2001 Annual Report

Cathedral
Energy Services Ltd.

CORPORATE PROFILE

Best in Class, Best in Service

Cathedral Energy Services Ltd. is engaged in the business of providing drilling services and related equipment rental to oil and natural gas exploration and development companies in western Canada and the Rocky Mountain region of the United States. Cathedral markets its services under two brand names: Directional Plus which provides horizontal and directional drilling services; and CAT Downhole Tools which provides drilling jars, shock tools, and high performance drilling motors on a rental basis. Cathedral strives to provide its clients with value added technologies and solutions to meet their drilling requirements. Its mandate is to supply "Best in Class, Best in Service" equipment and personnel to its clients.

The Company's Common Shares trade on the TSE under the symbol "CAT".

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FINANCIAL HIGHLIGHTS

Figures in thousands,
except per share amounts

	2001	2000	1999	[8 months] 1998
Revenues	**23,444**	19,036	5,793	1,561
Gross margin %	**54%**	48%	43%	54%
EBITDA *	**7,783**	5,678	1,526	280
Funds from operations	**7,491**	5,282	1,133	221
Income before income taxes	**5,102**	4,107	1,007	135
Net income	**5,206**	4,471	602	105
Per share - basic	**0.63**	0.75	0.28	0.06
Per share - diluted	**0.24**	0.23	0.06	0.01
Weight outstanding shares				
Basic	**8,248**	5,946	2,126	1,650
Diluted	**21,479**	19,395	10,931	8,484
Total assets	**25,278**	20,247	7,607	2,235
Total long-term debt	**5,110**	3,431	1,676	615
Shareholders' equity	**16,578**	11,372	3,013	345

* Earnings before interest, taxes, depreciation and amortization

FORWARD-LOOKING STATEMENTS

This Annual Report may contain forward-looking statements, including statements regarding the business and anticipated financial performance of Cathedral. These forward-looking statements involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of the Company to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. A number of factors could cause actual results to differ materially from those in the forward-looking statements, including, but not limited to, fluctuations in world oil and North American natural gas prices, weather, access to capital markets, competition, changes in technology and government policies. In light of the significant uncertainties inherent in the forward-looking statements included herein, the inclusion of such information should not be regarded as a representation by the Company or any other person that the objectives and plans of the Company will be achieved.

PRESIDENT'S MESSAGE

The year 2001 was exciting with Cathedral delivering its fourth consecutive record year in all financial areas. This was accomplished in a year of high volatility for oil and natural gas pricing which saw record commodity prices in the early part of the year and significantly lower prices in the later part of the year. The Company saw a 23% increase in revenues over fiscal 2000 despite an 11% decrease in the number of horizontal and directional wells drilled in western Canada. This was accomplished through an increase in market share and increased equipment rental revenues.

The outlook for the industry in the short term is of some concern with activity levels expected to be soft in the first half of 2002. This is primarily due to depressed natural gas pricing, which has been a function of the abundance of natural gas in storage. However, with the cut back in natural gas drilling and the high decline rates of existing fields, it is expected that this concern will be short lived.

Cathedral is in an excellent position to handle this downturn. The Company was founded in the last downturn (1998/1999) and has proven its ability to operate in a financially responsible manner and gain market share in adverse conditions.

In 2001, the Company spent $7.3 million on capital additions to expand its capabilities. This included the addition of 3 positive pulse retrievable MWD systems which allows the operator to wireline retrieve the system in the event the drill pipe becomes stuck in the hole. The second key area of expansion included the addition of downhole drilling jars, shock tools, stabilizers and related equipment to be utilized not only in directional wells, but also vertical wells. This equipment is marketed under the brand name of CAT Downhole Tools.

Mark L. Bentsen
President and Chief Executive Officer

In late October 2001, Cathedral, through its U.S. wholly owned subsidiary, Cathedral Energy Services Inc., established itself in the Rocky Mountain region of the United States. The first phase of the U.S. expansion was by way of renting downhole performance equipment to a senior Canadian producer with international operations for use in the DJ Basin within the State of Colorado.

The second phase of the U.S. expansion was to provide directional drilling in the same area and the Company commenced providing such services in January of 2002.

To date, the move to the Rocky Mountain region of the U.S. has been of great value to the Company and we look forward to having a full year of revenues from this area in 2002. The current plans are to further expand this region during the balance of 2002.

Our focus will be to continue to strengthen the balance sheet by reducing debt and improving the working capital position. This will position the Company to take advantage of potential acquisition opportunities as well as put Cathedral in a position for rapid growth when the market turns positive. As a result of extensive capital asset and personnel additions over the past years, the Company is in a position to significantly leverage these investments.

We thank our customers and suppliers for their continuing confidence and support. Cathedral is committed to providing its customers with drilling services and solutions that will help them achieve and maintain a competitive advantage in a dynamic business sector. As well, we would like to take this opportunity to thank our shareholders for their ongoing support and to acknowledge the effort of our employees.

Mark Bentsen

Mark L. Bentsen
President and Chief Executive Officer
April 15, 2002

OPERATIONS REVIEW

Cathedral is engaged in the business of providing drilling services and related equipment rental to oil and natural gas exploration and development companies in western Canada and the Rocky Mountain region of the United States. The Company offers its services under the brand names: Directional Plus and CAT Downhole Tools.

Directional Plus provides horizontal, directional and underbalanced drilling services. These services are provided in conjunction with the use of drilling rigs provided by drilling contractors who deal independently with Directional Plus' customers. CAT Downhole Tools provides drilling jars, shock tools and high performance drilling motors on a rental basis for both directional and vertical applications.

During Q4 of 2001, the Company, through its U.S. wholly owned subsidiary, Cathedral Energy Services Inc., commenced renting downhole performance drilling tools in the Rocky Mountain region of the United States. Cathedral is continuing with its low risk U.S. expansion plan by first providing services to Canadian based producers operating in the United States.

Equipment and Technology

During 2001, Directional Plus added 3 Geolink positive pulse Measurement While Drilling ("MWD") systems to its existing fleet of 14 Geolink negative pulse MWD systems for a total capacity of 17 MWD systems. This compares with 18 (14 owned and 4 leased) MWD systems at December 31, 2000. In Q1/Q2 of 2001, the leased MWD systems were returned to the supplier due to the seasonality related low utilization of this equipment, the opportunity to reduce leasing costs, and the fact that Directional Plus was expecting receipt of its order for 3 positive pulse MWD systems during Q3 of 2001. The acquisition of equipment over the past three years has allowed the Company to minimize its reliance on third-party rentals, thereby reducing overall costs.

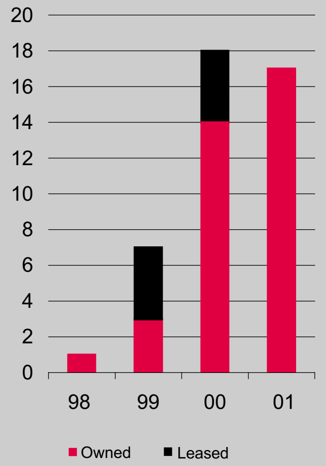
The addition of positive pulse MWD systems in our fleet is significant in that they are wireline retrievable in the event the drill string becomes stuck in the hole. In addition, these systems operate at a lower operating pressure and therefore allow the equipment to be run on smaller drilling rigs with limited pressure capabilities.

During Q4 of 2001, the Company commenced reviewing sources of available Electro-Magnetic ("EM") MWD technology and this process will continue into 2002. The Company expects to add EM-MWD technology to its fleet of MWD systems, with prototype testing to commence in Q2 of 2002.

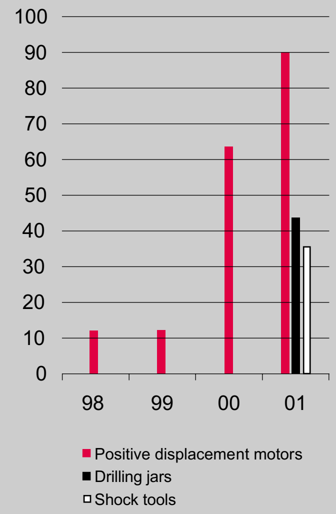
Reliability of equipment continues to be a prime objective of Cathedral. Extensive due diligence in equipment selection, high quality assurance/control, and implementation of a continuous improvement program has enabled the Company to operate equipment with the highest reliability rating in the Canadian marketplace. The result has been client cost savings and a reputation for delivering value added service, which has allowed Cathedral to increase its market share.

As at December 31, 2001, Directional Plus and CAT Downhole Tools shared a fleet of 89 positive displacement mud motors. This compares to 62 motors at December 31, 2000. Approximately 87% of the motor fleet consists of performance drilling motors, which have upwards of double the torque capacity of conventional drilling motors. Use of performance motors allows the customer to select more aggressive bits, and drill with substantially higher weights, resulting in significantly reduced drilling time and costs. This gives Cathedral a competitive advantage in overall cost performance and service delivery as compared to some of our competitors.

Number of MWD Systems
as of December 31



Positive Displacement Motors, Drilling Jars and Shock Tools
as of December 31



With the establishment of CAT Downhole Tools in Q3 of 2001, the Company acquired 43 drilling jars and 35 shock tools. The services provided by CAT Downhole Tools is complementary to Directional Plus' business in that drilling jars and shock tools are utilized in Directional Plus' operations. As well, the increased mud motor fleet provides Directional Plus with a wider range of sizes to draw upon for its operations. CAT Downhole Tools targets performance drilling in vertical drilling applications.

Personnel

One of Cathedral's many strengths is its personnel, whether in the field, service centers or head office. The management group, operations staff, support staff and field staff are recognized by clients and competitors as being among the best in the industry. The management group has in excess of 150 years of combined drilling industry and directional drilling experience.

The Company continues to utilize the services of consultants for the performance of fieldwork. As at December 31, 2001, the Company used the services of 33 directional drilling and 23 MWD field consultants. The strategy of using field consultants on contract has allowed the Company to operate with lower fixed overhead costs and remain financially profitable in seasonal low activity periods while taking advantage of the specialization these consultants have to offer.

Facilities

The Company operates out of three locations. Head office is located in downtown Calgary and houses the operations, engineering, sales and administration personnel, allowing for effective service delivery to the client base located primarily in downtown Calgary. The Company's MWD service center is located in south Calgary and its mud motor, drilling jar and shock tool service center is located in Nisku, Alberta. From its inception, the Company strategically pursued the goal of conducting equipment repairs and maintenance in house and that goal was attained in 2000. By assuming control over repairs and maintenance, the Company has been able to reduce operating costs, improve reliability and increase utilization of equipment by reducing the service turn-around time.

Health, Safety and Environment

Within the operations of Cathedral, health, safety and environment are a very important issue. The Company maintains a comprehensive system, which effectively combines health, safety and environment policies with loss control. The system involves a continuous improvement process that has allowed the Company to manage and minimize losses in all aspects of the Company's business, including most importantly, ensuring a safe work environment for both our employees and the public at large. In 2001, as in 2000, the Company had no lost time accidents.

The Company's health, safety and environment policies have allowed it to obtain and maintain its Certificate of Recognition ("COR"), which is issued through the partnerships program with Alberta Human Resources and Employment and the Petroleum Industry Training Service. The COR program is a formal acknowledgement that the employer has successfully implemented a basic workplace health and safety management system. A COR is often a pre-requisite for a company's services being considered for contract purposes.

Outlook

Over the past three years, Cathedral has invested significantly in equipment and personnel and is now in a very good position to leverage those investments. Even though the number of horizontal and directional wells drilled in 2001 decreased from record levels in 2000 (11% decrease), the Company was able to significantly increase its revenue (23%), mainly by way of increased market share.

During 2001, Cathedral obtained access to technology that allows it to compete in the Steam Assisted Gravity Drainage ("SAGD") market. The proposed SAGD projects should lead to a large market for drilling the required parallel horizontal well bores.

In January of 2002, the Company commenced providing directional drilling services in the Rocky Mountain region of the United States. The Company will monitor the results of this U.S. expansion plan and, if successful, the third stage of the overall plan will be implemented which includes pursuing additional revenue opportunities from U.S. based oil and natural gas producers.

The Company will continue to monitor other opportunities that exist in the domestic and international market place.

(Left to right)

Graham Challand - Operations Co-ordinator

Randy Pustanyk - Vice President, Operations

Aurele Maurice - Vice President, Sales and Marketing

Jeff Morden - Vice President, Engineering

Paul Thebeau - Operations Manager

Scott MacFarlane - Chief Financial Officer

MANAGEMENT'S DISCUSSION & ANALYSIS

Financial Results

Revenues and Operating Expenses

$ '000	2001	2000	Change	%
Revenues	$ 23,444	$ 19,036	$ 4,408	23
Operating expenses	10,703	9,827	876	9
Gross margin - $	$ 12,741	$ 9,209	$ 3,532	38
Gross margin - %	54.4%	48.4%		

For the year ended December 31, 2001, revenues increased $4,408,000 or 23% to $23,444,000. Directional Plus accounted for $22,800,000 or 97% of total revenues. The increase in Directional Plus revenues is a function of: (i) an increase in the number of activity days (2001 - 2,824; 2000 - 2,289); and (ii) a decrease in the average revenue per activity day (2001 - $8,074; 2000 - $8,207). The change in the number of activity days from 2000 to 2001 is related to the Company's ability to increase its market share. During 2001, Directional Plus was able to add a number of junior, intermediate and senior oil and natural gas exploration and development companies to its customer list.

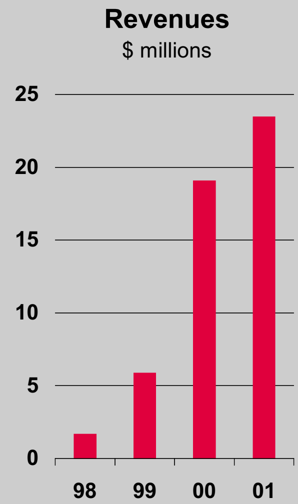
The gross margin increased from 48.4% in 2000 to 54.4% in 2001. This increase is mainly attributable to the Company's decreased reliance on third-party rentals, its continuing drive to reduce overall operating costs and the contribution by CAT Downhole Tools which generates a gross margin higher than that of Directional Plus.

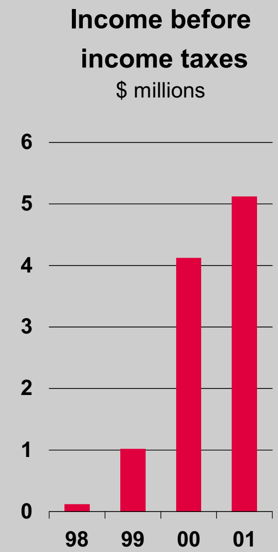
General and administrative expenses

$ '000	2001	2000	Change	%
General and administrative expenses	$ 4,966	$ 3,666	$ 1,300	35

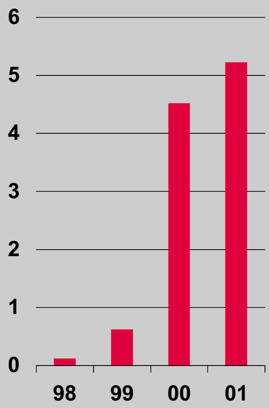
General and administrative expenses increased $1,300,000 (35%) from $3,666,000 in 2000 to $4,966,000 in 2001. As a percentage of revenues, general and administrative expenses were 21.2% and 19.3% for 2001 and 2000, respectively.

The increase in general and administrative expenses is mainly attributable to public company, personnel and occupancy costs. The later two cost items were incurred to facilitate the Company's current and future growth.

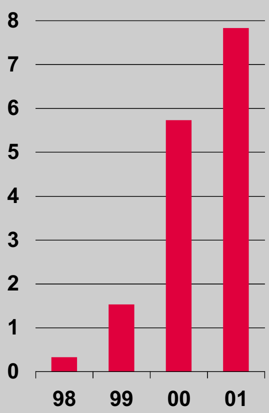




Net income
$ millions



EBITDA
$ millions



Depreciation

$ ‘000	**2001**	2000	Change	%
Depreciation	**$ 2,417**	$ 1,348	$ 1,069	79

Depreciation has increased from $1,348,000 in 2000 to $2,417,000 in 2001. The $1,069,000 or 79% increase is a result of the Company's continued investment in its capital asset base. Net capital asset additions for 2001 were $7,212,000.

As a percentage of revenues, depreciation expense has increased from 7.1% in 2000 to 10.3% in 2001. This increase is a direct result of the Company purchasing more revenue generating capital assets and therefore reducing its reliance on leased/rented equipment to produce revenue.

Interest on long-term debt

$ ‘000	**2001**	2000	Change	%
Interest on long-term debt	**$ 264**	$ 223	$ 41	18

Interest on long-term debt increased $41,000 to $264,000 in 2001 from $223,000 in 2000. The increase in interest on long-term debt is related to an increase in the average level of long-term debt outstanding in 2001 versus in 2000 but the overall increase in interest in long-term debt was partially offset by a decrease in the effective borrowing rate. The decrease in the effective borrowing rate is attributed to: (i) reduction in the bank prime lending rate; and (ii) a renegotiation of the Company's credit facility effective June 2001 that provided for a decrease in the effective interest rate from prime plus 1.5% to prime plus 0.75%.

Income taxes

$ ‘000	**2001**	2000	Change	%
Income taxes (reduction)	**$ (105)**	$ (364)	$ 259	71

The 2001 income tax reduction of $105,000 (2000 - $364,000) is net of the benefit of reduction in the overall income tax provision for: i) amortization and adjustment of the deferred credit in the amount of $978,000 (2000 - $1,223,000) and; ii) reduction in the valuation allowance related to the future income tax asset in the amount of $1,640,000 (2000 - $1,037,000).

Financial Condition and Liquidity

Working capital and funds from operations

Working capital of $942,000 at December 31, 2001 increased $855,000 from $87,000 at December 31, 2000. The increase in working capital is attributable to the increase in cash flow from operations. Funds from operations for 2001 increased $2,209,000 to $7,491,000 ($0.35 per share - diluted) from $5,282,000 ($0.27 per share - diluted) in 2000.

Investing Activities

In 2001, Cathedral continued with its extensive investment in capital assets. Net capital additions were $7,212,000 in 2001 and $8,370,000 in 2000. As at December 31, 2001, the Company owns 17 (2000 - 14) MWD systems, 89 (2000 - 62) mud motors, 43 (2000 - nil) drilling jars and 35 (2000 - nil) shock tools. For 2001 and 2000, the disposal of capital assets relates to the recovery of capital costs for equipment that was lost downhole.

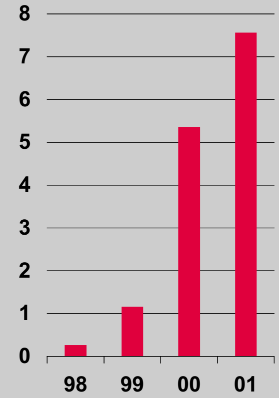
Financing activities

As a result of renegotiating its credit facility in June 2001, the Company was able to increase its operating line by $1,000,000 to $2,500,000 and reduce by 0.25% the interest rate formula applicable to the operating line. At December 31, 2001, the Company had the full $2,500,000 operating line available.

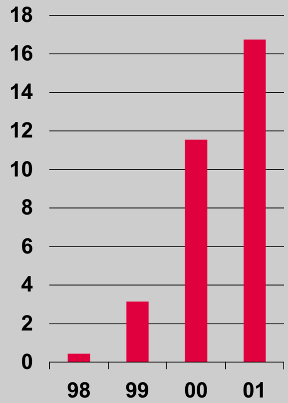
Long-term debt, including the current portion, was $5,110,000 at December 31, 2001 compared to $3,431,000 at December 31, 2000. During 2001, the Company incurred $3,250,000 of new long-term debt and the scheduled debt repayments amounted to $1,571,000. At December 31, 2001, Cathedral's total debt to equity ratio is a conservative 0.52 to 1 (0.78 to 1 at December 31, 2000).

During 2001, shareholders' equity increased $5,206,000 to $16,578,000 from $11,372,000 at December 31, 2000. The increase relates solely to the net income for the year of $5,206,000.

Funds from operations
$ millions



Shareholders' equity
$ millions



Business Risks Management

Cathedral derives its revenue by providing drilling services and related equipment rental to oil and natural gas exploration and development companies in western Canada and the Rocky Mountain region of the United States and demand for these services is directly impacted by the level of capital expenditures by Cathedral's customers.

In turn, the level of capital expenditures by Cathedral's customers are affected by factors including, but not limited to, world oil and North American natural gas prices, access to capital markets, government policies and weather.

The Company's success is also dependent on other factors such as competition, changes in technology and operational and environmental risks. Cathedral manages these risks by:

- providing the highest level of service and results available to the customer
- attracting and retaining experienced and skilled employees
- providing employees with effective training, technology and tools
- monitoring and adjusting to changes in technology
- maintaining a comprehensive insurance program
- strict adherence to the Company's safety standards
- complying with current environmental requirements

Accounting Standard Changes

In 2002, the Company will be required to adopt new Canadian accounting standards relating to stock based compensation and other stock based payments. The new standard is to be applied prospectively for stock based payments to non-employees and to employee awards that are direct awards of stock. For future awards, the Company will be required to follow the fair value method, as prescribed in the standard and calculate a fair value of the stock granted and record that fair value as an expense over the term of the grant.

The new standard, however, permits the Company to continue the present policy that no expense is recorded on the grant of the stock options to employees. Approximately 88% of all prior grants have been to employees and the Company does not expect the adoption of the new standard to have a material impact on the Company's financial condition or results of operations.

Outlook for 2002

2001 saw drilling activity in western Canada at a record level with 18,137 wells drilled (16,485 in 2000). For 2002, the forecast for wells drilled in western Canada is 14,400, which represents a 21% decrease from 2001 levels. Based upon historic drilling activity, the 2002 forecasted 14,400 wells will be the fourth highest number of wells drilled in western Canada.

Oil prices, by historical standards, remain strong and should provide our customers with the necessary cash flow to finance significant, but not record, levels of drilling related expenditures. On the natural gas side, continued softness in prices has been the major cause for the forecasted decrease in drilling activity in western Canada. The short-term fundamentals for natural gas prices may not be favorable, but on a longer-term basis they are. On a North American basis, natural gas reserve levels are decreasing as producers are not bringing on-stream new production that will meet or exceed current decline rates, which are approximately 30% in the United States and 21% in Canada.

Effective January 2002, the Company commenced providing directional drilling services in the Rocky Mountain region of the United States. As a result of the capital asset and personnel additions over the past three years, Cathedral is in a position to leverage those investments. Cathedral will continue to focus, as it has in the past, on the addition of new clients, expansion of services offered and obtaining increased market share.

MANAGEMENT'S REPORT

The Annual Report, including the consolidated financial statements, is the responsibility of management of the Company. The financial statements were prepared by management in accordance with Canadian generally accepted accounting principles and, where appropriate, reflect estimates based upon management's judgment. Financial information presented elsewhere in this Annual Report has been prepared by management and is consistent with the information in the financial statements.

Management is also responsible for a system of internal controls which is designed to provide reasonable assurance that assets are safeguarded and accounting systems provide timely, accurate financial reports.

The Audit Committee of the Board of Directors has reviewed in detail the financial statements with management and the external auditor. The Board of Directors has approved the financial statements on the recommendation of the Audit Committee.

External Auditors have examined the financial statements and their report is presented below.

Mark L. Bentsen
President and Chief Financial Officer

P. Scott MacFarlane
Chief Financial Officer

AUDITORS' REPORT TO THE SHAREHOLDERS

We have audited the consolidated balance sheets of Cathedral Energy Services Ltd. as at December 31, 2001 and 2000 and the consolidated statements of operations and retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. 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 consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2001 and 2000 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

KPMG LLP
Chartered Accountants

Calgary, Canada
February 8, 2002

CONSOLIDATED BALANCE SHEETS

December 31, 2001 and 2000

	2001	2000
Assets		
Current assets:		
Cash	**$ 345,737**	$ –
Accounts receivable	**5,260,506**	4,329,860
Inventory	**834,692**	892,435
Prepaid expenses and deposits	**145,420**	275,790
	6,586,355	5,498,085
Capital assets (note 3)	**16,036,224**	11,239,859
Future income tax asset (notes 2 and 6)	**2,655,814**	3,508,759
	$ 25,278,393	$ 20,246,703
Liabilities and Shareholders' Equity		
Current liabilities:		
Bank indebtedness (note 4)	**$ –**	$ 725,853
Accounts payable and accrued liabilities	**3,235,484**	3,405,548
Income taxes payable	**20,000**	–
Current portion of long-term debt (note 5)	**2,388,468**	1,279,365
	5,643,952	5,410,766
Long-term debt (note 5)	**2,721,205**	2,151,390
Deferred credit (notes 2 and 6)	**334,839**	1,312,537
Shareholders' equity:		
Share capital (note 7):		
Common shares	**3,062,344**	3,062,344
Special series shares	**3,131,370**	3,131,370
Retained earnings	**10,384,683**	5,178,296
	16,578,397	11,372,010
Contingency and commitments (note 12)		
	$ 25,278,393	$ 20,246,703

See accompanying notes to consolidated financial statements.

On behalf of the Board:

Mark L. Bentsen, Director

Rod Maxwell, Director

CONSOLIDATED STATEMENTS OF OPERATIONS AND RETAINED EARNINGS

Years ended December 31, 2001 and 2000

	2001	2000
Revenues	**$ 23,443,646**	$ 19,035,566
Expenses:		
Operating	**10,702,710**	9,826,240
General and administrative	**4,965,746**	3,665,716
Depreciation	**2,417,065**	1,348,085
Interest on long-term debt	**264,193**	222,986
	18,349,714	15,063,027
Operating income	**5,093,932**	3,972,539
Gain on disposal of capital assets	**7,702**	134,642
Income before income taxes	**5,101,634**	4,107,181
Income taxes (note 6):		
Current	**20,000**	39,087
Future (reduction)	**(124,753)**	(403,188)
	(104,753)	(364,101)
Net income	**5,206,387**	4,471,282
Retained earnings, beginning of year	**5,178,296**	707,014
Retained earnings, end of year	**$ 10,384,683**	$ 5,178,296
Net income per share (note 8):		
Basic	**$ 0.63**	$ 0.75
Diluted	**$ 0.24**	$ 0.23

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

Years ended December 31, 2001 and 2000

	2001	2000
Cash provided by (used in):		
Operations:		
Net income	**$ 5,206,387**	$ 4,471,282
Items not involving cash:		
Depreciation	**2,417,065**	1,348,085
Future income taxes	**(124,753)**	(403,188)
Gain on disposal of capital assets	**(7,702)**	(134,642)
Funds from operations	**7,490,997**	5,281,537
Changes in non-cash operating working capital (note 10)	**(892,597)**	(1,048,095)
	6,598,400	4,233,442
Investments:		
Capital asset additions	**(7,275,894)**	(9,102,178)
Proceeds on disposal of capital assets	**70,166**	1,024,845
	(7,205,728)	(8,077,333)
Financing:		
Advances under long-term debt	**3,250,000**	2,503,675
Net cash acquired on acquisition of CAT (note 2)	**–**	1,722,874
Repayments of long-term debt	**(1,571,082)**	(748,951)
Increase (decrease) in bank indebtedness	**(725,853)**	366,293
	953,065	3,843,891
Increase in cash	**345,737**	–
Cash, beginning of year	**–**	–
Cash, end of year	**$ 345,737**	$ –
Funds from operations per share (note 8):		
Basic	**$ 0.91**	$ 0.89
Diluted	**$ 0.35**	$ 0.27

See accompanying notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2001 and 2000

General:

Cathedral Energy Services Ltd. (the "Company"), was incorporated under the Alberta Business Corporations Act (Alberta) as 762732 Alberta Ltd. Pursuant to Articles of Amendment dated April 4, 1998, the name of the Company was changed to Directional Plus Ltd. ("Directional"). On June 16, 2000, Cathedral Gold Corporation ("CAT") acquired all of the issued and outstanding shares of Directional (see note 2). On June 16, 2000, CAT and Directional amalgamated and the amalgamated entity is continuing under the name of Cathedral Energy Services Ltd.

The Company is engaged in the business of providing drilling services to oil and gas exploration companies in western Canada and the Rocky Mountain region of the United States. The Company has two divisions: Directional Plus which provides horizontal and directional drilling services; and CAT Downhole Tools which provides drilling jars, shock tools and high performance drilling motors on a rental basis.

1. Significant accounting policies

These financial statements have been prepared in accordance with generally accepted accounting principles in Canada and include the following significant accounting policies:

(a) Principles of consolidation:

These consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, Cathedral Energy Services Inc.

(b) Foreign currency translation:

The Company's United States subsidiary is considered to be an integrated foreign operation and is translated using the temporal method. Under this method, monetary assets and liabilities are translated at the year-end exchange rate and non-monetary assets and liabilities at exchange rates prevailing on the transaction dates. Revenues and expenses (other than depreciation which is translated at the rate applicable to the related asset) are translated at the average exchange rate during the year. Gains and losses arising from the translation are included in income for the current year except where they relate to long-term monetary items, in which case they are deferred and amortized over the remaining life of the item.

1. Significant accounting policies (continued):

(c) Inventory:

Inventory is comprised of parts to be used in repairing capital assets. Inventory is valued at the lower of cost and market, with market represented by replacement value.

(d) Capital assets:

Capital assets are stated at cost less accumulated depreciation. Depreciation is provided using the declining balance method at the following annual rates:

Asset	Rate
Downhole tools	10-25%
Office and computer equipment	20%

Leasehold improvements are depreciated on a straight-line basis over the term of the lease.

(e) Future income taxes and deferred credit:

The Company uses the liability method of accounting for future income taxes whereby future income tax assets and liabilities are determined based on temporary differences between the accounting basis and the tax basis of the assets and liabilities, and are measured using the currently enacted, or substantively enacted, tax rates and laws expected to apply when these differences reverse. Income tax expense is the sum of the Company's provision for current income taxes and the difference between the opening and ending balances of the future income tax assets and liabilities.

The deferred credit, which arose on the acquisition of CAT (see note 2) is recognized in income in proportion to the realization of the future income tax asset recorded at that date. The original deferred credit represented the excess of future income taxes over the value of assets purchased.

(f) Revenue recognition:

Revenue is recognized as services are rendered and includes estimates for services provided on contracts using the percentage of completion method. Revenue related to the rental of downhole tools is recognized in the period during which the rental hours/days occur.

1. Significant accounting policies (continued):

(g) Per share amounts:

Basic net income per common share and funds from operations per common share are computed by dividing net income and funds from operations by the weighted average number of common shares outstanding for the period. Diluted per share amounts reflect the potential dilution that could occur if securities or other contracts to issue common shares were exercised or converted to common shares. The treasury stock method is used to determined the dilutive effect of stock options and other dilutive instruments.

(h) Stock-based compensation plans:

The Company has a stock based compensation plan which is described in note 7. No compensation expense is recognized for this plan when stock options are issued. Any consideration received on exercise of the stock options is credited to share capital.

(i) Use of estimates:

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

2. Acquisition of CAT:

Effective June 16, 2000, CAT acquired 100% of the outstanding common shares of Directional in exchange for 15,973,359 common shares and 66,158,790 special shares series 1. Upon acquisition, each shareholder of Directional received, in exchange for each Directional common share held, 2.75 common shares of CAT and 11.39 special series non-voting shares of CAT.

As a result of the acquisition, the previous shareholders of Directional control the largest percentage of the total issued and outstanding shares of CAT and therefore Directional was deemed to be the acquirer. Accordingly, the transaction has been accounted for as a reverse takeover using the purchase method whereby the assets and liabilities of CAT have been recorded at their fair market values and the operating results have been included in the Company's financial statements from the effective date of purchase.

2. Acquisition of CAT (continued):

Details of the acquisition are as follows:

Net assets acquired:	
Cash	$ 1,722,874
Capital assets	200,000
Future income tax asset	4,500,000
Deferred credit	(2,535,466)
	$ 3,887,408

Consideration rendered:	
15,973,359 common shares at an ascribed value of approximately $0.05 per share	$ 756,038
66,158,790 special series shares, at an ascribed value of approximately $0.05 per share	3,131,370
	$ 3,887,408

3. Capital Assets:

2001	Cost	Accumulated depreciation	Net book value
Downhole tools	$ 19,382,296	$ 3,950,049	$ 15,432,247
Office and computer equipment	685,052	219,755	465,297
Leasehold improvements	186,211	47,531	138,680
	$ 20,253,559	$ 4,217,335	$ 16,036,224
2000			
Downhole tools	$ 12,445,525	$ 1,664,837	$ 10,780,688
Office and computer equipment	511,598	121,866	389,732
Leasehold improvements	84,065	14,626	69,439
	$ 13,041,188	$ 1,801,329	$ 11,239,859

4. Bank indebtedness:

The Company has a $2,500,000 (2000 - $1,500,000) operating line of credit that bears interest at the bank prime rate plus 0.25% (2000 - 0.50%) per annum with interest payable monthly and is secured as described in note 5.

5. Long-term debt:

	2001	2000
Bank term loan, bearing interest at bank prime rate plus 0.75% (2000 - 1.50%) repayable in 48 equal monthly instalments of $35,000 plus interest	**$ 805,000**	$ 1,225,000
Bank term loan, bearing interest at bank prime rate plus 0.75% (2000 - 1.50%) repayable in 35 equal monthly instalments of $55,555 plus interest	**1,055,565**	1,777,780
Bank term loan, bearing interest at bank prime rate plus 0.75% (2000 - 1.50%) repayable in 48 equal monthly instalments of $10,400 plus interest	**281,600**	406,400
Bank term loan, bearing interest at bank prime rates plus 0.75% (2000 - 1.50%) repayable in 36 equal monthly instalments of $97,300 plus interest	**2,958,100**	–
Obligations under capital leases bearing interest rates varying between 9.6% and 21.5% per annum, repayable in monthly instalments ranging from $127 to $1,330 at various dates to June 2002 secured by specific assignments over the related capital assets	**9,408**	21,575
	5,109,673	3,430,755
Less current portion	**(2,388,468)**	(1,279,365)
	$ 2,721,205	$ 2,151,390

Principal repayments over the next three years are as follows:

	Long-term debt	Capital leases	Total
2002	$ 2,379,060	$ 9,408	$ 2,388,468
2003	2,010,950	–	2,010,950
2004	710,255	–	710,255
	$ 5,100,265	$ 9,408	$ 5,109,673

The bank term loans and the operating line of credit are secured by a general security agreement over all personal property with a first charge over downhole tool capital assets.

Interest of $2,938 (2000 - $4,942) relating to capital lease obligations has been included in interest on long-term debt.

6. Income taxes and deferred credit:

The provision for income taxes differs from the result that would have been obtained by applying the combined federal and provincial income tax rate for the following reasons:

	2001	2000
Effective tax rate	**42%**	45%
Basic rate applied to income before income taxes	**$ 2,142,687**	$ 1,832,625
Amortization and adjustment of deferred credit	**(977,698)**	(1,222,929)
Benefit for reduction of valuation allowance	**(1,640,000)**	(1,037,748)
Adjustment to future income tax asset for change in enacted tax rates	**100,942**	107,741
Non-deductible expenses	**32,771**	16,731
Small business deduction	**–**	(23,270)
Non-taxable portion of gain on disposal of capital assets	**(1,395)**	(10,382)
Large corporations tax and capital taxes	**20,000**	–
Other	**217,940**	(26,869)
	$ (104,753)	$ (364,101)

The components of the net future income tax asset at December 31, 2001 and 2000 are as follows:

	2001	2000
Future income tax assets:		
Capital assets	**$ 2,655,814**	$ 3,989,923
Loss carryforwards	**–**	1,537,192
Share issue costs	**–**	7,000
Future income tax asset before valuation allowance	**2,655,814**	5,534,115
Valuation allowance	**–**	(2,025,356)
Net future income tax asset	**$ 2,655,814**	$ 3,508,759

The balance of the deferred credit is summarized as follows:

	2001	2000
Balance, beginning of year	**$ 1,312,537**	$ –
Acquired on acquisition of CAT	**–**	2,535,466
Amortization for the year	**(922,199)**	(1,162,228)
Adjustment for change in enacted income tax rates	**(55,499)**	(60,701)
Balance, end of year	**$ 334,839**	$ 1,312,537

7. Share Capital:

(a) Authorized:

(i) An unlimited number of common shares without nominal or par value;

(ii) An unlimited number of special shares issuable in series without nominal or par value with the directors having the right to determine the number, designation and attributes of each series of shares; and

(iii) 16,000,000 non-voting, cumulative, non-convertible special share series 1, redeemable at the option of the Company at a price per share equal to the weighted average price at which the Company's common shares have traded on the Toronto Stock Exchange during the ten consecutive trading days ending five days prior to the redemption date, together with all declared and unpaid dividends.

(b) Issued:

	Number of Shares	Amount
Common shares:		
Balance, December 31, 1999	3,500,000	$ 7
Conversion of warrants into common shares	2,308,494	2,306,299
	5,808,494	2,306,306
Common share capital of the Company at time of acquisition	25,228,462	–
Issued in exchange for common shares of Directional (note 2)	15,973,359	756,038
Effect of 5:1 share consolidation	(32,954,258)	–
Balance, December 31, 2001 and 2000	8,247,563	$ 3,062,344
Special series shares:		
Balance, December 31, 1999	–	$ –
Issued in exchange for common shares of Directional (note 2)	**66,158,790**	3,131,370
Effect of 5:1 share consolidation	**(52,927,032)**	–
Balance, December 31, 2001 and 2000	**13,231,758**	$ 3,131,370
Special warrants:		
Balance, December 31, 1999	**2,308,494**	$ 2,306,299
Converted into common shares	**(2,308,494)**	(2,306,299)
Balance, December 31, 2001 and 2000	–	$ –

7. Share capital (continued)

(c) Stock Options

The Company has a stock based compensation plan under which a combined total of 2,080,000 (2000 - 1,260,000) options to purchase common shares can be granted to employees and directors. Under the plan, the exercise price of each option equals the fair market value of the Company's stock on the date of grant and the maximum term till expiry is ten years. Options vest over a period of five years from the date of grant as employees or directors render continuous service to the Company.

A summary of the status of the stock based compensation plan as at December 31, 2001 and 2000, and changes during the years then ended is presented below:

	2001			2000		
	Number of options		Weighted average exercise price	Number of options		Weighted average exercise price
Outstanding, beginning of year	1,000,000	$	1.25	-	$	-
Granted	280,000		1.25	1,000,000		1.25
Forfeited	(90,000)		1.25	-		-
Outstanding, end of year	1,190,000	$	1.25	1,000,000	$	1.25

The range of exercise prices for options outstanding as at December 31, 2001 are as follows:

	Total options outstanding				Exercisable options		
Range of exercise prices	Number		Weighted average exercise price	Weighted average remaining contractual life (years)	Number		Weighted average exercise price
$1.25	1,190,000	$	1.25	5.0	197,600	$	1.25

8. Per share amounts:

In calculating per share amounts, the Company utilizes the treasury stock method to determine the dilutive effect of stock options and other dilutive instruments. Under the treasury stock method, only "in the money" dilutive instruments impact the diluted calculations.

At December 31, 2001, the weighted average number of common shares outstanding was 8,247,563 (2000 - 5,945,611). In computing diluted net income and funds from operations per share, 13,231,758 (2000 - 13,449,307) shares were added to the weighted average number of common shares outstanding during the year ended December 31, 2001 for the dilutive effect of employee stock options and the possible issuance of common shares on redemption of special series shares.

9. Fair values:

The carrying values of the Company's current assets and current liabilities approximated their fair values as at December 31, 2001 and 2000 due to the relatively short period to maturity of the instruments. The fair value of long-term debt approximated its carrying value as it bears interest at floating rates.

10. Supplemental cash flow disclosure:

	2001	2000
Components of changes in non-cash working capital are as follows:		
Accounts receivable	**$ (930,646)**	$ (1,046,787)
Inventory	**57,743**	(892,435)
Prepaid expenses and deposits	**130,370**	(127,354)
Accounts payable and accrued liabilities	**(170,064)**	1,254,981
Income taxes payable	**20,000**	(236,500)
	$ (892,597)	$ (1,048,095)
Cash interest paid	**$ 306,112**	$ 265,665
Cash income taxes paid	**$ -**	$ 275,587

11. Segmented information:

The Company is engaged in the business of providing drilling services to oil and gas exploration companies in western Canada and the Rocky Mountain region of the United States and is viewed as single operating segment by the chief operating decision maker for the purpose of resource allocation and assessing performance.

During the year ended December 31, 2001, three customers accounted for 36% of consolidated revenues. During the year ended December 31, 2000, four customers accounted for 55% of consolidated revenues.

12. Contingency and commitments:

a) Legal Claim:
The Company is the co-defendant in a personal injury claim, the outcome of which is indeterminable. The plaintiff is claiming damages of $300,000 and any cost to the Company will be covered by insurance.

b) Leases:
The Company has commitments under operating leases for office space and vehicles. Amounts to be paid under these leases during the next five years are approximately as follows:

2002	$ 530,000
2003	282,000
2004	203,000
2005	203,000
2006	16,000

CORPORATE INFORMATION

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Aurele Maurice
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Graham Challand
Operations Co-ordinator

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Symbol - CAT

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