C

Lochiel Exploration Ltd.

INTERIM REPORT

THIRD QUARTER
1985

TO THE SHAREHOLDERS

EXPLORATION

CANADIAN FRONTIER

The Company, through its association with the Esso/Home consortium in the Beaufort Sea/Mackenzie Delta area, finalized plans for this winter's drilling program.

In the offshore area, two sacrifical beach islands at the Minuk and Arnak locations and a sub-sea berm to accommodate the steel caisson at Kaubvik were completed. Initial plans called for the drilling of all three wells during the 1985-86 winter season, however, due to abnormally heavy sea-ice conditions and a severe storm in September which damaged the rig at Minuk, only the Minuk I-53 well will be spudded this year. Arnak K-06 and Kaubvik I-43 will now be drilled in the latter half of 1986.

Onshore an extensive testing program on the Tuk H-30 well, drilled and suspended this spring, got underway in late November. An additional nine wells are scheduled to be drilled on the West Tuk Tertiary trend this winter with the first well to spud in early December. Six option wells are also planned for the current 1985-86 drilling season. Although the exact locations of these wells are still to be finalized five will be situated along the Tuk Tertiary trend while the sixth has been planned for the north delta area, a few miles east of the old Imperial Ivik J-26 oil discovery. Participation in these option wells will enable Lochiel to earn a maximum of additional interest in onshore matrix acreage outside of the present minimum land blocks (MLB).

Also in the Beaufort Sea, but in Dome operated territory, Lochiel participated through a 1.4% carried working interest and a 0.566% GORR in 15,621 acres within the 44,574 acre discovery block for the Dome Adlartok P-09 well which flowed oil at 4,132 BOPD.

FOREIGN

In Colorado a 720 BOPD well was completed in which the Company has a 3.125% override. The Company now has varying interests in 6 oilwells in Colorado.

In Egypt, through its 2.43% net royalty interest with Gupco, the Company completed three wells on the Sheiba concession. Two wells, Sheiba 18-2 and 42-1, were abandoned as dry holes while the third well, Sheiba 18-1 resulted in an oil discovery. This well tested 860 barrels of 22.4 degree oil and 823 thousand cubic feet of gas per day.

The Company also completed an approximate 250 km seismic program in the offshore Edremit Bay in Turkey through a 10.5% net profits interest with Amoco in licence AR/LOC/2470. Seismic processing and interpretation is now underway prior to determination of prospect drilling locations.

In the British North Sea, a wildcat well with Marathon was abandoned. Our interest was 10%. Also an agreement was signed in October to construct a spur pipeline from Buchan to the Forties field trunkline system and will be on stream by January, 1987. With the pipeline and the new gas lift facilities now operational in the Buchan field, an upgrading of recoverable reserves to 75 million barrels is estimated with an

Lochiel Exploration Ltd.

and Subsidiary Companies

CONSOLIDATED STATEMENT OF INCOME

for the nine months ended October 31, 1985
(unaudited)

	1985	1984
REVENUE		
Oil and Gas Sales	$ 6,566,000	$ 9,008,000
Less: Royalties and Mineral Taxes	949,000	1,638,000
Net Sales	5,617,000	7,370,000
Other Income	49,000	59,000
	$ 5,666,000	$ 7,429,000
EXPENSES		
Operating	1,918,000	1,537,000
General and Administrative	1,097,000	978,000
Interest on Long-Term Financing	1,801,000	2,084,000
Exchange Loss	214,000	121,000
Royalty Tax Recovery	(361,000)	(302,000)
	4,669,000	4,418,000
FUNDS FROM OPERATIONS	$ 997,000	$ 3,011,000
NON-CASH CHARGES		
Depletion, Depreciation and Amortization	2,478,000	2,958,000
Deferred Income Taxes	(2,000)	266,000
	2,480,000	3,224,000
NET INCOME (LOSS) FOR THE PERIOD	$(1,483,000)	$ (213,000)
RESULTS PER SHARE		
Funds From Operations		
Class A Common	5.4¢	21.6¢
Class B Common	6.1¢	18.3¢
Net Income (Loss) for the Period		
Class A Common	(10.4¢)	(1.5¢)
Class B Common	(11.3¢)	(1.3¢)

The Company is proceeding to negotiate the sale of a portion of its foreign assets. If successful, the sale should be concluded in principle by the end of the fourth quarter. Proceeds would be used to reduce long term debt and improve working capital.

The Company has obtained approval to delay continuance under the Business Corporations Act of Alberta until November 30, 1986.

OUTLOOK

Twice yearly at OPEC meetings OPEC ministers seem to forecast that the bottom may drop out of oil prices. This may be rhetoric, used to persuade the non-OPEC exporters like Britain, Nigeria, and Norway to reduce their exports and also to keep investment from expanding in the U.S. and Canada and other areas which may want to develop alternative means of energy. If OPEC can keep oil investment down for another couple of years, the universally expected oil shortage will occur that much quicker, allowing them to move back in control of rising prices.

Lochiel expects that Canadian frontier oil reserves will start to appear more valuable shortly as the public becomes increasingly aware that more oil is being produced each year than is being discovered. In addition, recent federal government announcements have reduced frontier royalties from 10% to 1% and the 25% back-in was eliminated. Foreign ownership restrictions during the exploration stage have also been removed so those Canadians presently in the frontiers can possibly look forward to some advantageous farmouts or financing arrangements with previously disallowed foreign companies.

On the natural gas front unfortunately, Alberta and Canada have literally joined the U.S. "gas bubble" by going to market pricing and it now appears that it will be some time before gas shortages will develop in the U.S. The overall outlook for the oil industry in Canada is good in that the net back per barrel is as high as any place in the world and the geological nature of the country provides that our finding costs are cheaper than in the United States.

Respectfully submitted,

N.W. Taylor
President

anticipated abandonment date of 1994, of which 42.3 million barrels have been produced to date.

WESTERN CANADA

In Alberta, Lochiel drilled one exploration well in the Cessford area which was abandoned after a test of the objective horizon proved the sand to be tight.

The Company also completed a 14 well infill drilling program on its 50% owned Atlee Buffalo gas field. All except one were successfully completed and should add substantially to our cash flow next year.

PRODUCTION

Nine Month Production Summary
Ending October 31, 1985

Area	1985	1984
Canada		
oil	77,897 bbls.	81,822 bbls.
gas	360.9 Mmcf	699.3 Mmcf
U.S.A.		
oil	18,446 bbls.	25,098.7 bbls.
gas	82.2 Mmcf	84.6 Mmcf
U.K.		
oil	51,365 bbls.	77,675.9 bbls.
Totals		
oil	147,708 bbls.	184,596.6 bbls.
gas	443.1 Mmcf	783.9 Mmcf

Lochiel's world wide oil and gas production for the nine months ending October 31, 1985 was 147,708 bbls. of oil and 443.1 Mmcf of gas.

Total oil production was down 20% from 1984, due to the Buchan field being shut down for the first quarter of 1985 for gas lift installations. Since May 20, 1985 the Buchan field has produced 51,365 bbls. net to Lochiel and is surpassing the expected production rates previously projected when the gas lift was first initiated.

Total gas production is down significantly from 1984 due to the shut down of the Alberta Atlee Buffalo gas field during the summer and autumn.

FINANCIAL

For the nine months ended October 31, 1985, oil and gas sales were $6,566,000 compared to $9,008,000 for the same period of 1984. The cash flow from operations was $997,000 compared to $3,011,000 the previous year. The net loss of $1,483,000 compares to a loss of $213,000 for the first nine months of 1984.

The impact of lower oil and gas pricing in 1985 versus 1984 and the shut down of the Buchan field to the end of May and Atlee Buffalo gas field since early June has hampered operating performance. During the period these fields were down, substantial operating costs were incurred to "clean up" operations. This is the primary reason for operating costs being unusually high relative to revenues.

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CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION

for the nine months ended October 31, 1985
(unaudited)

	1985	1984
Cash Provided by (used in) Operating Activities		
Net Income (loss) for the Period	$(1,483,000)	$ (213,000)
Add Charges to Operations Not Requiring a Current Cash Payment		
Depletion, Depreciation and Amortization	2,478,000	2,958,000
Deferred Income Taxes	2,000	266,000
	997,000	3,011,000
Cash Provided by (used in) Financing Activities		
Conversion of Preference Shares	(2,453,000)	—
Issue of Preference Shares	1,782,000	4,333,000
Increase (Decrease) in Long-Term Debt	105,000	2,086,000
Dividends	(420,000)	(128,000)
Increase in Deferred Credits and Other	47,000	—
Issue of Class A and Class B Common Shares	2,453,000	32,000
Net Change in Working Capital Balances Other than Cash	(2,605,000)	561,000
	(1,091,000)	6,884,000
Cash Provided by (used in) Investment Activities		
Purchase of Petroleum and Natural Gas Properties	(2,114,000)	(7,772,000)
Decrease (Increase) in Investments and Long-Term Receivables	(195,000)	(276,000)
Foreign Currency Translation Adjustments	(62,000)	(2,066,000)
	(2,371,000)	(10,114,000)
Net Increases (Decrease) in Cash During the Period	(2,465,000)	(219,000)
Cash Position at Beginning of Year	2,566,000	219,000
Cash Position at End of Period	$ 101,000	$ —
Net Changes in Working Capital Balances Other than Cash		
Accounts Receivable	(3,126,000)	(1,226,000)
Participant Notes Receivable	2,588,000	1,206,000
Prepaid Expenses	—	34,000
Bank Loan	—	(65,000)
Accounts Payable and Accrued Liabilities	(1,761,000)	612,000
Current Portion of Long-Term Debt	(306,000)	—
	$(2,605,000)	$ 561,000

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