based drilling contractor which operates 13 medium depth rigs. Activities of increasing importance include resource investments and related financial transactions.

The Company was incorporated under the Laws of the Province of Alberta on January 11, 1978. In December, 1985, the shareholders approved the change of name from Northstar Resources Ltd to Canadian Northstar Corporation. The common shares are listed on The Toronto Stock Exchange and The Alberta Stock Exchange under the trading symbol CNX.



Annual Meeting

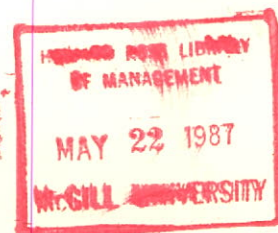
The annual meeting of the shareholders will be held at the Calgary Petroleum Club, 319 - 5th Avenue S.W., Calgary, Alberta at 3:00 p.m., Thursday, June 26, 1986.

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		1985	1984	Change
Financial (thousands, except per share data)	Gross revenues	\$27,961	\$17,859	57%
	Earnings (loss) before extraordinary items	17	(668)	N.A.
	per share	0.01	(0.29)	N.A.
	Net earnings	17	205	(92%)
	per share	0.01	0.09	(89%)
	Cash flow from operations	4,255	1,689	152%
	per share	1.83	0.73	151%
	Total assets	93,979	56,366	67%
Shareholders' equity	18,446	9,074	103%	
Oil and Gas Operations	Crude oil production (gross bbls)			
	Annual	126,000	80,665	56%
	Per day	345	221	
	Natural gas production (gross mcf)			
	Annual	923,000	584,000	58%
	Per day	2,500	1,600	
	Gross reserves			
	Crude oil and liquids (bbls)	1,375,000	1,055,000	30%
	Natural gas (Mmcf)	53,600	34,200	57%
	Land holdings			
Gross acres	830,000	817,000	2%	
Net acres	106,000	140,000	(24%)	
Drilling Operations	Rig operating days	2,114	1,779	19%
	Utilization rate — S & T	61%	52%	17%
	— industry	56%	47%	19%
Common Share Information	Market price			
	High	\$0.86	\$1.40	
	Low	\$0.57	\$0.62	
	Close	\$0.75	\$0.70	
	Number of shares traded	1,937,154	1,814,654	
Shares outstanding*	11,593,346	11,593,346		

*Share information data shown before consolidation of common shares at year end on 1 for 5 basis; financial per share data shown post consolidation with 2,318,669 shares outstanding.



Industry Overview

The negative impact of the precipitous fall in oil prices in recent weeks has been severe. Total industry cash flow has been sharply curtailed and a pall of gloom has been cast over an industry historically known for its optimism.

Ironically, the oil price "crisis" of 1986 has come hard on the heels of the enthusiasm generated in the industry only a few months ago by the elimination of the National Energy Program and the substantial deregulation of the industry in Canada.

While it is clear that industry activity levels will be greatly reduced over the next year, opportunities will be created. Assets such as land, reserves, equipment and facilities will all be available at historically low price levels. The capital needs of many companies will force them to make available low risk, high upside investment opportunities.

In the Northstar group, we believe we have the technical and financial expertise necessary to turn the challenges presently confronting this industry into opportunity.

Corporate Structure

The Company is involved in four inter-related sectors of the petroleum industry, with the focus in Alberta.

● Energy Financing & Investments

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

● Oil & Gas Operations

Northstar Energy, the proposed new name for the Company's principal operating subsidiary, Gane Energy, controls a rapidly expanding base of producing oil and gas assets and maintains a highly skilled exploration group.

● Processing and Facilities

Gane Petroleum owns and manages the Company's increasingly significant investments in processing and oilfield facilities.

● Contract Drilling

S & T Drilling, a well financed and long established Alberta based drilling contractor, operates thirteen drilling rigs in Western Canada.

Financial Results

Gross revenues were \$28.0 million in 1985, an increase of 57% over the \$17.9 million reported in 1984.

Cash flow from operations increased 152% to \$4.3 million, up from \$1.7 million the previous year. On a per share basis, cash flow from operations increased to \$1.83 from \$0.73.

During the first three months of 1986, revenues increased to \$11.5 million from \$8.2 million the previous year. Cash flow from operations was \$2.9 million or \$1.25 per share.

During 1985, the Company's \$9.4 million of convertible debentures due in 1988 were exchanged for voting junior preferred shares. This conversion of debt to permanent equity significantly strengthened the Company's balance sheet and, indeed, substantially eliminated the debt in the parent company.

The Company's consolidated balance sheet reflects increased debt primarily from acquisitions which occurred in the fourth quarter. The results of these transactions will not be fully reflected in the statement of earnings until 1986. In addition, the majority of the Company's debt has recourse solely to the assets of subsidiary companies.

Management believes that the recent share trading price of the common shares does not fully reflect underlying asset values, nor an appropriate multiple of cash flow performance.

Oil and Gas Operations

Average daily oil production surpassed 500 barrels per day during the fourth quarter of 1985 and averaged 345 barrels per day during the year. Similarly, gas production approximated 6 million cubic feet per day in the fourth quarter, averaging 2.5 million cubic feet per day throughout the year.

The principal focus for new exploration was in Alberta. In our Birch-Wavy gas contract area, several sizeable gas channel discoveries were made in 1985. In the Peerless area, the Company participated in a Keg River oil discovery offset by 25,000 acres of Company owned lands.

In Colorado, the Company sold its remaining working interest in the La Garita play, on which no reserves have yet been proved, for \$1.2 million.

A substantial package of Alberta producing oil and gas properties was purchased for \$11.6 million. Included in the acquisition were varying interests in 11 oil wells and 135 gas wells, involving a total of 186,000 gross acres.

Late in 1985, the Company purchased Turalta Resources Ltd., a private Alberta gas processing company, for \$9.8 million. The financing was provided, in part, by issuing \$5.0 million of 7% third preferred shares of Gane Petroleum Corporation.

Drilling Operations

The recovery in the Alberta drilling industry, which began two years ago, peaked in February of 1986. While the outlook for drilling activity levels for the balance of this year looks

exceptionally bleak, the profitable winter season just completed has left S & T Drilling in a strong financial position to face the challenges ahead. The financial restructuring completed in 1984 will ensure that S & T Drilling is one of the survivors in the contract drilling industry.

Objectives for 1986

The Company's oil and gas and drilling divisions will work overtime in the coming year to minimize costs and achieve maximum productivity from existing assets. Opportunities to acquire new assets for value will be carefully scrutinized.

An opportunity exists in these unsettled economic times to expand the Company's involvement in energy financing activities and to increase direct investments in processing and oilfield facilities. These areas will be the principal focus for growth this year.

The Company's share price does not currently reflect its fair value and we will seek to improve investor awareness of the Company's business in the months ahead.

The difficulties currently facing the petroleum industry in Canada and worldwide cannot be minimized. However, we believe that Canadian Northstar will be able to continue to meet its principal objective of maintaining long term growth in shareholder values.

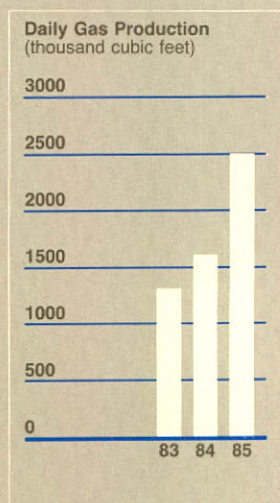
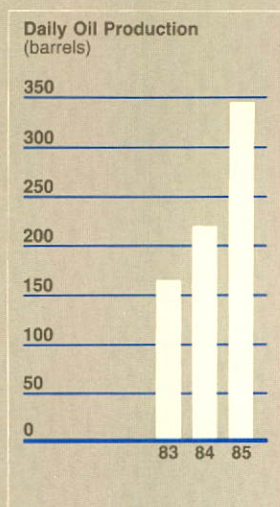
We are grateful for the support and assistance provided by our Board of Directors and appreciate the dedication of the Company's loyal employees.

On behalf of the Board,

Michael M. Kanovsky
President.

John A. Hagg,
Chairman.

May 1, 1986.



Oil and Gas Reserves

	Gross Reserves	
	Proved	Probable
Oil and gas liquids (bbbls)	1,324,000	51,000
Natural gas (MMcf)	45,300	8,300
Present value		
— undiscounted ('000s)	\$114,000	\$22,000
— discounted @ 15% ('000s)	\$ 34,000	\$ 3,000

Drilling Activity

In 1985, a total of 88 wells were drilled on Company acreage, resulting in 20 oil wells and 36 gas wells. Of these, 36 wells were drilled at no cost to the Company on acreage farmed out.

Projected drilling activity for the balance of 1986 has been substantially curtailed, reflecting the impact of lower oil and gas prices and generally poorer exploration economics.

Production and Reserves

In 1985, daily oil and gas production increased 56% to 345 barrels of oil per day and 2.5 million cubic feet of gas per day.

In the fourth quarter, daily oil production averaged over 500 barrels of oil per day and gas production, 5.5 million cubic feet per day.

The Company's oil reserves increased 30% to 1.4 million barrels. Gas reserves increased 57% to 53.6 billion cubic feet.

The increase in production and oil and gas reserves in 1985 is due both to the Company's drilling success in Alberta and the acquisition of certain producing oil and gas properties.

Birch-Wavy, Alberta

The Company acquired over 380 miles of seismic in our gas contract area and drilled 13 wells in 1985, of which 8 were completed as gas wells. Approximately 5.5 billion cubic feet of additional gas reserves were dedicated to the Company's TransCanada area gas contract and production commenced late in the year.

The Company has developed a high level of expertise in this area in combining detailed geological interpretation with high resolution seismic. We expect to benefit from this knowledge in 1986 by continuing to develop low risk prospects with high gas reserves potential.

Peerless Lake, Alberta

The Company owns an 11.5% working interest in approximately 25,000 acres in the Senex-Peerless-Trout area of north-central Alberta, encompassing approximately 25,000 acres. Canadian Roxy et al Trout 5-22-89-3 W5M was completed in February 1986 as a significant Keg River oil discovery and is capable of producing in excess of 600 barrels of oil per day. Anticipated reserves are in the order of 300,000 barrels recoverable per well.

A scheduled second exploratory well was deferred until next winter because of early spring break-up this year. Development drilling offsetting the initial discovery well will commence as soon as conditions permit.

Misty Lake, Alberta

In the Misty Lake area of eastern Alberta, 7 wells were drilled of which 4 were completed as oil wells and 3 as gas wells. The Company has an average 35% working interest in approximately 6,000 acres in the area.

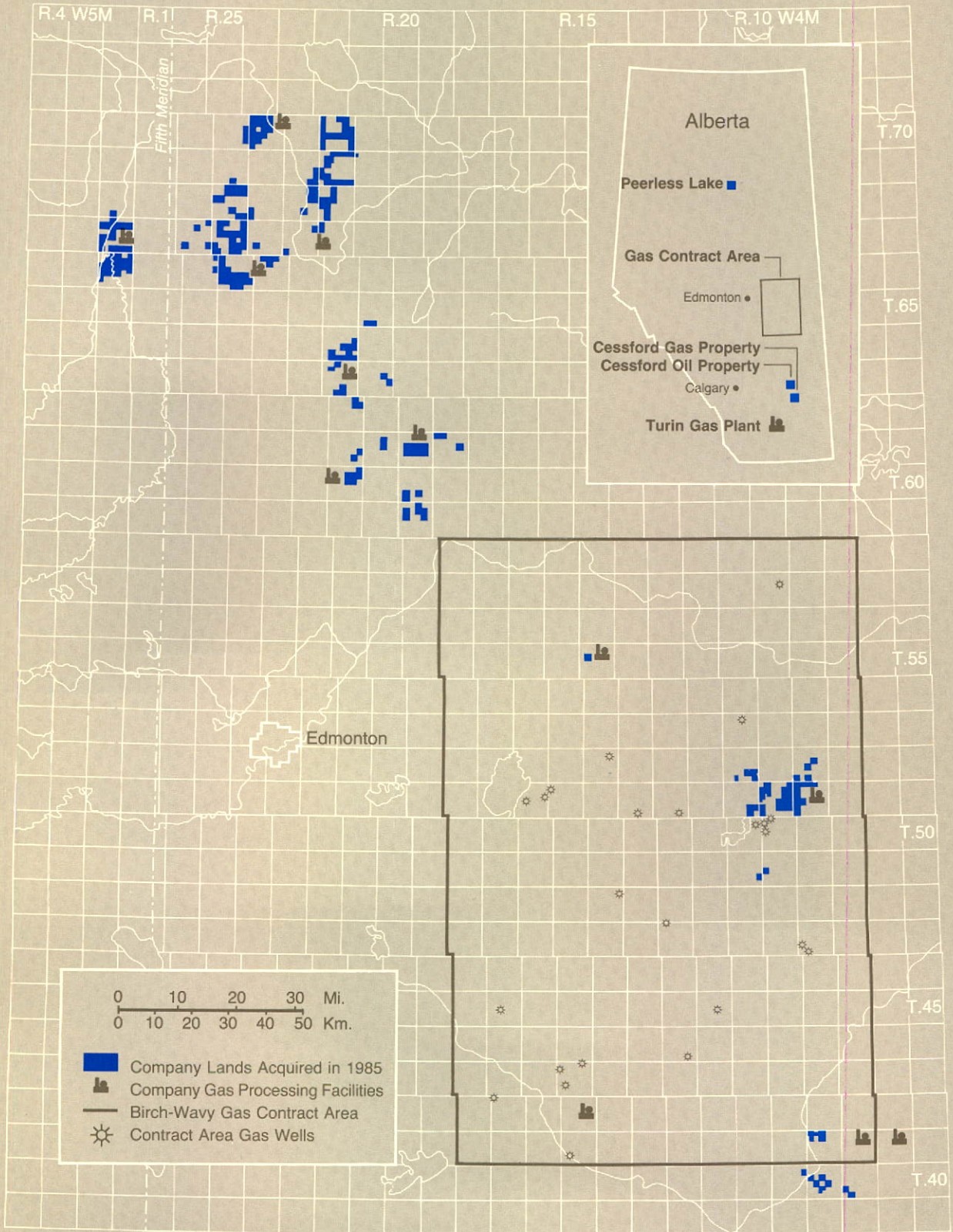
Gas has been encountered in 5 different zones and approximately 6 billion cubic feet of gas have been developed. We are currently examining the feasibility of building a plant and gathering system in the area to bring these reserves on production.

La Garita, Colorado

In late 1983, Canadian Northstar and its partners entered into a joint venture whereby a large U.S. independent purchased an 80% working interest in this 260,000 acre wildcat oil project.

The purchaser had undertaken to drill 2 wells while the Company was "carried" for a net working interest of 9.5%. The 2 earning wells were drilled in 1985 and were plugged and abandoned.

At the end of the year, the Company entered into an agreement to sell its remaining 9.5% working interest for approximately \$1.2 million, and retained an approximate 2% gross overriding royalty interest. This transaction was completed in January, 1986.



Gane Energy 1985-86 Fund — \$15 million

As part of the Company's continued thrust to structure and manage innovative financings for investors, Canadian Northstar Corporation successfully placed a \$15 million private fund during 1985 to undertake the majority of the Company's exploration activities through mid-1986.

Property Acquisitions

During the year, a substantial package of producing oil and gas properties was purchased by the Company's oil and gas subsidiary from an affiliate of the Company, for \$11.6 million.

The transaction involved approximately 186,000 gross acres, including 11 producing oil wells and 135 gas wells located principally in east-central Alberta.

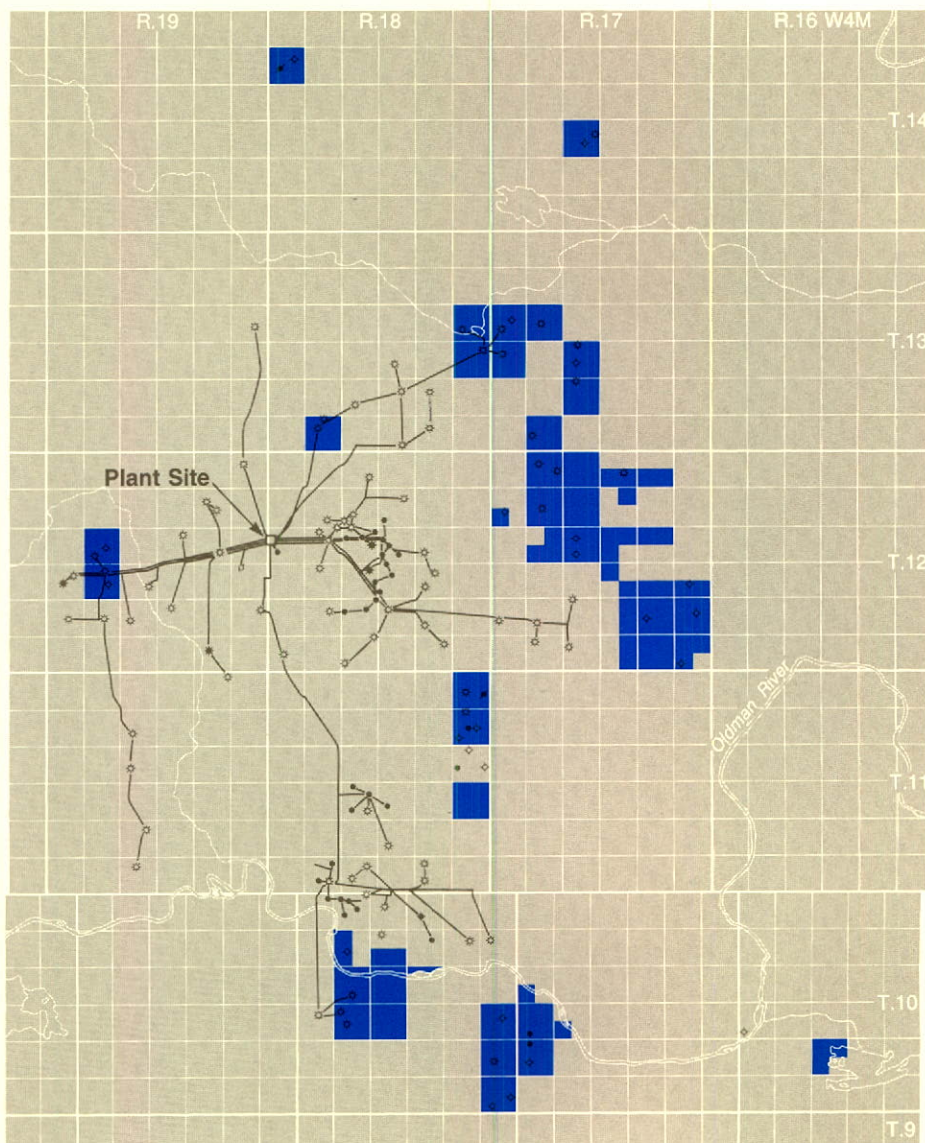
In the Cessford area, the Company acquired a 15% gross overriding royalty interest in 45 gas wells and an extensive drilling program was commenced in 1985.

Also included was a 21% working interest in 2¼ sections in the Cessford area, containing 11 producing Lower Cretaceous oil wells with gross remaining reserves under primary recovery in excess of 1.2 million barrels. A secondary recovery feasibility study is currently underway respecting this project.

Turin Gas Plant

The Company has made a significant investment in processing and oilfield facilities through the acquisition of Turalta Resources Ltd., a private Alberta company, in November 1985.

Through this \$9.8 million transaction, the company acquired control of the Turin Gas Plant, a 40 million cubic feet per day sour gas processing and liquids recovery facility in southern Alberta.



Turin Gas Plant & Gathering System
Southern Alberta

- Company Interest Lands
- Location
- Oil Well
- ★ Gas Well
- ⊗ Abandoned Well

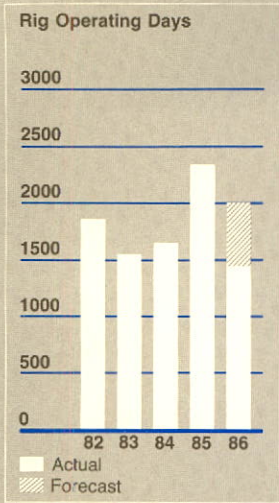
The Turin facility is one of the largest contract gas processing plants in southern Alberta, providing services to approximately two dozen independent gas producers. The facility includes an extensive network of pipelines and compressors tied into approximately 75 producing wells.

A number of additional wells have been tied into the plant in early 1986 and as a result, it is expected that 1986 processing volumes and revenues will increase over 1985 levels.

Market Opportunities

The Company believes that a specific opportunity exists in these unsettled economic times to provide contract processing and facilities services, particularly to small and intermediate sized oil companies.

We will aggressively pursue investment opportunities in the facilities side of the oil industry in order to develop a stable base of long term growth in cash flow and earnings.



Rig Inventory

Rig Equipment	Depth Rating
# 1 National 55	3700 m
2 National T-32	2000 m
3 National 55	3700 m
4 National 50CA	2450 m
5 National T-45	2900 m
6 National 610	3700 m
7 National 610	3200 m
8 Gardener Denver 800*	4000 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

*Both rigs currently racked pending recovery in deeper drilling demand.

Alberta Drilling Rig Utilization 1985-86

	S & T	Industry
No. of Rigs	12*	435
1985 January	81%	71%
February	87%	76%
March	71%	68%
April	25%	25%
May	23%	32%
June	56%	51%
July	53%	56%
August	63%	54%
September	68%	52%
October	55%	51%
November	69%	66%
December	87%	69%
Average	61%	56%
1986 January	84%	80%
February	89%	82%
March	56%	62%

*Rigs 14E and 15 initiated operations in May and September, 1985, respectively.

Contract Drilling Operations

The beginning of 1986 marks the thirty-fourth year of continuous service by S & T Drilling to the oil and gas industry and the fifth year of active participation by the Northstar group of companies.

These five years have once more demonstrated the highly cyclic and intensely competitive nature of this sector of the industry. In this short period, demand for drilling has gone "full cycle" from almost complete utilization in 1981 through fifty percent utilization in 1983 and back to full utilization in late 1985.

Throughout, however, S & T has consistently achieved competitive levels of activity based on the excellent depth distribution of its fleet of shallow to medium depth rigs and the ability of its operating personnel to function effectively on a performance related drilling incentive basis.

The combination of these strengths and the timely refinancing arrangements completed in 1984 have allowed S & T to weather the last slow down in activity and subsequently generate sufficient income to not only update its existing rigs, but also add new equipment to take full advantage of either a recovery in the industry or another down turn.

Progress in 1985

During 1985, S & T increased its overall rig utilization to 61% from 52% in 1984. More importantly, utilization during the high demand months of winter improved to 77%. Also, the successful completion of a heavy oil specialized drilling project in Cold Lake, Alberta and higher than normal summer activity significantly improved operating margins and profits.

Rig Additions

In late 1984 and early 1985, S & T added two modern shallow rigs to its fleet by combining under-utilized rig equipment in inventory with new components. In the sixteen months since construction of the first rig, the two rigs have together generated sufficient net revenue to payout the construction cost of both rigs. In addition, S & T capitalized on an opportunity to acquire a third shallow depth rig on a non-recourse supplier financed basis. This rig (Rig 15) complements the existing fleet by improving the depth distribution of S & T's rigs. In the six months since construction of this rig, it has generated excess revenues equal to fifty percent of the original capital cost.

Forecast

Current levels of hydrocarbon pricing will have a severe negative impact on all of S & T's clients. This will result in sharply reduced drilling activity and rig utilization. S & T now possesses upgraded equipment, a good mix of shallow to medium depth rigs, and a well organized, market responsive operations team that combine to make the Company highly competitive in any drilling environment.

Strong performances by both the Canadian oil and gas division and the contract drilling division resulted in a 57% increase in gross revenues to \$27.9 million and a 152% increase in cash flow from operations to \$4.2 million, or \$1.83 per share. Net earnings before extraordinary items also showed a considerable improvement, up from a loss of \$668,000 in 1984 to a profit (after deferred income taxes of \$1.3 million) of \$17,000 in 1985.

In November 1985, a subsidiary acquired Turalta Resources Ltd. ("Turalta") for \$9.8 million. Only the November and December results of the operations of Turalta are reflected in the consolidated earnings statement.

Capital Expenditures

In addition to the acquisition of Turalta, the Company and its subsidiaries spent \$19.0 million (net of deferred revenue) on property and equipment. This may be broken down as follows:

	Millions
Producing property acquisition (net)	\$ 8.9
Exploration and development drilling	7.7
Rig additions	2.4
	<u>\$19.0</u>

Long Term Debt

Consolidated long term debt increased significantly in 1985 to \$31.5 million from \$12.1 million in 1984, an increase of \$19.4 million. The majority of the increase was incurred in the fourth quarter by a subsidiary to finance the property acquisitions and the acquisition of Turalta. The effect of these acquisitions will not be fully reflected in the earnings statement until 1986.

The summary balance sheet detailed below has been prepared on an equity basis rather than on a consolidated basis, to highlight the financial condition of Canadian Northstar Corporation as a separate corporate entity. The only long term debt outstanding is the note payable of \$10.0 million which is balanced by the notes receivable from subsidiaries and affiliates.

Summary Balance Sheet December 31, 1985

	Millions
Assets:	
Net current assets	\$ 0.7
Notes receivable	10.0
Investments in subsidiaries	17.7
	<u>\$28.4</u>
Liabilities:	
Note payable	\$10.0
Shareholders' equity	18.4
	<u>\$28.4</u>

Share Capital Reorganization

In December, 1985, the Company's shareholders and debenture holders approved a series of special resolutions which resulted in:

- the consolidation of common shares on the basis of one new share for each five old shares and the change of name to Canadian Northstar Corporation.
- the exchange of all of the outstanding Convertible Debentures into an equivalent amount of floating rate Junior Preferred Shares and warrants to purchase Junior Preferred Shares (see Note 9 on Page 15).

All of the per share data detailed in this report is shown on a post consolidation basis.

The exchange of \$9.4 million of convertible debentures into Junior Preferred Shares has strengthened the balance sheet and has improved the debt to equity ratio to 1.9:1 from 2.9:1 in 1984. The ratio of consolidated debt to shareholders' equity, including minority interest's equity, was 1:1 in 1985.

Consolidated Balance Sheet

As at December 31, 1985

Assets	1985	1984
	(in thousands)	
Current assets		
Cash	\$ 1,417	\$ 982
Accounts receivable	9,501	5,359
Notes receivable (Note 4)	2,318	—
Inventory	246	225
	13,482	6,566
Notes receivable (Note 4)	7,338	—
Investments (Note 5)	3,068	6,181
Property and equipment (Note 6)	70,091	43,619
	\$93,979	\$56,366
Liabilities		
Current liabilities		
Accounts payable	\$12,209	\$ 5,385
Current portion of long-term debt	698	45
Note payable	1,260	—
	14,167	5,430
Deferred revenue	2,418	265
Long-term debt (Note 7)	31,501	12,130
Deferred income taxes	3,446	1,529
Minority interest	19,001	13,516
Convertible debentures	—	9,422
Subordinated income debentures (Note 8)	5,000	5,000
	75,533	47,292
Shareholders' Equity		
Share capital (Note 9)	18,089	8,734
Retained earnings	357	340
	18,446	9,074
	\$93,979	\$56,366

Approved on behalf of the Board

J. A. Hagg, Director

M. M. Kanovsky, Director

Consolidated Statement of Earnings

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For the Year Ended December 31, 1985

	1985	1984
	(in thousands)	
Revenue		
Oil and gas	\$ 6,897	\$ 4,428
Less royalties (net)	(1,255)	(565)
Processing	776	—
Contract drilling	19,065	13,076
Fees, interest, and other	2,478	920
	<u>27,961</u>	<u>17,859</u>
Expenses		
Operating — oil and gas	1,746	879
— contract drilling	15,835	11,389
General and administrative	3,023	2,824
Interest	3,193	1,455
Depreciation and depletion	2,514	1,506
	<u>26,311</u>	<u>18,053</u>
Earnings (loss) before income taxes	1,650	(194)
Income taxes (Note 10)		
Current (recovery)	(172)	(156)
Deferred	1,322	359
	<u>1,150</u>	<u>203</u>
Earnings (loss) before the following	500	(397)
Minority interest	(483)	(271)
Earnings (loss) before extraordinary items	17	(668)
Extraordinary items	—	873
Net earnings	<u>\$ 17</u>	<u>\$ 205</u>
Earnings (loss) per share before		
extraordinary items	<u>\$ 0.01</u>	<u>\$ (0.29)</u>
Earnings (loss) per share after		
extraordinary items	<u>\$ 0.01</u>	<u>\$ 0.09</u>
Cash flow from operations	<u>\$ 4,255</u>	<u>\$ 1,689</u>
Cash flow per share	<u>\$ 1.83</u>	<u>\$ 0.73</u>

Consolidated Statement of Retained Earnings

For the Year Ended December 31, 1985

	1985	1984
	(in thousands)	
Retained earnings (deficit), beginning of year		
As previously reported	\$ 340	\$(19,719)
Retroactive consolidation of		
S & T Drilling Ltd.	—	135
As restated	340	(19,584)
Elimination of deficit against		
common share capital (Note 9)	—	19,719
Net earnings	<u>17</u>	<u>205</u>
Retained earnings, end of year	<u>\$ 357</u>	<u>\$ 340</u>

Consolidated Statement of Changes in Financial Position

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For the Year Ended December 31, 1985

	1985	1984
	(in thousands)	
Funds provided		
From operations	\$ 4,255	\$ 1,689
Long-term debt	18,302	2,900
Issue of convertible debentures	—	3,500
Share capital issued by subsidiaries	5,002	2,863
Proceeds on sale of investments	5,880	464
Proceeds on sale of property and equipment	2,098	3,058
Deferred revenue	2,153	21
Net working capital provided on reorganization of S & T Drilling Ltd.	—	4,863
Petroleum incentive grants	904	300
Issue of junior preferred shares	9,362	—
	47,956	19,658
Funds used		
Property and equipment	21,045	6,005
Secured notes	7,338	—
Investments	2,685	1,632
Long-term debt	—	3,000
Acquisition of Turalta Resources Ltd. (Net of working capital of \$608,000)	9,287	—
Conversion of debentures	9,422	—
Acquisition of Consort Resources (1984) Ltd.	—	4,074
Other	—	43
	49,777	14,754
Increase (decrease) in working capital	(1,821)	4,904
Working capital (deficiency) at beginning of year	1,136	(3,768)
Working capital (deficiency) at end of year	\$ (685)	\$ 1,136

Auditors' Report

The Shareholders

We have examined the consolidated balance sheet of Canadian Northstar Corporation (formerly Northstar Resources Ltd.) as at December 31, 1985 and the consolidated statements of earnings, retained earnings and changes in financial 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, 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
April 4, 1986

Touche Ross & Co.
Chartered Accountants

December 31, 1985

1. CHANGE OF NAME

On December 18, 1985, as part of the reorganization of share capital described in Note 9, the shareholders approved the change of name to Canadian Northstar Corporation (the "Company").

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**(a) Principles of consolidation**

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiary, Northstar Resources Inc., its 54% owned subsidiary, Gane Energy Corporation Ltd. ("Gane Energy"), and its 54% owned subsidiary, S & T Drilling Ltd. ("S & T").

(b) Investments

Investments are carried at the lower of cost or net realizable value.

(c) Oil and gas exploration and development expenditures

The Company follows the full cost method of accounting for exploration and development expenditures, wherein all costs related to the exploration and development of oil and gas reserves in North America are capitalized. These costs include lease acquisition costs, geological and geophysical costs, carrying charges of non-producing properties, costs of drilling both productive and non-productive wells, interest and overhead expenses related to exploration activities and plant and equipment. The Company employs a ceiling test annually, whereby capitalized costs would be written off should they exceed the present values of future net revenues from estimated production of proven reserves using prices in effect at year-end. Proceeds on property sales and government grants are credited against costs. These costs, excluding undeveloped land, are depleted on the unit of production method, based on estimated proven recoverable reserves as determined by independent petroleum engineers.

(d) Depreciation — processing facilities

Depreciation is provided on the unit-of-throughput method calculated on the basis of the volume of gas processed by the facility in the year divided by the estimated total gas to be processed during the estimated useful life of the facility.

(e) Drilling and other equipment

Replacement of drilling equipment and pipe repair items are written off to expense as incurred.

Depreciation of drilling equipment and pipe is provided based upon operating days at daily rates estimated to reduce the net book value of the assets to salvage value at the end of their useful lives.

Depreciation of other fixed assets is provided at the following annual rates:

Camp equipment	10% straight-line
Automotive equipment	30% straight-line (to estimated salvage value)
Office furniture	20% reducing balance
Buildings	5% straight-line

(f) Joint venture accounting

Substantially all of the Company's exploration and production activities are conducted jointly with others and accordingly these financial statements reflect only the Company's proportionate interest in such activities.

(g) Deferred revenue

Payments received 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.

(h) Foreign currency translation

The accounts of the foreign subsidiary and other foreign operations have been translated to Canadian dollars using the temporal method on the following basis: monetary items at the rate of exchange at the year-end and other assets and liabilities at the historical rate of exchange. The items in the statement of earnings are translated at the average rates of exchange prevailing during the year except for depletion and depreciation which are translated at the same rates as used for the related assets. Resulting gains and losses are recognized in the statement of earnings.

(i) Earnings per share

Earnings per share has been calculated using the weighted average number of common shares outstanding during the year. Cash flow per share is calculated using cash flow from operations before deducting preferred share dividends and the weighted average number of shares outstanding during the year. The calculation of net earnings per share on a fully diluted basis assumes the conversion of preferred shares and the exercise of stock options. Fully diluted earnings per share is anti-dilutive. Fully diluted cash flow per share would be \$1.25 (1984 — \$0.62).

(j) Drilling revenue recognition

Drilling revenue is recognized as earned, either on a per day basis or by depth drilled.

(k) Inventory

Inventory is valued at the lower of cost and net realizable value.

3. ACQUISITION

Effective November 11, 1985, the Company's subsidiary, Gane Petroleum Corporation Ltd., acquired all of the issued shares of Turalta Resources Ltd., a private Alberta based resource company, for an aggregate consideration of \$9.9 million, satisfied by the issue of 1,224,924 7% Third Preferred Shares having a stated value of \$4.05 per share and \$4.9 million in cash.

The acquisition has been accounted for by the purchase method, with the purchase price allocated to the net assets as follows:

Working capital	\$ 608,000
Processing facilities	9,194,000
Petroleum and natural gas properties	1,676,000
Other assets	81,000
	<u>11,559,000</u>
Long-term debt	1,069,000
Deferred income taxes	595,000
	<u>\$ 9,895,000</u>

4. NOTES RECEIVABLE

	1985	1984
	(in thousands)	
Floating rate debenture due June 30, 1988	\$3,000	\$ —
Secured notes	6,308	—
Promissory notes	348	—
	<u>9,656</u>	<u>—</u>
Less current portion	2,318	—
	<u>\$7,338</u>	<u>\$ —</u>

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

5. INVESTMENTS

	1985	1984
	(in thousands)	
Investment in associated company	\$2,500	\$ 5,510
Other investments	568	671
	<u>\$3,068</u>	<u>\$ 6,181</u>

6. PROPERTY AND EQUIPMENT

	1985		1984	
	Cost or written down value	Accumulated depreciation and depletion	Net book value	Net book value
	(in thousands)			
Petroleum and natural gas properties	\$53,258	\$6,625	\$46,633	\$31,123
Drilling equipment	14,055	1,146	12,909	11,931
Processing facilities	9,580	67	9,513	—
Other	1,350	314	1,036	565
	<u>\$78,243</u>	<u>\$8,152</u>	<u>\$70,091</u>	<u>\$43,619</u>

7. LONG-TERM DEBT

	1985	1984
	(in thousands)	
Canadian Northstar		
Note payable	\$10,000	\$ 2,500
Due from Gane Energy	(6,828)	—
	3,172	2,500
Gane Energy		
Bank operating loan	4,170	4,225
Production loans	11,548	—
Promissory notes	372	—
Bank loans	623	—
Due to Canadian Northstar	6,828	—
	23,541	4,225
S & T		
Revolving term loan	4,327	5,000
Rig loan	405	450
	4,732	5,450
Northstar Resources Inc.		
Bank operating loan	755	—
	32,200	12,175
Less current portion	699	45
	\$31,501	\$12,130

(a) **Canadian Northstar**

The note payable is repayable on demand and bears interest at the bank prime rate plus $\frac{3}{8}\%$. The note is secured by a hypothecation and pledge of the shares of certain subsidiaries. In the event of demand, the Company may elect to convert the loan into a term facility paying interest at prime plus 1%. The term loan is repayable in full, eighteen months after the conversion date.

(b) **Gane Energy**

The bank operating loan is repayable on demand, bears interest at the bank prime rate plus $\frac{1}{2}\%$ and is secured by a first fixed charge on certain of the company's oil and gas properties and a general assignment of accounts receivable and production revenue. The loan is repayable out of 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 of \$2.3 million as at December 31, 1985.

The production loans are repayable on demand and bear interest at the bank prime rate plus $\frac{3}{8}\%$. The loans are secured by an assignment and pledge of the company's entire interest in certain limited partnerships and the secured notes (Note 4). The loans will be repaid out of cash flow from these partnerships.

The promissory notes are repayable in semi-annual installments of \$74,367, are non-interest bearing, and are secured by a first mortgage on the company's principal natural gas processing facility.

The bank loans are repayable in monthly installments of \$40,000 and bear interest at the bank prime rate plus $\frac{1}{2}\%$. They are secured by a general assignment of book debts and a chattel mortgage on certain equipment owned by a subsidiary of the company.

Total principal repayments due within the next five years have been estimated by management as follows: 1986 — \$637,000; 1987 — \$481,000; 1988 — \$391,000; 1989 — \$905,000; 1990 — \$757,000.

(c) **S & T**

The revolving term loan bears interest at the bank's prime rate and is repayable in three equal annual installments beginning in January 1987.

The revolving term loan and the subordinated income debenture described in Note 8 are secured by a fixed and floating charge against the assets of S & T and a general assignment of accounts receivable.

The rig loan bears interest at the bank's prime rate plus $1\frac{1}{4}\%$ and is secured by a fixed charge over certain equipment of S & T and a guarantee of Canadian Northstar. The minimum principal repayments over the next three years are as follows: 1986 — \$61,000; 1987 — \$76,600; 1988 — \$266,600.

(d) **Northstar Resources Inc.**

The bank operating loan bears interest at the bank prime rate plus $\frac{3}{4}\%$ and is secured by a charge on certain of the company's producing properties. At December 31, 1985, the company had unutilized credit facilities of U.S. \$60,000. The loan is repayable out of future production revenues and is not expected to require the use of working capital, therefore, no portion of the loan has been classified as current.

8. SUBORDINATED INCOME DEBENTURE

The debenture bears interest at a rate equal to one half of the bank's prime rate plus 1%. The interest will be payable annually in arrears to the extent of 30% of adjusted net income of S & T, if earned. The debenture matures in 1989, at which time S & T may require the bank to convert any unpaid portion of the debenture into non-voting class B common shares of S & T.

For the period ended October 31, 1985, there is no interest payable. Only in the period in which sufficient profits and cash flow are available will interest be accrued.

9. SHARE CAPITAL

(a) Share capital reorganization

On December 18, 1985, the shareholders of the Company approved a special resolution to reorganize the Company's share capital as follows:

- (i) consolidate the issued and outstanding common shares on the basis of one new common share for each five common shares previously outstanding;
- (ii) increase the number of common shares that the Company may issue to an unlimited number;
- (iii) delete the First Preferred Shares and the Second Preferred Shares from the authorized share capital of the Company; and
- (iv) create the Senior Preferred Shares and the Junior Preferred Shares.

At December 31, 1985, the share capital comprised:

	1985	1984
	(in thousands)	
Senior Preferred Shares, no stated value, authorized — unlimited; issued nil	\$ —	\$ —
Junior Preferred Shares, no stated value, authorized — unlimited; issued 1,884,460 Junior Preferred Shares, Series A having a stated value of \$5.00	9,422	—
Common Shares, without nominal or par value, authorized — unlimited; issued 2,318,669 shares after consolidation (1984 — 2,318,669 shares, after consolidation)	8,666	8,734
	\$18,088	\$ 8,734

(b) Convertible debentures

On December 18, 1985, the holders of floating rate convertible debentures approved a resolution to exchange their debentures into Junior Preferred Shares, Series A and warrants to purchase Junior Preferred Shares, Series A, on the basis of one Junior Preferred Share and one Share Purchase Warrant for each \$5.00 principal amount of debentures outstanding. Costs in connection with the exchange amounting to \$68,000 have been netted against common share capital.

(c) Junior preferred shares

The holders of Junior Preferred Shares, Series A, are entitled to receive a dividend equal to 75% of the average bank prime rate, on the paid up value of each share, and to attend and vote at all meetings of the common shareholders. The Junior Preferred Shares, Series A, are convertible into common shares on a one for one basis until June 30, 1988, and under certain terms and conditions will rank equally with the common shares in the payment of dividends or in the event of dissolution of the Company.

(d) Share purchase warrants

The share purchase warrants are non detachable from the Junior Preferred Shares, Series A, and expire on January 21, 1989. Two warrants entitle the holder 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 the exercise of these warrants.

(e) Stock options

At December 31, 1985, 30,720 common shares were reserved under stock option agreements granted to senior employees of the Company. The options are exercisable at prices which range between \$5 and \$10 and expire on June 29, 1994.

(f) Deficit elimination

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 at December 31, 1983.

10. INCOME TAXES

Income tax expense varies from the amounts that would be computed by applying the combined Federal and Provincial income tax rates to earnings (loss) before income taxes and extraordinary items as shown below:

	1985	1984
	(in thousands)	
Effective Canadian tax rate	47%	47%
Computed "expected" income taxes (recovery)	\$ 779	\$ (91)
Increases (decreases) resulting from:		
Non-deductible Crown payments	426	231
Non-deductible depletion	156	36
Resource allowance	(486)	(228)
Earned depletion	(60)	(92)
Alberta Royalty Tax Credit	(120)	(124)
U.S. accounting loss at lower tax rate	(8)	246
Loss carry forward without virtual certainty of recovery	383	225
Other	10	—
Provision for taxes on acquisition (Note 3)	70	—
Actual income tax provision	\$1,150	\$ 203

Property and equipment with a carrying value of \$24.4 million has a nil cost base for tax purposes.

The Company and its consolidated subsidiaries have unrecognized non-capital and capital losses carryforward of approximately \$5,700,000 and \$200,000 respectively available for offset against future income for tax purposes. The non-capital losses expire at various dates subsequent to December 31, 1987.

11. SEGMENTED INFORMATION

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

	1985			
	Oil and gas and other	Contract drilling	Processing (note 3)	Total
	(in thousands)			
Revenue	\$ 8,120	\$19,065	\$ 776	\$27,961
Earnings before extraordinary items	\$ (516)	\$ 352	\$ 181	\$ 17
Identifiable assets	\$65,127	\$18,185	\$10,667	\$93,979
	1984			
	Oil and gas and other	Contract drilling	Processing	Total
	(in thousands)			
Revenue	\$ 4,783	\$13,076	\$ —	\$17,859
Earnings (loss) before extraordinary items	\$ (669)	\$ 1	\$ —	\$ (668)
Identifiable assets	\$40,935	\$15,431	\$ —	\$56,366

12. RELATED PARTY TRANSACTIONS

- (a) During the year a subsidiary of the Company acquired petroleum and natural gas properties from an affiliate of the Company. The total acquisition cost of \$11,548,000 was financed by the affiliate (see Note 5) who received \$595,000 in respect of interest.
- (b) Included in the secured notes (Note 4) at the year end are \$514,000 due from officers and senior employees of a subsidiary. These notes have identical terms to those described in Note 4.

13. COMMITMENTS

The Company has minimum annual lease commitments covering vehicles, equipment and office space as follows: 1986 — \$532,000; 1987 — \$476,000; 1988 — \$312,000; 1989 — \$237,000; 1990 — \$149,000.

14. COMPARATIVE FIGURES

Certain 1984 comparative figures have been reclassified to conform with the current year's presentation.

Corporate Information

Head Office

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

Auditors

Touche Ross
Calgary, Alberta

Bankers

Continental Bank of Canada
Calgary, Alberta

Registrar and Transfer Agent

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

Stock Exchange Listings

Toronto Stock Exchange — CNX
Alberta Stock Exchange — CNX

Principal Subsidiaries

Northstar Energy Corporation
(formerly Gane Energy
Corporation Ltd.)
1130 Sunlife Plaza
140 - 4th Avenue S.W.
Calgary, Alberta T2P 3N3
Telephone (403) 233-8282

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

Gane Petroleum Corporation
1130 Sunlife Plaza
140 - 4th Avenue S.W.
Calgary, Alberta T2P 3N3
Telephone (403) 233-8282

Officers

John A. Hagg
Chairman

Michael M. Kanovsky
President

Anthea E. Lister
Treasurer and Corporate Secretary

Directors

John W. Burrows, Calgary (2)
Private businessman and
Company Director

James W. Davidson, Edmonton
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)
Executive Vice President and
Chief Operating Officer
Hees International Corporation

Douglas W. Miller, Calgary (1) (2)
President, Oil and Gas Division
Westmin Resources Limited

(1) Member of the Executive Committee

(2) Member of the Audit and Compensation
Committee

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