

## MANAGEMENT'S REPORT

The financial statements of Zargon Oil & Gas Ltd. were prepared by management in accordance with accounting principles generally accepted in Canada. The financial and operating information presented in this annual report is consistent with that shown in the financial statements.

Management has designed and maintains a system of internal controls to provide reasonable assurance that all assets are safeguarded and to facilitate the preparation of financial statements for reporting purposes. Timely release of financial information sometimes necessitates the use of estimates when transactions affecting the current accounting period cannot be finalized until future periods. Such estimates are based on careful judgements made by management.

External auditors appointed by the shareholders have conducted an independent examination of the corporate and accounting records in order to express their opinion on the financial statements.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal control. The Board exercises this responsibility through its Audit Committee. The Audit Committee, which consists of non-management directors has met with the external auditors and management in order to determine that management has fulfilled its responsibilities in the preparation of the financial statements. The Audit Committee has reported its findings to the Board of Directors who have approved the financial statements.

Signed

J. O. McCutcheon  
Chairman

Signed

C. H. Hansen  
President and Chief Executive Officer

## AUDITORS' REPORT

### To the Shareholders of Zargon Oil & Gas Ltd.

We have audited the balance sheets of Zargon Oil & Gas Ltd. as at December 31, 1999 and 1998 and the statements of income and retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in Canada. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Corporation as at December 31, 1999 and 1998 and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in Canada.

Calgary, Canada  
March 3, 2000

Signed

Ernst & Young LLP  
Chartered Accountants

## BALANCE SHEETS

| As at December 31<br>(\$ thousand)       | 1999   | 1998   |
|--|--------|--------|
| <b>ASSETS</b> [note 3]                   |        |        |
| <b>CURRENT</b>                           |        |        |
| Cash                                     | 116    | 194    |
| Accounts receivable                      | 5,165  | 2,734  |
| Deferred income taxes                    | –      | 300    |
| Prepaid expenses and deposits            | 361    | 169    |
|  | 5,642  | 3,397  |
| <b>PROPERTY AND EQUIPMENT</b> [note 2]   | 50,383 | 38,189 |
|  | 56,025 | 41,586 |
| <br><b>LIABILITIES</b>                   |        |        |
| <b>CURRENT</b>                           |        |        |
| Accounts payable and accrued liabilities | 5,787  | 3,639  |
| <b>LONG-TERM DEBT</b> [note 3]           | 14,116 | 6,179  |
| <b>FUTURE SITE RESTORATION COSTS</b>     | 1,265  | 860    |
| <b>DEFERRED INCOME TAXES</b>             | 2,334  | 1,588  |
|  | 23,502 | 12,266 |
| <br><b>SHAREHOLDERS' EQUITY</b>          |        |        |
| Share capital and warrants [note 4]      | 20,742 | 21,316 |
| Retained earnings                        | 11,781 | 8,004  |
|  | 32,523 | 29,320 |
|  | 56,025 | 41,586 |

See accompanying notes

Approved on behalf of the Board:

Signed  
C.H. Hansen  
Director

Signed  
J.O. McCutcheon  
Director

## STATEMENTS OF INCOME AND RETAINED EARNINGS

### For the years ended December 31

(\$ thousand, except for per share amounts)

|  | 1999          | 1998          |
|--|---------------|---------------|
| <b>INCOME</b>  |               |               |
| Oil and gas sales                                      | 24,048        | 14,264        |
| Hedging income (loss) <sup>[note 7]</sup>              | (1,095)       | 180           |
| Royalties (net of Alberta royalty tax credit)          | (4,033)       | (1,837)       |
|  | <u>18,920</u> | <u>12,607</u> |
| <b>EXPENSES</b>  |               |               |
| Production   | 6,120         | 5,080         |
| Administration   | 1,463         | 1,252         |
| Interest on long-term debt                             | 592           | 377           |
| Site restoration                                       | 585           | 482           |
| Depreciation and depletion                             | 4,750         | 3,659         |
|  | <u>13,510</u> | <u>10,850</u> |
| <b>INCOME BEFORE INCOME TAXES</b>                      | <u>5,410</u>  | <u>1,757</u>  |
| <b>INCOME TAXES <sup>[note 5]</sup></b>                |               |               |
| Deferred   | 1,046         | 430           |
| Current  | 103           | 77            |
|  | <u>1,149</u>  | <u>507</u>    |
| <b>NET INCOME FOR THE YEAR</b>                         | 4,261         | 1,250         |
| <b>RETAINED EARNINGS, BEGINNING OF YEAR</b>            | 8,004         | 6,754         |
| <b>REPURCHASE OF COMMON SHARES <sup>[note 4]</sup></b> | (484)         | —             |
| <b>RETAINED EARNINGS, END OF YEAR</b>                  | <u>11,781</u> | <u>8,004</u>  |
| <b>EARNINGS PER COMMON SHARE <sup>[note 6]</sup></b>   |               |               |
| Basic  | 0.29          | 0.10          |
| Fully diluted  | 0.29          | 0.10          |

See accompanying notes

## STATEMENTS OF CASH FLOWS

| For the years ended December 31                                    | 1999            | 1998            |
|--|-----------------|-----------------|
| (\$ thousand, except for per share amounts)                        |                 |                 |
| <b>OPERATING ACTIVITIES</b>  |                 |                 |
| Net income for the year  | 4,261           | 1,250           |
| Add non-cash items:  |                 |                 |
| Depreciation and depletion   | 4,750           | 3,659           |
| Site restoration   | 585             | 482             |
| Deferred income taxes  | 1,046           | 430             |
| Cash flow from operations  | 10,642          | 5,821           |
| Changes in non-cash working capital                                | (2,221)         | 70              |
|  | <u>8,421</u>    | <u>5,891</u>    |
| <b>FINANCING ACTIVITIES</b>  |                 |                 |
| Long-term debt   | 7,937           | 1,307           |
| Repurchase of common shares  | (1,058)         | –               |
| Issuance of common shares  | –               | 5,933           |
| Issue costs of common shares                                       | –               | (421)           |
|  | <u>6,879</u>    | <u>6,819</u>    |
| <b>INVESTING ACTIVITIES</b>  |                 |                 |
| Acquisition of property and equipment                              | (17,083)        | (13,071)        |
| Disposal of property and equipment                                 | 138             | 594             |
| Site restoration expenditures                                      | (180)           | (228)           |
| Changes in non-cash working capital                                | 1,747           | (29)            |
|  | <u>(15,378)</u> | <u>(12,734)</u> |
| DECREASE IN CASH   | (78)            | (24)            |
| CASH, BEGINNING OF YEAR  | 194             | 218             |
| CASH, END OF YEAR  | <u>116</u>      | <u>194</u>      |
| <b>CASH FLOW FROM OPERATIONS PER SHARE <small>[note 6]</small></b> |                 |                 |
| Basic  | 0.72            | 0.45            |
| Fully diluted  | 0.70            | 0.43            |

See accompanying notes

## **1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

### **Description of Business**

Zargon Oil & Gas Ltd. (the "Corporation") is a public company incorporated under the Business Corporations Act (Alberta) engaged in the production, development and exploration of oil and gas solely in Canada.

### **Property and Equipment**

The Corporation follows the full cost method of accounting for its oil and gas operations whereby all costs related to the acquisition of petroleum and natural gas rights are capitalized. Such costs include land and lease acquisition costs, annual carrying charges of non-producing properties, geological and geophysical costs, and costs of drilling and equipping productive and non-productive wells. Proceeds from disposals are recorded as a reduction of the related expenditures without recognition of a gain or loss unless the disposal would result in a change of 20 percent or more in the depletion rate.

Depreciation and depletion of capitalized costs is computed using the unit-of-production method based on the estimated proven reserves of oil and gas determined by independent consultants. Reserves are converted to common units on the basis that ten thousand cubic feet of gas is equivalent to one barrel of oil and liquids.

The Corporation applies a ceiling test to capitalized costs to ensure that such costs do not exceed estimated future net revenues from production of proven reserves at year end market prices less future production, general and administrative, financing, site restoration, and income tax costs plus the lower of cost or estimated market value of unproved properties.

Depreciation of office equipment is provided using the declining balance method at an annual rate of 20 percent.

### **Future Site Restoration Costs**

Estimated future site restoration and removal costs, net of salvage values, are provided using the unit-of-production method based on estimated proven reserves. The annual charge is accounted for as an expense and the accumulated provision is reflected as a deferred liability. Actual site restoration costs are deducted from the accumulated provision in the year incurred.

### **Financial Instruments**

Financial instruments of the Corporation consist mainly of cash, accounts receivable, accounts payable and accrued liabilities, and long-term debt. As at December 31, 1999 and 1998, there are no significant differences between the carrying values of these amounts and their estimated market values.

The Corporation enters into swap contracts, as described in note 7, that are designed as and are effective as a hedge against changes in commodity prices and foreign exchange rates. Gains and losses on the hedging contracts are deferred and are recognized when the hedged transaction occurs.

### **Measurement Uncertainty**

The amounts recorded for depletion and depreciation of property and equipment and for site restoration and reclamation are based on estimates of reserves and future costs. By their nature, these estimates and those related to the future cash flows used to assess impairment, are subject to measurement uncertainty and the impact on the financial statements of future periods could be material.

### Joint Operations

The majority of the oil and gas operations of the Corporation are conducted jointly with others and accordingly these financial statements reflect only the proportionate interests of the Corporation in such activities.

### Per Share Amounts

Per share amounts are calculated using the weighted average number of common shares outstanding during the year. The fully diluted earnings per share calculation assumes the exercise of vested stock options outstanding.

### Income Taxes

The Corporation follows the deferral method of accounting under which the income tax provision is based on the earnings reported in the accounts. Under this method, the Corporation provides for deferred income taxes to the extent that income taxes otherwise payable are reduced by capital cost allowances and exploration and development costs in excess of the depletion and depreciation provisions recorded in the accounts.

## 2. PROPERTY AND EQUIPMENT

| (\$ thousand)                       | 1999          |  |                   |
|-------------------------------------|---------------|--|-------------------|
|                                     | Cost          | Accumulated<br>Depreciation and<br>Depletion | Net Book<br>Value |
| Petroleum and natural gas rights    | 54,928        | 14,180                                       | 40,748            |
| Production equipment and facilities | 13,256        | 3,946  | 9,310             |
| Office equipment                    | 547           | 222  | 325               |
|                                     | <b>68,731</b> | <b>18,348</b>                                | <b>50,383</b>     |

  

| (\$ thousand)                       | 1998          |  |                   |
|-------------------------------------|---------------|--|-------------------|
|                                     | Cost          | Accumulated<br>Depreciation and<br>Depletion | Net Book<br>Value |
| Petroleum and natural gas rights    | 40,864        | 10,422                                       | 30,442            |
| Production equipment and facilities | 10,475        | 3,018  | 7,457             |
| Office equipment                    | 447           | 157  | 290               |
|                                     | <b>51,786</b> | <b>13,597</b>                                | <b>38,189</b>     |

At December 31, 1999, petroleum and natural gas rights include \$5,431,000 (1998 – \$2,810,000) relating to undeveloped properties which have been excluded from the depletion calculation.

## 3. LONG-TERM DEBT

The Corporation has a revolving demand credit facility which provides for a line of credit of \$25,000,000 bearing interest at prime (December 31, 1999 – 6.5 percent; December 31, 1998 – 6.75 percent) and has pledged an assignment of accounts receivable, a first floating charge on all of the assets and a fixed charge over certain property and equipment as collateral. While the credit facilities are of a demand nature, the bank has stated that it is not their present intention to demand repayment nor do they have information that would lead them to anticipate that the loan would be demanded before January 1, 2001. Accordingly, the loan is classified as long term.

#### 4. SHARE CAPITAL AND WARRANTS

The Corporation is authorized to issue an unlimited number of common shares and an unlimited number of first preferred shares and second preferred shares.

##### COMMON SHARES:

| (thousand)                            | 1999             |               | 1998             |               |
|---------------------------------------|------------------|---------------|------------------|---------------|
|                                       | Number of Shares | Amount (\$)   | Number of Shares | Amount (\$)   |
| <b>SHARES ISSUED,</b>                 |                  |               |                  |               |
| Balance, beginning of year            | 13,008           | 16,323        | 12,553           | 15,610        |
| Conversion of Special Warrants        | 1,800            | 4,993         | –                | –             |
| Normal course issuer bid              | (388)            | (574)         | –                | –             |
| Stock options exercised               | –                | –             | 455              | 713           |
|                                       | <b>14,420</b>    | <b>20,742</b> | <b>13,008</b>    | <b>16,323</b> |
| <b>SHARES TO BE ISSUED,</b>           |                  |               |                  |               |
| Special Warrants (net of issue costs) | –                | –             | 1,800            | 4,993         |
|                                       | <b>14,420</b>    | <b>20,742</b> | <b>14,808</b>    | <b>21,316</b> |

On November 18, 1998, the Corporation issued 1,800,000 Special Warrants at a price of \$2.90 for net proceeds of \$4,799,000 after costs of issuance of \$421,000. Each Special Warrant entitles the holder to exchange the Special Warrant for one common share at no additional cost. In 1999, 1,800,000 common shares were issued upon exercise of these special warrants.

Share issue costs in 1998 of \$421,000 are stated net of related deferred income taxes of \$194,000.

In accordance with the Normal Course Issuer Bid filed with The Toronto Stock Exchange on June 22, 1999, the Corporation is permitted to purchase and cancel up to 970,000 of its common shares prior to June 23, 2000. During 1999, a total of 388,000 shares were purchased and cancelled at an average cost of \$2.71 per share. The aggregate cost of common shares purchased and cancelled of \$1,056,000 was recorded as a charge against share capital of \$574,000 for the average carrying value of the common shares, with the balance of \$484,000 charged against retained earnings.

Stock options to acquire common shares are granted to employees and directors from time to time at exercise prices equal to the market value of the shares at the date of the grant. No compensation expense is recognized for grants under this Plan when stock or stock options are issued. Any consideration paid on exercise of stock options is credited to share capital.

The Corporation has reserved 1,480,000 shares at December 31, 1999 for issuance under the stock option plan.

A summary of the status of the Company's stock option plans as at December 31, 1999 and 1998, and changes during the years ending on those dates is presented below:

| OPTIONS                          | 1999         |                                 | 1998       |                                 |
|----------------------------------|--------------|---------------------------------|------------|---------------------------------|
|                                  | Shares       | Weighted Average Exercise Price | Shares     | Weighted Average Exercise Price |
|                                  | (thousand)   | (\$)                            | (thousand) | (\$)                            |
| Outstanding at beginning of year | 985          | 2.47                            | 960        | 1.77                            |
| Granted                          | 470          | 2.61                            | 510        | 2.92                            |
| Exercised                        | –            | –                               | (455)      | 1.57                            |
| Cancelled                        | (5)          | 2.83                            | (30)       | 2.50                            |
| Outstanding at end of year       | <b>1,450</b> | <b>2.51</b>                     | <b>985</b> | <b>2.47</b>                     |
| Options exercisable at year end  | <b>1,005</b> | <b>2.46</b>                     | <b>613</b> | <b>2.21</b>                     |

The following table summarizes information about stock options outstanding at December 31, 1999:

| Range of Exercise Prices | Options Outstanding            |   |                                 | Options Exercisable            |                                 |
|--------------------------|--------------------------------|---|---------------------------------|--------------------------------|---------------------------------|
|                          | Number Outstanding at 12/31/99 | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price | Number Exercisable at 12/31/99 | Weighted Average Exercise Price |
| (\$)                     | (thousand)                     |   | (\$)                            | (thousand)                     | (\$)                            |
| 1.55 to 1.65             | 292                            | 1 year                                      | 1.57                            | 292                            | 1.57                            |
| 2.14 to 2.59             | 235                            | 3 years                                     | 2.35                            | 198                            | 2.35                            |
| 2.60                     | 363                            | 4.3 years                                   | 2.60                            | –                              | –                               |
| 2.90 to 3.00             | 420                            | 4 years                                     | 2.99                            | 375                            | 2.99                            |
| 3.05 to 3.10             | 140                            | 3 years                                     | 3.06                            | 140                            | 3.06                            |
|                          | 1,450                          |   | 2.51                            | 1,005                          | 2.46                            |

## 5. INCOME TAXES

Income taxes differ from the amounts which would be obtained by applying statutory income tax rates to income before income taxes as follows:

| (\$ thousand)   | 1999    | 1998  |
|---|---------|-------|
| Computed income taxes at approximately 45 percent               | 2,435   | 790   |
| Add (deduct) income tax effect of:                              |         |       |
| Non-deductible crown charges, net of Alberta royalty tax credit | 1,079   | 411   |
| Resource allowance  | (1,377) | (754) |
| Non-tax base depletion (net)                                    | (55)    | 4     |
| Benefit of losses not previously recognized                     | (1,042) | –     |
| Large corporation and capital taxes                             | 103     | 77    |
| Other   | 6       | (21)  |
|   | 1,149   | 507   |

As at December 31, 1999, the Corporation has exploration and developments costs, undepreciated capital costs, unamortized share issue costs and loss carry forwards available for deduction against future taxable income in aggregate of approximately \$41,895,000 (December 31, 1998 – \$36,400,000).

## 6. WEIGHTED AVERAGE NUMBER OF COMMON SHARES

| (thousand)   | 1999   | 1998   |
|--|--------|--------|
| Weighted average number of common shares outstanding during the year               | 14,686 | 13,025 |
| Fully diluted weighted average number of common shares outstanding during the year | 15,691 | 14,138 |

Fully diluted earnings and cash flow from operations per share reflect the dilutive effect of the exercise of the vested stock options outstanding. Earnings on the funds which would have been received had the options been exercised of \$340,000 (1998 – \$137,000), net of tax, has been imputed at a rate of 13.8 percent (1998 – 4.8 percent) per annum after taxes.

## 7. FINANCIAL INSTRUMENTS

The Corporation is a party to certain off-balance sheet derivative financial instruments which have fixed the price of a portion of its oil and gas production. The Corporation enters into these contracts for hedging purposes only, in order to protect a portion of its future Canadian cash flow from the volatility of crude oil and gas commodity prices.

The Corporation enters into currency contracts for hedging purposes because the price received for its products varies in close relationship to the U.S. dollar currency exchange rate.

The Corporation has outstanding contracts at December 31, 1999 and 1998 as follows:

|                      | Volume           | Average Fixed Price Range         | Range of Terms         |
|----------------------|------------------|-----------------------------------|------------------------|
| AT DECEMBER 31, 1999 |                  |                                   |                        |
| Crude oil swaps      | 91,400 bbl       | \$19.05 – \$20.90 US              | Jan. 1/00 – Dec. 31/00 |
| Oil collar           | 36,600 bbl       | \$19.00 US Put<br>\$24.70 US Call | Jan. 1/00 – Dec. 31/00 |
| Natural gas swaps    | 609,000 GJ       | \$2.73 – \$2.97/GJ                | Jan. 1/00 – Oct. 31/00 |
| Currency swaps       | \$255,000 US/mo. | 1.5165 – 1.5435 exch.             | Jan. 1/00 – Dec. 31/01 |
| Interest rate swap   | 5.35% in.        | \$5,000,000 CAD                   | Jan. 1/00 – Apr. 30/02 |
| AT DECEMBER 31, 1998 |                  |                                   |                        |
| Natural gas swaps    | 760,000 GJ       | \$2.19 – \$2.62/GJ                | Jan. 1/99 – Oct. 31/99 |
| Currency swaps       | \$255,000 US/mo. | 1.4382 – 1.5435 exch.             | Jan. 1/99 – Dec. 31/00 |

At December 31, 1999, the cost to settle the above swap transactions would have been \$975,000 (1998 – \$427,000). These instruments have no book values recorded in the financial statements.