Cathedral

Energy Services Income Trust

annual report

2002

Cathedral

Energy Services Income Trust

ANNUAL MEETING

Unitholders are invited to attend the Annual General and Special Meeting which will be held at 2:30 p.m. on June 17, 2003, in the Royal Meeting Room of the Metropolitan Centre, 333 - 4th Avenue S.W., Calgary, Alberta

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Best in Class, Best in Service

Cathedral Energy Services Income Trust (the "Trust") is a limited purpose trust which owns the securities of Cathedral Energy Services Ltd. ("Cathedral"/ the "Company") representing the right to receive cash flow available for distribution from Cathedral. Cathedral is engaged in the business of providing drilling services and related equipment rentals to oil and natural gas companies in western Canada and the Rocky Mountain region of the United States. Cathedral markets its services under three brand names: ***Directional Plus*** *and* ***The Directional Company*** *which provide horizontal and directional drilling services; and* ***CAT Downhole Tools*** *which provides downhole equipment including drilling jars, shock subs 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 Trust's units trade on the TSX under the symbol: ***CET.UN.***

Directional Plus
A Division of Cathedral Energy Services Ltd.

CAT Downhole Tools
A Division of Cathedral Energy Services Ltd.

THE Directional Company
Horizontal & Directional Drilling Services

FINANCIAL HIGHLIGHTS

Figures in thousands of dollars, except
Trust Unit amounts*

	2002	2001	2000	1999	[8 months] 1998
Revenues	**22,075**	23,444	19,036	5,793	1,561
Gross margin %	**57%**	54%	48%	43%	54%
EBITDA **	**6,942**	7,783	5,678	1,526	280
Funds from operations	**5,943**	7,491	5,282	1,133	221
Income before taxes	**4,086**	5,102	4,107	1,007	135
Net income	**3,389**	5,206	4,471	602	105
Basic per Trust Unit	**0.24**	0.63	0.75	0.28	0.06
Diluted per Trust Unit	**0.16**	0.24	0.23	0.06	0.01
Cash distribution per Trust Unit ***					
Declared	**0.0938**	n/a	n/a	n/a	n/a
Paid	**0.0381**	n/a	n/a	n/a	n/a
Weighted outstanding Trust Units					
Basic	**13,866,571**	8,247,563	5,945,611	2,125,937	1,650,000
Diluted	**21,516,399**	21,479,321	19,394,918	10,931,183	8,484,000
Total assets	**24,811**	25,278	20,247	7,607	2,235
Total long-term debt including current portion	**2,721**	5,110	3,431	1,676	615
Unitholders' equity	**16,375**	16,578	11,372	3,013	345

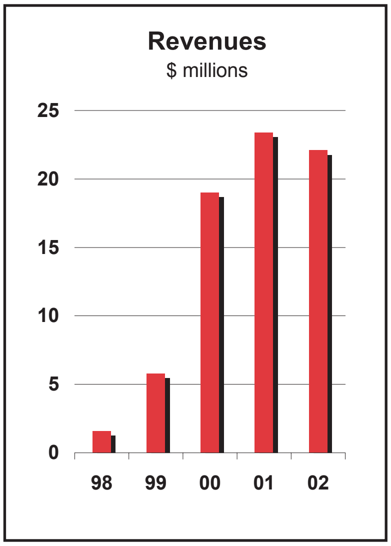
* The results of the Trust are presented based upon the continuity of interests method of accounting and, accordingly, the comparative figures are that of Cathedral Energy Services Ltd. Effective July 30, 2002, Cathedral Energy Services Ltd. was reorganized into an unincorporated, open-ended limited purpose mutual fund trust.

** EBITDA, earnings before interest, taxes, depreciation and amortization, is provided to assist investors in determining the ability of the Trust to generate cash from operations. EBITDA does not have any standardized meaning within Canadian Generally Accepted Accounting Principles and therefore may not be comparable to similar measures presented by other companies and/or trusts.

***Cash distributions for the two month period from the date of reorganization into a mutual fund trust on July 30, 2002 through September 30, 2002 of $818,000 ($0.0381/Trust Unit) were paid on October 15, 2002 and cash distributions for the quarter ended December 31, 2002 of $1,196,000 ($0.0557/Trust Unit) were paid on January 15, 2003.

FORWARD LOOKING STATEMENTS

This annual report may contain forward-looking statements, including statements regarding the business and anticipated financial performance of the Trust. These forward-looking statements involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of the Trust 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 Trust or any other person that the objectives and plans of the Trust will be achieved.


Revenues
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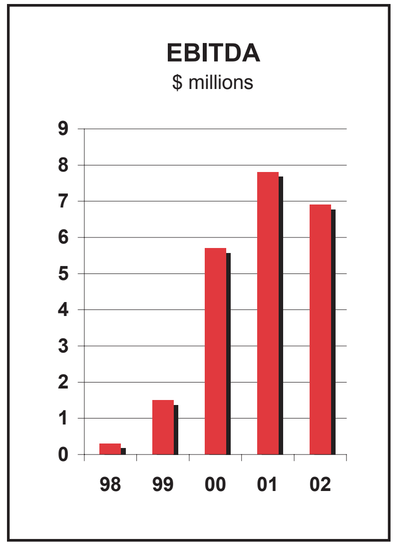
EBITDA
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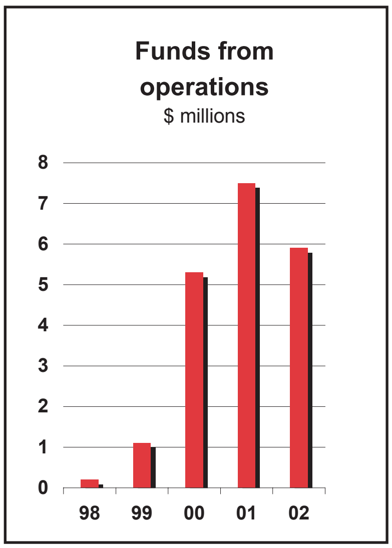
Funds from operations
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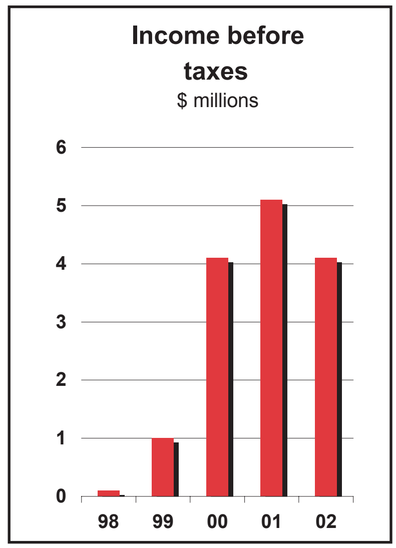
Income before taxes
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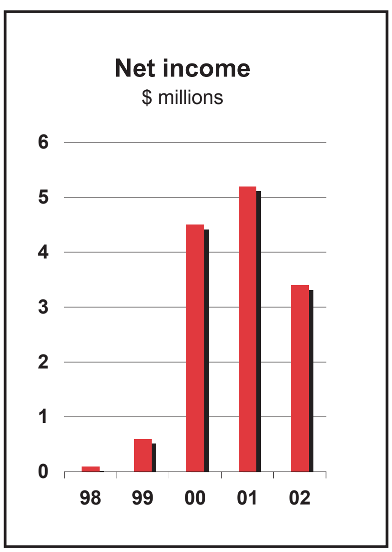
Net income
$ millions
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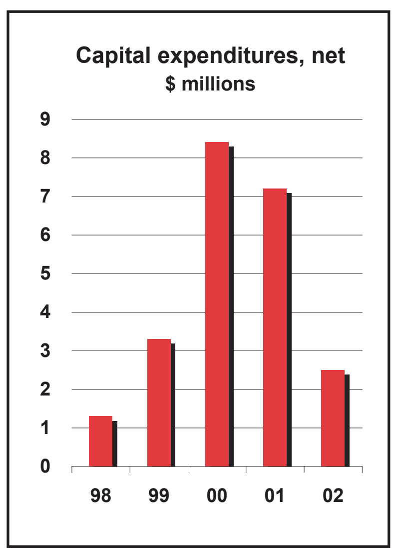
Capital expenditures, net
$ millions
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Report to Unitholders

Mark L. Bentsen
President and Chief Executive Officer
Cathedral Energy Services Ltd.

2002 was another year with extreme fluctuations in oil and natural gas pricing and as well dynamic changes to the Cathedral organization. Lets begin by discussing the drivers that determine drilling activity. The year began with an over-supply of natural gas in storage and has since moved to record lows in storage. As the storage levels moved so did natural gas pricing and as you are aware drilling in Western Canada is currently heavily weighted to natural gas. Tremendous swings in activity were seen as natural gas prices affected the cash flows operators had available for drilling.

Our expectations were for slower activity levels in the first half of the year with improvements in the second half. What actually occurred were record results in the first half with much weaker than expected results in the second. The first half was buffered by an extremely active time for many of Cathedral's clients. The second half was much slower than we expected largely due to the over hang of natural gas in storage. Our forecasts were for prices to rebound in the third quarter when in fact it didn't occur until the fourth quarter. In a year that saw overall drilling activity fall substantially, Cathedral was able to remain profitable in all four quarters of 2002.

For 2003, we expect natural gas prices to be substantially higher than 2002 as there is a looming shortfall of natural gas in storage. As for oil pricing, we expect it to remain relatively flat with any war premiums removed and a general certainty that there will be adequate supply to meet world oil demands. With solid commodity pricing in place we expect, as does the industry, a very active year in drilling.

The most dynamic change for Cathedral this year was the re-organization into an income trust effective July 30, 2002. The conversion was overwhelmingly approved by securityholders with 99.7% approval rate. Since the re-organization, daily trading volume has increased approximately 20% and there has been a firming in the trading price of the trust units. These factors contributed towards allowing Cathedral to utilize its trust units as part of consideration in acquiring the The Directional Company, Inc.("TDC") in February 2003.

The movement to a trust structure does not preclude our desire to grow. As noted above, effective February 12, 2003 Cathedral purchased TDC, a competitor to Cathedral's Directional Plus division. The acquisition of TDC will have a significant contribution to Cathedral, as there are many synergies created and the counter cyclical nature of TDC's market. TDC's busiest season is generally in the spring and summer, the opposite of Directional Plus'. This will allow for increased utilization of Cathedral's assets.

As well, additional growth is anticipated in the U.S. Rocky Mountain region. With rising natural gas prices activity levels have been steadily increasing, as has the activity for Cathedral. Effective April 1, 2003, Cathedral opened a repair facility in Casper, Wyoming to service and coordinate equipment in this region. This facility will eliminate the need to return equipment to Canada for repair, thereby reducing costs and improving utilization of the mud motor fleet.

Cathedral has been looking for an EM - MWD (Electro Magnetic - Measurement While Drilling) system to meet growing customer demand. Several systems have been tested however they did not meet the requirements of Cathedral.

Due to the inability to source a quality EM - MWD system, we moved forward in co-developing a system. Although this technology is not new to the industry, it has over time become the tool of choice of oil and natural gas operators. Cathedral's system will utilize the latest downhole and surface technology, therefore it is expected that the system will be more cost effective than others currently available. Development costs and the development time frame are on budget and on schedule. Beta testing of the system is anticipated to be underway in Q2 of 2003. Once commercialized, the system will be of significant value in the pursuit of shallow gas, fast horizontal and underbalanced markets.

Cathedral continues to foster relationships with companies planning SAGD projects. This is a tremendous opportunity to help development of one of the largest oil deposits in the world. There should be extensive growth in this area over the next 5 years.

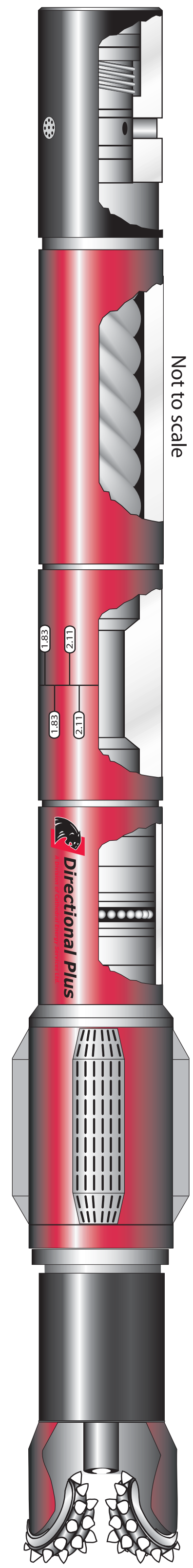
As well, Cathedral continues to look for acquisition opportunities and areas to further expand and diversify our revenue base. It will be another exciting year and we look forward to showing our unitholders not only return on their units, but additional growth to Cathedral.

We thank everyone associated with the organization for their participation and support in making Cathedral one of the best oil and gas service companies.

Yours truly,

Mark L. Bentsen
President and Chief Executive Officer
Cathedral Energy Services Ltd.

Performance Mud Motor



Review of Operations

Cathedral is engaged in the business of providing drilling services and related equipment rentals to oil and natural gas companies in western Canada and the Rocky Mountain region of the United States.

Cathedral markets its services under three brand names: ***Directional Plus*** and ***The Directional Company*** which provide horizontal and directional drilling services; and ***CAT Downhole Tools*** which provides downhole equipment including drilling jars, shock subs 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 since inception has been to supply ***"Best in Class, Best in Service"*** equipment and personnel to its clients.

Prior to 2002, the extent of services provided in the Rocky Mountain region of the US was limited to the rental of downhole equipment. In January 2002, Cathedral commenced providing directional drilling services in the Rocky Mountain region of the US to a major Canadian oil and natural gas producer with international operations. Since then, directional drilling services have been provided to US based oil and natural gas producers.

Equipment and Technology

At December 31, 2002, Cathedral had 19 Geolink Measurement While Drilling ("MWD") systems of which 15 are based upon negative pulse technology and 4 are based upon positive pulse technology. This compares with 17 (14 negative pulse and 3 positive pulse) MWD systems at December 31, 2001. The inclusion of positive pulse MWD systems in our fleet is significant in that they are retrievable in the event the drill string becomes stuck in 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 2002, Cathedral was reviewing sources of available Electro-Magnetic ("EM") MWD technology and as a result of this review process decided to utilize its internal expertise along with the services of a third-party to develop an EM-MWD system. The decision to develop an EM-MWD system internally, as opposed to purchasing from third parties, was based upon the lack of EM-MWD systems available for purchase at a reasonable cost. Field testing of the EM-MWD system is anticipated to commence in Q2 of 2003.

As at December 31, 2002, Cathedral has a fleet of 95 positive displacement mud motors which compares to 89 motors at December 31, 2001. Approximately 90% 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 competitors. Cathedral has additional downhole equipment in the form of 43 (2001 - 43) drilling jars and 35 (2001 - 35) shock tools.

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.

The acquisitions of equipment over the past three years have allowed the Company to minimize its reliance on third-party rentals thereby reducing overall costs.

Personnel

In line with the Cathedral's mandate of supplying **"Best in Class, Best in Service"** equipment and personnel to its clients, Cathedral prides itself on the strengths of 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.

Cathedral continues to utilize the services of consultants for the performance of fieldwork. As at December 31, 2002, the Company utilized the services of 49 (2001 - 56) directional drilling and MWD field consultants. The strategy of using field consultants on contract has allowed Cathedral to operate with lower fixed overhead costs and remain financially profitable in seasonally low activity periods while taking advantage of the specialization these consultants have to offer.

Facilities

At December 31, 2002, Cathedral was operating out of four locations. Head office is located in downtown Calgary and houses the operations, engineering, sales and administration personnel, allowing for effective service delivery to the Canadian 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. To service the Rocky Mountain region of the US, Cathedral operates a combined sales/operations office in Fort Lupton, Colorado.

Health, Safety and Environment

Within the operations of Cathedral, health, safety and environment are a very important issue. Cathedral 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.

Cathedral continues to 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.

MWD Service Center

Management's Discussion and Analysis

The following Management's Discussion and Analysis ("MD&A") highlights key business results and statistics for 2002 and 2001 and should be read in conjunction with the material contained in other parts of this annual report, including the consolidated financial statements and accompanying notes. The results of the Trust are presented based upon the continuity of interests method of accounting and accordingly, the comparative figures are that of Cathedral Energy Services Ltd. Effective July 30, 2002, Cathedral Energy Services Ltd. was reorganized into an unincorporated, open-ended limited purpose mutual fund trust. Cathedral Energy Services Ltd. continues to carry on the business it conducted prior to the reorganization into an income trust and, in addition to such activities, is responsible as administrator ("Administrator") of the Trust, for managing the affairs of the Trust.

This MD&A may contain forward-looking statements concerning the anticipated performance of the Trust. Forward-looking statements are based on the estimates and opinions of management at the date the statements are made, and the Trust undertakes no obligation to update forward-looking statements if conditions or opinions should change.

Financial Results

Revenues and Operating Expenses

$ 000's	**2002**	2001	Change	%
Revenues	**$ 22,075**	$ 23,444	$ (1,369)	(6)
Operating expenses	**9,430**	10,703	(1,273)	(12)
Gross margin - $	**$ 12,645**	$ 12,741	$ (96)	(1)
Gross margin - %	**57.3%**	54.3%	3%	

For the year ended December 31, 2002, revenues were $22,075,000 which is a $1,369,000 or 6% decrease from 2001 revenues of $23,444,000. This 6% decline in revenues occurred in an environment that saw the number of wells completed in western Canada during 2002 decrease 19% from levels in 2001. In 2002, Cathedral had 2,627 (2001 - 2,824) activity days related to horizontal and directional drilling services with an average day rate of $7,402 (2001 - $8,074). The Rocky Mountain region of the United States contributed $2,510,000 of revenues in 2002 which compares to $145,000 in 2001. In Q4 of 2001, Cathedral commenced renting downhole equipment in the US market and in January 2002, commenced providing directional drilling services in the same region. The Rocky Mountain region of the US is expected to be a growth area for Cathedral. During 2002, Directional Plus was able to add a number of junior and senior oil and natural gas exploration and development companies to its customer list.

Cathedral was able to increase its gross margin on a percentage basis by 3.0% from 54.3% in 2001 to 57.3% in 2002. The Company continues to focus on reducing operating expenses and improving the overall gross margin. Significant gains in gross margin have been experienced over the past years with the main contributing factor being less reliance on third-party rented equipment. In addition, the Company has increased the level of revenues from the rental of downhole equipment which generates a gross margin higher than that from providing horizontal and directional drilling services.

General and administrative expenses

$ 000's	**2002**	2001	Change	%
General and administrative expenses	**$ 6,062**	$ 4,966	$ 1,096	22

For the year ended December 31, 2002, general and administrative expenses were $6,062,000 which is an increase of $1,096,000 over 2001 expense of $4,966,000. The majority of the increased general and administrative expenses is attributable to an increase in personnel costs related to staffing of CAT Downhole Tools and establishing an increased presence in the Rocky Mountain region of the United States. Cathedral is in a position to increase revenues substantially without significant increases in the level of personnel. As a percentage of revenues, general and administrative expenses were 27.5% and 21.2% for 2002 and 2001, respectively.

Depreciation

$ 000's	**2002**	2001	Change	%
Depreciation	**$ 2,659**	$ 2,417	$ 242	10

Depreciation has increased from $2,417,000 in 2001 to $2,659,000 in 2002. The $242,000 or 10% increase is a result of the Company's continued investment in its capital asset base. Net capital asset additions were $2,498,000 and $7,213,000 for 2002 and 2001, respectively. As a percentage of revenues, depreciation expense has increased from 10.3% in 2001 to 12.0% in 2002. This increase is a direct result of the Company purchasing more revenue producing capital assets, and therefore reducing its reliance on leased/rented equipment to produce revenues, as well as a $1,369,000 decrease in revenues.

Interest on long-term debt

$ 000's	**2002**	2001	Change	%
Interest on long-term debt	**197**	264	(67)	(25)

Interest on long-term debt decreased $67,000 to $197,000 for the year ended December 31, 2002 compared to $264,000 in 2001. This decrease is related to a decrease in the average level of long-term debt outstanding in 2002 versus 2001 and a reduction in the effective borrowing rate. The decrease in the effective borrowing rate is attributed to: i) reductions in the bank prime lending rate; and ii) a renegotiation of Cathedral's credit facility effective June 2001 that provided for a decrease in the interest rate formula from prime plus 1.5% to prime plus 0.75%. In February 2003, the interest rate formula for Cathedral's long-term debt was adjusted to prime plus 0.50% - a 0.25% reduction.

Gain on disposal of capital assets

$ 000's	**2002**	2001	Change	%
Gain on disposal of capital assets	**659**	8	651	n/a

2002 saw a significant amount of downhole equipment being lost-in-hole. Cathedral has recovered lost-in-hole equipment costs, including previously expensed depreciation on the related assets, and this has resulted in a gain on disposal of capital assets of $659,000 (2001 - $8,000). A majority of the equipment lost-in-hole was replaced within 2002 and the balance was replaced in 2003 Q1.

Re-organization expenses

$ 000's	**2002**	2001	Change	%
Re-organization expenses	**300**	–	300	n/a

Costs associated with the re-organization into an income trust amounted to $300,000 for the year ended December 31, 2002 and have been disclosed separately on the statements of operations and accumulated income. These expenses were incurred in Q2 of 2002.

Taxes

$ 000's	**2002**	2001	Change	%
Taxes (reduction)	**697**	(105)	802	n/a

The effective tax rate for 2002 was 17.1% while the comparative figure for 2001 was a recovery of 2.1%. The fluctuation in the effective tax rates is net result of: 1) a reduction in 2001 tax provision for a $1,640,000 valuation allowance adjustment and the benefit of amortization and adjustment of the deferred credit of $978,000; and 2) the shift of tax burden to the Trust's unitholders effective July 30, 2002.

Distributions

$ 000's except per Trust Unit amounts	**2002**	2001	Change	%
Declared:				
Total	**2,014**	–	2,014	n/a
Per Trust Unit	**0.0938**	–	0.0938	n/a
Paid:				
Total	**818**	–	818	n/a
Per Trust Unit	**0.0381**	–	0.0381	n/a

The Trust has a quarterly distribution policy and the distributions for 2002 are noted above. Cash distributions for the two month period from the date of reorganization into a mutual fund trust on July 30, 2002 through September 30, 2002 of $818,000 ($0.0381/Trust Unit) were paid on October 15, 2002 and cash distributions for the quarter ended December 31, 2002 of $1,196,000 ($0.0557/Trust Unit) were paid on January 15, 2003. On March 19, 2003, the Trust announced a distribution of $0.0550 per Trust Unit related to 2003 Q1, payable on April 15, 2003 to Unitholders of record on March 31, 2003. On a go forward basis, it is the intention of the Trust to have equal quarterly distributions to Unitholders, subject to the operating results of Cathedral Energy Services Ltd. For tax purposes, the distributions declared in 2002 were 100% taxable to Unitholders as trust income.

The following table sets out distributions of the Trust since its conversion to an income trust on July 30, 2002:

2003 - Q1	$ 0.0550
2002 - Q4	$ 0.0557
2002 - Q3 (approx. 2 month period)	$ 0.0381

Financial Condition and Liquidity

The Trust had working capital of $966,000 at December 31, 2002 and this compares with $942,000 at December 31, 2001 - an increase of $24,000. It should be noted that the December 31, 2002 working capital figure is net of a distribution payable to Unitholders in the amount of $1,196,000 which has no comparable amount for 2001. As a result of renegotiating its credit facility in Q4 of 2002, Cathedral now has an operating loan facility in the amount of $3,500,000 (increased from $2,500,000) that bears interest at prime (previously prime plus 0.25%). As at December 31, 2002, Cathedral had utilized $429,000 of the operating loan facility (including a $184,000 carve-out for outstanding letters of guarantee).

At December 31, 2002, Cathedral had long-term debt including current portion of $2,721,000 which is down $2,389,000 from $5,110,000 at December 31, 2001. At December 31, 2002, Cathedral's debt to equity ratio is a conservative 0.52 to 1 (0.52 to 1 at December 31, 2001).

The debt to equity ratio has stayed constant from 2001 to 2002 even with a $2,389,000 repayment of long-term debt - the reason being that during 2002 $1,577,000 has been charged to equity as a result of the conversion to an income trust.

The conversion to an income trust created a situation in which certain tax pools of Cathedral Energy Services Ltd. could only be claimed against income from assets which were previously sold. Accordingly, the future income tax asset created by these tax pools, net of the related deferred credit, has been charged against Unitholders' capital in the amount of $1,577,000. This write-down was recorded in the accounts in Q3 of 2002 and was disclosed in the Cathedral Energy Services Ltd. Information Circular dated June 26, 2002.

During the period January 1, 2002 to July 29, 2002 (date prior to the conversion to an income trust), Cathedral Energy Services Ltd. was able to maximize its ability to claim the tax pools related to the write-down.

Subsequent to the 2002 year-end, Cathedral's long-term debt was increased to $7,200,000 and the related interest rate was reduced from prime plus 0.75% to prime plus 0.50%. The additional long-term debt was primarily incurred to finance the acquisition of The Directional Company, Inc. ("TDC"), including the repayment of TDC's existing long-term debt, but also included a portion to finance capital asset additions. The new long-term debt facility has repayment terms that amortizes the loan over 4 years.

Engineering and Well Planning Services

Business Risks Management

Cathedral derives its revenues by providing drilling services 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, oil and natural gas prices, access to capital markets, government policies and weather.

The Company's success is also dependant 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.

Cathedral has $3 million of debt which is at a floating interest rate and, therefore is at risk of rising interest rates. Management continually monitors interest rates and would consider locking in the rate of its term debt.

Our Accounting Policies

The Trust's consolidated financial statements have been prepared in accordance with Canadian Generally Accepted Accounting Principles ("GAAP") and significant accounting policies utilized by the Trust are described in Note 2 to the Trust's consolidated financial statements. The Administrator believes the accounting principles selected are appropriate under the circumstances. Under Canadian GAAP, the Trust is required to make certain estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. The estimates and assumptions utilized are based on past experience and other information available to the Administrator at the time the estimate or assumption is made. The estimates and assumptions used by the Administrator are constantly evaluated for relevance under the circumstances and if circumstances on which the estimates or assumptions were based change, the impact is included in the results of operations for the period in which the change occurs. The Administrator believes the estimates, judgments and assumptions involved in its financial reporting are reasonable.

With the conversion of Cathedral Energy Services Ltd. to an income trust effective July 30, 2002, the Administrator has used the continuity of interest method of accounting in preparing the Trust's consolidated financial statements and, accordingly, the comparative figures are that of Cathedral Energy Services Ltd.

Effective January 1, 2002, the Trust adopted the recommendations of the Canadian Institute of Chartered Accountants ("CICA") Handbook Section 3870, Stock-based compensation and other stock-based payments. The new recommendations are applied prospectively to all stock based payments to non-employees, and to employee awards that are direct awards of stock, call for settlement in cash or other assets, or are stock appreciation rights that call for settlement by the issuance of equity instruments, granted on or after January 1, 2002, except for grants outstanding at January 1, 2002, that call for settlement in cash or other assets or stock appreciation rights that call for settlement in equity instruments. For such grants, the new recommendations are applied retroactively, without restatement. As the Trust has no such grants, there is no retroactive impact of applying the standard. The recommendations encourage, but do not require, the use of the fair value method of accounting for all employee based stock-based compensation plans. The Trust has chosen not to use the fair value method to account for stock-based employee compensation plans and therefore, the Trust records no compensation expense when options are issued to employees. Any consideration paid by employees on the exercise of options is credited to Unitholders' capital. The Trust discloses the pro forma effect of accounting for these awards under the fair value based method in Note 7 to the consolidated financial statements.

The CICA recently issued a new Handbook Section 3063, Impairment of Long-Lived Assets. This pronouncement establishes new standards for the recognition, measurement and disclosure of the impairment of long-lived assets and establishes new write-down provisions. The Section comes into effect in 2004 for the Trust, but the CICA encourages earlier adoption. The Administrator does not expect that adopting the new standards will affect our consolidated financial statements.

Outlook for 2003

The combination of a cold winter, reduced drilling activity and increased production decline rates have contributed to a significant decline in natural gas storage levels in North America which, in turn, has contributed to strengthening in natural gas prices. World oil prices have been relatively strong, although one cannot expect the current prices to be maintained. That aside, by historical standards, world oil prices are expected to be strong for 2003. Industry analysts are expecting oil and natural gas pricing levels to contribute to significant levels of drilling in western Canada and the United States for 2003 and on into 2004.

Effective February 12, 2003, the Trust completed the acquisition of The Directional Company, Inc. ("TDC") which is a provider of horizontal and directional drilling services in western Canada. TDC's operating equipment included 2 owned Geolink negative pulse MWD systems (same equipment utilized by Cathedral) and 24 drilling motors. In the past, TDC has relied extensively on third party rentals to meet their operational equipment needs. Going forward, TDC's operations will be able to draw upon Cathedral's fleet of equipment, which on a combined basis, will increase the utilization of owned equipment and, therefore, significantly reduce TDC's former reliance on rented equipment.

In April 2003, Cathedral made a further commitment to its US operations with the establishment of a repair facility in Casper, Wyoming. This US based repair facility will reduce overall costs as well as provide for the timely turnaround of equipment.

Cathedral will continue to pursue opportunities in the Steam Assisted Gravity Drainage ("SAGD") market. The number of proposed SAGD projects should lead to a large market for drilling the required parallel horizontal well bores and Cathedral has the technology to participate in this market.

The Trust will continue to pursue opportunities offering an expanded range of services to its customers, increased market share, entry into new geographic territories, and strategic acquisitions.

Administrator's Report

The accompanying consolidated financial statements of Cathedral Energy Services Income Trust (the "Trust") for the year ended December 31, 2002 and all information in this annual report are the responsibility of Cathedral Energy Services Ltd. as administrator (the "Administrator") of the Trust. The consolidated financial statements have been prepared by the Administrator in accordance with Canadian generally accepted accounting principles and, where appropriate, reflect estimates based upon the Administrator's judgment. Financial information contained elsewhere in the annual report has been prepared on a consistent basis with that in the consolidated financial statements.

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

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

KPMG LLP, an independent firm of chartered accountants, have examined the Trust's consolidated financial statements in accordance with Canadian generally accepted auditing standards and provided an independent professional opinion. The auditors have full and unrestricted access to the Audit Committee to discuss their audit and their related findings as to the integrity of the financial reporting process.

Mark L. Bentsen
President and Chief Executive Officer
May 5, 2003

P. Scott MacFarlane
Chief Financial Officer

AUDITORS' REPORT TO THE UNITHOLDERS

We have audited the consolidated balance sheets of Cathedral Energy Services Income Trust as at December 31, 2002 and 2001 and the consolidated statements of operations and accumulated income and cash flows for the years then ended. These financial statements are the responsibility of the Trust'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 Trust as at December 31, 2002 and 2001 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 13, 2003
(except note 14 which
is as of April 29, 2003)

CONSOLIDATED BALANCE SHEETS

December 31, 2002 and 2001

	2002	2001
Assets		
Current assets:		
Cash	**$ –**	$ 345,737
Accounts receivable	**7,717,685**	5,260,506
Inventory	**723,913**	834,692
Prepaid expenses and deposits	**305,139**	145,420
	8,746,737	6,586,355
Capital assets (note 3)	**15,874,492**	16,036,224
Future income tax asset (note 6)	**190,000**	2,655,814
	$ 24,811,229	$ 25,278,393
Liabilities and Unitholders' Equity		
Current liabilities:		
Bank indebtedness (note 4)	**$ 245,372**	$ –
Accounts payable and accrued liabilities	**4,247,575**	3,235,484
Distribution payable to Unitholders (note 8)	**1,196,296**	–
Taxes payable	**25,301**	20,000
Current portion of long-term debt (note 5)	**2,066,305**	2,388,468
	7,780,849	5,643,952
Long-term debt (note 5)	**654,900**	2,721,205
Deferred credit (note 6)	**–**	334,839
Unitholders' equity:		
Unitholders' capital (notes 1 and 7)	**4,616,797**	6,193,714
Accumulated income	**13,773,345**	10,384,683
Accumulated distributions (note 8)	**(2,014,662)**	–
	16,375,480	16,578,397
Contingency and commitments (note 13)		
Subsequent event (note 14)		
	$ 24,811,229	$ 25,278,393

See accompanying notes to consolidated financial statements.

Approved by the Trustees:

Trustee

Trustee

Consolidated Statements of Operations and Accumulated Income

Years ended December 31, 2002 and 2001

	2002	2001
Revenues	**$ 22,075,218**	$ 23,443,646
Expenses:		
Operating	**9,430,248**	10,702,710
General and administrative	**6,062,268**	4,965,746
Depreciation	**2,659,248**	2,417,065
Interest on long-term debt	**196,967**	264,193
	18,348,731	18,349,714
Operating income	**3,726,487**	5,093,932
Other items:		
Gain on disposal of capital assets	**659,350**	7,702
Re-organization expenses (note 1)	**(300,095)**	–
Income before taxes	**4,085,742**	5,101,634
Taxes (note 6):		
Current	**143,122**	20,000
Future income taxes (reduction)	**553,958**	(124,753)
	697,080	(104,753)
Net income	**3,388,662**	5,206,387
Accumulated income, beginning of year	**10,384,683**	5,178,296
Accumulated income, end of year	**$ 13,773,345**	$ 10,384,683
Net income per Trust Unit (note 9):		
Basic	**$ 0.24**	$ 0.63
Diluted	**$ 0.16**	$ 0.24

See accompanying notes to consolidated financial statements.

Consolidated Statements of Cash Flows

Years ended December 31, 2002 and 2001

	2002	2001
Cash provided by (used in):		
Operations:		
Net income	**$ 3,388,662**	$ 5,206,387
Items not involving cash:		
Depreciation	**2,659,248**	2,417,065
Future income taxes (reduction)	**553,958**	(124,753)
Gain on disposal of capital assets	**(659,350)**	(7,702)
Funds from operations	**5,942,518**	7,490,997
Changes in non-cash operating working capital (note 11)	**(306,475)**	(892,597)
	5,636,043	6,598,400
Investments:		
Capital asset additions	**(3,515,818)**	(7,275,894)
Proceeds on disposal of capital assets	**1,677,652**	70,166
Changes in non-cash investing working capital	**(1,182,252)**	–
	(3,020,418)	(7,205,728)
Financing:		
Advances under long-term debt	**–**	3,250,000
Repayments of long-term debt	**(2,388,468)**	(1,571,082)
Distributions paid to Unitholders (note 8)	**(818,366)**	–
Proceeds from the issuance of Trust Units (note 7)	**100**	–
Increase (decrease) in bank indebtedness	**245,372**	(725,853)
	(2,961,362)	953,065
Increase (decrease) in cash and cash equivalents	**(345,737)**	345,737
Cash and cash equivalents, beginning of year	**345,737**	–
Cash and cash equivalents, end of year	**$ –**	$ 345,737
Funds from operations per Trust Unit (note 9):		
Basic	**$ 0.43**	$ 0.91
Diluted	**$ 0.28**	$ 0.35

See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements

Years ended December 31, 2002 and 2001

1. General:

Cathedral Energy Services Income Trust (the "Trust") is an unincorporated, open-ended limited purpose mutual fund trust established under the laws of the Province of Alberta on June 24, 2002. The Trust was created for the purpose of effecting a Plan of Arrangement (the "Arrangement") under the Business Corporations Act (Alberta) whereby 990401 Alberta Ltd., a wholly-owned subsidiary of the Trust, acquired from the shareholders of Cathedral Energy Services Ltd. all of the issued and outstanding Common Shares and Special Shares in return for subordinated notes (the "Notes"). The Trust then acquired these Notes from the holders in exchange for units of the Trust (the "Trust Units") on a one-for-one basis. Subsequently, 990401 Alberta Ltd. and Cathedral Energy Services Ltd. were amalgamated with the amalgamated company retaining the name Cathedral Energy Services Ltd. As a result of this Arrangement, the Trust owns all of the subordinated notes and all of the issued and outstanding common shares of Cathedral Energy Services Ltd., which represents the right to receive cash flow available for distribution from Cathedral Energy Services Ltd.

The Arrangement is described in the Cathedral Energy Services Ltd. Information Circular dated June 26, 2002. The Arrangement was approved by the securityholders of Cathedral Energy Services Ltd. on July 29, 2002 and was effective as of July 30, 2002.

The management of Cathedral Energy Services Ltd. is responsible for the administration of the Trust and the management of Cathedral Energy Services Ltd. (an internal management structure).

Cathedral Energy Services Ltd. is engaged in the business of providing drilling services to oil and natural gas exploration companies in western Canada and the Rocky Mountain region of the United States. The Company markets its services under two brand names: Directional Plus which provides horizontal and directional drilling services; and CAT Downhole Tools which provides downhole equipment including drilling jars, shock tools and high performance drilling motors on a rental basis.

2. Significant accounting policies

The Trust is considered to be a continuation of Cathedral Energy Services Ltd. following the continuity of interests method of accounting and, accordingly, the comparative figures are that of Cathedral Energy Services Ltd. These financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles and include the following significant accounting policies:

(a) Principles of consolidation:

These consolidated financial statements include the accounts of the Trust and its wholly-owned subsidiaries, Cathedral Energy Services Ltd. and Cathedral Energy Services Inc.

2. Significant accounting policies (continued):

(b) Foreign currency translation:

The Trust's United States subsidiary, Cathedral Energy Services Inc., 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.

(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.

Deferred development costs are expenses incurred with respect to pre-commercialization of proprietary downhole equipment. Once commercial activities have been commenced, these costs will be amortized on a straight-line basis over 5 years.

(e) Future income taxes and deferred credit:

The Trust 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 substantively enacted tax rates and laws expected to apply when these differences reverse. Tax expense is the sum of the Trust's provision for current taxes and the difference between the opening and ending balances of the future income tax assets and liabilities.

The deferred credit 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.

2. Significant accounting policies (continued):

(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.

(g) Per Trust Unit amounts:

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

(h) Unit-based compensation plan:

Effective January 1, 2002, the Trust adopted the recommendations of the Canadian Institute of Chartered Accountants Handbook Section 3870, Stock-based compensation and other stock-based payments. The new recommendations are applied prospectively to all stock based payments to non-employees, and to employee awards that are direct awards of stock, call for settlement in cash or other assets, or are stock appreciation rights that call for settlement by the issuance of equity instruments, granted on or after January 1, 2002, except for grants outstanding at January 1, 2002, that call for settlement in cash or other assets or stock appreciation rights that call for settlement in equity instruments. For such grants, the new recommendations are applied retroactively, without restatement. As the Trust has no such grants, there is no retroactive impact of applying the standard.

The recommendations encourage, but do not require, the use of the fair value method of accounting for all employee based stock-based compensation plans. The Trust has chosen not to use the fair value method to account for stock-based employee compensation plans and therefore, the Trust records no compensation expense when options are issued to employees. Any consideration paid by employees on the exercise of options is credited to Unitholders' capital. The Trust discloses the pro forma effect of accounting for these awards under the fair value based method (see note 7).

2. Significant accounting policies (continued):

(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.

(j) Cash and cash equivalents:

Cash and cash equivalents consist of cash and highly liquid investments which have maturities of less than three months at the date of acquisition.

(k) Distributions to Unitholders:

Distributions to Unitholders are declared on the last business date of each quarter and paid on or about the 15th of the following month. The amount of the annual distribution to Unitholders is equal to the total interest earned by the Trust on the Notes, dividends, if any, from its wholly-owned subsidiaries, less administrative expenses incurred by the Trust and amounts paid in connection with any cash redemption of Trust Units.

3. Capital Assets:

2002	Cost	Accumulated depreciation	Net book value
Downhole tools	$ 21,149,695	$ 6,132,840	$ 15,016,855
Office and computer equipment	766,824	324,421	442,403
Leasehold improvements	201,563	85,266	116,297
Deferred development costs	298,937	–	298,937
	$ 22,417,019	$ 6,542,527	$ 15,874,492

2001			
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

4. Bank indebtedness:

The Trust has a $3,500,000 (2001 - $2,500,000) operating line of credit that bears interest at the bank's prime rate (2001 - bank prime rate plus 0.25%) per annum with interest payable monthly and is secured as described in note 5.

5. Long-term debt:

	2002	2001
Bank term loan, bearing interest at the bank's prime rate plus 0.75% (2001 - 0.75%) repayable in monthly instalments of $35,000 plus interest	**$ 385,000**	$ 805,000
Bank term loan, bearing interest at the bank's prime rate plus 0.75% (2001 - 0.75%) repayable in monthly instalments of $55,555 plus interest	**388,905**	1,055,565
Bank term loan, bearing interest at the banks prime rate plus 0.75% (2001 - 0.75%) repayable in monthly instalments of $10,400 plus interest	**156,800**	281,600
Bank term loan, bearing interest at the bank's prime rates plus 0.75% (2001 - 0.75%) repayable in monthly instalments of $97,300 plus interest	**1,790,500**	2,958,100
Obligations under capital leases	–	9,408
	2,721,205	5,109,673
Less current portion	**(2,066,305)**	(2,388,468)
	$ 654,900	$ 2,721,205

Principal repayments over the next two years are as follows:

2003	$ 2,066,305
2004	654,900
	$ 2,721,205

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

6. Taxes and deferred credit:

The Trust is a mutual fund trust as defined under the Income Tax Act (Canada). For the period July 30, 2002 (the effective date of the reorganization into an income trust) to December 31, 2002, all taxable income earned by the Trust has been distributed to unitholders and such distributions are deducted for income tax purposes. Consequently, no provision for income taxes is required for the Trust. The Trust's wholly-owned subsidiaries are however, subject to income taxation and provide for income tax obligations based upon statutory corporate rates. The provision for taxes differs from the result that would have been obtained by applying the combined federal and provincial income tax rate for the following reasons:

	2002	2001
Effective tax rate	**39%**	42%
Income before taxes	**$ 4,085,742**	$ 5,101,634
Income of Trust subject to tax in the hands of the Unitholders, not the Trust (note 8)	**(2,014,662)**	–
Income before taxes of subsidiary companies	**$ 2,071,080**	$ 5,101,634
Effective tax rate applied to income before taxes of subsidiary companies	**$ 807,721**	$ 2,142,687
Amortization and adjustment of deferred credit	**(146,493)**	(977,698)
Benefit for reduction of valuation allowance	**–**	(1,640,000)
Adjustment to future income tax asset/liability for change in enacted tax rates	**5,812**	100,942
Non-deductible expenses	**68,640**	32,731
Non-taxable portion of gain on disposal of capital assets	**(65,130)**	(1,395)
Benefit of capital loss carryforward not previously recognized	**(21,060)**	–
Large corporations tax and capital taxes	**49,108**	20,000
Other	**(1,518)**	217,940
	$ 697,080	$ (104,753)

The components of the net future income tax asset at December 31, 2002 and 2001 are as follows:

	2002	2001
Future income tax asset (liability):		
Capital assets	**$ (665,000)**	$ 2,655,814
Loss carryforwards	**887,000**	–
	222,000	2,655,814
Valuation allowance	**(32,000)**	–
Net future income tax asset	**$ 190,000**	$ 2,655,814

6. Taxes and deferred credit (continued):

At December 31, 2002, the Trust's subsidiaries had non-capital loss carry forwards of approximately $2,274,000. The benefit of $2,192,000 of these loss carry forwards has been recorded in the accounts.

The balance of the deferred credit is summarized as follows:

	2002	2001
Balance, beginning of year	**$ 334,839**	$ 1,312,537
Amortization for the year, including $188,346 related to the write-down of future income tax asset (note 7)	**(334,839)**	(922,199)
Adjustment for change in enacted income tax rates	**–**	(55,499)
Balance, end of year	**$ –**	$ 334,839

7. Unitholders' capital:

(a) Authorized: An unlimited number of Trust Units without nominal or par value

(b) Issued:

	Number of Units/Shares	Amount
Common Shares:		
Balance, December 31, 2001 and 2000	8,247,563	$ 3,062,344
Converted to Trust Units	(8,247,563)	(3,062,344)
Balance, December 31, 2002	–	$ –
Special Shares, Series 1:		
Balance, December 31, 2001 and 2000	13,231,758	$ 3,131,370
Converted to Trust Units	(13,231,758)	(3,131,370)
Balance, December 31, 2002	–	$ –
Trust Units:		
Balance, December 31, 2001 and 2000	–	$ –
Issued for cash	100	100
Issued on conversion of Common Shares	8,247,563	3,062,344
Issued on conversion of Special Shares, Series 1	13,231,758	3,131,370
Write-down of future income tax asset, net of related deferred credit, on re-organization into an income trust	–	(1,577,017)
Balance, December 31, 2002	21,479,421	$ 4,616,797

The conversion to an income trust created a situation in which certain tax pools of Cathedral Energy Services Ltd. could only be claimed against income from assets which were previously sold. Accordingly, the future income tax asset created by these tax pools, net of the related deferred credit of $188,346, has been charged against Unitholders' capital in the amount of $1,577,017.

7. Unitholders' capital (continued):

(c) Trust Unit options:

The Trust has a Trust Unit based compensation plan under which a combined total of 2,080,000 (2001 - 2,080,000) options to purchase Trust Units can be granted to employees and trustees. Under the plan, the exercise price of each option equals the fair market value of the Trust Units on the day immediately prior to the grant and the maximum term till expiry is ten years. Options vest over a period of three to five years from the date of grant as employees or trustees render continuous service to the Trust.

A summary of the status of the Trust Unit based compensation plan as at December 31, 2002 and 2001, and changes during the years then ended is presented below:

	2002		2001	
	Number of options	**Weighted average exercise price**	Number of options	Weighted average exercise price
Outstanding, beginning of year	**1,190,000**	**$ 1.25**	1,000,000	$ 1.25
Granted	**738,000**	**1.08**	280,000	1.25
Forfeited	**(130,000)**	**1.17**	(90,000)	1.25
Outstanding, end of year	**1,798,000**	**$ 1.19**	1,190,000	$ 1.25
Exercisable, end of year	**414,000**	**$ 1.25**	197,600	$ 1.25

The range of exercise prices for options outstanding as at December 31, 2002 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	1,125,000	$ 1.25	4.1	414,000	$ 1.25
$1.09	457,000	$ 1.09	5.3	–	$ 1.09
$1.06	216,000	$ 1.06	5.9	–	$ 1.06
	1,789,000	$ 1.19	4.5	414,000	$ 1.25

7. Unitholders' capital (continued):

(c) Trust Unit options (continued):

No compensation expense has been recognized when employee Trust Unit options are granted, in accordance with the policy in note 2. Had compensation expense been determined based upon the fair value method for awards made after December 31, 2001, the Trust's net income and net income per Trust Unit for the year ended December 31, 2002 would have been adjusted to the pro forma amounts noted below:

	Year ended December 31, 2002
Net income - as reported	$ 3,388,662
Pro forma compensation expense	(72,000)
Net Income - pro forma	$ 3,316,662
Net income per Trust Unit - as reported	$ 0.24
Net income per Trust Unit - pro forma	$ 0.24
Diluted net income per Trust Unit - as reported	$ 0.16
Diluted net income per Trust Unit - pro forma	$ 0.15

The pro forma amounts exclude the effect of options granted prior to January 1, 2002. The following table set out the assumptions used in applying the Black-Scholes model for options issued in 2002:

	Date of Issue	
	March 28, 2002	November 26, 2002
Expected dividend/distribution yield	0.0%	20.75%
Risk-free interest rate	5.0%	4.25%
Expected volatility	60%	60%
Expected life (in years)	5.1	5.0

The Black-Scholes option valuation model used by the Trust to determine fair value was developed for use in estimating the fair value of freely traded options, which are fully transferable and have no vesting restrictions. The Trust's options are not transferable, cannot be traded and are subject to vesting restrictions and exercise restrictions under the Trust's blackout policy which would tend to reduce the fair value of the Trust's options. In addition, this model requires the input of highly subjective assumptions, including future stock price volatility and expected time until exercise, that can cause a significant variation in the estimate of the fair value of the options.

8. Distributions to Unitholders:

From July 30, 2002 (effective date for conversion to an income trust) to December 31, 2002 (an approximate 5 month period), the Trust has declared distributions in the form of cash to Unitholders in the amount of $2,014,662 or $0.0938 per Trust Unit.

The amounts and record dates of the distributions declared were:

Record date	Total	Per Trust Unit
September 30, 2002	$ 818,366	$ 0.0381
December 31, 2002	1,196,296	0.0557
	$ 2,014,662	$ 0.0938

The distribution of $1,196,296 ($0.0557 per Trust Unit) payable to Unitholders of record on December 31, 2002 was paid on January 15, 2003.

9. Per Trust Unit amounts:

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

At December 31, 2002, the basic weighted average number of Trust Units outstanding was 13,866,571 (2001 - 8,247,563). At December 31, 2002, the diluted weighted average number of Trust Units outstanding was 21,516,399 (2001 - 21,479,321) which includes the addition of 7,649,828 (2001 - 13,231,758) Trust Units to the basic weighted average number of Trust Units outstanding during the year ended December 31, 2002 for the dilutive effect of employee Trust Unit options and, prior to the conversion to an income trust, the possible issuance of common shares on redemption of special series shares.

10. Financial instruments:

(a) Credit risk:

Substantially all of the Trust's accounts receivable are due from customers in the oil and natural gas industry and are subject to normal industry credit risks. The carrying value of accounts receivable reflects management's assessment of the associated credit risks.

(b) Fair values:

The carrying values of the Trust's current assets and current liabilities approximated their fair values as at December 31, 2002 and 2001 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.

(c) Interest rate risk:

At December 31, 2002 and 2001, the Trust was exposed to changes in interest rates on it's bank indebtedness and long-term debt (see notes 4 and 5).

11. Supplemental cash flow disclosure:

	2002	2001
Components of changes in non-cash working capital are as follows:		
Accounts receivable	**$ (2,457,179)**	$ (930,646)
Inventory	**110,779**	57,743
Prepaid expenses and deposits	**(159,719)**	130,370
Accounts payable and accrued liabilities	**1,012,091**	(170,064)
Taxes payable	**5,301**	20,000
	$ (1,488,727)	$ (892,597)
Less: changes in working capital related to investing activities	**(1,182,252)**	–
	$ (306,475)	$ (892,597)
Cash interest paid	**$ 198,094**	$ 306,112
Cash taxes paid	**$ 138,055**	$ –

12. Segmented information:

The Trust, through its wholly-owned subsidiary, Cathedral Energy Services Ltd., is engaged in the business of providing drilling services to oil and natural gas exploration companies in western Canada and the Rocky Mountain region of the United States and is viewed as a single operating segment by the chief operating decision maker of Cathedral Energy Services Ltd. for the purpose of resource allocation and assessing performance.

Drilling services are provided in both Canada and the United States. The amounts related to each segment are as follows:

Revenues	2002	2001
Canada	$ 19,565,380	$ 23,298,768
United States	2,509,838	144,878
	$ 22,075,218	$ 23,443,646

Capital Assets	2002	2001
Canada	$ 13,704,492	$ 15,676,224
United States	2,170,000	360,000
	$ 15,874,492	$ 16,036,224

During the year ended December 31, 2002, one customer accounted for 43% of consolidated revenues. During the year ended December 31, 2001, two customers accounted for 36% of consolidated revenues.

13. Contingency and commitments:

(a) Legal claim:

The Cathedral Energy Services Ltd. 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 will be covered by insurance.

(b) Leases:

The Trust 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:

2003	$ 460,000
2004	384,000
2005	300,000
2006	84,000
2007	62,000

(c) Letters of guarantee:

At December 31, 2002, a wholly-owned subsidiary of the Trust is contingently liable for outstanding letters of guarantee in the amount of approximately $184,000.

14. Subsequent event:

Effective February 12, 2003, the Trust acquired all the issued and outstanding shares of The Directional Company, Inc. ("TDC"), a private company involved in providing horizontal and directional drilling services in western Canada, for fixed consideration of $2,581,000, net of an estimated $179,000 working capital adjustment. The fixed consideration comprised $2,312,000 of cash and $269,000 of Trust Units (225,812 Trust Units with an assigned value of $1.193 per Trust Unit). Cash consideration was financed by way of a bank term loan. Costs associated with the transaction are estimated to be $197,000.

Additional contingent consideration of up to a maximum of $1.25 million, payable in cash, will be paid over a 2-year period based upon the financial results of TDC for the periods ended December 31, 2003 and 2004. Additional consideration paid will be recorded as an additional cost of the purchase.

The acquisition will be accounted for by the purchase method whereby the assets and liabilities will be recorded at their fair market values and the operating results will be included in the Trust's financial statements from the effective date.

14. Subsequent event (continued):

Estimated details of the acquisition are as follows:

Net assets acquired:		
Net non-cash working capital	$	862,000
Capital assets		2,500,000
Goodwill		364,000
Long-term debt		(817,000)
Future income taxes		(220,000)
	$	2,689,000
Purchase price:		
225,812 Trust Units at approximately $1.193 per Trust Unit	$	269,000
Cash (including transaction costs totaling approximately $197,000)		2,420,000
	$	2,689,000

Nisku Service Center

Corporate Information

Trustees

Legal Counsel

Burstall Winger LLP
Calgary, Alberta

Banker

The Bank of Nova Scotia
Calgary, Alberta

Officers and Senior Management of Cathedral Energy Services Ltd.

Mark L. Bentsen
President and Chief Executive Officer

Randal H. Pustanyk
Vice President, Operations

P. Scott MacFarlane
Chief Financial Officer

Jeff Morden
Vice President, Engineering

Aurele Maurice
Vice President, Sales and Marketing

Paul Thebeau
Operations Manager

Graham Challand
Operations Co-ordinator

Ron Schell
TDC General Manager

Stock Exchange Listing

The Toronto Stock Exchange
Symbol - **CET.UN**

Registrar and Transfer Agent

Computershare Trust Company of Canada
Calgary, Alberta

Auditors

KPMG LLP
Calgary, Alberta

Cathedral Energy Services Income Trust
2800, 715 - 5th Avenue S.W.
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