OMEGA
HYDROCARBONS LTD.

1985 ANNUAL REPORT

Directors

Thomas Jack Hall, Calgary
Dennis E. Hall, Calgary
Douglas S. Morgan, Calgary
G. Edward Warriner, Calgary

Officers

President — Thomas Jack Hall
Vice President Corporate Planning — Dennis E. Hall
Vice President Exploration — Joseph S. Irwin
Vice President Finance — John L. Maclagan
Vice President Production — George E. Patey
Secretary — Bruce F. Sim

Head Office

Suite 1300, Sun Life Plaza III
112 - 4th Avenue S.W.
Calgary, Alberta
T2P 0H3

Auditors

Thorne Riddell
Chartered Accountants
1200 Bow Valley Square Two
205 - 5th Avenue S.W.
Calgary, Alberta
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Registrar

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

Transfer Agents

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

Solicitors

Howard, Mackie
700, 801 - 7th Avenue S.W.
Calgary, Alberta
T2P 3S4

Main Bankers

The Toronto-Dominion Bank
The Bank of Montreal

Company Profile

The Company was incorporated under The Companies Act of Alberta as Omega Natural Gas Co. Ltd. on September 4, 1958. By Certificate dated November 21, 1967 the name was changed to Omega Hydrocarbons Ltd. and by Certificate dated June 3, 1985, the Company was continued under The Business Corporations Act (Alberta).

In 1979, the Company sold 1,000,000 of its common shares to the public at $6.10 per share. On December 30, 1982, the common shares were split on a three-for-one basis. In conjunction with its continuation under The Business Corporations Act (Alberta) in 1985, the Company's share capital was changed by increasing the authorized number of common shares to 100,000,000 and creating 50,000,000 of each of Class A, Class B and Class C preferred shares.

On December 31, 1985, there were 11,510,485 common shares issued and outstanding. No preferred shares have been issued.

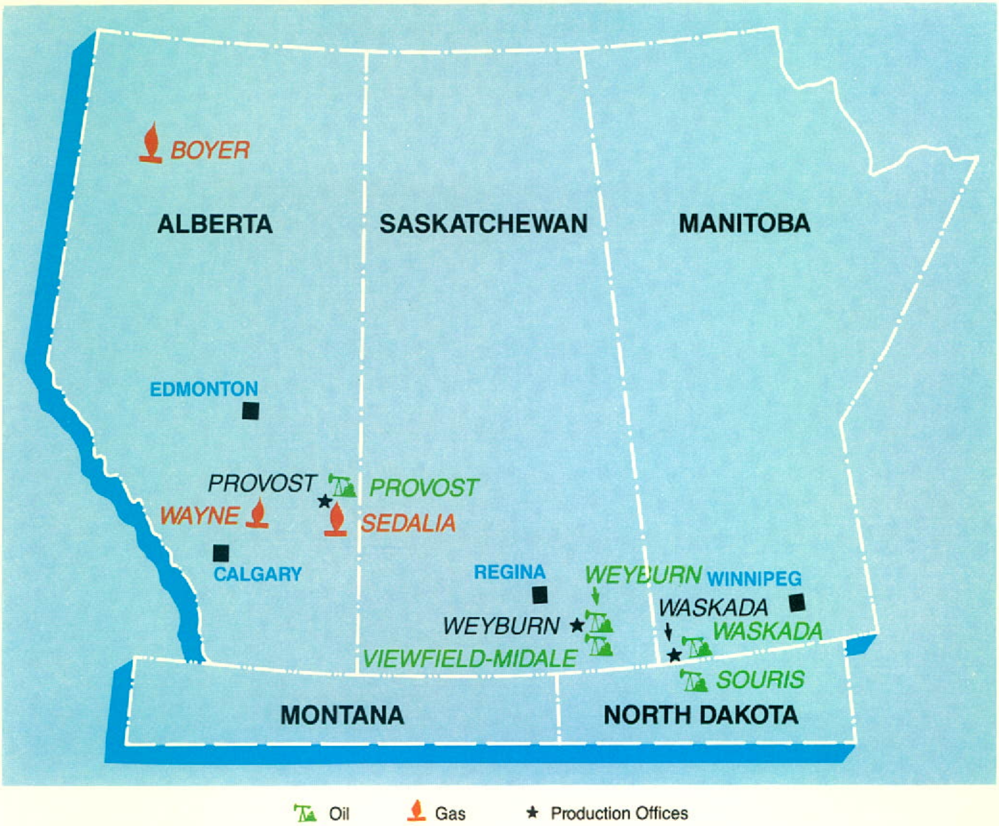
The Company's activities are primarily the exploration for and the development and production of crude oil and natural gas in western Canada with the largest developments at the present time being in the Waskada area of southwestern Manitoba and in southeastern Saskatchewan.

Annual Meeting of Shareholders

The Annual Meeting of Shareholders of Omega Hydrocarbons Ltd. will be held in the Bel Aire Room of the Westin Hotel at 320 - 4th Avenue S.W., Calgary, Alberta on Wednesday, the 28th day of May, 1986 at 3:30 p.m. (local time).

Contents

Highlights



Financial

	1985	1984	% Change
Revenue	**$51,966,000**	$52,725,000	− 1
Cash Flow From Operations	**$35,818,000**	$30,216,000	+ 19
— per share	**$ 2.77***	$ 2.24*	+ 24
— per share	**$ 3.11****	$ 2.31**	+ 35
Net Earnings	**$13,172,000**	$17,237,000	− 24
— per share	**$ 1.02***	$ 1.28*	− 20
— per share	**$ 1.14 ****	$ 1.32**	− 14
Capital Expenditures	**$32,859,000**	$38,680,000	− 15

* based on weighted average number of shares outstanding.
** based on number of shares outstanding as at December 31.

Operations

(Company share before royalties)

	1985	1984	% Change
Production of crude oil and natural gas liquids — barrels per day	**4,400**	4,430	− 1
Sales of natural gas — mcf per day	**3,300**	2,295	+ 44

Reserves

Proven reserves at December 31
(Company share before royalties)

	1985	1984	% Change
Crude oil and natural gas liquids — thousands of barrels	**20,107**	19,613	+ 3
Natural gas — mmcf	**42,611**	45,164	− 6

To Our Shareholders

The oil and gas industry in Canada continued to ride the roller coaster of external influences in 1985. The ups of the Western Accord, favourable Alberta royalty changes and deregulation in the first half of the year have now been followed by the breath-catching drop in international oil prices at year-end and to date.

Looking back to 1985, Omega had a satisfactory year in that financial results compared favourably with those achieved during 1984. Total assets were increased and the Company added significantly to its exploratory land holdings. Cash flow was 19% higher than the previous year reflecting the deferral of income taxes. Net earnings were lower, however, by 24% as a result of the levelling of revenues and higher costs.

Capital expenditures were substantial, although not as high as the previous year, mainly because of the maturity of development at Waskada, Manitoba. Before incentive grants, capital expenditures reached $32.9 million in 1985, 15% lower than in 1984. The Company's greater emphasis on exploration through lease acquisition, seismic and drilling should be reflected in future activities.

During 1985, Omega added 220,523 net acres of prospective lands to its existing holdings, 58.0% of that in Alberta including a one-third interest in a 110,765 acre lease block on the Blackfoot Indian Reserve in southern Alberta which will be a focus of activity in 1986.

The Company's drilling program in 1985 resulted in fewer wells than in the previous two years due to approaching the economic limits of the field at Waskada. Omega participated in a total of 91 wells during the year, 59 of which were at Waskada. The results of the total program were 77 oil wells and four gas wells, a success ratio of 89%. In addition, the Company purchased interests in 23 producing oil wells in the Waskada field.

The Company maintained its production level for crude oil and natural gas liquids during 1985, averaging 4,400 barrels per day compared to 4,430 barrels per day in 1984. Additional pumping equipment is currently being installed at Waskada which together with the success of waterflood is expected to increase daily production from that field. Natural gas sales improved significantly in 1985, averaging 3300 mcf per day compared to 2295 mcf per day in 1984. This was due to higher sales from fields previously connected as well as new deliveries from the Company's properties at Frog Lake and Wayne, in Alberta. Recent sales of natural gas reached an all time high of more than 6,000 mcf per day.

The continuing success of the waterflood program at Waskada has encouraged the expansion of that program. At the present time over 70% of the Lower Amaranth (Spearfish) zone is under waterflood and approval of additional applications is pending. Application has also been made to initiate waterflood over 90% of the productive area of the Mississippian formation.

Late in 1985, the Company gave Notice of a Substantial Issuer Bid to purchase for cancellation, common shares of the Company through the facilities of the Toronto Stock Exchange. A total of 1,559,895 shares were purchased and were subsequently cancelled. This represented a purchase of reserves at a very low cost per equivalent barrel and will enhance the value of the remaining outstanding shares.

The rapid and substantial drop in oil prices (by more than 50%) since December of 1985 has caught everyone by surprise, not necessarily the drop in itself but the speed and the significance. The Company will, however, meet the new challenges. Its operations, like those of most companies, will be cut back in response to the decrease in cash flow. It will seriously review all of its activities and will look on the period of lower activity as an opportunity to examine its costs, upgrade its programs and generally place itself in a position to take advantage of the inevitable improvement in conditions when that occurs. At that time the growth of the Company can be expected to resume. If depressed oil prices continue for a lengthy period of time, the Company's resources will be directed to programs that promise near term production and revenue enhancement and those that will strengthen the Company's financial base.

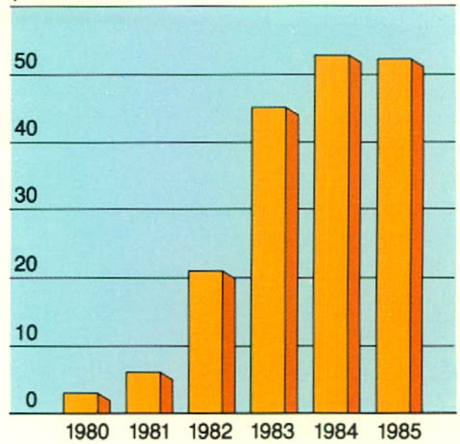
The Company recognizes the contribution made by all employees and extends its thanks for their efforts during the past year.

On behalf of the Board

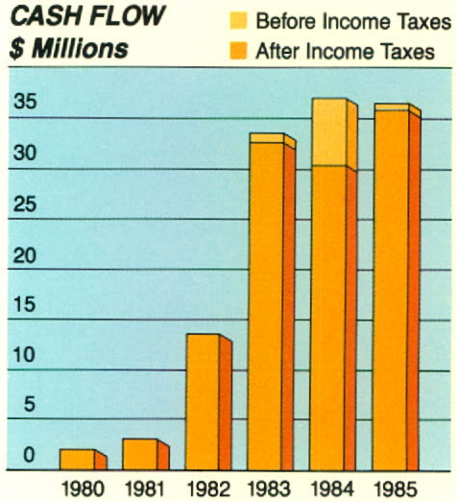
Thomas Jack Hall,
President

April 30, 1986

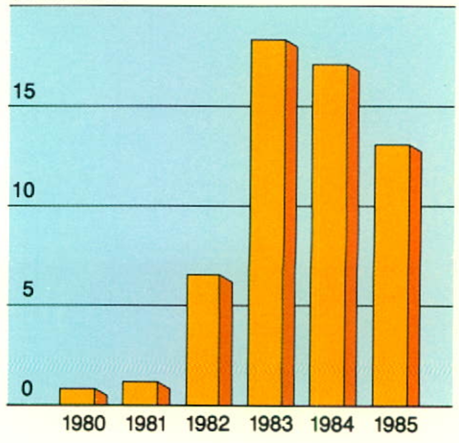
REVENUE
$ Millions



CASH FLOW
$ Millions



NET EARNINGS
$ Millions



Review of Operations

EXPLORATION

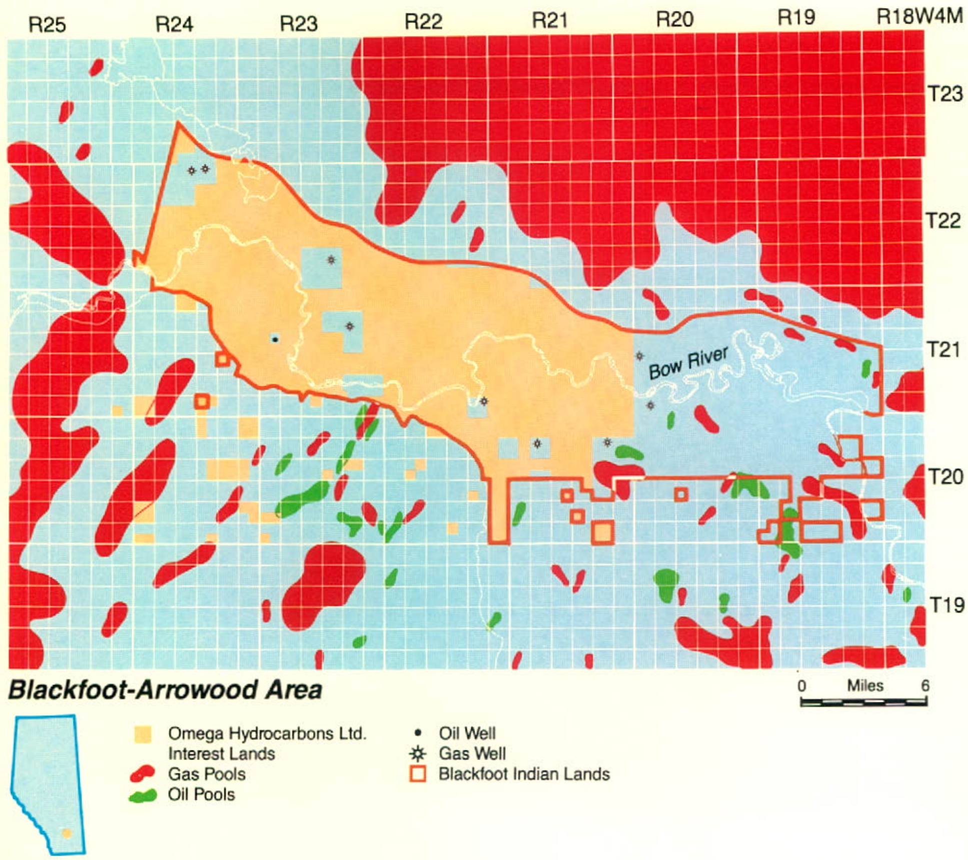
During 1985, the Company increased its emphasis on the acquisition of exploration acreage, primarily in Alberta. Total land acquired was 1,311,433 (220,523 net) acres, of which 1,090,000 (73,713 net) acres are Canada Lands earned through participation in two wells drilled in Hudson Bay. The accompanying map illustrates the areas in Alberta in which the majority of those lands are located. In the three western provinces and North Dakota, not including the Hudson Bay acreage, total company lands as at March 15, 1986 are 526,186 (363,594 net) acres as compared to 304,753 (216,784 net) acres as at March 15, 1985.

Omega's participation in exploratory drilling in 1985 totalled 17 (11.3 net) wells, two in Manitoba, eight in Alberta, three in Saskatchewan, two in Hudson Bay and two in North Dakota. That program resulted in three (three net) oil wells, four (four net) gas wells, one (0.6 net) well suspended at year end and nine (3.7 net) wells dry and abandoned. Of the dry holes, four were drilled by other operators on lands farmed out by the Company. Two of those were in Saskatchewan and two in North Dakota.

The Company continued its interest in Manitoba and southeastern Saskatchewan through review of potential exploration drilling prospects which may be followed up with drilling in 1986. Areas highlighted by maps on these pages will be the major focus of activity in 1986.

In Alberta, the Company acquired lands in the Nisku oil trend at Wainwright, two licences in the Cardium oil trend at Bigstone and three licences in the Peace River Arch area. New lands were also acquired throughout eastern Alberta where there is widespread production of Viking and Mannville oil and gas. In west-central Alberta, a lease position has been acquired on the attractive Glauconite gas producing trend at Hoadley. At Vega additional lands were acquired and an exploratory test yielded a Basal Quartz zone gas discovery which will be placed on production in 1986.

Location of Omega Hydrocarbons Ltd. Land Holdings



Blackfoot-Arrowood Area

Blackfoot-Arrowwood

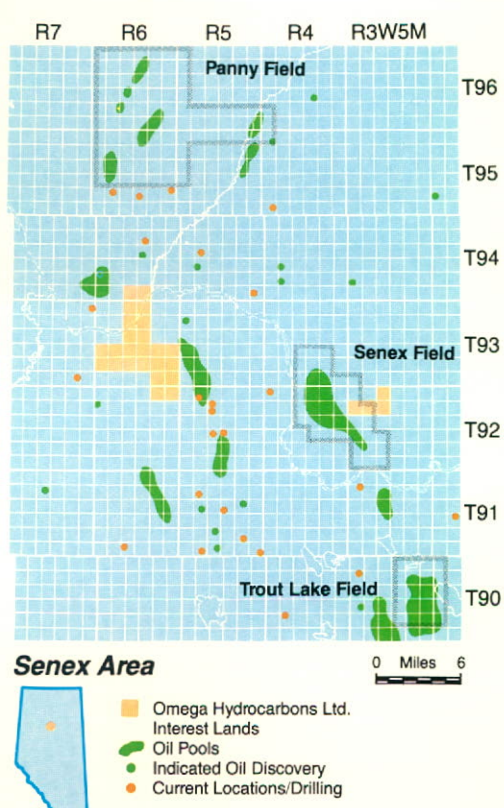
In the fourth quarter, Omega, in a joint bid with two other companies, acquired a one-third interest in exclusive exploration and development rights on 110,765 acres within the Blackfoot Indian Reserve which is located 60 miles southeast of Calgary. The exploration agreement was negotiated directly with the Blackfoot Indian Band and includes a major seismic commitment and a 10-well exploration drilling program to be completed within three years. This large spread of land is primarily prospective for Bow Island gas as well as Lower Mannville oil and gas. The seismic review work and additional field shooting is in progress and drilling is expected to begin later in 1986.

Throughout the year Omega conducted a freehold leasing program which resulted in the acquisition of 7,146 acres of 100% lands in the Arrowwood area south west of the Blackfoot Indian Reserve in southeastern Alberta.

Senex

The Company holds a 37½% interest in a block of three Crown licences totalling 15,360 acres in the Senex area of northwestern Alberta. Subsequent to year end, a fourth licence (2,560 acres) offsetting the original Senex field was acquired on a 100% basis. These lands are located in the Keg River oil trend which is being actively explored and developed by major operators over a wide area of north-central Alberta.

During 1985 and early in 1986 a detailed seismic field program was completed which increased the joint project seismic coverage to 75 miles. Omega has participated in the drilling of one exploratory test to date on these lands which was dry and abandoned. Further evaluation of the existing data respecting this prospect will be carried out in 1986.



Senex Area

North Dakota

In 1985, Omega purchased the former operator's 50% interest in the joint lands in Bottineau County, North Dakota immediately adjacent to the Waskada Spearfish/Mississippian producing trend in Manitoba and acquired additional lands in the same general area. The Company now holds an interest in 14,751 acres. The first well was drilled and completed in early 1986 as a Spearfish oil well. Further drilling is anticipated as economic prospects are identified and funds are available.

Outlook

Although the current oil price weakness will impact the speed with which the Company can undertake new exploration programs, Omega's ability to generate new plays has been improved with the addition of professional staff over the last two years. Review work will continue and the Company should be in an advantageous position to commence programs as oil prices strengthen and cash flow increases.

PRODUCTION AND RESERVES

The Company's development drilling program consisted of 74 (62.2 net) wells, 57 (50.0 net) at Waskada, Manitoba, nine (6.8 net) in Saskatchewan and eight (5.4 net) in Alberta. Four of the Waskada wells were completed as new pool discoveries in the Mississippian formation.

Total capital expenditures for the above drilling and related facilities, purchase of interests in producing wells, the Company's exploration program and other assets were $32.9 million. $3.8 million was recovered through government incentive programs.

Omega's production of oil and natural gas liquids before royalties and production taxes averaged 4,400 barrels per day (4,430 in 1984). Of the total, 3,600 barrels per day came from the Waskada field, 510 barrels per day from Saskatchewan and 290 barrels per day from Alberta.

Natural gas sales averaged 3,300 mcf per day in 1985, an increase of 44% over 2,295 mcf per day in 1984. In December, 1985 natural gas sales reached a record high of more than 6,000 mcf per day.

Independent petroleum consultants estimate Omega's proven and probable net oil and natural gas liquids reserves at December 31, 1985 to be 25.4 million barrels. This represents a decrease of 14% from the reserves at December 31, 1984. Proven net natural gas reserves decreased 4% to 41.7 billion cubic feet as at December 31, 1985. Details of the reserves appear in the table on page 10.

The future undiscounted cash flow from the Company's reserves also calculated by the independent consultants, amounts to $877.9 million. Using a 15% discount factor, the present worth of that cash flow is $199.8 million. Present worth values using other discount factors are shown in the table on page 10. The estimates shown in the table were calculated after deducting royalties, production taxes, operating costs and future capital expenditures required to place the proven undeveloped and probable reserves on production but do not include the effect of income taxes. The significant drop in present worth values of the Company's reserves is due to the fall in the international oil price which has been taken into consideration in the calculations.

Land Holdings (acres) as at March 15:

	Gross				Net			
	Developed		Undeveloped		Developed		Undeveloped	
	1986	1985	1986	1985	1986	1985	1986	1985
Alberta	109,763	106,897	290,401	92,272	69,049	59,159	181,659	64,064
Saskatchewan	11,181	9,460	47,484	44,425	9,571	8,405	45,544	44,425
Manitoba	18,556	13,943	34,050	27,336	16,743	12,564	29,130	22,957
North Dakota	801	960	13,950	9,460	367	480	11,531	4,730
Subtotal	140,301	131,260	385,885	173,493	95,730	80,608	267,864	136,176
Hudson Bay	—	—	1,090,000	—	—	—	73,713	—
Total	**140,301**	**131,260**	**1,475,885**	**173,493**	**95,730**	**80,608**	**341,577**	**136,176**

Wells Drilled During the Year Ended:

	December 31, 1985		December 31, 1984	
	Gross Wells	Net Wells	Gross Wells	Net Wells
Oil	**77**	**64.6**	142	124.0
Gas	**4**	**4.0**	1	0.4
Suspended	**1**	**0.6**	1	—
Dry and Abandoned	**9**	**4.3**	9	6.5
Total	**91**	**73.5**	153	130.9

Capital Expenditures

	1981	1982	1983	1984	1985
Land Acquisitions	$ 3,987,000	$ 2,150,000	$ 1,678,000	$ 2,045,000	**$ 4,470,000**
Drilling and Exploration	5,379,000	14,136,000	18,532,000	21,548,000	**14,814,000**
Production Equipment	3,049,000	11,538,000	15,517,000	13,657,000	**11,760,000**
Other Assets	—	—	—	1,430,000	**1,815,000**
Subtotal	12,415,000	27,824,000	35,727,000	38,680,000	**32,859,000**
Government Incentive Payments	(1,228,000)	(2,217,000)	(4,676,000)	(4,890,000)	**(3,763,000)**
Net	**$11,187,000**	**$25,607,000**	**$31,051,000**	**$33,790,000***	**$29,096,000**

* revised to conform with 1985 presentation

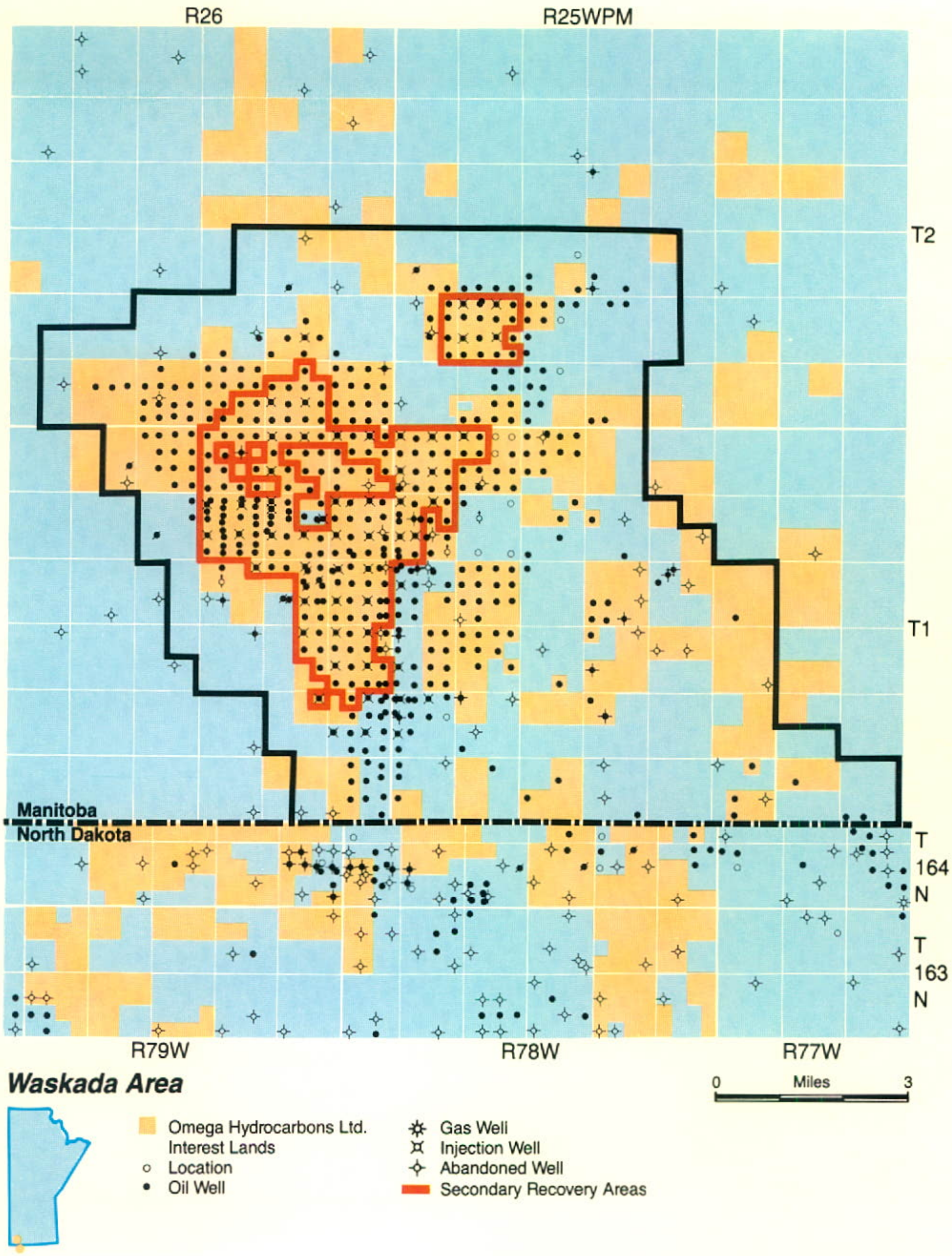
Waskada, Manitoba

All of the 59 (52 net) wells drilled in this field during 1985 were either producing or potential Lower Amaranth (Spearfish) wells and four of those were completed for production from Mississippian zones. In addition to the wells drilled, Omega purchased interests in 23 (16.9 net) wells, all of which were producing oil wells. With these additions, up to December 31, 1985 the Company has drilled or acquired interests in 386 wells in the Waskada field, of which 340 are producing or capable of production, 42 are water injection wells and four are water source wells.

The gas plant which commenced operation in 1984, operated for the entire 1985 year without serious problems. It is presently processing approximately 1100 mcf of gas per day which results in production of 75 barrels of propane, 30 barrels of butane and 60 barrels of pentanes.

The waterflood program at Waskada continues to give very encouraging results. As indicated on the accompanying map, expansion of the area under flood has continued. The program now includes a total of 7,700 acres either presently under flood or awaiting approval of applications for new units or expansions. Plans are in progress to continue the waterflood programs until all of the Spearfish wells are included. Early in 1986 applications were made for approval to commence waterflooding the various Mississippian pools and that work will continue until all of those pools are also under secondary recovery.

The oil transmission line from Waskada to Cromer, Manitoba, in which Omega has a 30% interest, operated without major problems during 1985. All of Omega's production now moves through this line thus eliminating the previous constraints related to the trucking of oil during road bans and adverse weather.

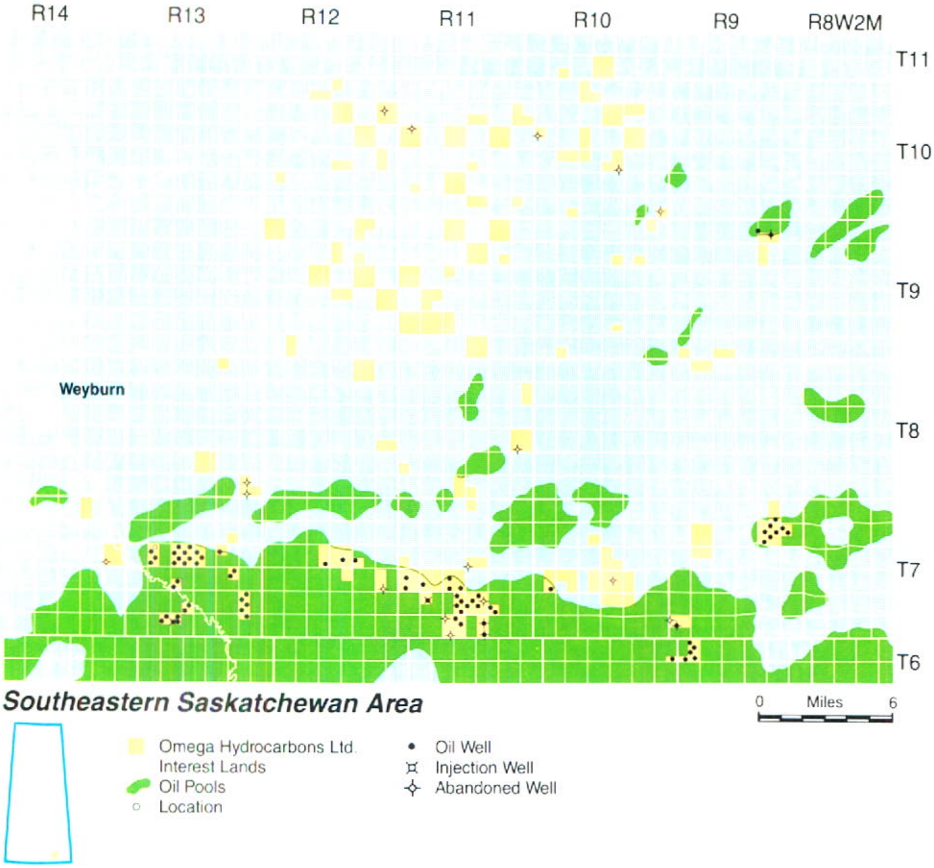


Waskada Area

The drilling program planned for Waskada for 1986 will be modified as a result of the impact of the current weakness in oil prices on the Company's cash flow. As funds become available the program will be reinstated. In the meantime the Company will concentrate on ways to optimize the production rates. Present expectations are that production will be maintained and likely increased as a result of the waterflood programs as well as changes that are planned for the production and gathering facilities.

Southeastern Saskatchewan

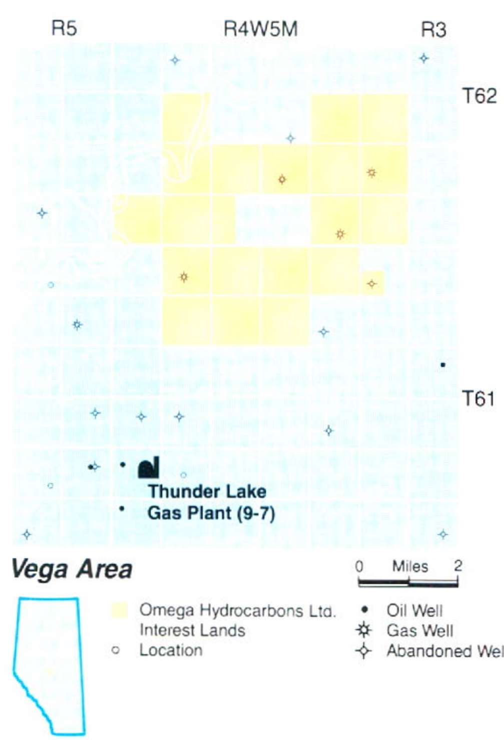
Omega now operates 68 (62 net) oil wells in the southeastern portion of Saskatchewan. During 1985, the Company's share of production before royalties and production taxes averaged 510 barrels per day compared to 610 barrels per day in 1984. Secondary recovery waterflood projects are planned for Weyburn, Midale and Huntoon. Those projects will improve recovery and should result in a gradual increase in production rates. Limited new drilling is expected during 1986 due to reduced production rates, high royalties and taxes and low oil prices.



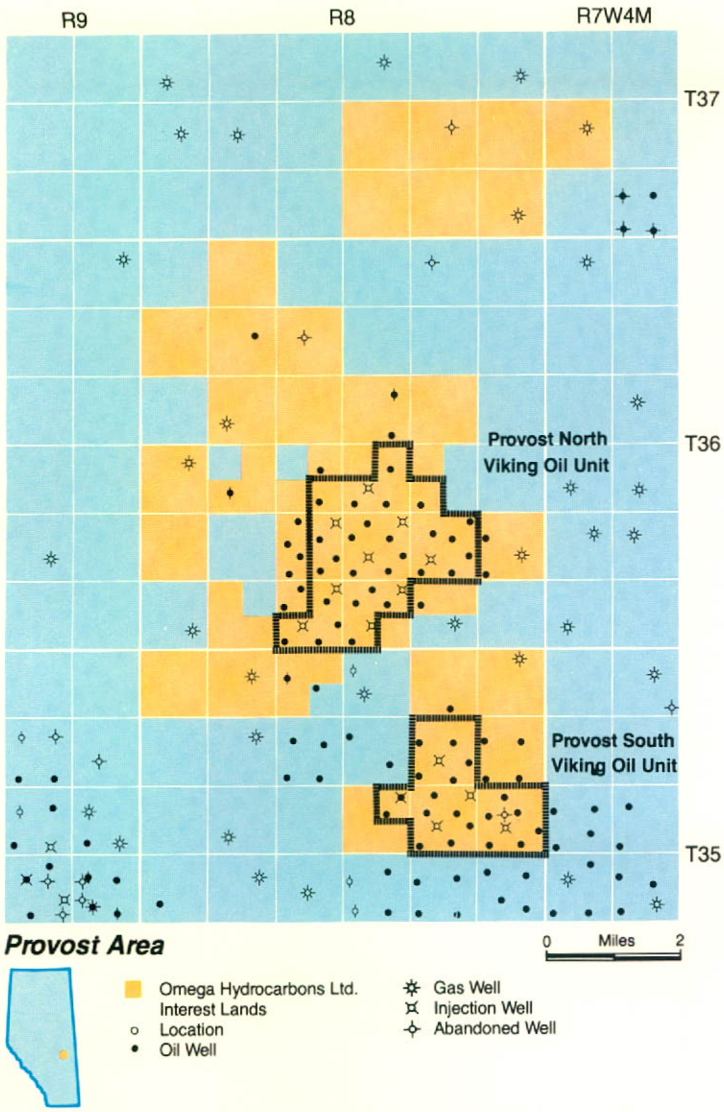
Southeastern Saskatchewan Area

Vega, Alberta

Late in the year an opportunity arose to connect the Company's reserves in this area to a market. Completing and testing of the four, 100% potential gas wells at Vega was accomplished early in 1986. Omega will participate in a processing plant and sales line during the first half of 1986. The Company's sales from this project are expected to be 1,000 mcf per day.



Vega Area



Provost Area

Provost, Alberta

During 1985, the Company drilled six (4.1 net) additional Viking oil wells in the Provost field. Omega's share of gross production from this field in 1985 averaged 285 barrels of crude oil and natural gas liquids per day and 1,180 mcf per day of natural gas.

Other Areas

The Company's share of natural gas sales from the Boyer field in northern Alberta amounted to 1,030 mcf per day in 1985 compared to 970 mcf per day in 1984.

Two gas wells in the Frog Lake area of Alberta were placed on production late in 1984 and produce into the Cold Lake gathering system. The Company's share of sales from those wells averaged approximately 500 mcf per day during 1985. Also in this area, Omega has a 25% interest in two Sparky oil wells which produced minimal volumes during 1985. The Company's land holdings will allow for additional drilling as demand for heavy oil increases.

As indicated in the Exploration section of this report, the Company has increased its holdings in North Dakota. The first well drilled following those acquisitions was completed as an oil well early in 1986.

Outlook

Omega's development drilling programs planned for 1986 in all areas will be affected by the serious impact on the Company's cash flow of the drop in crude oil prices. The availability of funds will be constantly monitored and drilling will be carried out on a selective basis designed to maximize the return from all investments.

Petroleum and Natural Gas Reserves

	Company Share Before Royalties		Company Share After Royalties	
	Crude Oil & NGL's (Mstb)	Natural Gas (MMcf)	Crude Oil & NGL's (Mstb)	Natural Gas (MMcf)
Proven Reserves at December 31, 1984	19,613	45,164	16,745	38,615
Additions	2,094	(1,337)	1,758	236
Production	(1,600)	(1,216)	(1,365)	(1,059)
Proven Reserves at December 31, 1985	20,107	42,611	17,138	37,792
Probable Additional Reserves	9,495	4,464	8,224	3,860
Total Proven and Probable Additional Reserves at December 31, 1985	29,602	47,075	25,362	41,652

Present Worth of Future Oil and Gas Net Production Revenue Discounted at:

	0%	12%	15%	20%
		($000)		
Proven Remaining Reserves	508,771	175,757	148,016	116,675
Probable Additional Reserves	369,120	68,443	51,785	35,224
Total Proven and Probable Additional Reserves	877,891	244,200	199,801	151,899

Company Share of Production Before Royalties

	1981	1982	1983	1984	1985
Petroleum (bbls)	211,202	599,550	1,378,094	1,621,348	1,600,163
Natural Gas (mcf)	1,133,914	839,844	1,233,846	839,930*	1,216,191

* adjusted.

Financial Review

Omega's revenues after royalties and production taxes during 1985, were $52.0 million ($4.02 per share) compared to $52.7 million ($3.92 per share) in 1984. The average price received for crude oil in 1985 was $37.94 per barrel ($38.60 in 1984) and for natural gas was $2.58 per mcf ($3.00 in 1984). The major impact of the precipitous drop in world oil prices was not yet a significant factor at the end of 1985.

Cash flow from operations was $35.8 million ($2.77 per share), an increase of 19% from $30.2 million ($2.24 per share) in 1984. This increase reflects the payment of income taxes in 1984 and deferral of taxes for 1985. Comparing the two years on a before income taxes payable basis the cash flow was approximately the same, $36.4 million in 1985 and $36.7 million in 1984.

Net earnings in 1985 were $13.2 million ($1.02 per share) compared to $17.2 million ($1.28 per share) in 1984.

Per share figures used on these pages and presented in the financial statements are based on the weighted average number of shares outstanding during the year. On November 25, 1985 the Company gave notice to the Toronto Stock Exchange of a Substantial Issuer Bid to purchase 1,500,000 of the outstanding common shares of the Company. In accordance with the by-laws and rules of the Toronto Stock Exchange, 1,559,895 common shares were purchased on December 19, 1985 at the bid price of $8.75 per share. Those shares were subsequently cancelled. As a result, the weighted average number of shares outstanding during the year was 12,943,389 compared to 11,510,485 outstanding as at December 31, 1985. The financial results on a per share basis based on the latter number are shown on the highlights page at the beginning of this annual report.

The major items affecting the Company's financial results during 1985 compared to 1984 were:

Levelling of revenues reflecting the static rates of production. Considering the number of wells taken out of production in 1984 and 1985 to be used as injection wells at Waskada and the decline in production in southeastern Saskatchewan, the maintaining of total production is a positive accomplishment and indicates the success of the water-flood program at Waskada.

Production expenses increased by 28% to $8.1 million. This resulted from the greater average number of wells on production during 1984, reflecting the success of drilling programs in 1984 and 1985.

General and administrative expenses were $3.6 million in 1985, 50% higher than in 1984. This increase is due to the greater number of employees required to manage the significant increase in the Company's operations during the past few years.

Interest on bank loans was 28% higher at $2.6 million reflecting the higher average amount of loans outstanding.

Provision for depletion and depreciation was $9.2 million in 1985, compared to $7.8 million in 1984, an increase of 18%. The increase results from the Company's growing investment in fixed assets.

Total provision for corporate taxes was $15.3 million in 1985 compared to $16.9 million in 1984. Most of that reduction was the result of lower Petroleum and Gas Revenue Tax due to the elimination of that tax on wells drilled after March 31, 1985.

Omega's capital expenditures in 1985 were moderately lower than in 1984, totalling $32.9 million before Petroleum Incentive grants compared to $38.7 million in 1984. Incentive grants totalled $3.8 million in 1985 compared to $4.9 million in 1984. The Company's Canadian Ownership Rating (COR) of 98% entitled it to the maximum amounts available under the incentive programs.

The extent of the Company's continuing investment in developing its reserve base is reflected in the 21% increase in total assets to $131.9 million.

The financial statements included with this report contain two changes made in response to guidelines issued by the Accounting Research Committee of the Canadian Institute of Chartered Accountants. Both changes are reflected in the accounts on a prospective basis.

The first relates to investment tax credits allowed under the Income Tax Act (Canada) which are now recorded as a reduction of investment in fixed assets rather than as a reduction of the provision for income taxes as was the case in prior years. This is described in note 6 to the Financial Statements.

The second change relates to the presentation of the Statement of Changes in Financial Position which is described in note 8 to the Financial Statements.

Auditors' Report

To the Shareholders of
Omega Hydrocarbons Ltd.

We have examined the consolidated balance sheet of Omega Hydrocarbons 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, Canada
March 28, 1986

Thorne Riddell
Chartered Accountants

Omega Hydrocarbons Ltd.

Consolidated Balance Sheet

As At December 31, 1985

ASSETS

	1985	1984
Current Assets		
Accounts receivable	$ 7,086,000	$ 7,209,000
Petroleum Incentive Program claims	4,894,000	2,231,000
Income taxes receivable	2,404,000	605,000
Current portion of notes receivable	202,000	791,000
	14,586,000	10,836,000
Fixed Assets (note 2)		
Petroleum and gas properties and equipment	144,703,000	117,441,000
Accumulated depletion and depreciation	(28,738,000)	(19,579,000)
	115,965,000	97,862,000
Other Assets		
Notes receivable	80,000	326,000
Other	1,315,000	57,000
	1,395,000	383,000
	$131,946,000	$109,081,000

LIABILITIES

	1985	1984
Current Liabilities		
Accounts payable and accrued liabilities	$ 12,375,000	$ 9,986,000
Petroleum and Gas Revenue Tax payable	357,000	1,525,000
Gas production prepayments	519,000	—
Current maturities on bank loans	1,901,000	—
	15,152,000	11,511,000
Bank Loans (note 3)	35,800,000	28,939,000
Gas Production Prepayments	—	519,000
Deferred Taxes	31,855,000	18,368,000

SHAREHOLDERS' EQUITY

	1985	1984
Capital Stock (note 4)	11,534,000	13,163,000
Retained Earnings	37,605,000	36,581,000
	49,139,000	49,744,000
	$131,946,000	$109,081,000

Contingent Liabilities (note 5)

Approved by the Board

Director

Director

Consolidated Statement of Earnings

Year Ended December 31, 1985

	1985	1984
Revenue		
Oil and gas sales, net of royalties	**$ 51,324,000**	$ 52,610,000
Other	**642,000**	115,000
	51,966,000	52,725,000
Expenses		
Production	**8,124,000**	6,345,000
General and administrative	**3,560,000**	2,373,000
Interest on bank loans	**2,633,000**	2,061,000
Depletion and depreciation	**9,159,000**	7,783,000
	23,476,000	18,562,000
Earnings before corporate taxes	**28,490,000**	34,163,000
Provision for corporate taxes (note 6)	**15,318,000**	16,926,000
Net Earnings	**$ 13,172,000**	$ 17,237,000
Net Earnings per Common Share	**$1.02**	$1.28

Consolidated Statement of Retained Earnings

Year Ended December 31, 1985

	1985	1984
Balance at beginning of year	**$ 36,581,000**	$ 25,578,000
Net earnings	**13,172,000**	17,237,000
Purchase of common shares (note 4)	**(12,148,000)**	(6,234,000)
Balance at End of Year	**$ 37,605,000**	$ 36,581,000

Consolidated Statement of Changes in Financial Position

Year Ended December 31, 1985

	1985	1984
Operations		
Net earnings	**$ 13,172,000**	$ 17,237,000
Items not involving cash		
Depletion and depreciation	**9,159,000**	7,783,000
Deferred taxes	**13,487,000**	5,196,000
	35,818,000	30,216,000
Changes in non-cash working capital items related to operations	**(1,284,000)**	(5,686,000)
	34,534,000	24,530,000
Financing Activities		
Bank loans	**8,762,000**	14,852,000
Notes receivable	**769,000**	1,272,000
Purchase of common shares	**(13,711,000)**	(6,953,000)
	(4,180,000)	9,171,000
Cash Available for Investing Activities	**$ 30,354,000**	$ 33,701,000
Investing Activities		
Fixed assets	**$ 32,859,000**	$ 38,680,000
Petroleum Incentive Program claims	**(3,763,000)**	(4,890,000)
Other	**1,258,000**	(89,000)
	$ 30,354,000	$ 33,701,000

Notes to Consolidated Financial Statements

Year Ended December 31, 1985

1. ACCOUNTING POLICIES

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in Canada and conform in all material respects with International Accounting Standards. The accounting policies of significance to the Company are as follows:

(a) Principles of Consolidation

These consolidated financial statements include the accounts of Omega Hydrocarbons Ltd. and its wholly-owned subsidiaries, Omega Oil & Gas Ltd. and Omega Oil & Gas, Inc. and the Company's proportionate interest in the accounts of Omega Producing Partnership, Omega Oil and Gas Fund #1 (a limited partnership) and Omega Oil and Gas Fund #2 (a limited partnership).

(b) Oil and Gas Operations

The Company follows the full cost method of accounting for its oil and gas operations whereby all costs of exploring for and developing oil and gas reserves are capitalized by cost centre. A separate cost centre is established for Canada and the United States. Costs include land acquisition costs, geological and geophysical costs, carrying charges on non-producing property, costs of drilling both productive and non-productive wells, production equipment costs and overhead expenditures related to exploration activities. The carrying value of petroleum and gas properties and equipment is limited to the aggregate of future net revenues from estimated production of proved reserves at current prices and costs at the balance sheet date and the estimated fair market value of unproved properties. Capitalized costs are depleted by cost centre using the unit of production method based on estimated proved oil and gas reserves.

Certain of the exploration and production activities of the Company are conducted jointly with others and these consolidated financial statements reflect the Company's proportionate interest in such activities.

(c) Depreciation

Depreciation of other equipment is provided using the declining balance method at rates ranging from 5% to 30% per annum.

(d) Petroleum Incentives

Petroleum incentives which are earned by the Company pursuant to legislation enacted by the Federal and Alberta governments are recorded as a reduction of the related fixed assets.

(e) Segmented Information

All of the Company's activities are in one business segment, oil and gas exploration, development and production and substantially all of the Company's operations are conducted in one geographical segment, Canada. Accordingly, no separate disclosure has been made of financial data by segment.

2. FIXED ASSETS

	December 31, 1985		
	Cost	Accumulated Depletion and Depreciation	Net
Lease acquisition, exploration and drilling	$ 80,240,000	$ 17,577,000	$ 62,663,000
Production equipment and gathering facilities	60,591,000	10,330,000	50,261,000
Other equipment	3,872,000	831,000	3,041,000
	$144,703,000	$ 28,738,000	$115,965,000

	December 31, 1984		
	Cost	Accumulated Depletion and Depreciation	Net
Lease acquisition, exploration and drilling	$ 66,553,000	$ 12,603,000	$ 53,950,000
Production equipment and gathering facilities	48,831,000	6,510,000	42,321,000
Other equipment	2,057,000	466,000	1,591,000
	$117,441,000	$ 19,579,000	$ 97,862,000

3. BANK LOANS

Lines of credit in the aggregate amount of $45,000,000 have been established with two Canadian chartered banks. Borrowings under a $30,000,000 line of credit are made on a revolving basis. Present terms of this line of credit call for a reduction in the available credit facility of $9,200,000 in 1986 and $4,200,000 annually thereafter. Borrowings under a $15,000,000 line of credit are made on a revolving basis and, at the bank's option, may be converted to a six year term loan in 1987.

The loans bear interest at the banks' prime lending rates, are evidenced by demand promissory notes and are secured by the Company's interests in certain oil and gas properties and a general assignment of accounts receivable.

4. CAPITAL STOCK

(a) Authorized Share Capital

The Company was continued under the Business Corporations Act of Alberta on June 3, 1985. The changed authorized share capital as at December 31, 1985 is as follows:

50,000,000 Class A Preferred shares with a par value of $1.00 each
50,000,000 Class B Preferred shares with a par value of $1.00 each
50,000,000 Class C Preferred shares with a par value of $1.00 each
100,000,000 Common shares without nominal or par value

(b) Issued Common Shares

Changes in issued common shares during the two years ended December 31, 1985 were as follows:

	Number of Shares	Consideration
Balance at December 31, 1983	13,821,879	$ 14,009,000
Cancellation of shares forfeited under share purchase plan	(33,499)	(127,000)
Purchased and cancelled	(712,000)	(719,000)
Balance at December 31, 1984	13,076,380	13,163,000
Cancellation of shares forfeited under share purchase plan	(6,000)	(66,000)
Purchased and cancelled	(1,559,895)	(1,563,000)
Balance at December 31, 1985	11,510,485	$ 11,534,000

(c) Purchased and Cancelled Common Shares

Pursuant to a Substantial Issuer Bid dated November 26, 1985, the Company advised its shareholders of its intention to purchase 1,500,000 of its issued and outstanding common shares. In accordance with the bylaws and rules of the Toronto Stock Exchange, 1,559,895 shares were purchased on December 19, 1985 at a cost of $13,711,000. The excess of the cost of the shares over the stated value of the shares has been allocated to retained earnings. The shares purchased were subsequently cancelled.

(d) Common Shares Reserved

As of December 31, 1985, 760,498 common shares were reserved under the Company's Share Purchase Plan and Stock Option Plan for issue to officers and employees from time to time as determined by the directors of the Company.

Changes in common shares reserved during the two years ended December 31, 1985 were as follows:

	1985	1984
Shares reserved at beginning of year	754,498	720,999
Shares forfeited under Share Purchase Plan	6,000	33,499
Shares reserved at end of year	760,498	754,498

5. CONTINGENT LIABILITIES

The Company is contingently liable for the payment of bank loans totalling $2,084,000 of limited partnerships managed and operated by the Company.

The Company has been named as one of several defendants in a legal action commenced by a limited partner of a partnership managed and operated by the Company. The plaintiff has alleged that certain actions of the defendants constituted a breach of the Partnership Agreement thereby entitling the plaintiff to damages. Following the initial trial, the Court of Queen's Bench of Alberta held that the purchase of certain non-producing partnership properties by the Company in 1981 was in breach of the Partnership Act of Alberta. The Court did not consider the question of damages, if any, but directed that the Company is holding these properties in trust for the limited partnership and that certain accountings and enquiries be undertaken with respect thereto. The Company appealed the judgment of the Court of Queen's Bench. That appeal was successful in that it was allowed by the Court of Appeal of Alberta. The plaintiff has been granted leave to appeal the decision of the Court of Appeal of Alberta by the Supreme Court of Canada.

6. PROVISION FOR CORPORATE TAXES

The components of the provision for corporate taxes are as follows:

	1985	1984
Income Taxes		
Current	$ 578,000	$ 6,489,000
Deferred	10,828,000	5,196,000
	11,406,000	11,685,000
Petroleum and Gas Revenue Tax		
Current	1,541,000	5,445,000
Deferred	2,659,000	—
	4,200,000	5,445,000
Alberta Royalty Tax Credit	(288,000)	(204,000)
	$15,318,000	$16,926,000

Income tax expense differs from the amounts which would be obtained by applying the Canadian statutory federal income tax rate to the respective years' earnings before corporate taxes. The reconciliation of the Canadian statutory federal income tax rate and the effective income tax rate is as follows:

	1985	1984
Statutory federal income tax rate	46%	46%
Royalties and other payments to provincial governments	6	5
Federal resource allowance	(16)	(15)
Investment tax credits	—	(4)
Provincial income taxes in excess of federal abatement	3	3
Federal corporate surtax	1	—
Other	—	(1)
Effective income tax rate	40%	34%

Effective January 1, 1985 the Company changed its method of accounting for investment tax credits by adopting prospectively the recommendations as set forth by the Canadian Institute of Chartered Accountants. Investment tax credits are recorded as a reduction in the cost of the related assets, provided there is reasonable assurance that the credits will be realized. Prior to 1985, the credits were recorded as an income tax expense reduction when realization was reasonably assured. This change in accounting policy has not had a material effect on the consolidated financial statements for the year ended December 31, 1985.

Deferred taxes represent the income taxes and Petroleum and Gas Revenue Tax otherwise payable as a result of deducting property, exploration, development and equipment costs for tax purposes in excess of the corresponding depletion and depreciation recorded in the accounts. At December 31, 1985 there were approximately $29,000,000 of unclaimed property, exploration and development costs and approximately $31,000,000 of unclaimed capital costs available to be carried forward.

7. RELATED PARTY TRANSACTIONS

(a) Prior to 1985 the Company entered into a number of farmin and other similar agreements with Alberta Gas Products System Ltd. (AGP), a private company controlled by the president of the Company. Under these agreements, the Company acquired interests in oil and gas properties held by AGP, with AGP retaining an overriding royalty or other interest in the properties.

(b) New North Oil & Gas Ltd., a private company controlled by the president of the Company, participates with the Company as a joint venture partner in the Provost area.

8. STATEMENT OF CHANGES IN FINANCIAL POSITION

The definition of funds and the methods of presentation of the statement of changes in financial position have been changed during the year. Funds are now defined as cash. Previously funds were defined as working capital. Certain of the 1984 amounts shown for comparative purposes have been reclassified to conform with the new definition of funds and the method of presentation adopted in the current year.

9. COMPARATIVE STATEMENTS

Certain of the 1984 amounts shown for comparative purposes have been reclassified to conform with the method of presentation adopted in the current year.

Ten Year Statistical Review

Per share figures and number of shares shown on these pages have been adjusted for the 3 for 1 stock split on December 30, 1982.

	1985 $	1984 $	1983 $
Revenues and Earnings			
Revenues	**51,966,000**	52,725,000	45,370,000
Cash flow from operations	**35,818,000**	30,216,000	32,894,000
— per share	**2.77**	2.24	2.38
Depreciation and depletion	**9,159,000**	7,783,000	6,162,000
Petroleum and Gas Revenue Tax — deferred	**2,659,000**	—	—
— current	**1,541,000**	5,445,000	4,783,000
Alberta Royalty Tax Credit	**(288,000)**	(204,000)	(433,000)
Income taxes — deferred	**10,828,000**	5,196,000	8,263,000
— current	**578,000**	6,489,000	840,000
Net earnings	**13,172,000**	17,237,000	18,469,000
— per share	**1.02**	1.28	1.34
Balance Sheet			
Working capital (deficiency)	**(566,000)**	(1,815,000)	(8,254,000)
Total Assets	**131,946,000**	109,081,000	83,511,000
Shareholders' equity	**49,139,000**	49,744,000	39,587,000
— per share	**4.27**	3.80	2.86
Number of shares outstanding December 31	**11,510,485**	13,076,380	13,821,879
Market price per share — high	**10.25**	13.12	15.12
— low	**7.00**	8.00	7.12
Capital Expenditures			
Land	**4,470,000**	2,045,000	1,678,000
Drilling and exploration	**14,814,000**	21,548,000**	18,532,000
Production equipment	**11,760,000**	13,657,000	15,517,000
Other	**1,815,000**	1,430,000	—
TOTAL	**32,859,000**	38,680,000**	35,727,000
Government incentive payments	**(3,763,000)**	(4,890,000)**	(4,676,000)
Net	**29,096,000**	33,790,000**	31,051,000
Operations			
Proven reserves before royalties			
— Petroleum (barrels)	**20,107,000**	19,613,000	15,760,000
— Natural gas (mcf)	**42,611,000**	45,164,000	45,050,000
Production before royalties			
— Petroleum (barrels)	**1,600,000**	1,621,000	1,378,094
— per day	**4,400**	4,430	3,776
—Natural gas (mcf)	**1,216,000**	839,930***	1,233,846
— per day	**3,300**	2,295***	3,380
Land holdings — gross acres	**1,616,186**	304,753	303,411
— net acres	**437,307**	216,784	209,134
Wells drilled — gross	**91**	153	137
— net	**74**	131	116
Number of employees	**88**	69	47

* not available

** revised to conform with 1985 presentation

*** adjusted.

1982 $	1981 $	1980 $	1979 $	1978 $	1977 $	1976 $
20,730,000	5,715,000	2,583,000	1,110,000	678,000	627,000	451,000
13,412,000	2,802,000	1,813,000	718,000	502,000	489,000	331,000
.97	.21	.15	.06	.05	.05	.04
3,469,000	947,000	287,000	170,000	78,000	71,000	34,000
—	—	—	—	—	—	—
2,146,000	431,000	—	—	—	—	—
(521,000)	(312,000)	(165,000)	(80,000)	(35,000)	(35,000)	(33,000)
3,327,000	818,000	614,000	220,000	166,000	175,000	118,000
—	—	—	—	—	—	—
6,616,000	1,038,000	912,000	328,000	268,000	417,000	319,000
.48	.08	.07	.03	.03	.05	.04
(9,001,000)	(306,000)	682,000	1,971,000	(106,000)	(167,000)	202,000
55,171,000	30,084,000	17,203,000	9,669,000	2,950,000	1,096,000	529,000
20,932,000	14,908,000	9,402,000	8,010,000	1,272,000	886,000	384,000
1.52	1.07	.73	.64	.14	.10	.04
13,815,879	13,998,078	12,791,718	12,551,718	9,251,718	9,096,468	8,586,468
9.37	5.33	3.08	2.79	1.23	1.00	.33
3.05	2.58	1.88	.93	.60	.27	.03
2,150,000	3,987,000	410,000	700,000	202,000	176,000	—
14,136,000	5,379,000	4,358,000	2,255,000	766,000	218,000	55,000
11,538,000	3,049,000	3,630,000	1,091,000	154,000	148,000	60,000
—	—	—	—	—	—	—
27,824,000	12,415,000	8,398,000	4,046,000	1,122,000	542,000	115,000
(2,217,000)	(1,228,000)	—	—	—	—	—
25,607,000	11,187,000	8,398,000	4,046,000	1,122,000	542,000	115,000
8,419,000	5,782,000	1,670,000	657,000	*	*	*
36,618,000	38,898,000	43,357,000	37,052,000	*	*	*
599,550	211,202	143,051	50,878	38,948	54,313	38,202
1,643	579	391	139	107	149	104
839,844	1,133,914	343,623	361,320	204,170	267,182	337,572
2,300	3,107	939	990	559	732	922
274,594	267,370	226,650	191,638	121,381	*	*
187,809	171,672	151,185	124,620	99,627	*	*
104	45	51	24	14	2	1
100	35	32	15	6	2	1
33	15	13	8	5	3	2

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