Ocelot Industries Ltd.

annual
report

1986

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Company Profile

Ocelot Industries Ltd. is a Canadian-owned diversified natural resource enterprise headquartered in Calgary, Alberta.

Ocelot was incorporated as a small private natural gas and petroleum company in 1968 and by 1973 had assets of $1.6 million. Since then the business base has expanded to include Petroleum Industry Services and Supplies and Petrochemicals. Assets today total $552 million.

Ocelot's shares are listed on the Toronto, Montreal, and Alberta stock exchanges.

Annual Meeting

The Annual General Meeting of Shareholders of Ocelot Industries Ltd. will be held in the Bonavista Room, Westin Hotel, Calgary, Alberta on May 22, 1987 at 10:30 a.m. Formal notice of this meeting and proxy materials are enclosed.

Contents

Facts at a Glance

Year Ended December 31, 1986
(thousands of dollars)

	1986	1985
Financial		
Revenue	$146,313	$260,712
Cash used for operations	56,646	19,448
Loss for the year	221,325	40,378
Loss per common share (in dollars)	15.29	2.80
Cash used for operations per common share (in dollars)	3.91	1.38
Capital expenditures	9,085	17,120
Operating bank loans at end of year	64,264	14,424
Long-term debt at end of year	670,690	717,042
Operations		
Crude oil and natural gas liquids production (barrels per day)	2,495	2,997
Natural gas production (millions of cubic feet per day)	96	109
Number of drilling and service rigs	62	63

Highlights

■ Overhead reduced in virtually every area of operation.

■ Development fund programs continued to prove effective.

■ New gas sales contracts secured as gas deregulation became a reality.

■ Peco interests sold for $75.7 million.

Reassessment of Operations

The loss for the year was $221.3 million after extraordinary items which included a $171.6 million write-down on Petrochemical assets. Management is working closely with its principal banker on refinancing arrangements to assure Ocelot's long-term viability. Throughout 1986, Ocelot reassessed all areas of operations with an aim to improving short-term profitability. Costs were substantially lowered in virtually all segments of operations. Some producing properties and Petroleum Services and Supplies interests were sold and the Petrochemicals operations were restructured. Strategically, Ocelot plans to actively develop its shallow gas reserves and explore for oil and gas primarily in southern Alberta where costs and risks are relatively low. The newest government assistance programs are expected to help the Services and Supplies segment and more stable methanol and ammonia prices have begun to improve the economics of the Petrochemicals operations.

Letter to Shareholders

Financial performance

Cash generated from operations before interest expense was $28.2 million for the year ended December 31, 1986 as compared to $68.8 million for 1985. Interest expense of $84.8 million in 1986 and $88.2 million in 1985 resulted in cash used for operations of $56.6 million in 1986 as compared to $19.4 million in 1985. Proceeds from sale of property, plant and equipment amounted to $86.1 million in 1986, compared to $49.5 million in 1985. Accordingly, internally generated cash totalled $29.5 million in 1986 and $30.1 million in 1985.

Ocelot's consolidated statement of earnings reflects a loss before extraordinary items of $53.9 million ($3.72 per share) as compared to $40.4 million in 1985 ($2.80 per share). An extraordinary loss in the amount of $171.6 million ($11.85 per share) was recognized on the write-down to estimated realizable value of Ocelot's subsidiary companies' assets in the Petrochemicals segment. This extraordinary loss was reduced by the tax benefits realized on the application of losses carried forward from prior years of $4.2 million ($0.29 per share). The total loss for the year was $221.3 million ($15.29 per share) after recognizing the extraordinary items, compared to a loss of $40.4 million ($2.80 per share) in 1985.

Ocelot continued its restraint program in 1986, recording $9.1 million in capital expenditures, down from $17.1 million in 1985.

In December, 1986, Ocelot sold its interests in the Peco area of Alberta for $75.7 million and recognized a gain of $53.8 million in the accounts. This indicates there is a large excess of value of reserves as compared to the historical carrying cost in the consolidated financial statements.■

Reshaping operations for greater profitability

Ocelot's overall financial performance triggered a reassessment of all areas of operations with a view to improving short-term profitability. Interests in the Peco area of Alberta were sold for $75.7 million, certain minor-interest producing properties were earmarked for sale, and some oil and gas operations have been identified for streamlining and overhead reduction.

A careful review of the entire Services and Supplies segment dictated widespread changes as well. Costs were trimmed through staff and salary reductions, and most operations were significantly curtailed. Both the oilfield supply division in the United States and the Canadian helicopter service division were sold.

In Petrochemicals, arrangements were made with partners in Ocelot Ammonia Company to provide financial support for the methanol plant, and release Ocelot Industries Ltd. from any funding obligations for the Petrochemicals operations for the next two years. Overhead costs were substantially lowered through staff reductions in both Kitimat and Calgary, and new arrangements were made to reduce natural gas feedstock costs.■

Letter to Shareholders

Ocelot's strategy

Ocelot is one of the pioneers of shallow gas development in western Canada and shallow gas is still at the heart of Ocelot's operation. This is one of the company's greatest strengths, particularly with the long-awaited deregulation of the Canadian gas industry becoming a reality in 1986.

Shallow gas development is ideally suited to the company's present situation because costs and risks are low and there is ready access to existing pipeline systems. Proven low design and facility costs, strong technical support and a highly competent field staff amply demonstrate Ocelot's expertise in both Alberta and Saskatchewan.

To finance large-scale shallow gas development, Ocelot's innovative third-party financing approach has proven effective in the form of development fund programs. During 1986, approximately $36 million from these funds was used for drilling and related activity, and Ocelot is actively pursuing additional funds to proceed with new shallow gas development programs in Saskatchewan in 1987.

A program is also under way to attract third-party participation in relatively low-risk exploration and development in parts of southern Alberta where Ocelot has historically been successful.

Challenge of natural gas deregulation met

The Canadian natural gas industry experienced the most volatile year in its history in 1986. The new environment became more market-oriented and competitive. It offered greater opportunity for new investment and favoured companies that were more efficient and responsive. Ocelot's management took steps to ensure the company would thrive in the new circumstances and Ocelot led the way, making Canada's first direct sale and Saskatchewan's first export sale of natural gas to the Ontario market early in 1986.

New royalty holidays introduced

Alberta instituted a five-year royalty holiday for oil wells drilled outside of pool boundaries on or after October 1, 1986 and before November 1, 1987 and a three-year oil royalty holiday for wells drilled between November 1, 1987 and October 31, 1988. As well, the royalty rates for certain existing oil and gas production were reduced by approximately 12 per cent for wellhead prices below $30.00 (Cdn.) per barrel of oil and $2.00 (Cdn.) per thousand cubic feet of natural gas. While these changes will have little direct effect on Ocelot, they will help attract third party funds for the exploration program mentioned previously and will increase industry activity levels generally, which will impact on the company's Services and Supplies segment.

Effective January 1, 1987, Saskatchewan decreased its oil royalties and granted royalty holidays for three years for oil wells drilled over the next 18 months. A major new natural gas policy was also unveiled by the Saskatchewan government in February, 1987, easing the regulation of the province's gas industry. A price-sensitive royalty tax system was introduced that allows buyers and sellers to negotiate prices in an expanded market. The changes make the development, pricing and marketing of natural gas in Saskatchewan more consistent with other deregulated markets; particularly with Alberta markets.

Outlook

Ocelot expects 1987 to be a year of some uncertainty in the oil and gas industry as prices continue to fluctuate. The company plans to actively develop its shallow gas reserves and explore for oil and gas primarily in southern Alberta. Recently announced Federal assistance programs should stimulate drilling activity which in turn will help the Services and Supplies segment of Ocelot's business. In the Petrochemicals area, methanol and ammonia prices have begun to firm up and Ocelot expects this trend to continue.

Management will be working closely with its principal banker on refinancing arrangements to assure Ocelot's long-term viability. The dedication, skills and loyalty of Ocelot's employees through these difficult times are highly valued and greatly appreciated.

J.V. Lyons

J.V. Lyons
Chairman and Chief Executive Officer
March 31, 1987

Highlights

■Grand Forks/Ronalane programs raised field production 40 per cent to average 3,500 barrels of oil a day.

■Active drilling programs involved 206 development wells and 13 exploration wells.

■New contracts secured in 1987 for gas sales of 100 million cubic feet a day.

■Peco operations sold for $75.7 million.

■Extensive development programs increased Ocelot's Saskatchewan natural gas production by 47 per cent to 85 million cubic feet per day.

Emphasis on Shallow Gas

Ocelot's underlying strength is its ability to develop its extensive shallow gas properties economically.

The deregulation of the Canadian natural gas industry offered new and expanded market opportunities, and action was taken to position Ocelot to capitalize on these potential new sources of revenue. Ocelot's short-term strategy focussed on shallow gas development, which is ideally suited to the company's present situation because costs and risks are low, and there is ready access to existing pipeline systems. To help fund this activity, Ocelot plans to sell some of its minor-interest producing properties, streamline existing operations and reduce overhead. Funds provided will be applied to ongoing work on existing lands, and to the acquisition of proven, producing or prospective new shallow gas properties.

Natural Gas and Petroleum Operations

Ambitious programs made possible *through third-party financing*

Over the past four years, Ocelot has carried out large-scale development programs together with some exploration activities through third-party financing. During 1986, these programs provided approximately $36 million for drilling and related activities. The company is actively pursuing additional funds to proceed with shallow gas development programs in Saskatchewan in 1987.

A program is also under way to attract third-party participation in relatively low-risk exploration and development in parts of southern Alberta where Ocelot has historically been successful. The two areas of focus are the oil-prone Grand Forks/ Ronalane area and the gas-prone Tilley/ Alderson region.■

Gas marketing proved effective in deregulated climate

The Canadian natural gas industry experienced the most volatile year in its history in 1986. Natural gas marketing required constant attention and adjustment as events unfolded throughout the year. The introduction of natural gas deregulation in late 1985, coupled with lower crude oil prices, caused highly unpredictable markets. Gas sales were severely impacted by inequitable United States transportation policies and the continuation of the United States "gas bubble".

Extensive development of Ocelot's shallow gas reserves in Saskatchewan over the last two years and the province's proximity to eastern markets gave Ocelot a distinct marketing advantage. Ocelot secured the first deregulated gas sale to eastern Canada in January, 1986,and by May, 1986 three more direct sales were won, bringing total direct sales of Ocelot and its partners to 45 million cubic feet a day. Early in 1987, Ocelot negotiated additional long-term contracts to sell approximately 100 million cubic feet a day to utility and industrial users in Canada and the United States. Ocelot intends to accelerate the development of its existing gas properties in western Canada to supply the new customers. Some of the contracts are conditional upon regulatory approvals.

Ocelot's strategy throughout 1986 was to strike an appropriate balance between optimizing netbacks and maintaining a market presence. This will continue to be the approach for 1987.■

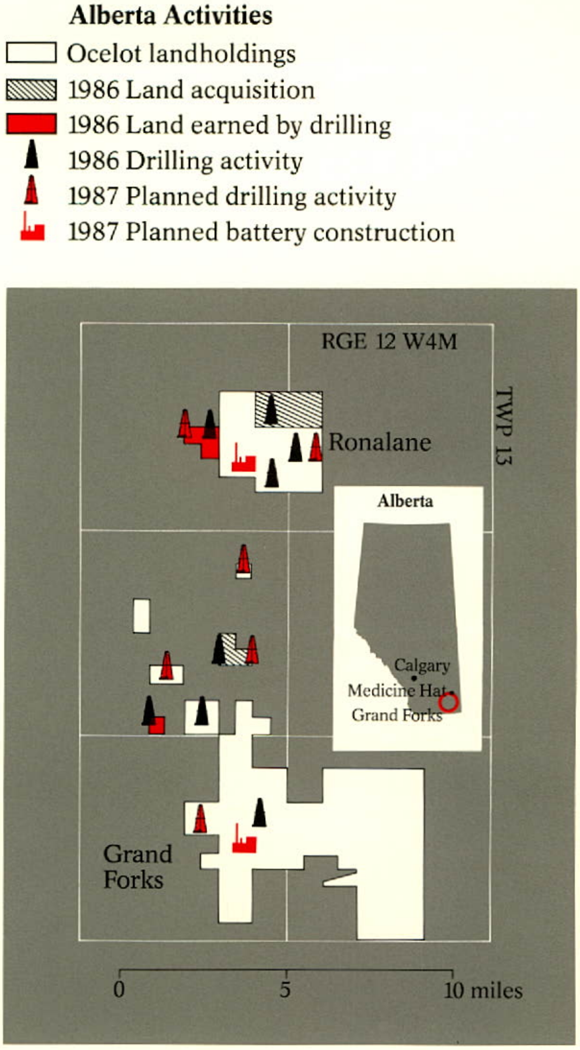
Drilling activity strong despite industry downturn

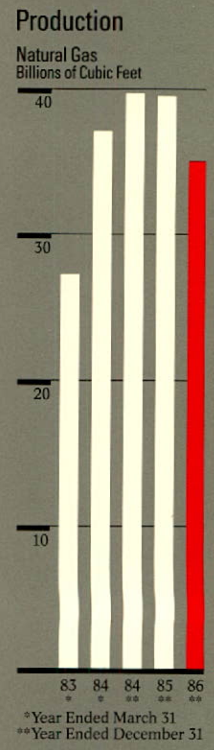
Ocelot remained relatively active in western Canada, despite the downturn in the industry. Through programs funded by third parties, 13 exploration wells and 206 development wells were drilled in 1986. The exploration programs yielded three oil wells, four gas wells, one service well and five dry holes. The extensive development drilling resulted in 13 oil wells, 184 gas wells, five service wells, and four dry holes. Additionally, 13 wells were drilled on lands farmed out by Ocelot, resulting in six oil wells and two gas wells.■

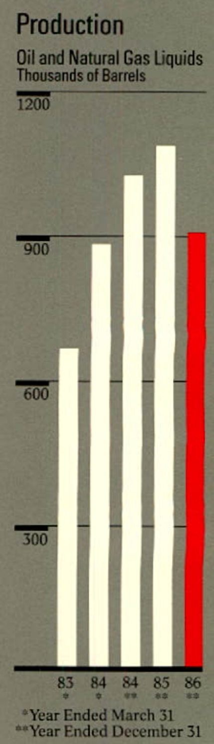
Alberta spotlight on Grand Forks/Ronalane

With the downturn in oil and gas prices, Ocelot's development and exploration emphasis was directed toward low risk, low cost prospects. The oil-prone Grand Forks/Ronalane region received most of the attention during 1986. Ocelot's proven geological and geophysical expertise combined with its excellent operational capabilities gave it a competitive technical and economic edge in the discovery and development of new reserves in the area. Ten oil wells were drilled at Grand Forks/Ronalane during 1986, raising field production by 40 per cent. Plans for 1987 feature ongoing seismic and drilling programs along with the construction of two production batteries. At the end of 1986, Ocelot operated 57 oil wells in the area and production averaged 3,500 gross (760 net) barrels of oil a day. Drilling elsewhere in Alberta resulted in oil wells at Hussar, Caroline, Crystal, Peco and Valhalla.

In Alberta's Medicine Hat area, Ocelot maintained field deliverability and gas nominations while minimizing capital spending during 1986. Rather than implement capital intensive programs involving infill drilling and facility construction, Ocelot undertook a comprehensive main-







Natural Gas and Petroleum Operations

tenance program. Through well cleanouts, recompletions and minor facility modifications, field deliverability was increased without large capital outlays. Ocelot expects this program will reduce the need for large capital outlays in the future. In addition, Ocelot plans to make the most of existing gas facilities in 1987 by exploring deeper horizons in established producing fields. New reserves will then be developed that are economic and readily marketed.

In the Monogram area of southwestern Alberta, an infill drilling program was completed with the drilling of seven wells early in 1986, bringing the total to 83 gas wells. This enabled Ocelot to increase gas sales contracts from 23.6 million cubic feet per day to 39 million cubic feet per day late in 1986. Ocelot's working interest is 22.8 per cent.■

Peco operations sold

In the Edson area of west central Alberta, Ocelot developed new reserves and completed a deep-cut recovery facility at the Peco gas plant in September.

Early in December, Ocelot sold its interests in the Peco area for $69.5 million cash. Arrangements were also made for the purchaser to assume $6.2 million of related Top Gas obligations. The transaction was completed in early March, 1987.■

Canadian Drilling Results

Year Ended December 31, 1986

	Oil		Gas		Service		Dry		Total	
	Gross	Net*	Gross	Net*	Gross	Net*	Gross	Net*	Gross	Net*
Exploration	3	1.4	4	2.6	1	0.2	5	2.0	13	6.2
Development	13	3.8	184	128.0	5	0.9	4	2.4	206	135.1
Total	16	5.2	188	130.6	6	1.1	9	4.4	219	141.3

*The Company's interests in the Development Programs have been included using Ocelot's working interest after payout.

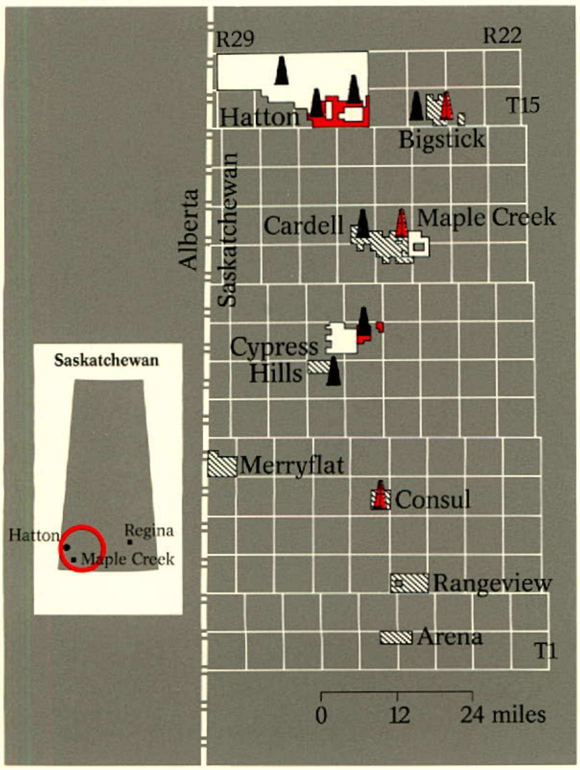
Hatton shallow gas expansion increased Saskatchewan production by 47 per cent

Through a development program funded by third parties, Ocelot undertook a $24 million program to increase gas sales volumes in the Hatton shallow gas block of southwestern Saskatchewan to 85 million cubic feet a day during 1986. Field deliverability increased by 27 million cubic feet a day, providing Ocelot with sufficient volumes to service Saskatchewan gas markets as well as new industrial gas export markets in eastern Canada and the United States. Ocelot added two new compressor stations and completed a 173-well development program along with 104 miles of field gathering and sales pipelines. This brought the total well count to some 600 wells at Hatton. Efficient drilling and completion techniques allowed the expansion to come in well under budget. Ocelot also negotiated with its partners to partition the Hatton landholdings through a trade-off of interests in certain blocks to gain a higher interest in other blocks. These higher-interest blocks were then developed as part of the 1986 drilling program, resulting in higher net gas sales for Ocelot.

A widespread exploratory program was begun in southwestern Saskatchewan. Ocelot was the largest purchaser of Crown rights during 1986, acquiring 71,000 acres

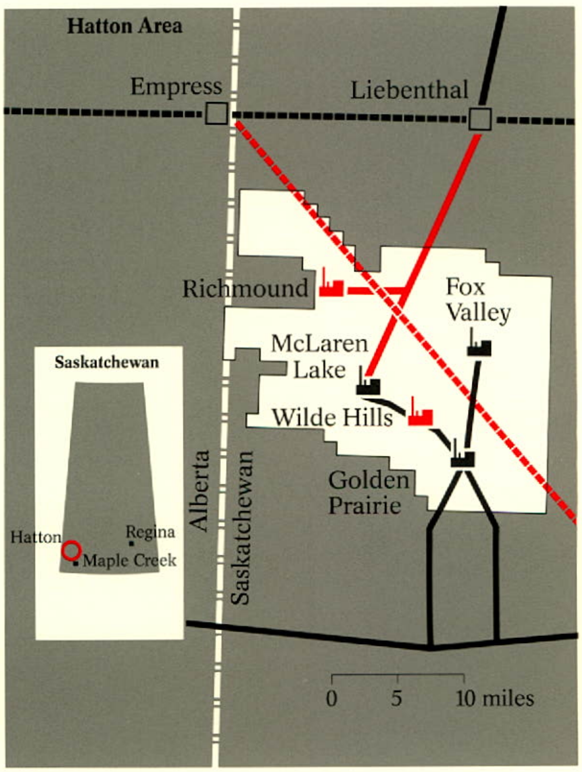
Saskatchewan Exploration Activities

- Ocelot landholdings
- 1986 Land acquisition
- 1986 Land earned by drilling
- 1986 Exploratory drilling activity
- 1987 Planned exploratory drilling activity



Saskatchewan Development Activities

- Ocelot Hatton landholdings (249,300 gross acres)
- Existing compressor station
- 1986 compressor station construction
- Ocelot pipeline
- Saskatchewan Power Corporation pipeline to domestic markets
- Foothills pipeline to United States markets
- TransCanada pipeline to eastern markets



Natural Gas and Petroleum Operations

of land. Six exploration wells were drilled, leading to four gas discoveries. Plans are under way to explore for further gas reserves in 1987.■

First half gas sales remained constant

Canadian natural gas production in 1986 averaged 96 million cubic feet a day, a 12 percent decrease from 1985. Ocelot's gas sales were forecast to rise in 1986, but remained at 1985 levels for the first half of the year owing to the decline in crude oil prices and intense competition among gas producers. Demand was also lower because of a less active petrochemical industry in Alberta. As summer approached, tight competition in all markets, coupled with restrictions on United States pipelines, resulted in lower exports to the United States. The resulting excess in supply forced prices down, requiring Ocelot to shut-in substantial volumes of production because of low netbacks. A yearly high of 131 million cubic feet a day was reached during November, but sales dropped to 96 million cubic feet a day in December because of unseasonably warm temperatures in all market areas.

Crude oil and natural gas liquids production in Canada averaged 2,184 barrels a day, down 18 percent from 1985, mainly because of the sale of some oil producing properties in late 1985 and first quarter pipeline capacity restrictions in Ocelot's producing areas. Pipeline restrictions are not anticipated in 1987.■

Landholdings - Developed and Undeveloped
at December 31, 1986

	Gross Acres	Net Acres
Canada (1)		
British Columbia	239,817	73,116
Alberta	851,030	450,080
Saskatchewan	270,280	136,650
Manitoba	158	64
Total	1,361,285	659,910
International		
Australia	847,300	129,721
Cameroon	194,527	30,359
Senegal	511,500	511,500
Total	1,553,327	671,580
Total Landholdings	**2,914,612**	**1,331,490**

(1) Does not include varying royalty interests in 116,710 gross acres.

Reserves

Proven reserves of natural gas totalled 1.04 trillion cubic feet at December 31, 1986, a decrease of 250 billion cubic feet since December 31, 1985. Production of 35 billion cubic feet, the sale of proven gas reserves from the Peco field plus revisions of proven reserves at Peco and Hatton accounted for the reduction.

Proven reserves of crude oil and natural gas liquids totalled 7.3 million barrels at December 31, 1986, a decrease of 22.2 million barrels since December 31, 1985 after production of 797,000 barrels. This decrease reflects revisions of proven reserves at Peco, Grand Forks and Luseland and the subsequent sale of the Peco property.■

Production Summary

	Crude Oil and Natural Gas Liquids (thousands of barrels)		Natural Gas (millions of cubic feet)	
	Year Ended December 31,			
	1986	1985	**1986**	1985
Canada				
Alberta	**737**	913	**30,849**	37,339
Saskatchewan	**41**	35	**2,367**	932
Manitoba	**1**	2	**—**	—
British Columbia	**18**	19	**1,677**	1,244
	797	969	**34,893**	39,515
International	**114**	125	**117**	98
Grand Total	**911**	1,094	**35,010**	39,613

Reserves Summary

	Crude Oil and Natural Gas Liquids (thousands of barrels)		Natural Gas (billions of cubic feet)
	Canada	International	Canada
Proven Reserves			
Reserves at December 31, 1985	29,534	562	1,291
Added by drilling	844	0	19
Revisions & dispositions	(22,243)	14	(234)
Production	(797)	(114)	(35)
Reserves at December 31, 1986	7,338	462	1,041
Probable Reserves	421	558	14
Total Proven and Probable Reserves	7,759	1,020	1,055

Ocelot's proven and probable reserves at December 31, 1986 are shown on a before royalty basis. The Canadian reserve evaluations and estimated net cash flows have been carried out by independent consultants. The definitions for proven and probable reserves are as follows:

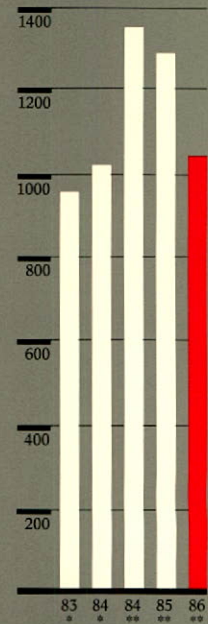
Proven Reserves - Quantities of crude oil, natural gas, and natural gas by-products, which, upon analysis of geologic and engineering data, appear with a high degree of certainty to be recoverable at commercial rates in the future from known oil and gas reservoirs under presently anticipated economic and operating conditions.

Probable Reserves - Reserves which may be recovered in the future by using pressure maintenance or other secondary recovery methods, or by more favourable performance of the existing recovery mechanism than that which would be deemed proven at the present time. They may also be reserves which are assumed to exist because of geophysical or geological indications and drilling done in regions which contain proven reserves.

	Estimated Net Cash Flows (thousands of dollars)	
	Discounted at 10%	Discounted at 12%
Proven Reserves		
Canada	$ 1,005,961	$845,227
International	5,234	4,828
	1,011,195	850,055
Probable Reserves		
Canada	22,147	25,520
International	4,222	3,716
	26,369	29,236
Total Proven and Probable Reserves	$ 1,037,564	$879,291

Proven Reserves

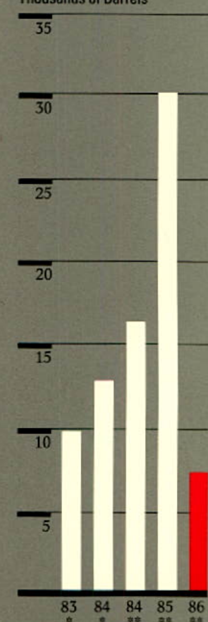
Natural Gas
Billions of Cubic Feet



*Year Ended March 31
**Year Ended December 31

Proven Reserves

Oil and Natural Gas Liquids
Thousands of Barrels



*Year Ended March 31
**Year Ended December 31

Highlights

- Critical review of Services and Supplies segment results in substantial cost reductions.
- Methanol plant feedstock costs lowered.
- New ammonia plant on stream.
- Petrochemicals restructuring frees Ocelot from future funding obligations.

Ammonia Added to Operations

Ocelot entered the world ammonia market with the completion of a new 550-tonne-a-day plant early in December. Ammonia prices began to stabilize early in 1987, improving the economics of operation with 80 per cent of the production sold-forward to the California market and the remainder to be sold on the spot market. The construction project came in well under budget and Ocelot owns 51 per cent of the ammonia plant, built on a project-financed basis requiring no funding from Ocelot.

Other Business Activities

Overhead reduced in Services and Supplies segment

After a careful review of the entire Services and Supplies segment, widespread changes were made. Costs were trimmed through staff and salary reductions, and most operations were significantly curtailed. Both the oilfield supply division in the United States and the Canadian helicopter service division were sold. Key personnel were retained to ensure Ocelot will be able to respond to renewed activity. As oil prices stabilize and the full effects of Alberta's new royalty incentives are felt, Ocelot is strategically positioned to take full advantage of new opportunities.

Earnings from operations during the first quarter of 1986 were very good, but the dramatic drop in oil and natural gas prices severely cut industry activity in both Canada and the United States for the remainder of the year, causing difficulties for Ocelot's Services and Supplies segment. Alberta's new incentive credits created a surge in industry activity late in the year, mitigating the accumulated operating loss for 1986.

The loss from operations was $8.7 million in 1986, compared to a $1.5 million loss in 1985. Revenues from all divisions were down in 1986; however, the Canadian drilling division and the small-diameter pipeline construction division contributed positive earnings from operations.

Cactus Drilling experienced a 35 per cent decrease in rig utilization for the year, and revenues dropped 34 per cent to $27 million. Despite a 65 per cent decline in rig utilization, Cardinal Drilling, Ocelot's U.S. drilling contractor, broke even on a cash flow basis. Following record highs in 1985 in the service rig industry, Brooks Field Service posted a 50 percent drop in 1986 revenues.

While it was a slow year for pipeline construction, South Eastern Pipeline Construction generated positive earnings on revenues of $2.5 million in 1986. O.J. Pipelines was involved in six construction projects during the year with revenues amounting to $9.3 million. Near the end of 1986, O.J. Pipelines obtained a $3 million contract which was completed in March, 1987.

Revenues from oilfield equipment sales in Wilson Oilfield Supply dropped by 41 per cent to a total of $28.8 million in 1986. In the manufacturing area, Lynx Tool Company reported a 50 per cent drop in revenues.■

Petrochemicals restructured

A world oversupply of methanol and lower prices for methanol-blended gasoline cut sharply into methanol markets and revenue.

This situation forced Ocelot's wholly owned subsidiary, Ocelot Investments Ltd., which owns the Kitimat methanol plant, to shut down the facility for a brief period in early November. However, it was reopened when new arrangements were made with partners in Ocelot Ammonia Company.

The new 550-tonne-a-day ammonia plant came on stream early in December, utilizing hydrogen, a by-product of the methanol manufacturing process. Ocelot owns 51 per cent of the ammonia plant, which was built on a project-financed basis requiring no funding by Ocelot.

The rapid drop in world methanol prices during the third quarter of 1986 forced Ocelot to completely restructure the petrochemical operations. Ocelot granted management control of the methanol plant to its ammonia plant partner for a two-year period. This arrangement provides the necessary financial support to enable the methanol plant to continue operations.

Overhead costs were substantially decreased through staff reductions in both Kitimat and Calgary. In addition, a new transportation agreement was negotiated to lower the natural gas feedstock costs which account for over 75 per cent of methanol production costs.

While the agreements covering the ownership and management of both the methanol and ammonia plants are complex, the new structure of the overall Petrochemicals operation frees Ocelot Industries Ltd. from any funding obligations for at least the next two years.■

Australian 1987 drilling fund finalized

Production in 1986 from the Blina, Sundown and West Terrace fields in Western Australia averaged slightly over 1,000 barrels of oil a day. Ocelot has a 15.3 per cent interest in these lands. The decline in world oil prices during 1986 put all drilling programs on hold. Early in 1987, an exploration drilling fund was finalized to drill at least six wells before the end of the year.

In Senegal, Ocelot retained a 100 per cent interest in the 511,500-acre offshore Sangomar Block. A consortium of three international companies decided not to exercise an option to drill an interest-earning well during 1986.

A lack of natural gas markets continues to delay the development of extensive gas and condensate reserves in the Republic of Cameroon. Ocelot holds a 15.6 per cent interest in the 194,500-acre offshore permit.■

■$53.8 million gain realized on sale of producing properties.

Highlights

■$36 million expended by Ocelot Development Programs.

Development Drilling Programs Raise Revenues on Payout

Development activity remained high through the use of funds raised by Ocelot Development Drilling Programs. During 1986, these programs provided approximately $36 million for drilling and related activities. The company is actively pursuing additional funds to proceed with shallow gas development programs in Saskatchewan in 1987. Production increases from these programs will substantially increase Ocelot's revenues on payout, as Ocelot's working interest will rise from 10 per cent to 80 per cent.

Financial Review

Cash generated from operations before interest expense was $28.2 million for the year ended December 31, 1986 as compared to $68.8 million for 1985. Interest expense of $84.8 million in 1986 and $88.2 million in 1985 resulted in cash used for operations of $56.6 million in 1986 as compared to $19.4 million in 1985. Proceeds from sale of property, plant and equipment amounted to $86.1 million in 1986, compared to $49.5 million in 1985. Accordingly, internally generated cash totalled $29.5 million in 1986 and $30.1 million in 1985.

Ocelot's consolidated statement of earnings reflects a loss before extraordinary items of $53.9 million ($3.72 per share) as compared to $40.4 million in 1985 ($2.80 per share). An extraordinary loss in the amount of $171.6 million ($11.85 per share) was recognized on the write-down to estimated realizable value of Ocelot's subsidiary companies' assets in the Petrochemicals segment. This extraordinary loss was reduced by tax benefits realized on the application of losses carried forward from prior years of $4.2 million ($0.29 per share). The total loss for the year was $221.3 million ($15.29 per share) as compared to $40.4 million ($2.80 per share) for 1985.

Earnings from operations in the Natural Gas and Petroleum segment were $72.5 million for 1986 as compared to $74.7 million in 1985. The earnings from operations, after eliminating the sale of natural gas and petroleum properties of $53.8 million (1985 - $31.4 million) and the write-down of foreign natural gas and petroleum properties of $1.7 million (1985 - $9.6 million), amounted to $20.4 million, down from $52.9 million in 1985. The reduced earnings are primarily attributable to lower product prices and sales volumes brought about by property sales and a gas surplus in market areas served by Ocelot.

The Petroleum Industry Services and Supplies segment incurred a loss from operations of $8.7 million on $81.9 million of revenue. This compares with a loss from operations of $1.5 million on revenue of $166.4 million in 1985.

The Petrochemicals segment experienced increased financial pressure in 1986 as a result of the continuing deterioration of world methanol prices and the petrochemical operations were shut down briefly in November. Operations reopened under the control of Ocelot Ammonia Company with the support of the principal secured creditor of Ocelot Investments Ltd. ("Investments"). Ocelot's investment in its petrochemical subsidiaries has been accounted for using the cost basis as of November 7, 1986 as a result of significant restrictions imposed by the major creditors of Investments, which impairs Ocelot's control on both Investments and Ocelot Ammonia Company. In addition, Investments was, and continues to be, in default of a loan secured by a debenture. Under the terms of the debenture, the holder can demand immediate repayment of the loan by Investments and has the right to request Ocelot to purchase the debenture. This latter request has been made, but not satisfied. However, no action has been taken to realize on the secured assets and discussions are ongoing in an attempt to remedy the default. Management is confident that realization on the petrochemical assets would more than satisfy current and continuing obligations with no additional funding required from Ocelot.■

Capital expenditures

Ocelot continued its restraint program in 1986, recording $9.1 million in capital expenditures, down from $17.1 million in 1985.

Development activity remained high through the use of funds raised by Ocelot Development Drilling Programs. During 1986, approximately $36 million was expended by these programs for drilling and related facilities.

Production increases from these programs will substantially increase Ocelot's revenues on payout, as Ocelot's working interest rises from 10 per cent to 80 per cent.■

Financial position

Operating bank loans increased $49.8 million from 1985 to $64.3 million at December 31, 1986. Long-term debt was reduced by $21.6 million. This does not reflect the $69.5 million receivable from the Peco sale, which was applied to the operating bank loans in 1987. The Peco purchaser also assumed $6.2 million of related Top Gas obligations.

Ocelot's gain on the sale of the company's interest in Peco was $53.8 million on proceeds of $75.7 million. This was computed according to the Guideline on Full Cost Accounting in the Oil and Gas Industry issued by the Canadian Institute of Chartered Accountants. This gain indicates the large excess of value of the reserves as compared to their historical carrying cost in the consolidated financial statements.■

Change in accounting policy

Ocelot has prospectively adopted a change in the method of accounting for depreciation of production equipment to comply with the Guideline on Full Cost Accounting in the Oil and Gas Industry issued by the Canadian Institute of Chartered Accountants. The adoption of this method did not have a material effect on the consolidated financial statements.■

Auditors' Report

To the Shareholders of Ocelot Industries Ltd.

We have examined the consolidated balance sheet of Ocelot Industries Ltd. as at December 31, 1986 and the consolidated statements of earnings, deficit 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, 1986 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.

Thorne Ernst & Whinney

Calgary, Canada
March 12, 1987 Chartered Accountants

financial statements

1986

Ocelot Industries Ltd.
Consolidated Balance Sheet
as at December 31, 1986
(thousands of dollars)

Assets	**1986**	1985 (restated)
Current Assets		
Cash	**$ 740**	$ 7,769
Accounts receivable	**100,977**	65,758
Inventories, at lower of cost and net realizable value	**6,618**	11,329
Prepaid expenses	**3,063**	1,108
	111,398	85,964
Long-term Investments (Note 3)	**39,911**	252,437
Property, Plant and Equipment (Note 4)	**370,889**	421,809
Deferred Charges and Other Assets (Note 5)	**29,602**	37,383
	$551,800	$797,593

Approved by the Board

J V Gyme

Director

R O Fisher

Director

Liabilities	1986	1985 (restated)
Current Liabilities		
Bank indebtedness, secured	**$ 65,004**	$ 22,193
Accounts payable and accrued liabilities	**67,567**	95,208
Deferred gas revenue	**6,584**	5,750
Current maturities on long-term debt	**52,973**	31,520
	192,128	154,671
Deferred Gas Revenue (Note 6)	**35,275**	48,652
Long-term Debt (Note 7)	**670,690**	717,042
Deferred Taxes	**21,406**	20,609
Minority Interest	**—**	3,002
	919,499	943,976
Commitments and Contingencies (Notes 1 and 12)		
Capital Stock and Deficit		
Capital Stock (Note 8)		
Authorized		
25,000,000 Preferred shares without nominal or par value		
7,500,000 Class A Common shares without nominal or par value		
25,000,000 Class B Subordinate voting shares without nominal or par value		
Issued		
3,552,351 (1985 - 3,552,351) Class A shares	**6,635**	6,635
10,927,540 (1985 - 10,925,640) Class B shares	**54,896**	54,887
Deficit	**(429,230)**	(207,905)
	(367,699)	(146,383)
	$551,800	$797,593

Consolidated Statement of Earnings

Year Ended December 31, 1986
(thousands of dollars)

	1986	1985 (restated)
Revenue		
Operating (Note 9)	$ 146,313	$ 260,712
Sale of natural gas and petroleum properties	53,824	31,418
	200,137	292,130
Costs and Expenses		
Cost of sales and operating expenses	110,806	181,602
Depletion and depreciation	24,056	27,743
Write-down of foreign natural gas and petroleum properties	1,679	9,625
	136,541	218,970
Earnings from Operations before Undernoted Items (Note 9)	63,596	73,160
Share of subsidiary companies' losses (Note 3)	26,684	8,982
Other expenses	3,889	300
Interest on long-term debt	77,882	84,348
Other interest	6,963	3,906
Minority interest	(192)	123
	115,226	97,659
Loss before Taxes and Extraordinary Items	51,630	24,499
Income and other taxes (Note 10)	2,269	15,879
Loss before Extraordinary Items	53,899	40,378
Extraordinary Items (Note 3)		
Write-down of subsidiary companies' assets to estimated realizable values	171,595	—
Tax benefit from utilization of a subsidiary company's loss carried forward	(4,169)	—
Loss for the Year	$ 221,325	$ 40,378
Per Share		
Weighted average number of Class A and Class B shares outstanding during the year	14,479,773	14,423,521
Loss per Class A and Class B share		
Before extraordinary items	$ 3.72	$2.80
Loss for the year	$15.29	$2.80
Cash used for operations per Class A and Class B share	$ 3.91	$1.38

Consolidated Statement of Changes in Financial Position

Year Ended December 31, 1986
(thousands of dollars)

	1986	1985 (restated)
Cash Provided by (Used for)		
Internally Generated Cash		
Cash from operations before interest expense (Note 13)	$28,199	$68,806
Interest expense	(84,845)	(88,254)
Cash used for operations	(56,646)	(19,448)
Proceeds from sale of property, plant and equipment	86,179	49,506
	29,533	30,058
Financing Activities		
Long-term debt — borrowings	1,067	982
— repayments	(22,644)	(36,690)
Issue of shares	9	415
Dividends to minority shareholders	—	(500)
Accounts receivable and accounts payable	(62,860)	17,680
Deferred charges and other assets	3	331
	(84,425)	(17,782)
Investing Activities		
Property, plant and equipment	(9,085)	(17,120)
Long-term investments	18,416	19,765
Minority interest	(3,110)	1,712
Deferred charges and other assets	(1,169)	(9,939)
	5,052	(5,582)
Increase (Decrease) in Operating Bank Loans	49,840	(6,694)
Operating Bank Loans* at Beginning of Year	14,424	21,118
Operating Bank Loans* at End of Year	$64,264	$14,424

**Operating bank loans are net of cash.*

Consolidated Statement of Deficit

Year Ended December 31, 1986
(thousands of dollars)

	1986	1985
Balance at Beginning of Year	$207,905	$167,527
Loss for the Year	221,325	40,378
Balance at End of Year	$429,230	$207,905

Notes to Consolidated Financial Statements

Year Ended December 31, 1986

Summary of Significant Accounting Policies (Note 1)

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and certain of its subsidiaries. The subsidiary companies which have been excluded from consolidation and the underlying reasons for not consolidating these subsidiaries are described in Note 3. The amount by which the cost of the shares of consolidated subsidiaries exceeded the underlying net book value at dates of acquisition has been allocated to property, plant and equipment, and is subject to the accounting policies outlined below.

Natural Gas and Petroleum Operations

The Company follows the full cost method of accounting for natural gas and petroleum operations as prescribed in the Guideline on Full Cost Accounting in the Oil and Gas Industry issued by the Canadian Institute of Chartered Accountants.

All costs of exploration for and development of natural gas and petroleum reserves are capitalized on a country-by-country cost centre basis. Such costs include land acquisition costs, geological and geophysical expenses, carrying charges of non-producing property, costs of drilling both productive and non-productive wells and overhead charges related to exploration and development activities. Grants received and accrued under Federal and Provincial incentive programs are applied as a reduction of the related capitalized costs. Proceeds received on the sale of natural gas and petroleum properties are credited to the capitalized costs except for dispositions which would significantly alter the relationship between capitalized costs and proven natural gas and petroleum reserves.

Capitalized costs are depleted and depreciated using the unit of production method based on estimated gross proven reserves of natural gas and petroleum in each cost centre, as determined by Company engineers and substantiated periodically by independent engineers. Reserves and production quantities, for depletion and depreciation calculations, are converted to equivalent units of gas based on the relative sales value.

The Company places limits on the aggregate costs of natural gas and petroleum assets which may be carried forward for amortization against revenues of future periods (the "Ceiling Test"). The "Ceiling 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 estimated future net revenues from proven reserves (based on current prices and costs as at the balance sheet date) plus unproved properties (at cost less impairment, the "Cost Centre Ceiling").

The total capitalized costs less depletion and depreciation and deferred income taxes of all cost centres are further limited to the aggregate estimated future net revenues for all cost centres less recurring general and administrative expenses, future financing costs and income taxes (the "Enterprise Ceiling"). Any costs carried on the balance sheet in excess of the ceiling test limits are charged to earnings.

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

Drilling and Well Service Rigs and Related Property and Equipment

Costs of new equipment and upgrading existing equipment are capitalized. Repairs and replacements which do not extend the useful lives of assets are expensed as incurred. The cost and related accumulated depreciation are removed from the accounts when an asset is sold or retired and the resulting gain or loss is included in earnings.

Depreciation

Depreciation of drilling and construction assets is provided on methods and at rates which will amortize the cost of the assets over their estimated useful lives. The annual rates of depreciation on major classes of assets are:

Drilling and service rigs — 10 per cent (based on operating days)
Construction equipment— 20 per cent to 35 per cent

Revenue Recognition

The revenues and expenses on drilling and construction contracts are recorded on the percentage of completion basis.

Foreign Currency Translation

The Company follows the temporal method when translating foreign currency transactions and the financial statements of integrated foreign subsidiaries. Under this method:

(i) monetary items are translated at the rates of exchange prevailing at the balance sheet date;

(ii) non-monetary items are translated at historic exchange rates; and

(iii) revenue and expenses (other than depletion and depreciation) are translated at average rates of exchange during the year.

The resulting gains or losses are credited or charged to 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. In previous years, the Company's U.S. dollar denominated debt was hedged by U.S. dollar revenue streams and the resulting foreign exchange exposure was deferred. During the year the Company's hedge ceased to become effective and the resulting foreign exchange exposure is being charged to earnings over the remaining life of the debt.

Pension Plan

The Company and its U.S. subsidiary have implemented non-contributory benefit-based pension plans for substantially all permanent, full-time employees. Pension costs associated with current service are expensed and funded in the year in which the service is rendered. Past service costs remaining to be charged to earnings are amortized and funded in accordance with applicable government legislation.

Deferred Gas Revenues

Amounts received under take-or-pay provisions of gas sales contracts are deferred and are recognized as revenue when reserves committed under the contracts are delivered to the purchasers.

Deferred Financing Charges

Expenses relating to the refinancing of certain of the Company's bank loans are being amortized over ten years.

Comparative Figures

Certain comparative figures have been restated from those previously reported to conform with the financial statement presentation adopted at December 31, 1986 (reference is made to Note 3). These reclassifications and restatements had no effect on the December 31, 1985 consolidated loss or deficit.

Note 1 Financial Position of the Company

During the year and subsequent to December 31, 1986, the Company's principal banker agreed to temporarily defer certain scheduled payments on the bank loans and, based upon present financial forecasts, further rescheduling of bank loan repayments will be required. The Company needs to obtain additional funds to finance ongoing operational and capital expenditures subsequent to December 31, 1986. The Company is presently reviewing future cash requirements and an appropriate repayment schedule with its principal banker. The Company's principal banker has indicated that it intends to work closely with the Company in this regard. Management believes that, in light of existing collateral security, present worth and cash flow margins, a refinancing arrangement can be achieved with its principal banker to warrant presentation of consolidated financial statements which assume the Company's continuing operations.

Note 2 Change in Accounting Policy

Effective January 1, 1986, the Company changed its method of accounting for depreciation of production equipment from a project area basis to a country-by-country basis to comply with the Guideline on Full Cost Accounting in the Oil and Gas Industry issued by the Canadian Institute of Chartered Accountants.

This change has been applied prospectively from January 1, 1986 and accordingly the previously reported balance sheet at December 31, 1985 and statement of earnings, deficit and changes in financial position for the year then ended, have not been restated. This change in accounting did not have a material effect on the consolidated financial statements.

Note 3 Long-term Investments

Investment in and advances to non-consolidated subsidiary companies consists of:

	1986	1985
	(thousands of dollars)	
(a) Petrochemical subsidiaries		
Ocelot Investments Ltd. (100% owned)	**$26,892**	$232,635
Ocelot Ammonia Company, a British Columbia Partnership (51% owned)	**10,691**	10,691
Ocelot Chemical Corp. (100% owned)	**1**	5,606
	37,584	248,932
(b) Other		
Ocelot Oil Corp. (55% owned; 1985 - 51% owned)	**1,366**	1,273
Lynx Oilfield Supply, Inc. (53% owned; 1985 - 100% owned)	**961**	2,232
	2,327	3,505
	$39,911	$252,437

(a) Ocelot Investments Ltd. ("Investments") incurred significant operating losses during 1986 and its petrochemical operations were shut down in November due to Investments' failure to meet certain of its liabilities. Operations were recommenced on November 7, 1986 under the control of Ocelot Ammonia Company with the support of Investments' principal secured creditor. Pursuant to the negotiations that permitted operations to recommence, the Company agreed to significant restrictions which seriously impair its ability to control both Investments and Ocelot Ammonia Company. Continued petrochemical operations depend upon the outcome of ongoing negotiations.

Accordingly, the Company's investment in its petrochemical operations has been included in these consolidated financial statements to November 6, 1986 on the equity basis of accounting. Subsequent to November 6, 1986 the Company's investment in its petrochemical subsidiaries have been accounted for on the cost basis.

The Company is contingently liable in respect of a debenture issued by Investments. During 1986, Investments was and continues to be in default of the repayment of a loan secured by the debenture. Under the terms of the debenture, the debenture holder has the right to make formal demand on Investments for repayment of the loan and has formally requested the Company to purchase the debenture. Notwithstanding these formal steps, no other action has been taken by the debenture holder as discussions are ongoing in an attempt to remedy the default. The debenture security comprises the methanol plant and its ancillary facilities and the Company's interest in Ocelot Ammonia Company. In the event a resolution of the above-noted matter is not achieved, management believes the debenture security would more than satisfy Investments' indebtedness. Reference is made to Note 12.

(b) Subsequent to December 31, 1986, the Company approved in principle the sale of Ocelot Oil Corp. and Lynx Oilfield Supply, Inc. Accordingly, the accounts of these companies have been included in these consolidated financial statements on the equity basis of accounting.

The following summary presents the results of Ocelot Investments Ltd., Ocelot Ammonia Company, Ocelot Chemical Corp., Ocelot Oil Corp. and Lynx Oilfield Supply, Inc. (the non-consolidated subsidiaries):

	Year Ended December 31, 1986	1985
	(thousands of dollars)	
Revenue	**$ 44,447**	$ 93,675
Costs and expenses	**71,273**	97,836
Loss from operations before undernoted items	**26,826**	4,161
Interest and other income	**(4,929)**	(2,286)
Interest on long-term debt	**4,287**	5,500
Other interest	**1,365**	1,607
Loss before taxes and extraordinary items	**27,549**	8,982
Deferred tax reduction	**(865)**	—
Loss before extraordinary items	**26,684**	8,982
Extraordinary items		
Write-down of methanol assets to estimated realizable values	**171,595**	—
Tax benefit from utilization of loss carry forwards	**(4,169)**	—
Loss for the year	**$194,110**	$ 8,982

Note 4 Property, Plant and Equipment

	1986 Cost	1986 Accumulated Depletion and Depreciation	1986 Net	1985 Net
	(thousands of dollars)			
Natural gas and petroleum leases and rights together with exploration, development and equipment thereon	**$380,234**	**$114,659**	**$265,575**	$302,708
Contract drilling equipment	**119,014**	**47,282**	**71,732**	75,067
Pipeline construction equipment	**31,916**	**18,532**	**13,384**	16,383
Land, buildings and other equipment	**41,738**	**21,540**	**20,198**	27,651
	$572,902	**$202,013**	**$370,889**	$421,809

(a) As at December 31, 1986, the Enterprise Ceiling amount (as determined in accordance with the method outlined in the Summary of Significant Accounting Policies and based on prices and costs in effect on that date) on all of the Company's natural gas and petroleum cost centres approximates $1.025 billion before deduction of estimated future income tax expense in excess of unclaimed tax deductions in the amount of $305 million. The net amount of $720 million represents the maximum amount at which the natural gas and petroleum properties could be carried on the consolidated balance sheet at December 31, 1986 for accounting purposes.

(b) Overhead charges related to exploration and development activities of $3.1 million (1985 - $3.1 million) have been capitalized and included in the cost of properties.

Note 5 Deferred Charges and Other Assets

	1986	1985
	(thousands of dollars)	
Unrealized foreign exchange losses on long-term debt, less accumulated amortization of $2,565,000 (1985 - Nil)	**$22,005**	$27,892
Deferred financing charges, less accumulated amortization of $3,193,000 (1985 - $1,940,000)	**4,482**	5,735
Other assets	**3,115**	3,756
	$29,602	$37,383

Note 6 Deferred Gas Revenue

The December 31, 1986 balance of deferred gas revenue represents payments received under take-or-pay provisions of major gas contracts. These amounts received for natural gas not yet delivered are to be repaid by deliveries of natural gas at a minimum rate of 10% of prepaid volumes per contract year. During the year, $6.3 million (1985 - $5.6 million) of natural gas was delivered and recognized as revenue. In addition, $6.2 million of the Company's obligations under the take-or-pay provisions were assumed in 1986 by the purchaser of certain of the Company's natural gas properties.

Note 7 Long-term Debt

	1986	*1985*
	(thousands of dollars)	
Canadian dollar bank loans (a)	**$514,005**	$524,660
U.S. dollar bank loans (a) (1986 - $105,000,000 U.S.; 1985 - $105,000,000 U.S.)	**144,953**	146,738
9½% Senior secured notes due March 31, 1998 (b) (1986 - $39,487,500 U.S.; 1985 - $42,775,000 U.S.)	**54,512**	59,778
10½% Senior secured notes due March 31, 1998 (b)	**8,529**	9,239
Other	**1,664**	8,147
	723,663	748,562
Less current maturities included in current liabilities	**52,973**	31,520
	$670,690	$717,042

(a) Late in 1986, the Company converted $500 million of its Canadian dollar bank loans into fully hedged U.S. London Interbank Offer Rate ("Libor") Notes. The principal balance of these hedged bank loans is included in the accounts at $500 million Canadian and bears an interest cost of Libor plus 1%. The cost of the hedge is being amortized over the life of the Notes (which is limited to a maximum of 90 day periods). The remaining loans bear interest at ½% and 1¼% above bank prime rate. The loans are secured by the Company's interest in certain petroleum and natural gas properties.

The U.S. dollar bank loans are evidenced by demand promissory notes and are secured by a fixed mortgage on certain contract drilling rigs and related equipment and the Company's interest in certain Canadian oil and gas properties. The loans bear interest at 1½% above a certain United States bank base rate, ¼% above a certain United States bank prime rate and at 1% and 2% above Libor.

Both the Canadian and U.S. dollar bank loans are also secured by an assignment of an intercompany debenture in the amount of $350 million which represents a floating charge on the assets of the petrochemical subsidiaries, by the hypothecation of all the outstanding shares of the petrochemical subsidiaries and by the hypothecation of a fixed and floating debenture on manufacturing equipment. In addition, the Company has issued a $200 million debenture to its principal banker representing a first fixed mortgage over certain specific property and a first floating charge over virtually all of the Company's property and assets.

(b) These notes are secured by mortgages on certain producing petroleum and natural gas properties.

As described in Note 1, the Company's principal banker is presently reviewing the repayment terms of the bank loans. Based upon present projections of the Company's future cash flow and its corresponding capability to make principal repayments, revisions to established repayment schedules will be required. The estimated minimum amount of long-term debt maturities set out below have been determined on the basis of existing repayment schedules for the bank loans, however, if the negotiations are successful and a favourable revision to the repayment schedule is received, then the accompanying consolidated financial statements would be affected by the reclassification of the amount of any additional payments deferred in 1987 from current liabilities to long-term debt.

The estimated minimum amount of long-term debt maturities for the five years subsequent to 1986 are as follows: 1987 - $53.0 million; 1988 - $59.7 million; 1989 - $85.4 million; 1990 - $115.4 million; and 1991 -$115.3 million. In accordance with arrangements made with the Company's principal banker, the Company may be required to make additional payments on bank loans such that total payments would equal 60% of the net annual cash flow generated from operations.

Note 8 Capital Stock

(a) The Class A and Class B shares rank equally one with the other except that each Class A share carries twenty votes and each Class B share carries one vote, and Class A shares are convertible at the option of the holder into Class B shares on a one-for-one basis.

(b) The declaration of dividends on all issued and outstanding shares is subject to the approval of the Company's principal banker.

(c) Changes in the capital stock of the Company during the year were as follows:

	Number of Shares		Consideration	
	Class A	Class B	Class A	Class B
			(thousands of dollars)	
Balance, December 31, 1985	3,552,351	10,925,640	$ 6,635	$ 54,887
Issued on exercise of employee stock options	—	1,900	—	9
Balance, December 31, 1986	**3,552,351**	**10,927,540**	**$6,635**	**$54,896**

(d) As of December 31, 1986, there were 643,200 Class B shares of the Company reserved for exercise of employee stock options to 1991 at prices ranging from $4.50 to $6.875 per share as follows:

Outstanding at December 31, 1985	737,100
Granted at $6.875 per share	50,500
Exercised at $4.65 per share	(1,900)
Expired	(142,500)
Outstanding at December 31, 1986	643,200

All options were granted under employee stock option plans and at December 31, 1986, an additional 691,500 Class B shares were reserved for future options which may be granted under these plans.

Note 9 Segmented Information

The Company's operations are conducted through two business segments. These segments are Natural Gas and Petroleum Operations and Petroleum Industry Services and Supplies (which comprises contract drilling of oil and gas wells, sales of oilfield equipment and supplies, and pipeline construction). For information regarding the Company's Petrochemicals operations refer to Note 3. Presented below are data relative to each business and geographic segment.

Business Segments

	Natural Gas and Petroleum Operations	Petroleum Industry Services and Supplies	Petro-chemicals	Eliminations (b)	Total
	(thousands of dollars)				
Revenue					
1986	**$ 66,475(a)**	**$ 81,907**	**$ —**	**$ (2,069)**	**$146,313**
1985	$ 96,747(a)	$ 166,392	$ —	$ (2,427)	$ 260,712
Earnings (loss) from operations					
1986	**$ 72,482**	**$ (8,664)**	**$ —**	**$ (222)**	**$ 63,596**
1985	$ 74,698	$ (1,484)	$ —	$ (54)	$ 73,160
Total assets					
1986	**$394,041**	**$120,175**	**$ 37,584**	**$ —**	**$551,800**
1985	$ 394,249	$ 154,412	$ 248,932	$ —	$ 797,593
Capital expenditures					
1986	**$ 7,706**	**$ 1,379**	**$ —**	**$ —**	**$ 9,085**
1985	$ 10,405	$ 6,715	$ —	$ —	$ 17,120
Provision for depletion and depreciation					
1986	**$ 15,509**	**$ 8,547**	**$ —**	**$ —**	**$ 24,056**
1985	$ 16,403	$ 11,340	$ —	$ —	$ 27,743

Geographic Segments

	Canada	United States	Other Foreign	Eliminations (b)	Total
			(thousands of dollars)		
Revenue					
1986	**$137,098**	**$ 8,089**	**$ 1,126**	**$ —**	**$146,313**
1985	$ 216,533	$ 42,482	$ 1,697	$ —	$ 260,712
Earnings (loss) from operations					
1986	**$ 70,960**	**$ (4,107)**	**$ (3,257)**	**$ —**	**$ 63,596**
1985	$ 88,501	$ (4,598)	$ (10,743)	$ —	$ 73,160
Total assets					
1986	**$505,600**	**$ 40,292**	**$ 5,908**	**$ —**	**$551,800**
1985	$ 730,743	$ 53,591	$ 13,259	$ —	$ 797,593

(a) Natural gas and petroleum revenue is net of royalties (1986 - $16.8 million; 1985 - $31.0 million) and Alberta Royalty Tax Credit (1986 - $2.8 million; 1985 - $2.0 million).

(b) Eliminations relate to inter-segment transactions which are priced at market prices for similar products and services.

Note 10 Income and Other Taxes

(a) Income tax expense differs from the amounts which would be obtained by applying the Canadian basic federal income tax rate to the respective year's loss before taxes and extraordinary items. These differences result from the following items:

	Year Ended December 31, 1986	1985
	(thousands of dollars)	
Expected Canadian Federal tax rate	**47.8%**	46.9%
Computed "expected" tax recovery	**$ (24,679)**	$(11,490)
Royalties and other payments to federal and provincial governments	**2,836**	6,444
Other non-deductible costs	**3,535**	1,671
Federal resource allowance and earned depletion	**(7,259)**	(11,379)
Provincial income tax less federal abatements	**9**	156
Non-deductible losses and unrecognized benefits carried forward	**26,039**	21,965
Petroleum and gas revenue tax	**1,788**	8,512
Total actual tax	**$ 2,269**	$ 15,879
Actual tax represented by:		
Deferred income tax	**$ 481**	$ 7,367
Petroleum and gas revenue tax	**1,788**	8,512
	$ 2,269	$ 15,879

(b) As at December 31, 1986, the Company had available for deduction against future years' taxable income the following amounts (subject to final determination by taxation authorities):

	Canada	United States
	(thousands of dollars)	
Loss carry-forwards (expiring in varying amounts to the year 2001)	$ 31,431	$ 53,538
Property and capital costs (deductible at varying rates and methods)	$ 199,862	$ 12,647

The Company estimates that it has earned investment tax credits of $6.0 million as at December 31, 1986 which have not been recognized in the accounts. These credits can be applied in future years to reduce federal taxes otherwise payable and are subject to final determination by the taxation authorities.

(c) The Company has potential income tax benefits of $26.5 million which relate to accumulated accounting losses to December 31, 1986 on which no tax benefit has been recorded in the accounts. These benefits will be recognized in the accounts as an extraordinary item in future years upon their realization.

Note 11 Pension Plans

The Company and its United States subsidiary have non-contributory pension plans covering substantially all permanent, full-time employees. The plans provide a defined benefit pension at retirement based on earnings and length of service.

Pension costs are actuarially computed whereby the Company's annual contributions consist of the current service cost for the plan in Canada, and the current service cost plus a contribution towards the unfunded past service liability for the plan in the United States. For the year ended December 31, 1986, the pension expense was $1,232,000 (1985 - $1,089,000).

Based on the most recent actuarial evaluation, the Canadian pension plan was fully funded in respect of past service liabilities, and the United States pension plan had an unfunded past service obligation of $1,252,000 at December 31, 1986 (1985 - $1,126,000). This obligation is being funded in accordance with applicable government legislation.

Note 12 Commitments and Contingencies

(a) The Company is contingently liable as guarantor of the bank indebtedness and the secured debenture granted by Investments in the amount of $3.7 million and $45.6 million respectively. Management is confident that realization on the secured assets would satisfy these obligations with no additional funding required by the Company. Reference is made to Note 3.

(b) A statement of claim has been served by the contractor of the Kitimat methanol plant claiming $2.6 million owing to the contractor. Management believes that the Company has outstanding claims against the contractor for credits and adjustments at least equal to the claim by the contractor, and has not provided in the accompanying consolidated financial statements for the amounts claimed. In addition, counsel for the Company has advised that such claim is without merit and the Company has filed a statement of defence and counter claim in the amount of $83.2 million. The ultimate outcome of these legal proceedings is not predictable.

(c) A United States subsidiary of the Company is in a dispute with a customer over certain work performed under a construction contract. Management believes that adequate provision has been made in the accounts for all anticipated losses under this contract.

(d) Future minimum lease payments under operating leases relating primarily to office space and equipment (but excluding leases relating to gas, oil and mineral rights) are as follows:

	(thousands of dollars)
1987	$2,946
1988	2,368
1989	1,582
1990	1,019
1991	272
Thereafter	150
	$8,337

Note 13 Consolidated Statement of Changes in Financial Position

	1986	1985
	(thousands of dollars)	
Loss before extraordinary items	**$(53,899)**	$(40,378)
Add (deduct)		
Depletion and depreciation	**24,056**	27,743
Share of subsidiary companies' losses	**26,684**	8,982
Write-down of foreign natural gas and petroleum properties	**1,679**	9,625
Sale of natural gas and petroleum properties	**(53,824)**	(31,418)
Deferred income tax	**481**	7,367
Other non-cash items	**8,322**	1,820
Interest expense	**84,845**	88,254
	38,344	71,995
Inventories and prepaid expenses	**2,756**	1,193
Deferred charges and other assets	**(358)**	1,179
Deferred revenue	**(12,543)**	(5,561)
	(10,145)	(3,189)
Cash from operations before interest expense	**$ 28,199**	$ 68,806

Five Year Summary – Financial
(thousands of dollars)

	Years Ended December 31,			Nine Months Ended December 31,	Years Ended March 31,	
	1986	1985	1984 (unaudited)	1984	1984	1983
Revenue						
Operating	**$ 146,313**	$ 260,712	$ 226,127	$ 160,097	$ 193,036	$ 322,958
Sale of natural gas and petroleum properties	**53,824**	31,418	–	–	–	–
	200,137	292,130	226,127	160,097	193,036	322,958
Costs and Expenses						
Cost of sales and operating expenses	**110,806**	181,602	141,254	98,544	122,609	211,100
Depletion and depreciation	**24,056**	27,743	29,564	21,266	29,367	25,312
Write-down of foreign natural gas and petroleum properties	**1,679**	9,625	–	–	–	–
	136,541	218,970	170,818	119,810	151,976	236,412
Earnings from Operations Before Undernoted Items	**63,596**	73,160	55,309	40,287	41,060	86,546
Share of subsidiary companies' losses	**26,684**	8,982	15,677	7,277	27,602	121,356
Other expense (income)	**3,889**	300	(2,156)	(1,326)	(2,525)	(1,573)
Interest on long-term debt	**77,882**	84,348	92,293	71,526	81,459	69,975
Other interest	**6,963**	3,906	5,827	4,496	7,699	9,494
Minority interest	**(192)**	123	123	99	51	5,117
	115,226	97,659	111,764	82,072	114,286	204,369
Loss before Undernoted Items	**51,630**	24,499	56,455	41,785	73,226	117,823
Income and other taxes	**2,269**	15,879	607	130	(13,443)	6,979
Loss from Continuing Operations	**53,899**	40,378	57,062	41,915	59,783	124,802
Loss from operations of discontinued mining segment	**–**	–	2,036	1,404	2,599	4,120
Loss before Extraordinary Items	**53,899**	40,378	59,098	43,319	62,382	128,922
Extraordinary items						
Write-down of subsidiary companies' assets to estimated realizable values	**171,595**	–	–	–	–	–
Tax benefit from utilization of a subsidiary company's loss carried foward	**(4,169)**	–	–	–	–	–
Write-down of mining assets, net of applicable income taxes of $4,353	**–**	–	5,929	5,929	–	–
Loss for the Period	**$ 221,325**	$ 40,378	$ 65,027	$ 49,248	$ 62,382	$ 128,922
Weighted average number of Class A and B shares outstanding during the period	**14,479,773**	14,423,521	14,380,553	14,382,909	14,369,488	13,635,974
Loss per Class A and B share						
From continuing operations	**$ 3.72**	$2.80	$3.97	$2.91	$4.16	$9.15
Before extraordinary items	**$ 3.72**	$2.80	$4.11	$3.01	$4.34	$9.45
Loss for the period	**$15.29**	$2.80	$4.52	$3.42	$4.34	$9.45
Revenues by Segment						
Natural gas and petroleum operations	**$ 66,475**	$ 96,747	$ 96,567	$ 67,225	$ 86,571	$ 74,001
Petroleum industry services and supplies	**79,838**	163,965	129,560	92,872	106,465	248,957
	$ 146,313	$ 260,712	$ 226,127	$ 160,097	$ 193,036	$ 322,958

Five Year Summary — Operations

	Years Ended December 31,			Nine Months Ended December 31,	Years Ended March 31,	
	1986	1985	1984	1984	1984	1983
Production						
Net crude oil and natural gas liquids						
Barrels	**910,731**	1,093,887	1,030,817	732,293	887,219	666,657
Barrels per day	**2,495**	2,997	2,816	2,663	2,424	1,819
Net natural gas						
Millions of cubic feet	**35,010**	39,613	39,839	28,532	37,221	27,262
Millions of cubic feet per day	**96**	109	109	104	101	75
Methanol - tonnes	**355,973**	446,902	428,679	319,672	347,774	141,062
Proven Reserves						
Crude oil and natural gas liquids						
Thousands of barrels	**7,741**	30,096	16,366	16,366	12,808	9,850
Natural gas						
Billions of cubic feet	**1,041**	1,291	1,350	1,350	1,023	955
Shareholders and Employees						
Number of employees at year end	**984**	1,528	1,510	1,510	1,417	1,400
Number of common shareholders at year end	**1,358**	1,477	1,675	1,675	1,910	2,104

Wells Drilled

	Years Ended December 31,						Nine Months Ended December 31,		Years Ended March 31,			
	1986		1985		1984		1984		1984		1983	
	Gross	**Net**	Gross	Net	Gross	Net	Gross	Net	Gross	Net	Gross	Net
Exploratory												
Oil	**3**	**1.4**	9	1.1	7	1.0	5	0.6	6	1.2	17	2.5
Gas	**4**	**2.6**	10	2.6	7	3.0	6	2.8	13	4.8	5	1.1
Dry	**5**	**2.0**	22	4.5	15	3.8	10	2.8	17	2.4	42	5.7
Total	**12**	**6.0**	41	8.2	29	7.8	21	6.2	36	8.4	64	9.3
Development												
Oil	**13**	**3.8**	27	6.6	72	17.8	50	13.5	81	28.7	46	9.8
Gas	**184**	**128.0**	301	158.5	284	192.2	278	189.8	86	41.6	24	9.0
Dry	**4**	**2.4**	16	3.5	10	3.5	9	2.7	11	3.6	11	2.4
Service	**5**	**0.9**	8	1.3	18	3.4	14	2.4	10	3.9	2	0.8
Total	**206**	**135.1**	352	169.9	384	216.9	351	208.4	188	77.8	83	22.0

Shareholder Information

Annual Meeting

The Annual General Meeting of Shareholders of Ocelot Industries Ltd. will be held in the Bonavista Room, Westin Hotel, Calgary, Alberta on May 22, 1987 at 10:30 a.m. Formal notice of this meeting and proxy materials are enclosed.

Share Information

Ocelot's common shares are listed for trading on the Toronto, Montreal and Alberta Stock Exchanges. The Class A shares and Class B subordinate voting shares carry voting rights of 20 votes per share and one vote per share respectively.

At December 31, 1986 the weighted average of Class A and Class B shares outstanding was 14,479,773, and the shareholders of record totalled 1,358. Over 90 per cent of the outstanding shares are owned by Canadians. The stock market designations for the common shares are Ocelot A and Ocelot B with the respective Toronto Stock Exchange computer symbols being OILA and OILB.

Transfer Agents and Registrars

National Trust Company offices are at Toronto, Montreal, Calgary, Vancouver and Regina.

Banker

The Royal Bank of Canada
335 - 8th Avenue S.W.
Calgary, Alberta
T2P 2N5

Auditors

Thorne Ernst & Whinney
Chartered Accountants
1200 Bow Valley Square Two
205 - 5th Avenue S.W.
Calgary, Alberta
T2P 4B9

Duplicate Shareholder Materials

Some holders of Ocelot Industries Ltd. securities receive more than one copy of the Annual Report and other materials mailed to shareholders. We make an effort to eliminate duplication of such mailings. However, if securities are registered in different names and addresses, multiple copies will be received. Security holders receiving more than one copy of material who wish to consolidate their holdings under one name should contact either the Secretary of Ocelot or the Transfer Agent at the following addresses:

Secretary
Ocelot Industries Ltd.
900, 333 - 5th Avenue S.W.
Calgary, Alberta T2P 3B6
Telephone: (403) 261-2100

National Trust Company
150 Toronto Dominion Square
320 - 8th Avenue S.W.
Calgary, Alberta T2P 3B2
Telephone: (403) 263-1460

Market Information

Market Price Per Share
(as per Toronto Stock Exchange)
(expressed in dollars)

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Class A Common Shares				
1986 High	**6½**	**4½**	**4¾**	**5**
Low	**4**	**3⅛**	**3**	**2⅛**
1985 High	4¾	8⅛	9¾	7¾
Low	4	4½	7¼	6¼
Class B Subordinate Voting Shares				
1986 High	**7**	**3½**	**3¼**	**5**
Low	**3**	**2½**	**2⅝**	**2¼**
1985 High	4⅞	8¼	9¼	8
Low	3¾	4½	6¼	5¾

Corporate Information

Board of Directors

William J. Bushnell*
Corporate Director
Toronto, Ontario

Basil R. Cheeseman*
Partner,
McCarthy & McCarthy
(Barristers and Solicitors)
Toronto, Ontario

Royden O. Fisher*
President
Ocelot Industries Ltd.

Norbert M. Hannon*
President,
Murcon Development Ltd.
(a private investment company)
Calgary, Alberta

J. Verne Lyons
Chairman of the Board and
Chief Executive Officer
Ocelot Industries Ltd.

George C. Solomon
President,
Western Limited
(a private investment and
property development company)
Regina, Saskatchewan

**Members of the Audit Committee*

Officers

J.V. Lyons
Chairman and
Chief Executive Officer

R.O. Fisher
President

I.L. Levorson
Executive Vice President

B.W. Wilson
Executive Vice President

I.J. Bond
Vice President, Exploration

M.I. Erickson
Vice President, Finance

K.M. Guise
Vice President, Land and
International Operations

W.D. Lyons
Vice President,
Corporate Development

D.J. McKinnon
Vice President, Production

R.J. Russell
Vice President,
General Counsel and
Secretary

B.N. Wade
Vice President,
Special Projects

Corporate Head Office

900, 333 - 5th Avenue S.W.
Calgary, Alberta T2P 3B6
Telephone: (403) 261-2100
Telex: 03-827925

Lynx Energy Services

900, 333 - 5th Avenue S.W.
Calgary, Alberta T2P 3B6
Telephone: (403) 264-0650
Telex: 03-827925

Cactus Drilling
Calgary, Alberta

Cardinal Drilling Company
Billings, Montana

Brooks Field Service
Calgary, Alberta

O.J. Pipelines Inc.
Edmonton, Alberta

South Eastern Pipeline Construction
Medicine Hat, Alberta

Wilson Oilfield Supply
Calgary, Alberta

Lynx Tool Company
Calgary, Alberta

Lowe Valve Ltd.
Scarborough, Ontario

International Office

Ocelot International Pty Ltd.
Perth, Western Australia

Ocelot
Industries
Ltd.

900, 333 - 5 Ave. S.W.
Calgary, Alberta
T2P 3B6
(403) 261-2100
Telex 03-827925

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