OMEGA HYDROCARBONS LTD.

1986 ANNUAL REPORT

Directors

Thomas Jack Hall, Calgary
Dennis E. Hall, Calgary
Bonnie C. Hall-Staples, Calgary
John L. Maclagan, 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

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Transfer Agents

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505 - 3rd Street S.W.
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Solicitors

Howard Mackie
700, 801 - 7th Avenue S.W.
Calgary, Alberta
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Main Bankers

The Toronto-Dominion Bank
The Bank of Montreal

Company Profile

Omega Hydrocarbons Ltd. is an independent Canadian exploration and production company with headquarters in Calgary, Alberta. The Company is engaged in the acquisition of petroleum and natural gas rights, and the exploration for and development and production of oil and natural gas primarily in western Canada. Operations in the United States are carried out through its wholly-owned subsidiary, Omega Oil & Gas, Inc.

The Company is a successor to Omega Natural Gas Co. Ltd. which was incorporated 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).

Omega is a shareholder of Canpet Marketing Ltd. and Methon Gas Marketing Ltd. Both of those companies were established for the primary purpose of marketing product for the founding producers.

The Company has various interests in 1,613,149 acres of land located in Canada and North Dakota. It concentrates its exploration and development efforts in southwestern Manitoba, southeastern Saskatchewan and southcentral Alberta.

On December 31, 1986, the Company's issued and outstanding capital stock consisted of 11,510,485 common shares which are listed on the Toronto Stock Exchange.

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 Thursday, the 28th day of May, 1987 at 3:30 p.m. (local time).

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Highlights

Financial

	1986	1985	% Change
Revenue	**$25,556,000**	$51,966,000	−51
Cash Flow From Operations	**$12,387,000**	$35,818,000	−65
— per share	**$ 1.08***	$ 2.77*	−61
Net Earnings	**$ 2,444,000**	$13,172,000	−81
— per share	**$ 0.21***	$ 1.02*	−79
Capital Expenditures	**$13,919,000**	$32,859,000	−58

* based on weighted average number of shares outstanding.

Operations

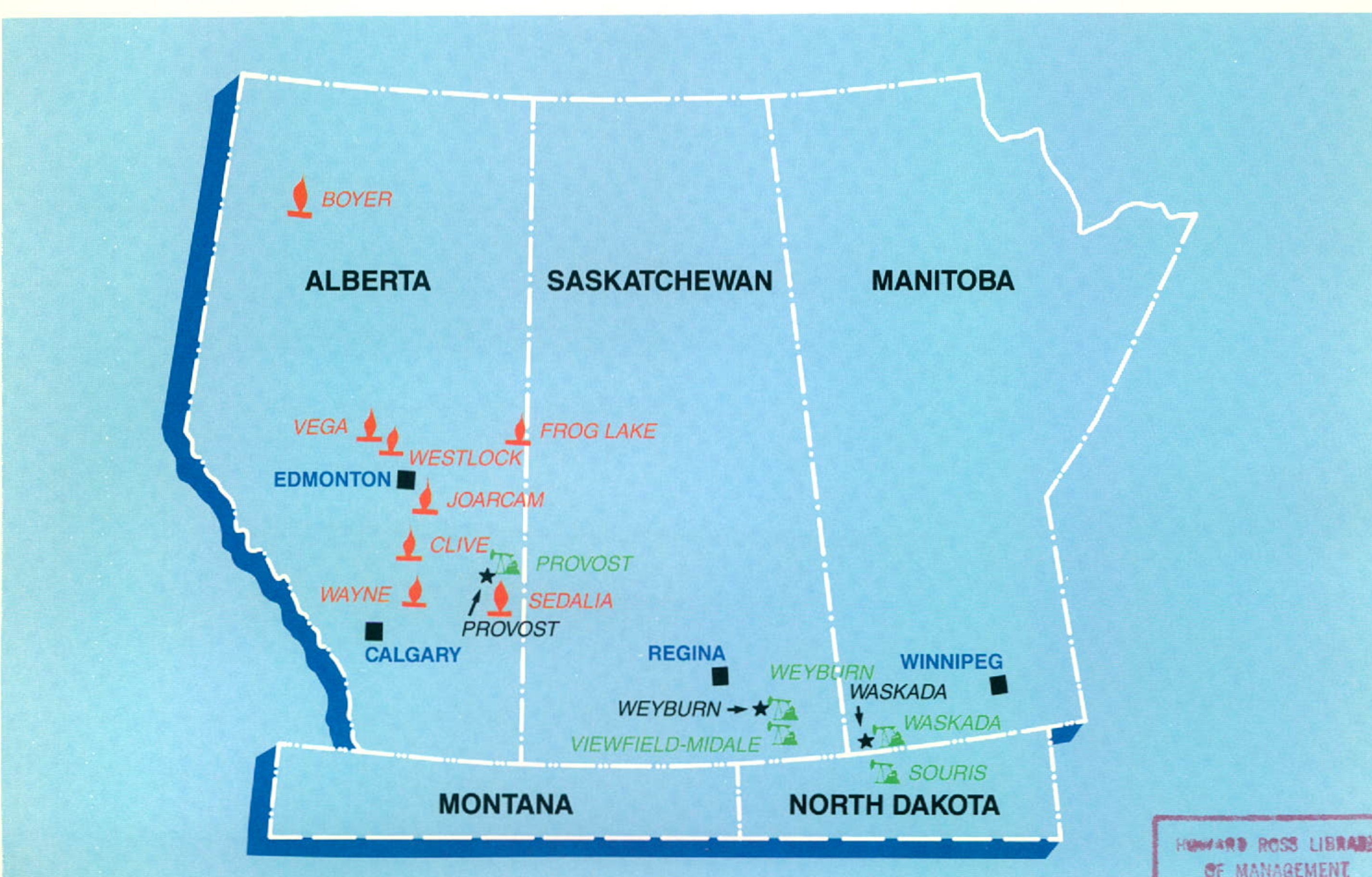
(Company Share Before Royalties)

	1986	1985	% Change
Production of Crude Oil and Natural Gas Liquids — barrels per day	**4,000**	4,400	− 9
Sales of Natural Gas — mcf per day	**3,700**	3,300	+12

Reserves

Proven Reserves at December 31
(Company Share Before Royalties)

	1986	1985	% Change
Crude Oil and Natural Gas Liquids — thousands of barrels	**17,600**	20,100	−12
Natural Gas — mmcf	**44,300**	42,600	+ 4



Oil   Gas   ★ Production Office

To Our Shareholders

During 1986, the producing sector of the Canadian oil and gas industry became painfully aware of the control over its destiny that is held by international interests. The oil price collapse that occurred early in 1986 lasted throughout the year and it was not until January of 1987 that we saw the return to a price of $18.00 U.S. per barrel, still well below prices in 1985. That price level will not return the industry to its former health but will certainly offer the prospect of some return to financial stability.

Omega's financial results for 1986 reflect the seriousness of the sudden drop in oil prices. Revenues dropped by more than 50% to $25.6 million, cash flow fell 65% to $12.4 million and net earnings were down more than 80% to $2.4 million. These results are certainly not attractive but, considering the disaster that befell the industry during the year, the Company's results can be assessed positively as a base from which siginificant improvement can be achieved in the more attractive current and expected pricing conditions and as a result of recent positive actions of governments in Canada.

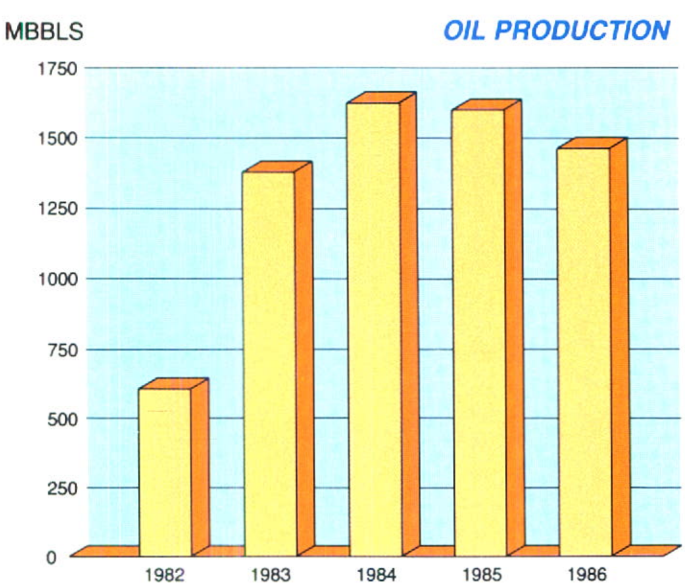
In the face of substantially reduced cash flow, careful monitoring of available funds enabled the Company to reduce its bank debt by $4.5 million and still carry out a capital expenditure program totalling $13.9 million. The amount by which these two items exceeded cash flow was obtained from government grants received during the year.

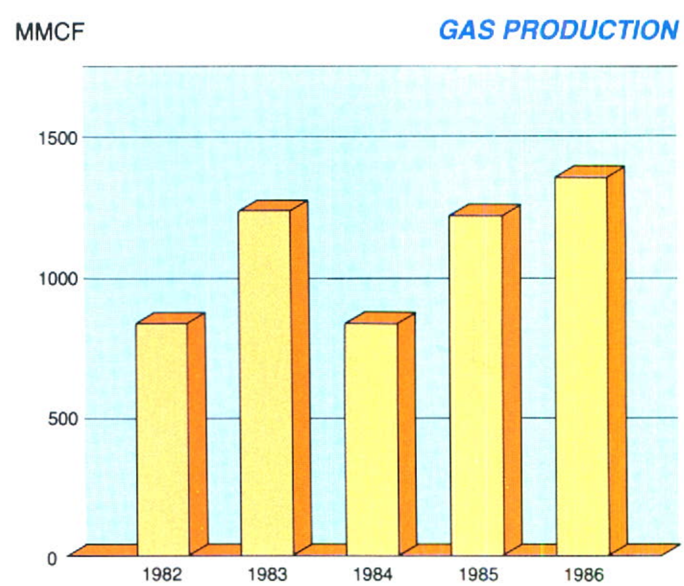
Omega maintained its holdings of prospective lands during 1986; net acreage decreased slightly to a total of 414,383 net acres. The most significant addition was a one-third interest in a new 24,902-acre block of lands on the Blackfoot Indian Reserve in southern Alberta. The Company now holds 54,284 net acres on the Reserve and in the adjacent Arrowwood area. Substantial seismic work on the Blackfoot reserve has been completed and wells are planned for 1987. This is a very prospective area, largely unexplored in the past and the Company is excited about its participation in the programs expected in 1987 and future years.

The Company's drilling program in 1986 was significantly reduced from previous years because of the financial constraints imposed by lower oil prices. Omega participated in 25 wells, 11 of which were in the Waskada field in Manitoba. The Company drilled or took a working interest share in one exploratory well in Manitoba, five exploratory or follow-up wells in Alberta, one exploratory well in Saskatchewan and one development well in North Dakota. A further six exploratory wells were drilled in Alberta by other operators on lands farmed out by Omega. The results of this total program were 15 oil or potential oil wells, four suspended gas wells and six dry holes.

As a result of this limited program, the Company did not replace its crude oil and liquids production. In the case of natural gas, however, proved reserve additions were more than double the production, resulting in a net increase of 4% during the year.

Crude oil and natural gas liquids production during 1986 averaged 4,000 barrels per day compared to 4,400 barrels per day in 1985. This 9% decline resulted largely from conversion of an additional 24 Waskada wells to injectors as part of the ongoing expansion of the waterflood area in that field. Some production was also lost due to shutting in certain wells that became uneconomic to produce or repair at the lower prices in effect in 1986. Natural gas sales





increased by 12% in 1986 to 3,700 mcf per day compared to 3,300 mcf per day in 1985. This increase came mainly from increased volumes at Wayne and Provost in Alberta.

The waterflood expansion at Waskada continued during 1986, with eight new project areas initiated, including five in the Spearfish (Lower Amaranth) and three in the Mississippian zones. At the end of the year 85% of the producing Spearfish zone and 50% of the Mississippian were under waterflood.

The past year was particularly disappointing. There are, however, a number of very positive signs that improvement can be expected in 1987 and future years. The strengthening of the price of crude oil to the $18.00 U.S. level and hopeful signs that international efforts to maintain it there or even higher may succeed is a very positive outlook. So too is the elimination of the punitive Petroleum and Natural Gas Revenue Tax with effect on October 1, 1986.

The disappointments brought by the lower prices in 1986 will turn to positive factors if prices can be stabilized at levels of $18.00 to $20.00 U.S. or higher. Locations not drilled because of cash constraints are still there and will be drilled. Most of the uneconomic wells which were shut in have been returned to production. Both of these factors together with production enhancement from the Waskada waterflood programs should reverse the production decline experienced in 1986. The possibility that some of Omega's shut-in gas reserves may be connected during 1987 should also improve the Company's cash flow in the coming year. The Company's participation as a founding shareholder in producer marketing groups for both crude oil and liquids (Canpet Marketing Ltd.) and natural gas (Methon Gas Marketing Ltd.) should prove to be very positive factors in the increasingly competitive product marketing environment.

Although the Company's bank debt is not onerous, it is still considered to be a desirable policy to reduce the interest costs and, therefore, enhanced cash flow will be used in part to reduce debt levels.

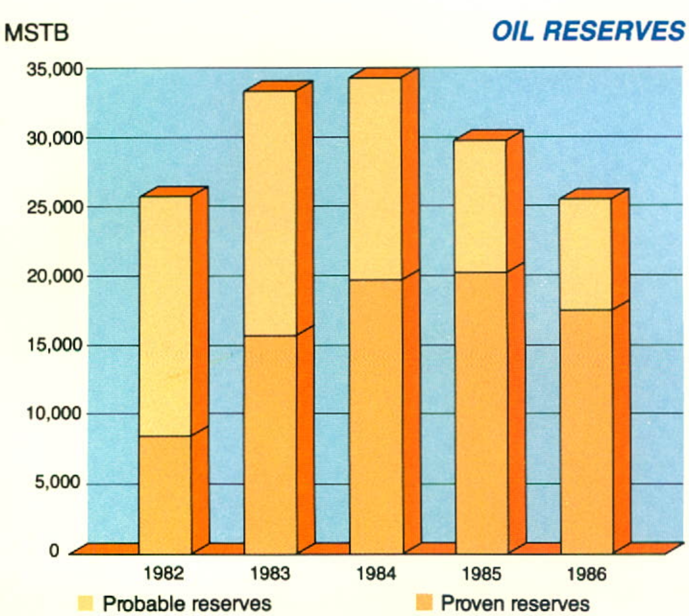
A more optimistic outlook brought about by the prospect of improved prices and renewal of activities postponed during the past year warrants re-emphasis. Omega has maintained a conservative approach during difficult times, is very able and intends to undertake an active and aggressive role under improved conditions.

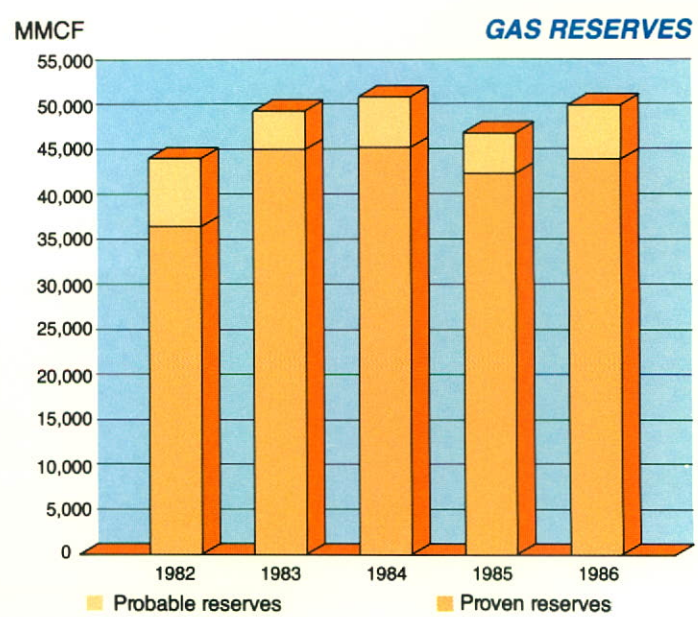
The Company wishes to thank the employees for the extra effort and sacrifices made during a most difficult period. We are optimistic that we will experience a brighter and more prosperous year in 1987.

On behalf of the Board of Directors,

Thomas Jack Hall,
President

April 30, 1987





Review of Operations

EXPLORATION

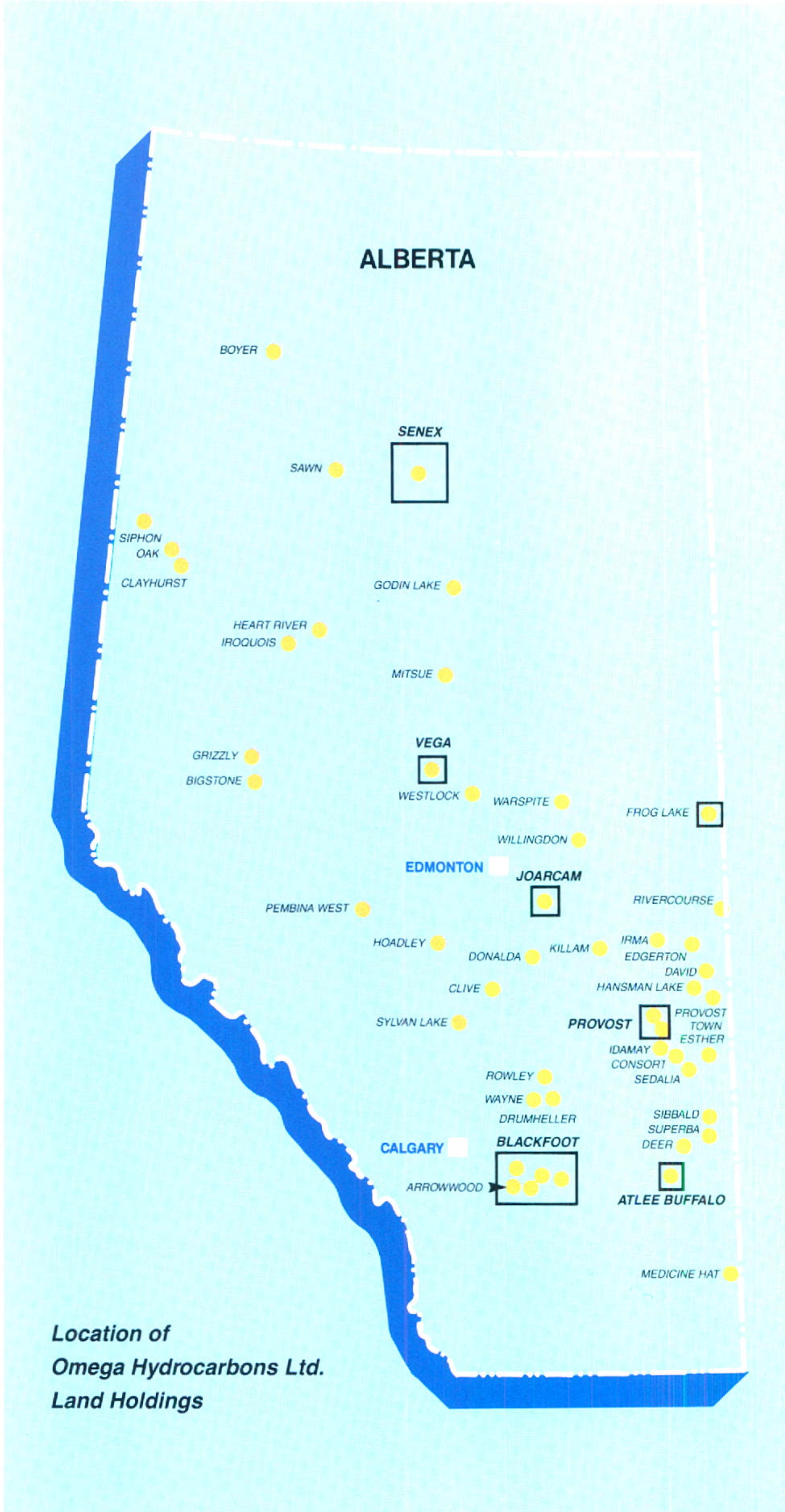
The down-turn in oil prices in 1986 severely impacted the Company's exploration activity over the course of the year. Many of the budgeted activities in terms of seismic and subsequent drilling, particularly in Alberta, were postponed. Land acquisition activity was reduced to very specific projects. A strategy of farming-out certain prospects with limited immediate cash flow potential was undertaken. This program resulted in the drilling of six exploratory wells in Alberta at no cost to the Company. Two of those wells, one at Hoadley and one at Hansman Lake resulted in gas well completions. The others were dry holes.

Omega's capital expenditures for exploratory drilling, seismic and land acquisitions during 1986 totalled $3.5 million.

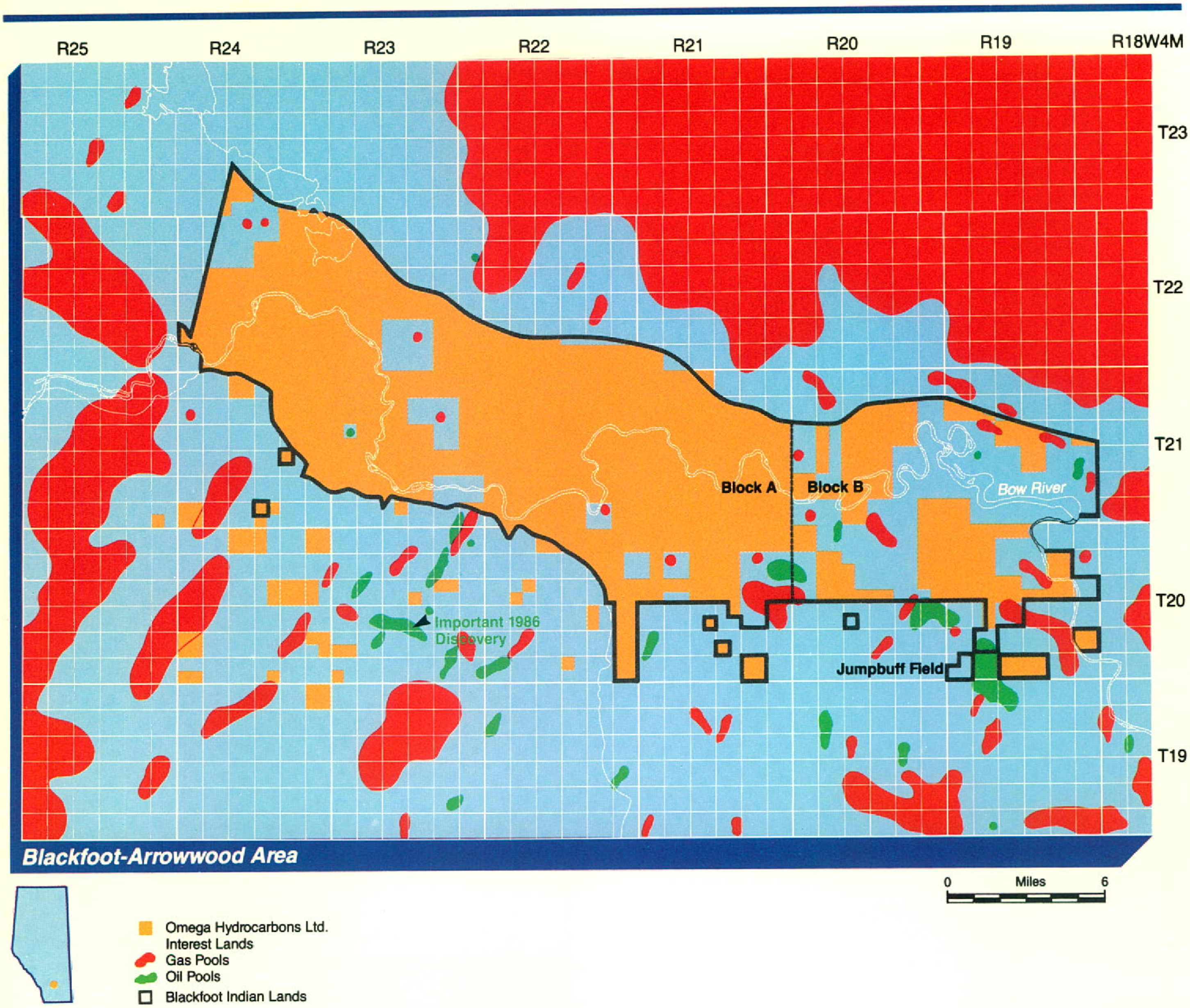
In the first quarter of 1986, when the Petroleum Incentive Program was still in effect, Omega drilled one, 100% interest well at Linklater, Manitoba on an attractive block of leases which had been held for some years. This well, on the active Lodgepole oil trend, was dry and abandoned.

In Saskatchewan, a 50% interest was acquired in lands and seismic on the Lodgepole trend in the Kennedy area, north of the Parkman Field. The Hazlewood 15-29-11-3-W2M exploratory wildcat was completed as a Lodgepole oilwell. However, subsequent high water production has made the well uneconomic. The prospect area has further potential given better economic conditions.

Omega held a working interest in four exploratory wells drilled in Alberta in 1986 with participation varying from 33% to 75%. A farm-in was taken in the Provost Idamay area and the Omega 14-5-34-7-W4M well was drilled and completed as a modest Detrital oil discovery. Follow-up drilling in 1987 has been disappointing. In the Wainwright Nisku trend, one joint-venture well was drilled and abandoned. The remaining two wells, at Senex and Atlee-Buffalo are discussed under the following exploration highlights.



Location of Omega Hydrocarbons Ltd. Land Holdings



Blackfoot-Arrowwood Area

During 1986, Omega and partners successfully acquired the remaining undisposed petroleum and natural gas rights offered to industry by the Blackfoot Indian Band within the Blackfoot Indian Reserve southeast of Calgary. This acquisition of 24,902 acres complements the major block of lands (Block "A") acquired by the group in the last quarter of 1985. Total acreage now held under agreement with the Blackfoot Band is 136,968 acres. Similar to the initial block, the new Block "B" addition is subject to seismic and drilling commitments by the group prior to the end of 1988.

Work carried out on this project in 1986 consisted of field seismic on Block "A" sufficient to meet the commitment and its evaluation.

Early in 1987, a further detailed seismic program was completed on specific areas of interest and field work was done on Block "B" (the eastern portion of the Reserve) to meet the seismic commitment required under the terms of the new exploration agreement. Interpretation of all seismic data was completed by the end of the first quarter of 1987. The Company and partners have developed a variety of prospective anomalies for drilling.

A six-well initial drilling program will commence in the second quarter of 1987. Of major interest are the prolific but high-risk "Glauconite channel" oil prospects. Significant gas and oil reserves in the Glauconite zone have been discovered on Crown and freehold lands on trend to the south of the Blackfoot Indian Reserve.

In addition, the Company is confident that gas reserves of substance are present on the lands in the shallower Viking and Medicine Hat sand zones. Deeper horizons, basically untested, will warrant critical review for potential as the program continues into 1988.

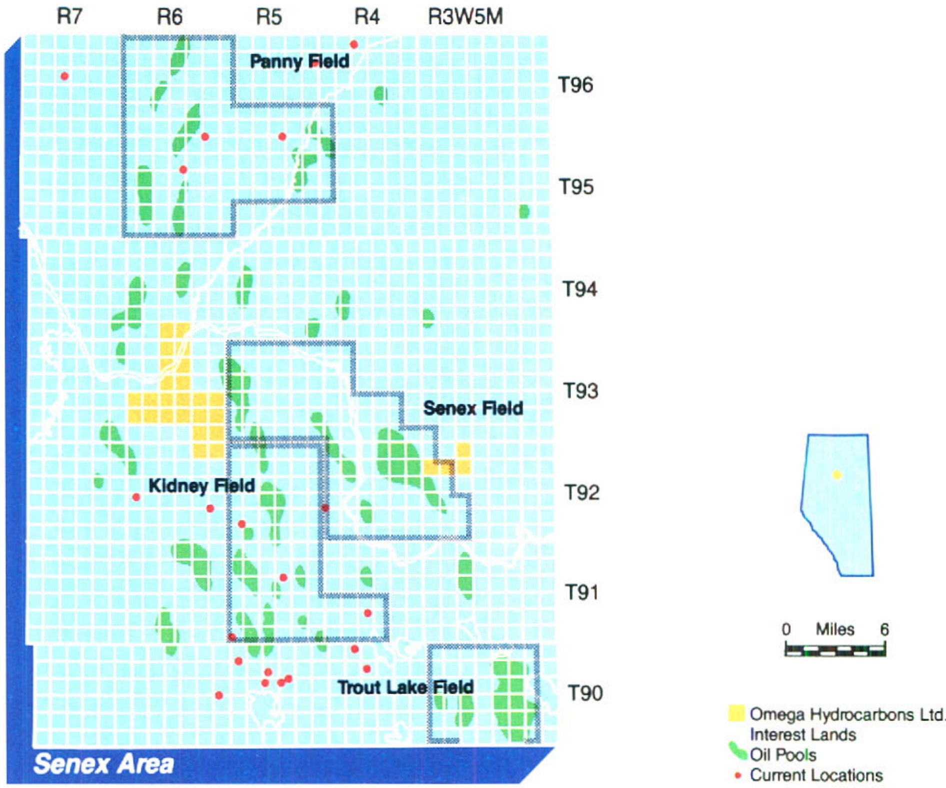
In the adjacent Blackfoot-Arrowwood area, Omega holds 8,628 net acres of freehold lands. Discussions are underway with a number of major explorers which should result in seismic or drilling activity on this project during 1987.

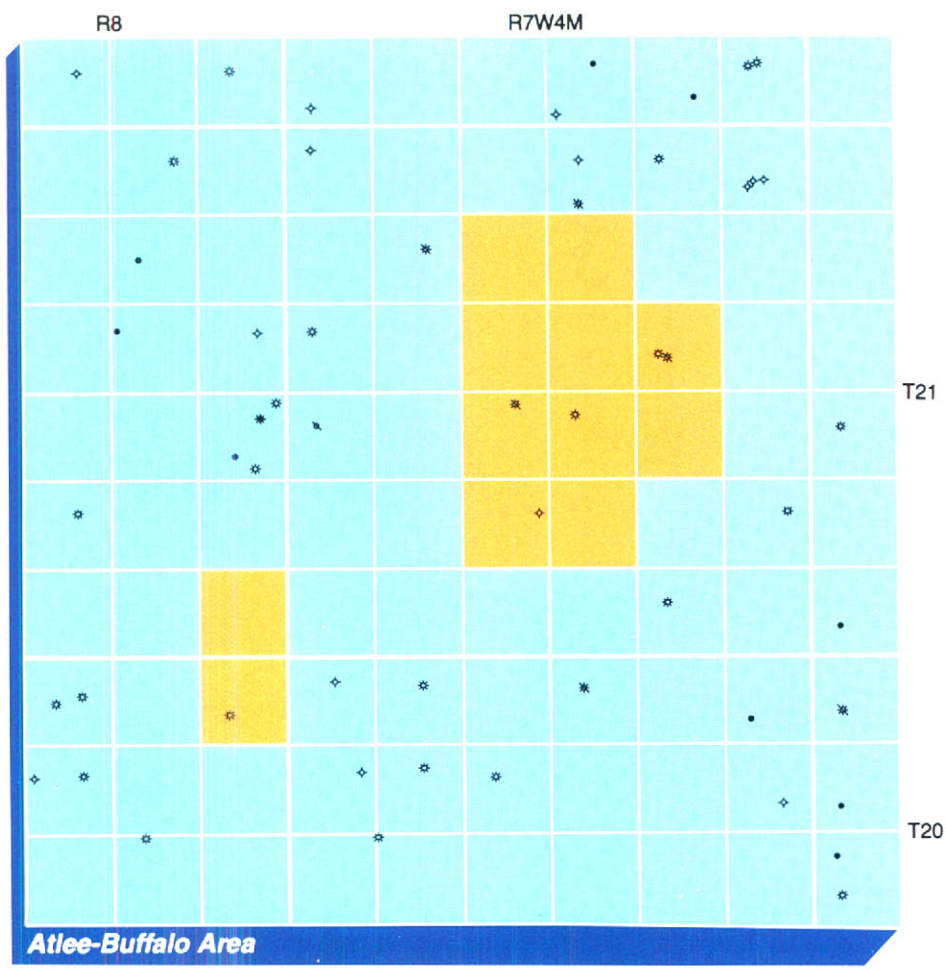
Senex

The Senex area Keg River oil trend of northern Alberta has been a very active scene of new oil discoveries in the past two winter drilling seasons. Omega maintains a 37½% interest in three Licences totalling 15,360 gross acres and a 100% interest in one licence totalling 2,560 acres. Omega participated in the drilling of one exploratory test to the Keg River in early 1986. This test, based on seismic, resulted in a dry hole.

During the fourth quarter of 1986, negotiations with a major company resulted in an attractive seismic-option arrangement. Options to drill a number of earning wells at no cost to Omega are currently under consideration. One Keg River test has been committed on Section 18-93-6-W5M and is scheduled to be drilled in the second quarter of 1987.

The lands in which Omega has an interest are well located on the Keg River trend. Industry operators continue a strong exploration and development drilling program adjacent to our lands.



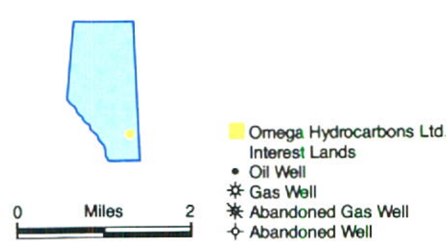


Atlee-Buffalo

Omega negotiated a seismic-option arrangement on a 3,200 acre Licence adjacent to its 1985 Atlee-Buffalo 6-23-21-7-W4M well which was completed as a Lower Mannville gas well. The Company exercised the right to drill a test well on the Licence following a modest seismic program and the well, 14-15-21-7-W4M, has resulted in a Colony sand gas well.

Immediately southwest of this area of interest, Omega entered a joint-venture arrangement with two other companies to focus upon Glauconite gas prospects. In the first quarter of 1987, Omega participated in the acquisition of two 640-acre Crown leases and the drilling and completion of a gas well at 6-36-20-8-W4M. More recently the group acquired two additional 640-acre Crown leases on which drilling is expected during 1987.

The Company plans additional land acquisition and exploration activity in the Atlee-Buffalo area during 1987.



Outlook

Following a period of economic uncertainties which has restricted aggressive exploration, the outlook for 1987 looks attractive. The Company will focus on quality prospects in Alberta. With lower drilling and seismic costs and an inventory of good potential lands, a renewed exploration effort is anticipated. New opportunities for either oil or gas reserves are being pursued throughout Alberta with emphasis on the eastern and southern Plains areas.

PRODUCTION AND RESERVES

During 1986, Omega drilled 13 development wells all but one of which were located on lands owned 100% by the Company. Geographically, 11 of those wells were located in Manitoba, one was in North Dakota and one (0.2 net) was in Alberta.

Omega's capital expenditures for development drilling and related facilities, purchase of interests in producing wells and other assets were $10.4 million.

Omega's production of oil and natural gas liquids before royalty and production taxes in 1986 averaged 4,000 barrels per day (4,400 in 1985). Of the total, 3,330 barrels per day were produced from the Waskada field, 385 barrels per day from Saskatchewan, 270 barrels per day from Alberta and 15 barrels per day from North Dakota.

Natural gas sales averaged 3,700 mcf per day in 1986 compared to 3,300 mcf per day in 1985.

Land Holdings (acres) as at March 1:

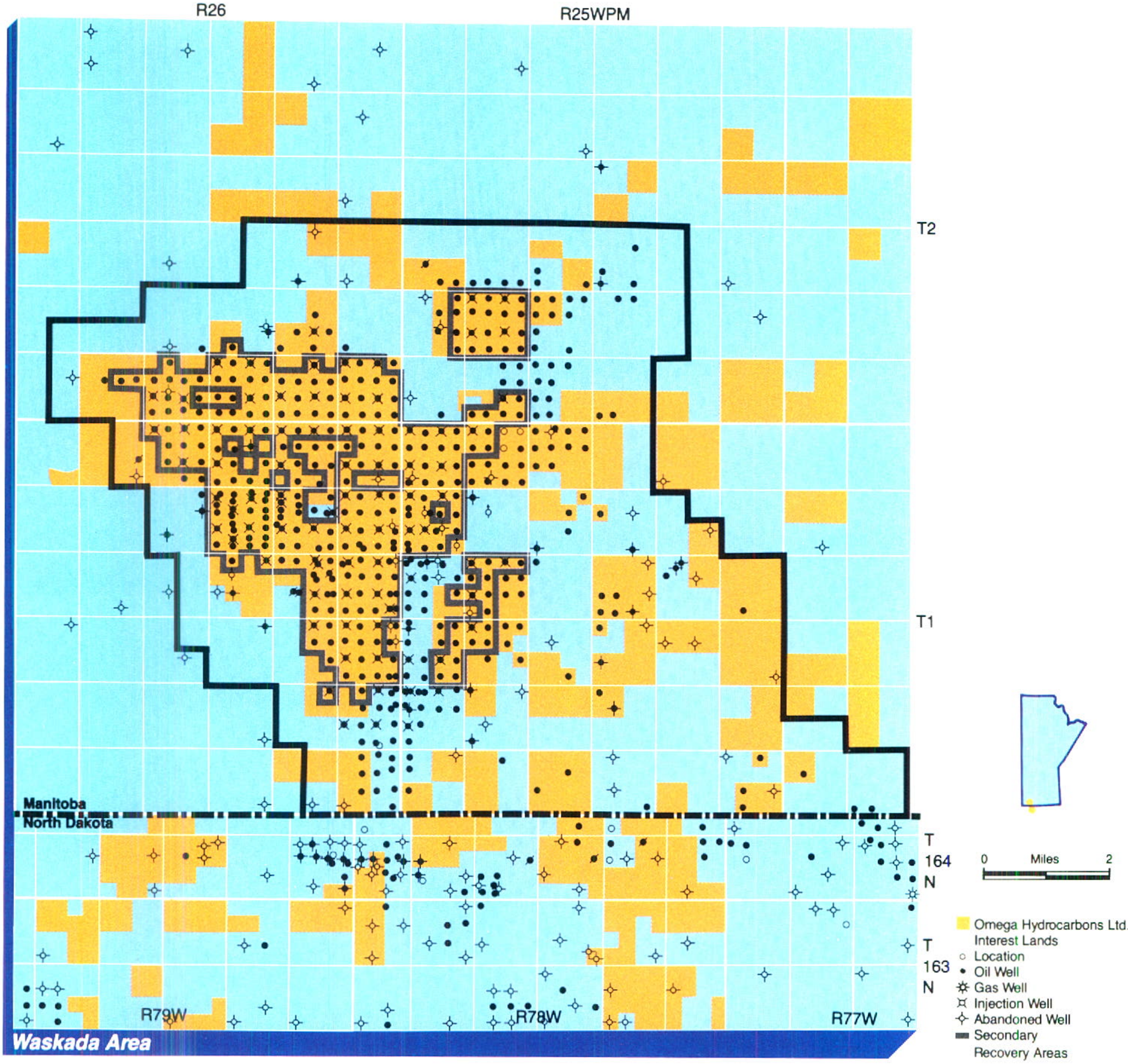
	Gross				Net			
	Developed		Undeveloped		Developed		Undeveloped	
	1987	1986	1987	1986	1987	1986	1987	1986
Alberta	110,858	109,763	305,900	290,401	69,556	69,049	175,058	181,659
Saskatchewan	10,309	11,181	39,630	47,484	8,884	9,571	38,069	45,544
Manitoba	18,556	18,556	32,158	34,050	16,820	16,743	27,601	29,130
North Dakota	932	801	4,806	13,950	455	367	4,227	11,531
Subtotal	**140,655**	**140,301**	**382,494**	**385,885**	**95,715**	**95,730**	**244,955**	**267,864**
Hudson Bay	—	—	1,090,000	1,090,000	—	—	73,713	73,713
Total	**140,655**	**140,301**	**1,472,494**	**1,475,885**	**95,715**	**95,730**	**318,668**	**341,577**

Wells Drilled During the Year Ended:

	December 31, 1986		December 31, 1985	
	Gross Wells	Net Wells	Gross Wells	Net Wells
Oil	**15**	**13.0**	77	64.6
Gas	**4**	**2.1**	4	4.0
Suspended	**—**	**—**	1	0.6
Dry and abandoned	**6**	**2.4**	9	4.3
Total	**25**	**17.5**	91	73.5

Capital Expenditures

	1986	1985	1984	1983	1982
Land Acquisitions	**$ 1,188,000**	$ 4,470,000	$ 2,045,000	$ 1,678,000	$ 2,150,000
Drilling and Exploration	**8,825,000**	14,814,000	21,548,000	18,532,000	14,136,000
Production Equipment	**4,783,000**	11,760,000	13,657,000	15,517,000	11,538,000
Other Assets	**(877,000)**	1,815,000	1,430,000	—	—
Subtotal	**13,919,000**	32,859,000	38,680,000	35,727,000	27,824,000
Government Incentive Payments	**(4,478,000)**	(3,763,000)	(4,890,000)	(4,676,000)	(2,217,000)
Net	**$ 9,441,000**	$29,096,000	$33,790,000	$31,051,000	$25,607,000



Waskada

All of the 11 wells (11.0 net) drilled in this field during 1986 were either producing or potential Lower Amaranth (Spearfish) wells and four were also capable of production from Mississippian zones. As of December 31, 1986 the Company has interests in 397 wells in the Waskada field of which 327 are producing or capable of producing, 66 are water injection wells and four are water source wells.

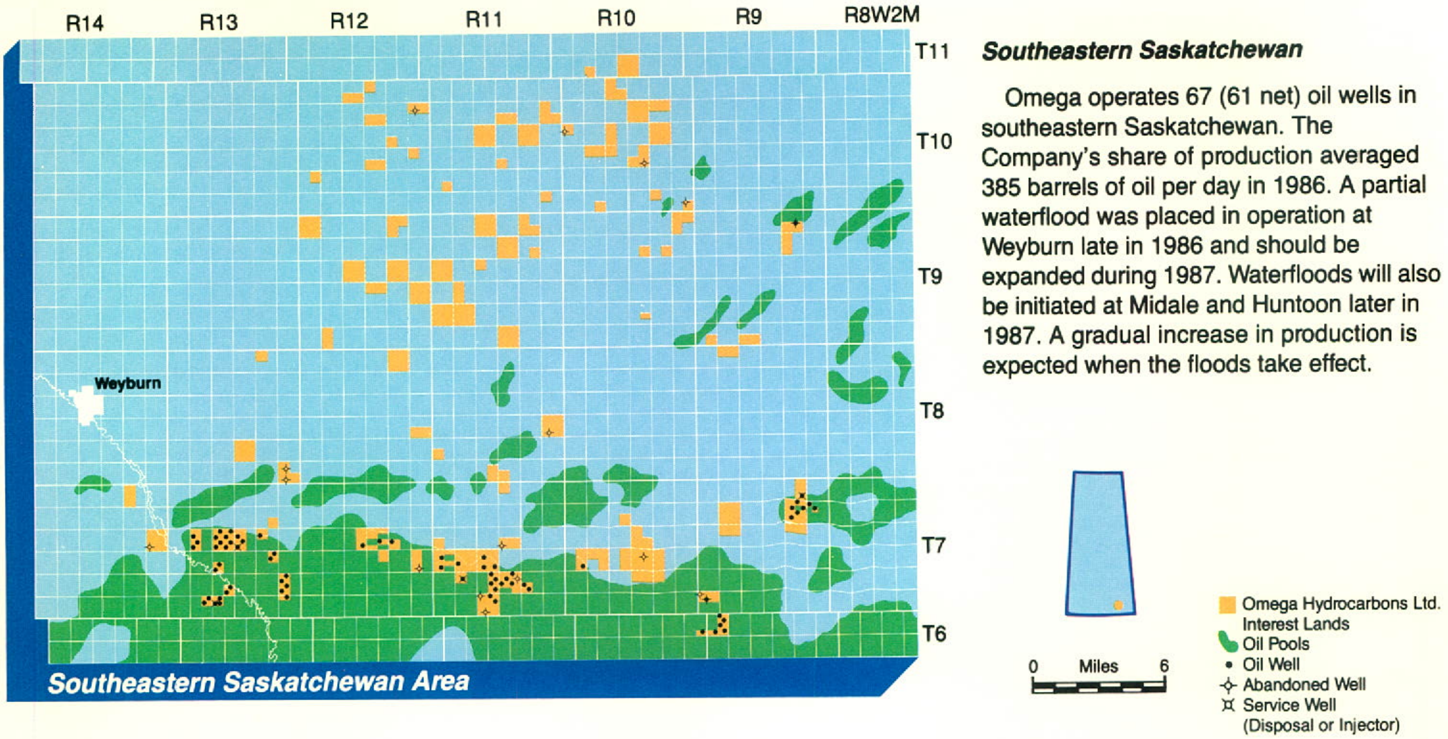
The gas plant which was placed in operation in 1984 continues to operate trouble free, processing 1,100 mcf of gas per day which produces approximately 75 barrels per day of propane and 60 barrels per day of butanes and pentanes plus. The solution gas is being reinjected for possible future sale or for use as fuel gas for the processing equipment.

The Spearfish waterflood which was initiated in 1983 continues to give very encouraging results. Mississippian wells were placed on flood during 1986 and these results have also been extremely encouraging. As of December 31, 1986 a total of 10,160 acres was under flood and plans are to expand until most of the field is included.

The oil transmission line from Waskada to Cromer, Manitoba, in which Omega has a 30% interest, operated without any problems in 1986. During the year the line was extended to gather oil from two other producing companies in the area. During 1986, 4,200 barrels per day of crude oil were transported through the pipeline.

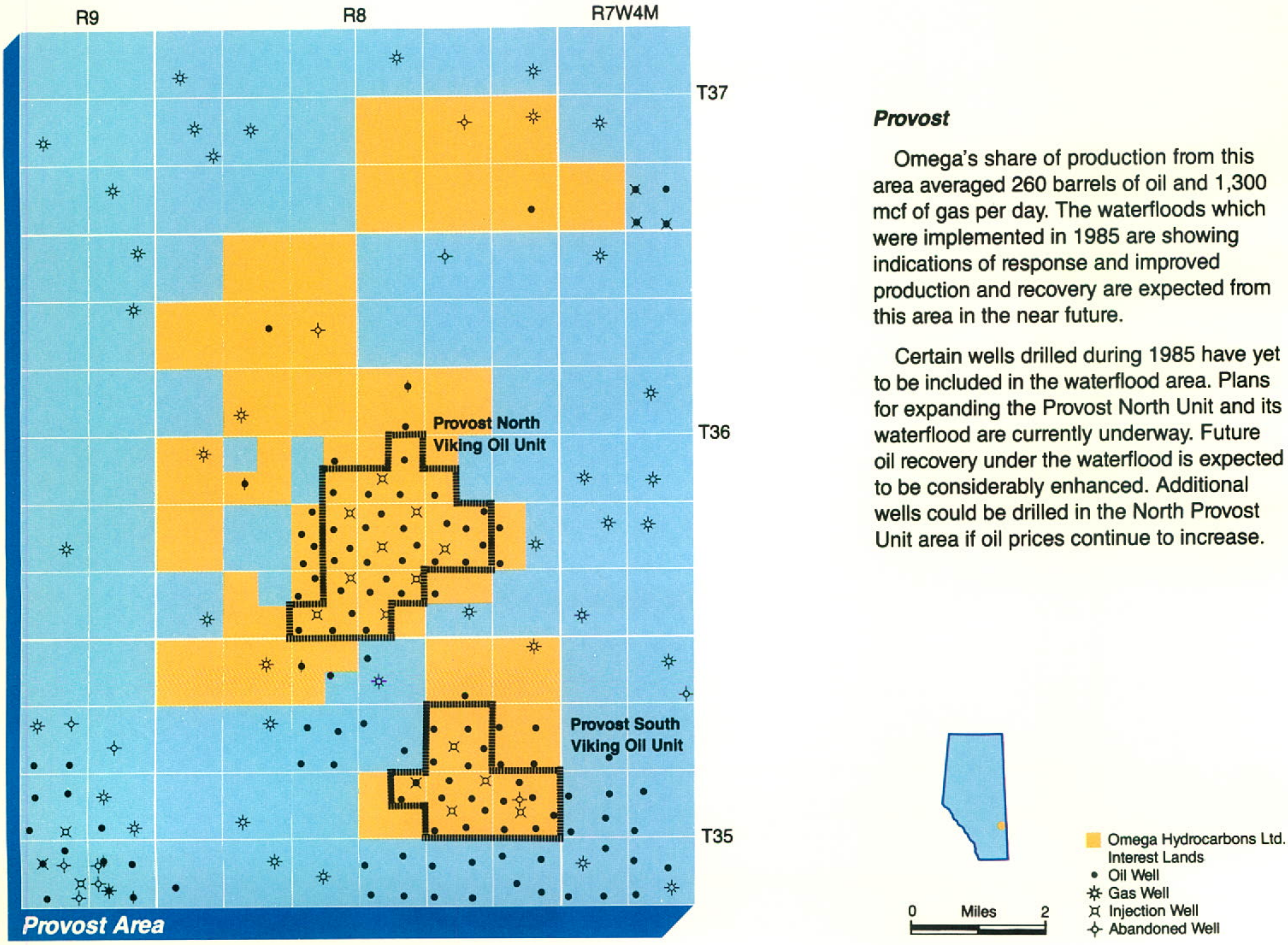
North Dakota

The Company drilled and completed one Spearfish oil well in 1986. Oil production from the two producing wells in this area presently totals approximately 25 barrels per day. Additional drilling will be carried out when the economics are more favourable. This area, like Waskada, has excellent potential for waterflood.



Southeastern Saskatchewan

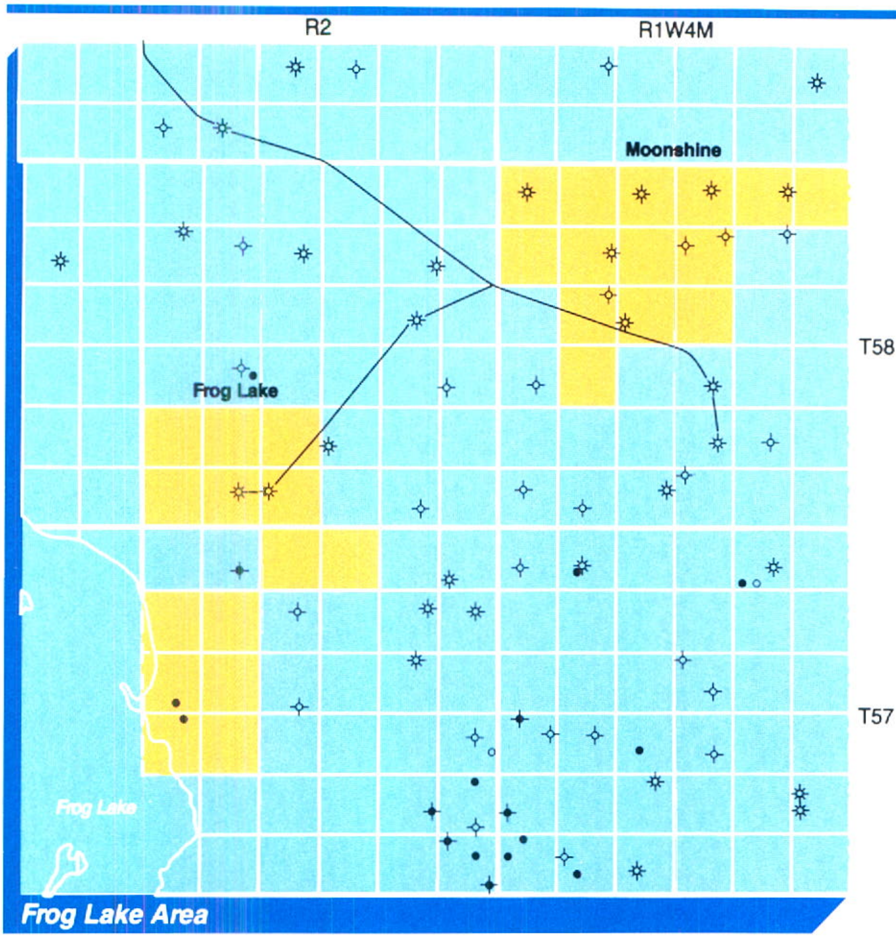
Omega operates 67 (61 net) oil wells in southeastern Saskatchewan. The Company's share of production averaged 385 barrels of oil per day in 1986. A partial waterflood was placed in operation at Weyburn late in 1986 and should be expanded during 1987. Waterfloods will also be initiated at Midale and Huntoon later in 1987. A gradual increase in production is expected when the floods take effect.



Provost

Omega's share of production from this area averaged 260 barrels of oil and 1,300 mcf of gas per day. The waterfloods which were implemented in 1985 are showing indications of response and improved production and recovery are expected from this area in the near future.

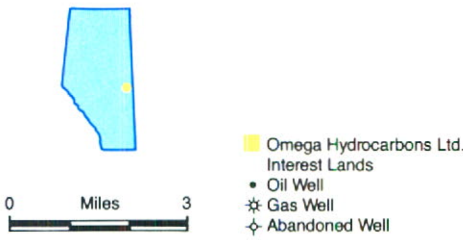
Certain wells drilled during 1985 have yet to be included in the waterflood area. Plans for expanding the Provost North Unit and its waterflood are currently underway. Future oil recovery under the waterflood is expected to be considerably enhanced. Additional wells could be drilled in the North Provost Unit area if oil prices continue to increase.

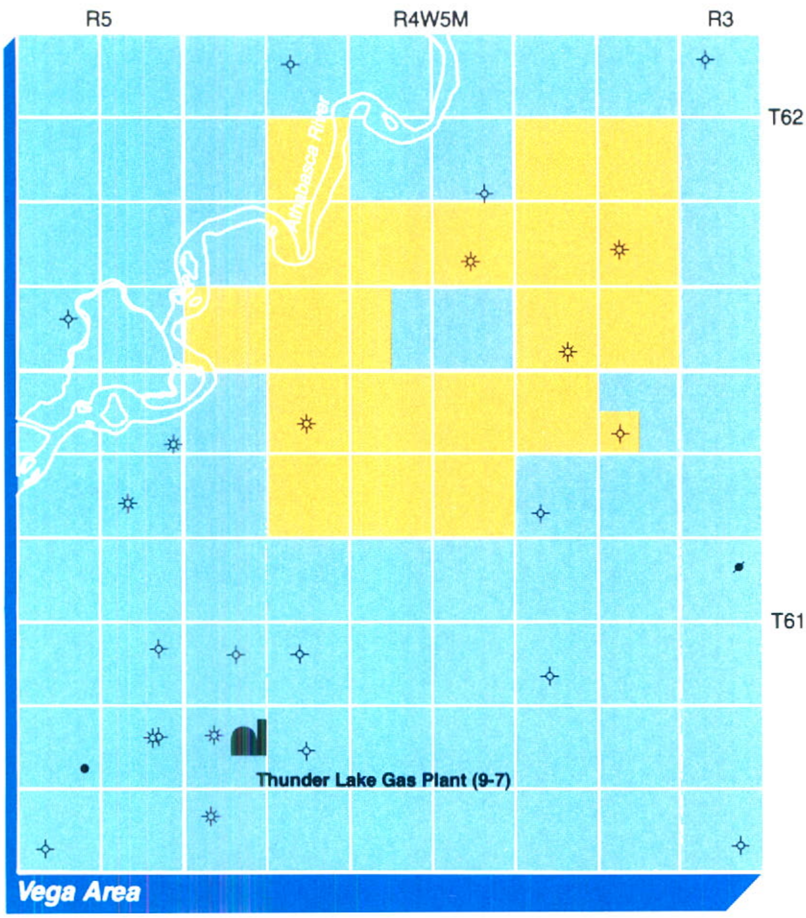


Frog Lake

Two gas wells in the Frog Lake (Moonshine) area were tied-in and placed on production in 1985. Production during 1986 averaged approximately 2,000 mcf per day (Omega's share 500 mcf per day). There is potential for higher deliveries from several shut-in gas wells and further development drilling in this area when additional markets for gas become available.

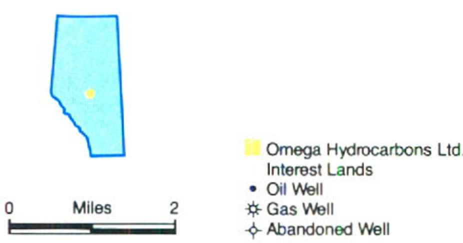
Two Frog Lake oil wells remain shut-in due to the depressed prices for heavy quality oil. Omega has interests in additional lands in this area which could be drilled as early as 1987 if oil prices continue to improve.

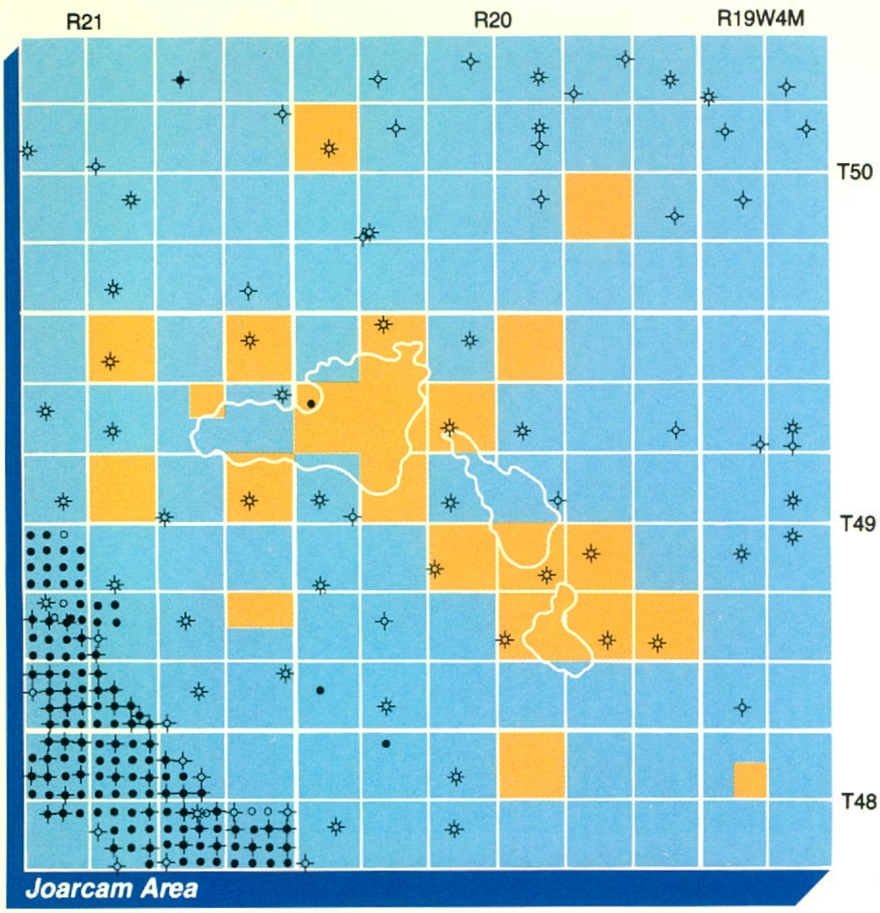




Vega

A gas contract is being discussed for the Vega area. When that is obtained, Omega has the opportunity to participate in an existing processing plant and gathering system. The Company's share of gas sales from the area is expected to be 1,000 mcf per day. Depending on market conditions, gas from this area could be on production by late 1987.





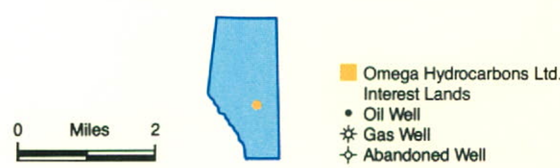
Joarcam

An engineering study is underway to tie-in four gas wells at Joarcam. If sales contracts can be negotiated, the tie-ins will be completed this summer and gas sales of approximately 2,000 mcf per day (Omega's share 1,000 mcf per day) should commence in the third quarter of 1987.

Outlook

The slowdown in the drilling activity during 1986 has allowed a concentrated effort to be made to optimize existing oil production. Secondary recovery programs have been expanded or are planned for all areas where they are feasible. Results of these projects should continue to improve production performance.

Strengthening of world oil prices will improve the economics of development drilling which will resume when it is determined that investment of funds in such programs will provide appropriate returns.



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, 1985	20,107	42,611	17,138	37,792
Additions	(1,049)	2,995	(760)	2,484
Production	(1,459)	(1,354)	(1,216)	(1,082)
Proven Reserves at December 31, 1986	17,599	44,252	15,162	39,194
Probable Additional Reserves	7,821	6,019	6,745	5,083
Total Proven and Probable Additional Reserves at December 31, 1986	25,420	50,271	21,907	44,277

Present Worth of Future Oil and Gas Net Production Revenue Discounted at:	0%	12%	15%	20%
		($000)		
Proven Remaining Reserves	446,564	156,257	131,091	102,448
Probable Additional Reserves	236,576	43,611	32,198	20,797
Total Proven and Probable Additional Reserves	683,140	199,868	163,289	123,245

Company Share of Production Before Royalties	1986	1985	1984	1983	1982
Petroleum (bbls)	1,458,703	1,600,163	1,621,348	1,378,094	599,550
Natural Gas (mcf)	1,353,587	1,216,191	839,930	1,233,846	839,844

Financial Review

During 1986, Omega's revenues after royalties and production taxes were $25.6 million ($2.22 per share) compared to $52.0 million ($4.02 per share) in 1985. That decrease resulted mainly from a 50% drop in the average price received for crude oil to $18.46 per barrel from $37.94 in 1985. The average price received for natural gas was $2.22 per mcf compared to $2.58 in 1985.

Cash flow from operations was $12.4 million ($1.08 per share), a decrease of 65% from $35.8 million ($2.77 per share) in 1985. The three major factors contributing to that decrease were the 50% drop in oil prices, a 9% decrease in crude oil production and a 53% increase in interest costs.

Net earnings in 1986 were $2.4 million ($0.21 per share) compared to $13.2 million ($1.02 per share) in 1985.

During 1986, total expenses were reduced.

Production expenses were cut by 19% as a result of stringent reviews of expenditures in all areas of operations.

General and administrative costs, including modest amounts capitalized, were slightly lower. Because of the drastic fall in oil prices, salaries throughout the Company were reduced and employees who resigned were not replaced wherever possible. At the end of 1986 the Company employed 45 people in the Calgary office and 35 at various field locations or 80 staff members in all compared to 88 at the end of 1985.

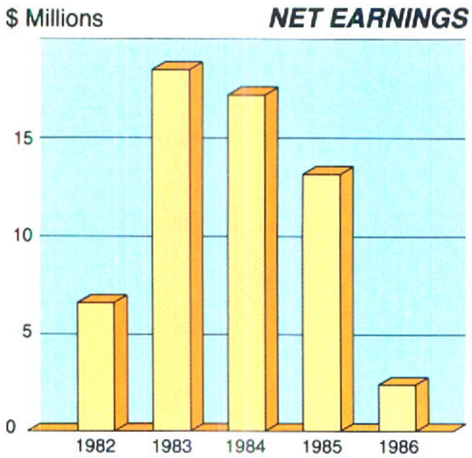
Interest on bank loans was up by a substantial 53% reflecting the higher average amount of loans outstanding. A significant drop is expected in 1987 as a result of the policy of debt reduction adopted early in 1986 which can be accelerated by higher prices, and the fall in interest rates which occurred during the latter part of 1986 and early 1987, and which may apply well into 1987.

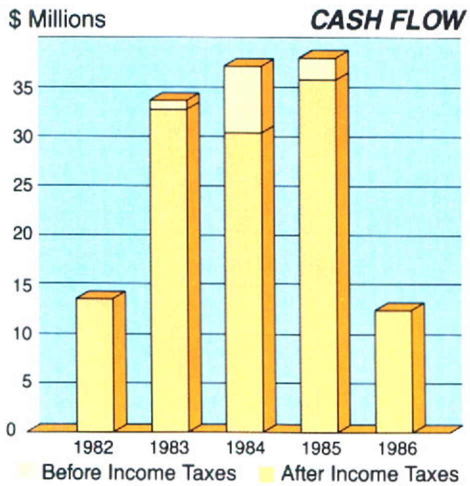
The provision for depletion and depreciation was essentially unchanged from the prior year.

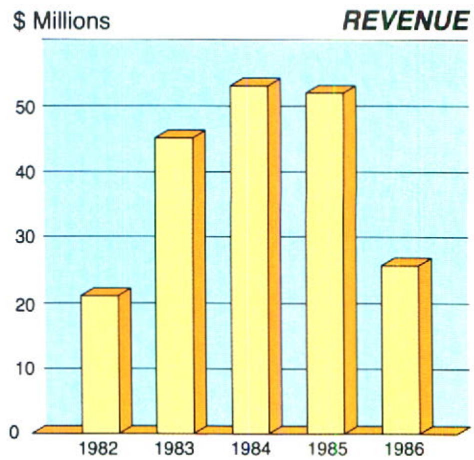
Total provision for corporate taxes was very significantly reduced as a result of the substantial drop in the Company's earnings. Provision for income taxes was $0.8 million for 1986 compared to $11.4 million in 1985. A major contribution to earnings came from elimination of the Petroleum and Gas Revenue Tax at the end of September, 1986 and increased exemptions and offsets which eliminated current tax on Omega's production from the first of the year and allowed for deferral of such tax applicable to the years 1986 and part of 1985.

Omega's capital programs were significantly curtailed in 1986 as a result of the lower oil prices. Net capital expenditures before government incentive grants were $13.9 million compared to $32.9 million in 1985. Incentive grants received totalled $4.5 million in 1986 compared to $3.8 million in 1985. The federal and provincial Petroleum Incentive Programs ended for conventional areas on March 31, 1986. Claims under those and other provincial grant programs which terminated at the end of 1986 are now being finalized.

During 1986, the Canadian Institute of Chartered Accountants issued a Guideline On Full Cost Accounting In The Oil And Gas Industry with which the Company was in substantial compliance. That Guideline limits the capitalized costs of property, plant and equipment to the estimated future net revenues from proved reserves (based on prices and operating costs at the balance sheet date) less estimated future general and administrative expenses, financing costs and income taxes. This has been commonly referred to as the "ceiling test". The Company has applied this ceiling test to the production forecast provided by the outside engineers and the net book value of property, plant and equipment reported in the accompanying financial statements is well below the estimated future net revenues. Omega, therefore, very comfortably meets the "ceiling test".







Auditors' Report

To the Shareholders of
Omega Hydrocarbons Ltd.

We have examined the consolidated balance sheet of Omega Hydrocarbons Ltd. as at December 31, 1986 and the consolidated statements of income, 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, 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
Chartered Accountants

Calgary, Canada
March 27, 1987

Consolidated Balance Sheet

As At December 31, 1986

ASSETS

	1986	1985
Current Assets		
Accounts receivable	$ 3,225,000	$ 6,540,000
Petroleum Incentive Program claims	1,002,000	4,894,000
Income taxes receivable	401,000	2,404,000
Notes receivable	—	202,000
	4,628,000	14,040,000
Property, Plant and Equipment (note 1)		
Petroleum and gas properties and equipment	152,360,000	145,249,000
Accumulated depletion and depreciation	(37,921,000)	(28,738,000)
	114,439,000	116,511,000
Other Assets	1,826,000	1,395,000
	$120,893,000	$131,946,000

LIABILITIES

	1986	1985
Current Liabilities		
Accounts payable and accrued liabilities	$ 3,545,000	$ 12,375,000
Current maturities on bank loans	5,800,000	1,901,000
Petroleum and Gas Revenue Tax payable	—	357,000
Gas production prepayments	—	519,000
	9,345,000	15,152,000
Bank Loans (note 2)	27,350,000	35,800,000
Deferred Taxes	32,615,000	31,855,000

SHAREHOLDERS' EQUITY

	1986	1985
Capital stock (note 3)	11,534,000	11,534,000
Retained earnings	40,049,000	37,605,000
	51,583,000	49,139,000
	$120,893,000	$131,946,000

Contingent liabilities (note 4)

APPROVED BY THE BOARD:

Director

Director

Consolidated Statement of Income

Year Ended December 31, 1986

	1986	1985
Revenue		
Oil and gas sales, net of royalties	**$24,708,000**	$51,324,000
Other	**848,000**	642,000
	25,556,000	51,966,000
Expenses		
Production	**6,543,000**	8,124,000
General and administrative	**3,085,000**	3,560,000
Interest on bank loans	**4,032,000**	2,633,000
Depletion and depreciation	**9,183,000**	9,159,000
	22,843,000	23,476,000
Income before corporate taxes	**2,713,000**	28,490,000
Provision for corporate taxes (note 5)	**269,000**	15,318,000
Net Income	**$ 2,444,000**	$13,172,000
Net Income per Common Share	**$0.21**	$1.02

Consolidated Statement of Retained Earnings

Year Ended December 31, 1986

	1986	1985
Balance at beginning of year	**$37,605,000**	$36,581,000
Net income	**2,444,000**	13,172,000
Purchase of common shares	**—**	(12,148,000)
Balance at End of Year	**$40,049,000**	$37,605,000

Consolidated Statement of Changes in Financial Position

Year Ended December 31, 1986

	1986	1985
Operating Activities		
Net income	**$ 2,444,000**	$13,172,000
Items not involving cash		
Depletion and depreciation	**9,183,000**	9,159,000
Deferred taxes	**760,000**	13,487,000
	12,387,000	35,818,000
Changes in non-cash working capital items related to operating activities	**1,834,000**	(1,284,000)
	14,221,000	34,534,000
Financing Activities		
Bank loans	**(4,551,000)**	8,762,000
Notes receivable	**202,000**	769,000
Purchase of common shares	**—**	(13,711,000)
	(4,349,000)	(4,180,000)
Cash Available for Investing Activities	**$ 9,872,000**	$30,354,000
Investing Activities		
Additions to property, plant and equipment	**$14,698,000**	$32,859,000
Proceeds of disposal of property, plant and equipment	**(779,000)**	—
Petroleum Incentive Program payments received	**(4,478,000)**	(3,763,000)
Other	**431,000**	1,258,000
	$ 9,872,000	$30,354,000

Notes to Consolidated Financial Statements

Year Ended December 31, 1986

SUMMARY OF SIGNIFICANT 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.

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).

Oil and Gas Operations

The company follows the full cost method of accounting for oil and gas operations as prescribed in the Guideline on Full Cost Accounting in the Oil and Gas Industry, which was issued by the Canadian Institute of Chartered Accountants in 1986.

All costs of exploring for and developing oil and gas reserves are capitalized, including land acquisition costs, geological and geophysical costs, carrying charges on non-producing properties, costs of drilling both productive and non-productive wells, production equipment costs and overhead related to exploration and development activities and construction projects. Such costs are depleted and depreciated on the unit of production method based on estimated gross proved reserves of oil and natural gas. Oil and natural gas production and reserves are converted into equivalent units based upon estimated relative energy content.

The capitalized costs less accumulated depletion, depreciation and deferred taxes are limited to an amount equal to the estimated net revenue from proved reserves (based on prices and costs at the balance sheet date) less estimated future general and administrative expenses, financing costs and taxes.

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.

Depreciation

Depreciation of other equipment is provided using the declining balance method at rates ranging from 10% to 30% per annum.

Government Incentives

Incentives which are earned by the Company pursuant to legislation enacted by the Federal and Provincial governments are recorded as a reduction of the related property, plant and equipment.

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.

1. PROPERTY, PLANT AND EQUIPMENT

	December 31, 1986		
	Cost	Accumulated depletion and depreciation	Net
Lease acquisition, exploration and drilling	$ 86,563,000	$ 22,777,000	$ 63,786,000
Production equipment and gathering facilities	62,802,000	14,157,000	48,645,000
Other equipment	2,995,000	987,000	2,008,000
	$152,360,000	$ 37,921,000	$114,439,000

	December 31, 1985		
	Cost	Accumulated depletion and depreciation	Net
Lease acquisition, exploration and drilling	$ 80,786,000	$ 17,577,000	$ 63,209,000
Production equipment and gathering facilities	60,591,000	10,330,000	50,261,000
Other equipment	3,872,000	831,000	3,041,000
	$145,249,000	$ 28,738,000	$116,511,000

1. PROPERTY, PLANT AND EQUIPMENT (Continued)

During the year ended December 31, 1986 the Company commenced capitalizing overhead costs directly related to acquisition, exploration and development activities. As a result, costs of $430,000 have been capitalized in 1986. The effect of this change is to increase current year's net income by $240,000 ($.02 per common share).

2. BANK LOANS

Lines of credit in the aggregate amount of $35,000,000 at December 31, 1986, have been established with three Canadian chartered banks under which borrowings are made on a revolving basis. Present terms of these lines of credit call for a reduction in the available credit facilities of $7,650,000 in 1987. Borrowings under each line of credit, may, at the bank's option, be converted to five or six year term loans 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 interest in certain oil and gas properties and a general assignment of accounts receivable.

3. CAPITAL STOCK

(a) Authorized Share Capital

The authorized share capital 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, 1986 were as follows:

	Number of Shares	Consideration
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 and 1986	11,510,485	$11,534,000

(c) Common Shares Reserved

As of December 31, 1986, 760,498 (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.

4. CONTINGENT LIABILITIES

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. No date has been set to hear that appeal.

5. PROVISION FOR CORPORATE TAXES

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

	1986	1985
Income taxes		
Current	$ —	$ 578,000
Deferred	760,000	10,828,000
	760,000	11,406,000
Petroleum and Gas Revenue Tax	—	4,200,000
Alberta Royalty Tax Credit	(491,000)	(288,000)
	$269,000	$15,318,000

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

	1986	1985
Statutory federal income tax rate	46%	46%
Royalties and other payments to provincial governments	35	6
Federal resource allowance	(58)	(16)
Provincial income taxes in excess of federal abatement	3	3
Federal corporate surtax	1	1
Other	1	—
Effective income tax rate	28%	40%

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, 1986 there were approximately $34,000,000 of unclaimed property, exploration and development costs and approximately $19,000,000 of unclaimed capital costs available to be carried forward.

6. RELATED PARTY TRANSACTIONS

(a) Prior to 1986 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. During 1986, AGP participated in certain drilling activities respecting these properties thereby maintaining its interest and participated with the Company in the acquisition of certain other properties in the Province of Alberta.

(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 in the Province of Alberta.

7. COMPARATIVE STATEMENTS

Certain of the 1985 amounts shown for comparative purposes have been reclassified to conform with the method of presentation adopted in the current year.

Ten Year Statistical Review

	1986 $	1985 $	1984 $
Revenues and Earnings			
Revenues	**25,556,000**	51,966,000	52,725,000
Cash flow from operations	**12,387,000**	35,818,000	30,216,000
— per share	**1.08**	2.77	2.24
Depreciation and depletion	**9,183,000**	9,159,000	7,783,000
Petroleum and Gas Revenue Tax — deferred	**—**	2,659,000	—
— current	**—**	1,541,000	5,445,000
Alberta Royalty Tax Credit	**(491,000)**	(288,000)	(204,000)
Income taxes — deferred	**760,000**	10,828,000	5,196,000
— current	**—**	578,000	6,489,000
Net earnings	**2,444,000**	13,172,000	17,237,000
— per share	**.21**	1.02	1.28
Balance Sheet			
Working capital (deficiency)	**(4,717,000)**	(1,112,000)	(1,815,000)
Total assets	**120,893,000**	131,946,000	109,081,000
Shareholders' equity	**51,583,000**	49,139,000	49,744,000
— per share	**4.48**	4.27	3.80
Number of shares outstanding December 31	**11,510,485**	11,510,485	13,076,380
Market price per share — high	**7.37**	10.25	13.12
— low	**4.15**	7.00	8.00
Capital Expenditures			
Land	**1,188,000**	4,470,000	2,045,000
Drilling and exploration	**8,825,000**	14,814,000	21,548,000
Production equipment	**4,783,000**	11,760,000	13,657,000
Other	**(877,000)**	1,815,000	1,430,000
TOTAL	**13,919,000**	32,859,000	38,680,000
Government incentive payments	**(4,478,000)**	(3,763,000)	(4,890,000)
Net	**9,441,000**	29,096,000	33,790,000
Operations			
Proven reserves before royalties			
— Petroleum (barrels)	**17,599,000**	20,107,000	19,613,000
— Natural gas (mcf)	**44,252,000**	42,611,000	45,164,000
Production before royalties			
— Petroleum (barrels)	**1,459,000**	1,600,000	1,621,000
— per day	**4,000**	4,400	4,430
— Natural gas (mcf)	**1,354,000**	1,216,000	839,930
— per day	**3,700**	3,300	2,295
Land holdings — gross acres	**1,613,149**	1,616,186	304,753
— net acres	**414,383**	437,307	216,784
Wells drilled — gross	**25**	91	153
— net	**18**	74	131
Number of employees	**80**	88	69

* not available

1983	1982	1981	1980	1979	1978	1977
$	$	$	$	$	$	$
45,370,000	20,730,000	5,715,000	2,583,000	1,110,000	678,000	627,000
32,894,000	13,412,000	2,802,000	1,813,000	718,000	502,000	489,000
2.38	.97	.21	.15	.06	.05	.05
6,162,000	3,469,000	947,000	287,000	170,000	78,000	71,000
—	—	—	—	—	—	—
4,783,000	2,146,000	431,000	—	—	—	—
(433,000)	(521,000)	(312,000)	(165,000)	(80,000)	(35,000)	(35,000)
8,263,000	3,327,000	818,000	614,000	220,000	166,000	175,000
840,000	—	—	—	—	—	—
18,469,000	6,616,000	1,038,000	912,000	328,000	268,000	417,000
1.34	.48	.08	.07	.03	.03	.05
(8,254,000)	(9,001,000)	(306,000)	682,000	1,971,000	(106,000)	(167,000)
83,511,000	55,171,000	30,084,000	17,203,000	9,669,000	2,950,000	1,096,000
39,587,000	20,932,000	14,908,000	9,402,000	8,010,000	1,272,000	886,000
2.86	1.52	1.07	.73	.64	.14	.10
13,821,879	13,815,879	13,998,078	12,791,718	12,551,718	9,251,718	9,096,468
15.12	9.37	5.33	3.08	2.79	1.23	1.00
7.12	3.05	2.58	1.88	.93	.60	.27
1,678,000	2,150,000	3,987,000	410,000	700,000	202,000	176,000
18,532,000	14,136,000	5,379,000	4,358,000	2,255,000	766,000	218,000
15,517,000	11,538,000	3,049,000	3,630,000	1,091,000	154,000	148,000
—	—	—	—	—	—	—
35,727,000	27,824,000	12,415,000	8,398,000	4,046,000	1,122,000	542,000
(4,676,000)	(2,217,000)	(1,228,000)	—	—	—	—
31,051,000	25,607,000	11,187,000	8,398,000	4,046,000	1,122,000	542,000
15,760,000	8,419,000	5,782,000	1,670,000	657,000	*	*
45,050,000	36,618,000	38,898,000	43,357,000	37,052,000	*	*
1,378,094	599,550	211,202	143,051	50,878	38,948	54,313
3,776	1,643	579	391	139	107	149
1,233,846	839,844	1,133,914	343,623	361,320	204,170	267,182
3,380	2,300	3,107	939	990	559	732
303,411	274,594	267,370	226,650	191,638	121,381	*
209,134	187,809	171,672	151,185	124,620	99,627	*
137	104	45	51	24	14	2
116	100	35	32	15	6	2
47	33	15	13	8	5	3

Printed in Canada
Cal/Oka Printing Ltd.

OMEGA
HYDROCARBONS LTD.

1986 ANNUAL REPORT