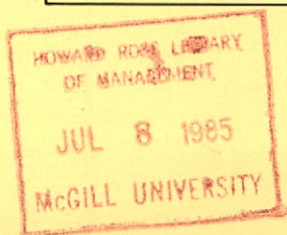


Lochiel Exploration Ltd.

INTERIM REPORT

**FIRST QUARTER
1985**



TO THE SHAREHOLDERS

EXPLORATION

Activity in the Beaufort Sea-Mackenzie Delta Exploration Programme dominated Company attention in the first quarter of 1985. Drilling results were excellent and future prospects bright.

Onshore in the Beaufort, the Company participated in four wells spudded this year. The first, Tuk J-29, was drilled to follow up the Tuk M-09 gas and condensate discovery of 1984. J-29 encountered new shallow Tertiary-age oil and gas reservoirs after drilling to a total depth of 3 096 m. Drillstem tests flowed 1,961 barrels of oil per day and 18.8 million cubic feet of gas per day from a gross pay interval of 340 m. Highly encouraged by these results, the participants immediately commenced a further delineation well, Tuk H-30, 1.75 km north of J-29. H-30 has reached total depth of 1 400 m and has been cased and suspended with testing planned from a gross hydrocarbon interval of 725 m after next winter's freeze-up.

Two other onshore wells were drilled in the first quarter. Itkerlik B-52, on a separate structure from the Tuk area, was abandoned as a dry hole. W. Taglu H-06, located on the flank of the Taglu gas field, is currently approaching total depth of 4 250 m after encountering a number of good hydrocarbon shows.

Offshore in the Beaufort, two wells were tested with extremely good results. Nipterk L-19, 98 km northwest of Tuktoyaktuk in 11 m of water, was drilled to a total depth of 3 864 m from a sacrificial beach island. Drillstem tests were extremely encouraging and a cumulative flow of 8,090 barrels of oil per day and 5.39 million cubic feet of gas per day were recovered from six zones. Two additional zones, one containing oil and the other gas, were not tested. Results from the Nipterk discovery were so encouraging that the partners proceeded with a delineation well, Nipterk L-19A. This well has been directionally drilled at a 52 degree angle to a deviated total depth of 3 520 m. The well is currently testing with good flow tests being recorded from new zones updip from the discovery well.

Farther to the east, Amerk O-09 was drilled to a total depth of 5 000 m on a caisson-retained island. Tests flowed a total of 20.34 million cubic feet of gas per day with traces of condensate. Prior to completion of the Amerk and Nipterk wells, the Company farmed-out one-half of its earned interest of 4.29 percent in the wells in exchange for an interest in 8,744 acres located between Amerk and Gulf's Amauligak J-44 oil discovery, 4.25 km northeast.

The Company also maintains a net carried interest of 1.4 percent and a gross overriding royalty of 0.567

Lochiel Exploration Ltd.

and Subsidiary Companies

CONSOLIDATED STATEMENT OF INCOME

for the three months ended April 30, 1985

(unaudited)

	<u>1985</u>	<u>1984</u>
REVENUE		
Oil and gas sales	\$1,914,000	\$3,126,000
Less: royalties and mineral taxes	<u>343,000</u>	<u>675,000</u>
Net sales	1,571,000	2,451,000
Other income	<u>30,000</u>	<u>21,000</u>
	1,601,000	2,472,000
EXPENSES		
Operating	621,000	606,000
General and administrative	294,000	300,000
Interest on long-term financing	542,000	470,000
Exchange loss	104,000	—
Royalty tax recovery	<u>(121,000)</u>	<u>(100,000)</u>
	1,440,000	1,276,000
CASH FLOW FROM OPERATIONS	<u>161,000</u>	<u>1,196,000</u>
NON-CASH CHARGES		
Depletion, depreciation and amortization	628,000	973,000
Deferred income taxes	<u>33,000</u>	<u>91,000</u>
	661,000	1,064,000
NET INCOME (LOSS) FOR THE PERIOD	<u><u>\$ (500,000)</u></u>	<u><u>\$ 132,000</u></u>
RESULTS PER SHARE		
Funds from operations		
Class A Common	1.1¢	8.6¢
Class B Common	1.0¢	7.3¢
Net income (loss) for the period		
Class A Common	(4.0¢)	—
Class B Common	(4.6¢)	—

The chief cause of this decline was the shut-down of the Buchan oil field. The gas lift facilities having been completed by May 1, 1985, the Company will receive \$225,000 per month in cash flow which will substantially benefit the second quarter.

During the first quarter, the Company successfully completed the private placement of flow-through preference shares with a total issue of \$1,800,000. The proceeds were used to finance the continuing exploration programme in the Beaufort Sea led by Esso Resources and Home Oil.

OUTLOOK

In addition to reserve additions, other recent developments in northern Canada indicate that the Beaufort discoveries are within five years of development. The pipeline connecting the Norman Wells oil field and continental markets means that the Beaufort area is about 140 to 200 km from transportation. Governments and native groups in the Northwest Territories have begun to formulate land claims and resource-management policies based upon the premise that development will occur as soon as possible.

The Western Accord and the just-announced new Alberta Royalty regime will have a mildly beneficial impact on the Company. Revisions of royalty and tax rates will modestly boost future cash flows. But independent producers still face important decisions about how to proceed amidst policy changes clearly designed chiefly for large integrated companies. Lochiel will, however, complete its full participation in the Beaufort Exploration Programme prior to the conclusion of the Petroleum Incentives Programme.

In sum, we are looking hard at ways to increase our immediate income and prospects, for, due to the results from the Beaufort, we are extremely confident about our position for future production.

Respectfully submitted,

A handwritten signature in black ink, appearing to read 'N. W. Taylor', with a stylized flourish at the end.

N. W. Taylor
President

percent in 85,986 acres on lands on which the Dome et al. Havik well, northeast of Amerk, will be tested this summer. Elsewhere in the Arctic Islands, 32 km from King Christian Is., where the Company has a 3 percent gross overriding royalty convertible to a 12 percent working interest after production in 239,610 acres, Panarctic made a significant discovery at Cape Allison C-47, which flowed 3,666 barrels of oil per day and 275 million cubic feet of gas per day.

The Tuk discoveries have resulted in plans to drill up to eleven delineation wells into the Tuk Tertiary zone in the discovery area. Lochiel participates to an average earned interest of 4.123 percent in these lands.

PRODUCTION

The Company's production worldwide for the three months ended April 30, 1985 was 280.0 million cubic feet (3.15 million cubic feet per day) of natural gas and 33,008.0 barrels (370.9 barrels per day) of crude oil. While oil production in Canada remained at the same level as the same period last year, oil production in the United Kingdom was nil due to the planned installation of a gas-lift facility. Therefore, overall oil production was down 40 percent. This facility will increase the Company's remaining proven production from Buchan by 90,800 barrels or 50 percent.

Three Month Production Summary February 1 to April 30

Area	1985	1984
Canada		
oil	26,520.0 bbls.	26,409.0 bbls.
gas	237.9 mmcf	237.8 mmcf
U.S.A.		
oil	6,488.0 bbls.	9,176.1 bbls.
gas	42.1 mmcf	39.0 mmcf
U.K.		
oil	0 bbls.	21,522.0 bbls.
Totals		
oil	33,008.0 bbls.	57,107.1 bbls.
gas	280.0 mmcf	276.8 mmcf

FINANCIAL

For the three months ended April 30, 1985, oil and gas sales were \$1,914,000 compared to \$3,126,000 during the same period of 1984. The cash flow from operations was \$161,000 compared to \$1,196,000 a year earlier. Net loss for the period was \$500,000 compared to net income of \$132,000 for the first three months of 1984.

Lochiel Exploration Ltd.

and Subsidiary Companies

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION

for the three months ended April 30, 1985
(unaudited)

	1985	1984
Cash provided by (used in)		
operating activities		
Net income (loss) for the period ..	\$ (500,000)	\$ 132,000
Add charges to operations not requiring a current cash payment		
Depletion, depreciation and amortization	628,000	973,000
Deferred income taxes	33,000	91,000
	<u>161,000</u>	<u>1,196,000</u>
Cash provided by (used in)		
financing activities		
Issue of preference shares	360,000	—
Increase in long-term debt	191,000	938,000
Dividends	(152,000)	(38,000)
Increase in deferred credits and other	54,000	—
Issue of class A and class B common shares	—	32,000
Net change in working capital balances other than cash	(2,315,000)	(162,000)
	<u>(1,862,000)</u>	<u>770,000</u>
Cash provided by (used in)		
investment activities		
Purchase of petroleum and natural gas properties	(467,000)	(2,179,000)
Reduction of capital lease obligation	—	—
Decrease (increase) in investments and long-term receivables	(46,000)	(82,000)
Foreign currency translation adjustments	41,000	76,000
	<u>(472,000)</u>	<u>(2,185,000)</u>
Net increase (decrease) in cash during the period	(2,173,000)	(219,000)
Cash position at beginning of year ..	2,566,000	219,000
Cash position at end of period	<u>\$ 393,000</u>	<u>\$ 0</u>
Net change in working capital balances other than cash		
Accounts receivable	\$ 260,000	\$(1,143,000)
Participant notes receivable	695,000	1,206,000
Prepaid expenses	—	35,000
Bank loan	—	6,000
Accounts payable and accrued liabilities	(3,112,000)	(266,000)
Current portion of capital lease obligation	—	—
Current portion of long-term debt	(158,000)	—
	<u>\$(2,315,000)</u>	<u>\$ (162,000)</u>