**Cathedral**

**Energy Services Income Trust**

# *2005 ANNUAL REPORT*

*Cathedral Energy Services Income Trust (the "Trust") is a limited purpose trust which owns the securities of Cathedral Energy Services Ltd. and Cathedral Energy Services Limited Partnership (collectively "Cathedral") representing the right to receive cash flow available for distribution from Cathedral. Cathedral is engaged in the business of providing selected oilfield services to oil and natural gas exploration and development entities in Western Canada and the Rocky Mountain region of the United States and currently provides directional/horizontal drilling services and related equipment rentals, production testing services and wireline services. Cathedral markets its services under six brand names:* ***Directional Plus*** *and* ***The Directional Company*** *which provide horizontal and directional drilling services;* ***CAT Downhole Tools*** *which provides downhole equipment including drilling jars, shock subs and high performance drilling motors on a rental basis;* ***Tier One Oil Services*** *which provides oil and natural gas production testing services;* ***Advance Wireline*** *which provides cased hole logging and perforating, casing integrity inspection logging and complete slickline services; and* ***Xtreme Wireline*** *which provides slickline services. Cathedral strives to provide its clients with value added technologies and solutions to meet their drilling, production testing and wireline 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***

**Annual and Special Meeting:**

Unitholders are invited to attend the Annual and Special Meeting which will be held at 3:30 pm on May 18, 2006 in the Royal Meeting Room of the Metropolitan Centre, 333 – 4th Avenue S.W., Calgary, Alberta.

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# FINANCIAL HIGHLIGHTS

| $ '000's except Trust Unit amounts (1) | 2005 | 2004 | 2003 | 2002 | 2001 |
|---|---|---|---|---|---|
| Revenues | **86,002** | 46,478 | 32,715 | 22,075 | 23,444 |
| Gross Margin % (revenues less operating expenses) | **51%** | 52% | 49% | 57% | 54% |
| EBITDA (2) | **31,580** | 15,108 | 8,269 | 6,942 | 7,783 |
| Operating income (3) | **22,705** | 10,143 | 4,623 | 3,726 | 5,094 |
| Income before taxes | **24,817** | 11,231 | 4,828 | 4,086 | 5,102 |
| Net income | **21,807** | 9,128 | 4,441 | 3,389 | 5,206 |
| Basic per Trust Unit | **0.76** | 0.39 | 0.20 | 0.24 | 0.63 |
| Diluted per Trust Unit | **0.76** | 0.38 | 0.20 | 0.16 | 0.24 |
| Cash distributions declared per Trust Unit | **0.385** | 0.245 | 0.22 | 0.0938 | n/a |
| Distributable income (4) | **27,551** | 12,924 | 6,373 | 3,535 | n/a |
| Cash distributions declared | **11,162** | 5,768 | 4,792 | 2,014 | n/a |
| Payout ratio (5) | **41%** | 45% | 75% | 57% | n/a |
| Capital asset additions and corporate acquisitions (6) | **31,245** | 8,472 | 7,986 | 3,516 | 7,276 |
| Non-cash issuance of Trust Units for corporate acquisitions | **13,712** | - | 269 | - | - |
| Total capital asset additions and corporate acquisitions | **44,957** | 8,472 | 8,255 | 3,516 | 7,276 |
| Weighted outstanding Trust Units | | | | | |
| Basic ('000) | **28,711** | 23,233 | 21,710 | 13,867 | 8,248 |
| Diluted ('000) | **28,712** | 23,783 | 22,004 | 21,516 | 21,479 |
| Working capital | **10,571** | 10,839 | 1,955 | 966 | 942 |
| Total assets | **102,908** | 46,822 | 33,080 | 24,811 | 25,278 |
| Long-term debt and capital lease obligations excluding current portion | **12,797** | - | 5,700 | 655 | 2,271 |
| Unitholders' equity | **59,615** | 33,564 | 16,589 | 16,375 | 16,578 |

(1) Effective July 30, 2002, Cathedral Energy Services Ltd. was reorganized into an unincorporated, open-ended limited purpose mutual fund trust. 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.

(2) EBITDA, earnings before interest on long-term debt and capital lease obligations, taxes, non-cash compensation expense, 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.

(3) Operating income is defined as revenues less expenses relating to operating, general and administrative, depreciation and amortization, interest, non-cash compensation expense and foreign exchange loss (gain). Operating income does not have any standardized meaning within Canadian Generally Accepted Accounting Principles and therefore may not be comparable to similar measures provided by other companies and/or trusts.

(4) Distributable income is defined as funds from operations less required principal repayments on long-term debt and capital lease obligations and maintenance capital expenditures. Distributable income does not have any standardized meaning within Canadian Generally Accepted Accounting Principles and therefore may not be comparable to similar measures presented by other trusts. Conversion to an income trust was effective July 30, 2002.

(5) Cash distributions declared as a percentage of distributable income.

(6) Excludes value of non-cash issuance of Trust Units

**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.

# REPORT TO UNITHOLDERS

Cathedral Energy Services Income Trust ("Cathedral" and/or the "Trust") is pleased to report to its Unitholders the consolidated financial and operating results for the year ended December 31, 2005. The results for 2005 represent the best year in Cathedral's history. The growth that occurred during 2005 was the culmination of several significant factors including record high commodity prices for both oil and natural gas, several acquisitions completed during the year and the internal growth from existing business lines. This growth allowed the Trust to increase cash distributions to its Unitholders four times during 2005. Cash distributions increased from $0.27 per Trust Unit annually in January 2005 to $0.60 per Trust Unit annually in December 2005 - an increase of 122%. A further 20% increase in the monthly distribution to $0.06 per Trust Unit ($0.72 per annum) was approved by the Board of Trustees for the March 2006 distribution.

The significant accomplishments in 2005 included three acquisitions. From a strategic standpoint the Trust believed that by diversifying and expanding its services it would be able to further expand growth opportunities and reduce overall business risk. The Trust is no longer dependent on one business area, directional drilling, as it has expanded into providing production testing and wireline services.

The businesses that Cathedral acquired are all top quartile performers within their respective business lines and had a strong platform in place for further growth. The acquisitions were:

**Tier One Oil Services**

Tier One is involved in production testing. Production testing generally allows natural gas wells to be flow tested enabling the producer to determine the deliverability of natural gas from individual wells and reservoirs. Tier One was a relatively new company (4 years old) and with its strong management team was able to secure work from some of the industry's largest producers. Subsequent to the closing of the transaction Cathedral has been able to increase the job capability of Tier One from 9 to 16 at December 31, 2005. Current plans are to continue the expansion of this division by adding four production testing units in 2006.

**Advance Wireline**

Advance Wireline is a cased hole wireline operator offering both electric line and slickline services. Advance Wireline is a leader in the industry and offers several specialty services that set it apart from its competition, thus making it attractive to Cathedral whose objective is to acquire businesses that are leaders within their perspective business lines. Current plans for 2006 have Advance Wireline adding 9 wireline units to bring their total fleet to 19.

**Xtreme Wireline**

Xtreme Wireline is a slickline operator with a very short history but with a tremendous amount of experience. The Xtreme Wireline acquisition is complementary to Advance Wireline and has enabled Cathedral to further expand and create critical mass within the slickline service business. The management team of Xtreme Wireline is poised for further expansion in 2006 and 2007.

These acquisitions have set a tremendous framework for the Trust to continue growing its business and service lines. Each division within the organization will be expanding its job capacity in 2006 to meet demands as the Board of Trustees has approved a capital expenditure program of $19 million for 2006. As well, Cathedral continues to build out its infrastructure and strengthen the business with additions to our safety and human resource departments.

Our directional drilling divisions have continued to grow and expand with market gains in both Western Canada and the U.S. Rocky Mountains. Cathedral added 14 MWD systems to the fleet in 2005 bringing the total number of systems to 54 at the end of 2005. This has been enhanced by another 12 systems in Q1 2006. The growth has been largely due to the tremendous success of Cathedral's in-house developed EM-MWD system. The EM-MWD system is in tremendous demand and we expect this demand to continue particularly after Cathedral's recent successes in operating the EM-MWD tool in some difficult underbalanced wells.

In recent weeks we have seen some significant downward pressure on natural gas pricing reducing the commodity from its highs of $14.00 down to the $7.00 range. Cathedral's largest exposure to natural gas is in the U.S. Rocky Mountains. Recently Cathedral moved an additional 3 EM-MWD systems into this area bringing the total to 18 systems. The U.S. expansion is driven by Cathedral's U.S. customers who continue to demand more capacity from Cathedral.

We look forward to another tremendous year in 2006 and would like to thank everyone who has participated in the success of Cathedral.

Sincerely

Mark Bentsen

Mark L. Bentsen
President and Chief Executive Officer
Cathedral Energy Services Ltd.
March 21, 2006

# REVIEW OF OPERATIONS

**2005 significant developments included:**

- Further growth in the Rocky Mountain region of the United States
- May 6, 2005 acquisition of Tier One Oil Services Ltd.
- June 16, 2005 internal reorganization
- September 8, 2005 acquisition of Advance Wireline Inc.
- November 1, 2005 commercialization of newly developed positive pulse MWD system
- December 22, 2005 acquisition of Xtreme Wireline

**Further U.S. Expansion** Due to increased demand in the U.S. market, Cathedral's U.S. job capacity was increased from 9 at the start of 2005 to 13 at December 31, 2005. On a year-over-year basis, revenues from the U.S. market have increased 98% from $9,943 in 2004 to $19,657 in 2005. During 2005 our U.S. directional drilling services were provided in Colorado, Wyoming, Utah, Montana and North Dakota. The U.S. market continues to be a growth area for Cathedral. In early 2006 Q1, 2 additional MWD systems were transferred to the U.S. fleet and by the end of 2006 Q1 an additional 3 MWD systems will be transferred to the U.S. to bring the U.S. fleet to 18 MWD systems.

**Tier One Oil Services Ltd. acquisition** The May 6, 2005 acquisition of Tier One Oil Services Ltd. ("Tier One") is the Trust's entry into providing production testing services. On acquisition, Tier One had 9 production testing units and 7 additional units were added in the balance of 2005 to bring the total number of production testing units as at December 31, 2005 to 16. Current plans are to add 4 production units in 2006. Post acquisition operational results for Tier One have exceeded management's original expectations.

**Internal reorganization** Management of the Trust had concluded that in order to maximize cash distributions to unitholders it would make future investments in new business initiatives, lines of business, services, product expansion and other investments through a wholly-owned trust and a limited partnership. Furthermore, management believed that by combining Cathedral Energy Services Ltd. ("LTD"), Tier One and a new partnership (as opposed to operating as separate entities) there would be savings in administrative costs and effort. As a result, effective June 16, 2005, a new structure was implemented in which the Canadian operations of LTD and Tier One were combined into a limited partnership ("Cathedral Energy Services Limited Partnership"). The combining of the operations of LTD and Tier One have reduced administrative costs and efforts and provided a "combined" platform for future investments/growth in a tax efficient manner.

**Advance Wireline Inc. acquisition** The September 8, 2005 acquisition of Advance Wireline Inc. ("Advance Wireline") is the Trust's entry into providing oilfield wireline services. Advance Wireline provides cased hole logging and perforating, casing integrity inspection logging and complete slickline services in Western Canada. On acquisition, Advance Wireline had 10 wireline units. At the close of 2006 Q1 Advance Wireline will have 14 wireline units. Current plans are to add a further 5 wireline units in the balance of 2006. Post acquisition operational results for Advance Wireline have exceeded management's original expectations.

**New Positive Pulse MWD Tool** On November 1, 2005, the Trust announced the commercialization of its new positive pulse Measurement-While-Drilling ("MWD") system. The commercialization of this MWD system has positively impacted the operations of the Trust in that it has expanded our ability to meet our customer's needs and arrive at solutions to their drilling requirements. The positive pulse system utilizes a rotary drive valve mechanism which has an anti-jam feature for debris management. The design does not utilize hydraulic assist for pulse generation and therefore is well suited for high viscosity drilling fluids. It is also well suited for silicate mud systems where seal wear is a concern. The positive pulse MWD tool is based upon the same platform as the Trust's Electro-Magnetic MWD ("EM-MWD") tool and therefore provides an increased level of flexibility in providing alternative methods of transmitting directional drilling information to surface. Six complete positive pulse MWD systems have been introduced to the MWD fleet by December 31, 2005 and six additional positive pulse systems were added to the fleet in early 2006 Q1.

**Xtreme Wireline Inc. acquisition** The December 22, 2005 acquisition of the capital assets and business of Xtreme Wireline represented the Trust's second wireline business acquisition. Xtreme Wireline provides slickline services to oil and natural gas exploration and development entities in Western Canada. On acquisition, Xtreme Wireline had 4 wireline units. In 2006 Q2 Xtreme Wireline expects to add 3 wireline units to its fleet which will bring its total fleet to 7 units.

**Equipment** The following is a summary of major directional/horizontal drilling equipment owned by Cathedral:

| | | **As at December 31** | |
|---|---|---|---|
| | **2005** | **2004** | **2003** |
| Measurement-While-Drilling systems - | | | |
| Mud pulse | **24** | 19 | 20 |
| Electro-magnetic | **30** | 21 | 3 |
| | **54** | 40 | 23 |
| Drilling mud motors | **236** | 175 | 149 |

# GOVERNANCE

Pursuant to an administration agreement, the management and administration of Cathedral Energy Services Income Trust is delegated to the Board of Directors and management of Cathedral Energy Services Ltd. ("Company"), as Administrator of the Trust. The Board of Directors of the Company are also Trustees of the Trust. The committees of the Company's Board of Directors extend their respective mandates to governance of the Trust. The Trust strives to comply with National Instrument 58-101 ("NI 58-101") on Corporate Governance and currently is in compliance with NI 58-101.

**Mandate of the Board** The Board of Directors of the Administrator has approved a mandate which includes among other duties and responsibilities: the approval and monitoring of the strategic, business and financial plans of the Company and Cathedral Energy Services Limited Partnership (collectively, "Cathedral"); supervise performance and succession planning of senior officers; assessment of principal risk factors relating to the business of Cathedral; and to monitor and oversee the integrity of the financial reporting and disclosure. Every Director and Trustee is required to act honestly and in good faith and in the best interests of the Administrator and the Trust and to exercise the care, diligence and skill of a reasonably prudent person. Responsibilities not delegated to senior management or to a committee of the Board remain those of the full Board.

**Composition of the Boards** The Board of Directors of the Administrator is currently composed of six members of which four are independent to the Administrator. All of the Board of Directors of the Administrator are also Trustees of the Trust. In addition, the Board of Directors has elected a lead director who is an independent director.

**Board Committees** The Board of Directors has established three committees – Audit, Compensation and Governance.

**Audit Committee** The Board of Directors have approved a mandate for the Audit Committee which includes among other duties and responsibilities: monitoring the financial reporting process and systems of internal controls; monitoring the independence and performance of the external auditors; and reviewing interim and year end financial statements and other regulatory filings and furthermore recommending such financial statements and filings for approval of the Board of Directors. The Audit Committee is comprised of independent directors.

**Compensation Committee** The Board of Directors have approved a mandate for the Compensation Committee which includes among other duties and responsibilities: monitoring the performance and compensation of senior management; and reviewing and providing recommendations to the Board of Directors with respect to implementation and variation of option, compensation and incentive plans. The Compensation Committee is comprised of independent directors.

**Governance Committee** The Board of Directors have approved a mandate for the Governance Committee which includes among other duties and responsibilities: monitoring the effectiveness of the system of governance within the Trust; assessing the effectiveness of the Board of Directors as a whole, committees of the Board and the contributions of individual members; and identifying, recommending, orienting and educating new directors. The Governance Committee is comprised of independent directors.

# MANAGEMENT'S DISCUSSION AND ANALYSIS

This Management's Discussion and Analysis ("MD&A") for the year ended December 31, 2005 provides an analysis of the consolidated results of operations, financial position and cash flows of Cathedral Energy Services Income Trust (the "Trust") and should be read in conjunction with the accompanying audited financial statements for the year ended December 31, 2005, as well as the Trust's 2005 interim MD&A's. Dollars are in '000's except for day rates, Trust Unit amounts and per Trust Unit amounts. This MD&A is dated March 21, 2006.

This MD&A is intended to assist the reader in the understanding and assessment of significant changes and trends, as well as the risks and uncertainties, related to the results of the operations and financial position of the Trust.

Certain statements within this MD&A may contain forward-looking statements, including (without limitation) statements regarding the business and anticipated financial performance of the Trust preceded by, followed by or that include the words "believes", "expects", "anticipates", "estimates", "intends", "plans", "forecasts" or similar expressions. 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.

### NON-GAAP MEASURES

This MD&A includes additional measures of earnings, such as "EBITDA" (earnings before interest on long-term debt and capital lease obligations, taxes, non-cash compensation expense, depreciation and amortization), "gross margin" (revenues less operating expenses); "distributable income" (funds from operations less required principal repayments on long-term debt and capital lease obligations and maintenance capital expenditures) and "operating income" (revenues less expenses related to operating, general and administrative, depreciation and amortization, interest, foreign exchange loss (gains) and non-cash compensation), as we believe that this information will assist investors' understanding of the level of our earnings, to assess our performance in 2005 compared to the prior year and assess the ability of the Trust to generate cash from operations. We believe that conventional financial measures of performance prepared in accordance with Canadian generally accepted accounting principles ("GAAP") do not fully illustrate performance information. EBITDA, gross margin, distributable income and operating income do not have any standardized meaning within Canadian GAAP and therefore may not be comparable to similar measures presented by other companies and/or trusts. Accordingly, they are intended to provide additional information and should not be considered in isolation or as a substitute for measures of performance prepared in accordance with Canadian GAAP.

### OVERVIEW

Cathedral Energy Services Income Trust is an unincorporated, open-ended mutual fund trust established under the laws of the Province of Alberta pursuant to a Declaration of Trust dated June 24, 2002. The Trust is publicly traded on the Toronto Stock Exchange under the symbol CET.UN. The Trust, through its wholly-owned subsidiary, Cathedral Energy Services Ltd. and indirectly wholly-owned entity, Cathedral Energy Services Limited Partnership (collectively "Cathedral"), are engaged in the business of providing selected oilfield services to oil and natural gas exploration and development entities in Western Canada and the Rocky Mountain region of the United States and currently provides directional/horizontal drilling services and related equipment rentals, production testing services and wireline services. Cathedral markets its services under six brand names: Directional Plus and The Directional Company which provide horizontal and directional drilling services; CAT Downhole Tools which provides downhole equipment including drilling jars, shock subs and high performance drilling motors on a rental basis; Tier One Oil Services which provides oil and natural gas production testing services; Advance Wireline which provides cased hole logging and perforating, casing integrity inspection logging and complete slickline services; and Xtreme Wireline which provides slickline services. Cathedral strives to provide its clients with value added technologies and solutions to meet their drilling, production testing and wireline requirements. Its mandate is to supply "Best in Class, Best in Service" equipment and personnel to its clients.

### ACQUISITIONS

During 2005, the Trust completed three strategic acquisitions – Tier One Oil Services Ltd. ("Tier One"); Advance Wireline Inc. ("Advance Wireline") and Xtreme Wireline. These acquisitions have been accounted for by the purchase method and results of operations have been included in the consolidated financial statements from the respective dates of acquisition.

Tier One Oil Services Ltd., a Canadian privately held company which provides oil and natural gas production testing services in Western Canada, was acquired effective May 6, 2005 for consideration of $6,136 comprised of $3,193 in cash and $2,943 of Trust Units (668,864 Trust Units at an assigned value of $4.40 per Trust Unit). At the date of acquisition, Tier One had 9 production testing units.

Advance Wireline Inc., a Canadian privately held company which provides cased hole logging and perforating, casing integrity inspection logging and complete slickline services in Western Canada, was acquired effective September 8, 2005 for consideration of $16,999 comprised of $7,999 in cash and $9,000 of Trust Units (1,072,706 Trust Units at an assigned value of $8.39 per Trust Unit). At the date of acquisition, Advance Wireline had 10 wireline units.

Effective December 22, 2005, the Trust acquired all the capital assets and business of Xtreme Wireline, which is involved in providing slickline services in Western Canada, for consideration of $3,238. Consideration was comprised of $1,469 of cash and $1,769 of Trust Units (149,691 Trust Units with an assigned value of $11.82 per Trust Unit). At the date of acquisition, Xtreme Wireline had 4 slickline units.

# MANAGEMENT'S DISCUSSION AND ANALYSIS

### COMMERCIALIZATION OF POSITIVE PULSE MEASUREMENT-WHILE-DRILLING SYSTEM

On November 1, 2005, the Trust announced the commercialization of its new positive pulse Measurement-While-Drilling ("MWD") system. The commercialization of this MWD system has positively impacted the operations of the Trust in that it has expanded our ability to meet our customer's needs and arrive at solutions to their drilling requirements. The positive pulse system utilizes a rotary drive valve mechanism which has an anti-jam feature for debris management. The design does not utilize hydraulic assist for pulse generation and therefore is well suited for high viscosity drilling fluids. It is also well suited for silicate mud systems where seal wear is a concern. The positive pulse MWD tool is based upon the same platform as the Trust's Electro-Magnetic MWD ("EM-MWD") tool and therefore provides an increased level of flexibility in providing alternative methods of transmitting directional drilling information to surface. Six complete positive pulse MWD systems were introduced to the MWD fleet by December 31, 2005 and by December 31, 2005 the major components for six additional positive pulse systems were received but the related systems were not operational. Since December 31, 2005 these six additional positive pulse systems were assembled and are available for use.

### SELECTED ANNUAL INFORMATION (in $'000's except per Trust Unit amounts) -

| | 2005 | Increase (decrease) | 2004 | Increase (decrease) | 2003 |
|---|---|---|---|---|---|
| Revenues | **$ 86,002** | $ 39,524 | $ 46,478 | $ 13,763 | $ 32,715 |
| % change | | 85% | | 42% | |
| EBITDA (1) | **31,580** | 16,472 | 15,108 | 6,839 | 8,269 |
| % change | | 109% | | 83% | |
| Income before taxes | **24,817** | 13,586 | 11,231 | 6,403 | 4,828 |
| % change | | 121% | | 133% | |
| Net income | **21,807** | 12,679 | 9,128 | 4,687 | 4,441 |
| % change | | 139% | | 106% | |
| Net income per Trust Unit - | | | | | |
| Basic | **0.76** | 0.37 | 0.39 | 0.19 | 0.20 |
| Diluted | **0.76** | 0.38 | 0.38 | 0.18 | 0.20 |
| % change - diluted | | 100% | | 90% | |
| Funds from operations | **27,942** | 14,954 | 12,988 | 5,194 | 7,794 |
| % change | | 115% | | 67% | |
| Cash distributions declared per Trust Unit | **0.385** | 0.14 | 0.245 | 0.025 | 0.22 |
| Distributable income (2) | **27,551** | 14,628 | 12,924 | 6,551 | 6,373 |
| Cash distribution declared | **11,162** | 5,394 | 5,768 | 976 | 4,792 |
| Payout ratio (3) | **41%** | (4%) | 45% | (30%) | 75% |
| Working capital | **10,571** | (268) | 10,839 | 8,884 | 1,955 |
| Total assets | **102,908** | 56,086 | 46,822 | 13,742 | 33,080 |
| Long-term debt and capital lease obligations (4) | **12,797** | 12,797 | – | (5,700) | 5,700 |
| Unitholders' equity | **59,615** | 26,051 | 33,564 | 16,975 | 16,589 |

(1) EBITDA, earnings before interest on long-term debt and capital lease obligations, taxes, non-cash compensation expense, 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 Policies and therefore may not be comparable to similar measures presented by other companies and/or trusts.

(2) Distributable income is defined as funds from operations less required principal repayments on long-term debt and capital lease obligations and maintenance capital expenditures. Distributable income does not have any standardized meaning within Canadian Generally Accepted Accounting Policies and therefore may not be comparable to similar measures presented by other trusts. Conversion to an income trust was effective July 30, 2002.

(3) Cash distributions declared as a percentage of distributable income.

(4) Excludes current portion of long-term debt and capital lease obligations, which are included in working capital

# MANAGEMENT'S DISCUSSION AND ANALYSIS

## RESULTS OF OPERATIONS

### *2005 COMPARED TO 2004*

#### Overview

Cathedral Energy Services Income Trust (the "Trust") completed fiscal 2005 with record results. On a year-over-year basis, revenues increased $39,524 or 85% to $86,002 from $46,478 in 2004. EBITDA for the year ended December 31, 2005 was $31,580 while the comparative figure for 2004 was $15,108 – an increase of $16,472 or 109%.

For the year ended December 31, 2005, net income was $21,807 ($0.76 per diluted Trust Unit) compared to $9,128 ($0.38 per diluted Trust Unit) for 2004 – an increase of 139%.

#### Revenues and operating expenses

| $ '000's except per day rates | **2005** | 2004 | Change | % |
|---|---|---|---|---|
| Revenues | **$ 86,002** | $ 46,478 | $ 39,524 | 85 |
| Operating expenses | **42,312** | 22,453 | 19,859 | 88 |
| Gross margin - $ | **$ 43,690** | $ 24,025 | $ 19,665 | 82 |
| Gross margin - % | **50.8%** | 51.7% | (0.9)% | |

Record revenues for all quarters in 2005 combined for record annual revenues of $86,002 which represented an increase of 85% over 2004 revenues. The increase was mainly a result of: i) a 45% increase in directional/horizontal drilling activity days to 8,472 activity days; ii) a 7.1% increase in the average day rate for directional/horizontal drilling services to $7,935 per day; and iii) the inclusion of revenues from the Tier One and Advance acquisitions effective May 6, 2005 and September 8, 2005, respectively. The Tier One and Advance Wireline acquisitions account for 38% of the year-over-year increase in revenues. The acquisition of Xtreme Wireline occurred on December 22, 2005 and therefore did not contribute significantly to 2005 revenues. The increase in directional/horizontal drilling activity days is a reflection of the continuing strength in the oil and natural gas sector of the economy. The Rocky Mountain region of the U.S. remains a very active area and the Trust's revenues from this region increased $9,714 on a year-over-year basis. The increase in the average day rate for directional/horizontal drilling services is due to providing additional specialty services and tools as well as ancillary charges and modest day rate increases.

Despite an increase in the average day rate for directional/horizontal drilling services the gross margin related to this revenue source only increased marginally due to increased field labour costs including training costs and general price increases for supplies purchased. On a product line basis, the gross margin percentage obtained from production testing and wireline services is marginally lower than that obtained from providing of directional/horizontal drilling services and that accounts for the decrease in gross margin percentage on a year-over-year basis.

#### General and administrative expenses

| $ '000's | **2005** | 2004 | Change | % |
|---|---|---|---|---|
| General and administrative expenses | **$ 14,125** | $ 9,879 | $ 4,246 | 43 |

The year-over-year increase in general and administrative expenses is mainly related to personnel costs, an overall increase in activity levels both in Western Canada and the Rocky Mountain region of the U.S. as well as the inclusion of general and administrative expenses related to the acquisitions of Tier One effective May 6, 2005 and Advance Wireline effective September 8, 2005. As a percentage of revenues, general and administrative expenses were 16.4% in 2005 and 21.3% in 2004.

#### Depreciation and amortization

| $ '000's | **2005** | 2004 | Change | % |
|---|---|---|---|---|
| Depreciation and amortization | **$ 5,686** | $ 3,582 | $ 2,104 | 59 |

This increase is related to a larger capital asset base due to the Trust's continued investment in capital assets over the past 12 months to meet demand as well as the inclusion of depreciation and amortization on capital assets and intangibles acquired as a result of the acquisitions of Tier One effective May 6, 2005, Advance Wireline effective September 8, 2005 and Xtreme Wireline on December 22, 2005. Included in depreciation and amortization for 2005 is $46 related to the amortization of intangibles (non-competition agreements and customer relationships) acquired through the Advance Wireline acquisition. As a percentage of revenues, depreciation and amortization amounted to 6.6% for 2005 and 7.7% for 2004.

#### Interest

| $ '000's | **2005** | 2004 | Change | % |
|---|---|---|---|---|
| Interest - long-term debt and capital lease obligations | **$ 235** | $ 279 | $ (44) | (16) |
| Interest - other | **$ 71** | $ 58 | $ 13 | 22 |

The year-over-year decrease in interest on long-term debt and capital lease obligations is the net result of an increase in the effective interest rate and a decrease in the average level of debt obligations outstanding (despite the inclusion of debt obligations assumed on the acquisitions of Advance Wireline and Xtreme Wireline).

The increase in other interest expense is due mainly to an increase in the use of the Trust's operating loan facility.

# MANAGEMENT'S DISCUSSION AND ANALYSIS

### Foreign exchange loss

| $ '000's | | **2005** | | 2004 | | Change | % |
|---|---|---|---|---|---|---|---|
| Foreign exchange loss | **$** | **25** | $ | 69 | $ | (44) | (64) |

The Trust derives revenues from the U.S. which are denominated in the local currency. This causes a degree of foreign currency exchange rate risk which the Trust attempts to mitigate by matching local purchases in the same currency. Furthermore, the Trust's Canadian operations are subject to foreign currency exchange rate risk in that some purchases for parts, supplies and components in the manufacture of equipment are denominated in U.S. dollars. As a result of the decline in the U.S. dollar relative to the Canadian dollar, the Trust experienced a relatively small foreign exchange loss in 2005 in the amount of $25 (2004 - $69).

### Non-cash compensation expense

| $ '000's | | **2005** | | 2004 | | Change | % |
|---|---|---|---|---|---|---|---|
| Non-cash compensation expense | **$** | **842** | $ | 17 | $ | 825 | n/a |

The increase in non-cash compensation expense is due to the expense related to Trust Unit options granted during 2005. Until the 2005 options were granted non-cash compensation expense was minimal. The overall increase in the value of non-cash compensation expense is due to: i) the significant appreciation in the market price for the underlying Trust Units which in turn has increased substantially the value attributed to the Trust Unit options granted during the period using the Black-Scholes option pricing model; and ii) the overall increase in the number of options granted. The value of the options is being amortized against income over the three-year vesting period.

### Gain on disposal of capital assets

| $ '000's | | **2005** | | 2004 | | Change | % |
|---|---|---|---|---|---|---|---|
| Gain on disposal of capital assets | **$** | **2,112** | $ | 1,088 | $ | 1,024 | 94 |

The gain on disposal of capital assets can vary significantly from year-to-year as almost all of the disposals relate to downhole equipment lost-in-hole. Cathedral recovers 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 $2,112 in 2005 which compares to $1,088 in 2004.

### Taxes

| $ '000's | | **2005** | | 2004 | | Change | % |
|---|---|---|---|---|---|---|---|
| Taxes | **$** | **3,010** | $ | 2,103 | $ | 907 | 43 |

The effective tax rate for 2005 was 12.1% while the comparative figure for 2004 was 18.7%. The 2005 tax provision includes the benefit of a reduction in future income taxes related to the June 16, 2005 internal reorganization. In addition, a portion of the post June 15, 2005 income from the Trust's Canadian operating entities is not subject to corporate income taxes within the corporate structure as this income flows through to unitholders and is taxed in their hands. Accordingly, there is no tax provision within the Trust's financial statements for that portion of the income which is allocated to the unitholders. The decreased effective tax rate is due to a higher portion of the Trust's pre-tax income being allocated to unitholders.

## *2004 COMPARED TO 2003*

### Overview

2004 was a very robust year for the energy service sector in general and specifically for Cathedral Energy Services Income Trust. The Trust completed fiscal 2004 with record annual net income of $9,128 ($0.38 per diluted Trust Unit) which compares to $4,441 ($0.20 per diluted Trust Unit) in 2003 – an increase of $4,687 or 106%. EBITDA for the year ended December 31, 2004 was also a record at $15,108 while the comparative figure for 2003 was $8,269 – an increase of $6,839 or 83%.

### Revenues and operating expenses

| $ '000's except per day rates | | 2004 | | 2003 | | Change | % |
|---|---|---|---|---|---|---|---|
| Revenues | $ | 46,478 | $ | 32,715 | $ | 13,763 | 42 |
| Operating expenses | | 22,453 | | 16,681 | | 5,772 | 35 |
| Gross margin - $ | $ | 24,025 | $ | 16,034 | $ | 7,991 | 50 |
| Gross margin - % | | 51.7% | | 49.0% | | 2.7% | |

Revenues for fiscal 2004 were at a record level of $46,478 which compares to $32,715 in 2003 – an increase of $13,763 or 42%. As a result of an overall increase in the level of drilling in the regions in which the Trust operates (Western Canada and the Rocky Mountain region of the United States) which were at record levels, plus an increase in Cathedral's market share, Cathedral completed 2004 with 5,845 (2003 – 4,125) activity days related to providing horizontal and directional drilling services. The average day rate for providing horizontal and directional drilling services increased from $7,096 per day in fiscal 2003 to $7,406 per day in 2004. Also contributing to the increase in revenues was the inclusion of revenues from the February 12, 2003 acquisition of The Directional Company, Inc. ("TDC") for a full 12 months in 2004 as opposed to 10 ½ months in 2003.

# MANAGEMENT'S DISCUSSION AND ANALYSIS

During Q2 of 2004, Cathedral commenced its first extended duration SAGD project for a major Canadian integrated energy company. SAGD is an area that Cathedral has identified as a tremendous niche market area for its growth. With the vast amount of heavy oil in place in northeastern Alberta, and much of it too deep to be mined, SAGD technology will be the preferred method of production. Cathedral commenced drilling additional SAGD wells for a second customer in Q2 of 2005.

The 2.7% increase in gross margin on a percentage basis from 49.0% in 2003 to 51.7% in 2004 was mainly attributed to less reliance on rented equipment and an increase in the average day rate in providing horizontal and directional drilling services and was partially offset by increased field labour costs as well as increased field training costs associated with the expansion of the Electro-Magnetic Measurement-While-Drilling ("EM-MWD") fleet.

**General and administrative expenses**

| $ '000's | 2004 | 2003 | Change | % |
|---|---|---|---|---|
| General and administrative expenses | $ 9,879 | $ 7,809 | $ 2,070 | 27 |

The year-over-year increase in general and administrative expenses was $2,063,000. The increase was related to personnel costs (mainly related to bonus accruals) and an overall increase in activity levels both in Western Canada and the Rocky Mountain region of the U.S. As a percentage of revenues, general and administrative expenses were 21.3% in 2004 and 23.9% in 2003.

**Depreciation**

| $ '000's | 2004 | 2003 | Change | % |
|---|---|---|---|---|
| Depreciation | $ 3,582 | $ 3,118 | $ 464 | 15 |

Depreciation for 2004 was $3,582 compared to $3,118 in 2003. This increase of $464 was related to a larger capital asset base due to the Trust's investment in capital assets over the past 12 months. As a percentage of revenues, depreciation amounted to 7.7% for 2004 and 9.5% for 2003 - this decrease was mainly the result of the increase in revenues on a year-over-year basis.

**Interest expense**

| $ '000's | 2004 | 2003 | Change | % |
|---|---|---|---|---|
| Interest - long-term debt | $ 279 | $ 319 | $ (40) | (13) |
| Interest - other | $ 58 | $ 96 | $ (38) | (40) |

The decrease in interest on long-term debt was the result of a decrease in both the effective interest rate and the average level of long-term debt outstanding. In Q4 of 2004, the Trust repaid all of its outstanding long-term debt and finished 2004 with no long-term debt. The decrease in other interest expense (non-long-term debt related) was due mainly to a decrease in the use of the Trust's operating loan facility.

**Foreign exchange loss**

| $ '000's | 2004 | 2003 | Change | % |
|---|---|---|---|---|
| Foreign exchange loss | $ 69 | $ 64 | $ 5 | 8 |

The Trust derives revenues from the U.S. which are denominated in the local currency. This causes a degree of foreign currency exchange rate risk which the Trust attempts to mitigate by matching local purchases in the same currency. Furthermore, the Trust's Canadian operations are subject to foreign currency exchange rate risk in that some purchases for parts, supplies and components in the manufacture of equipment are denominated in U.S. dollars.

As a result of the decline in the U.S. dollar relative to the Canadian dollar, the Trust experienced a relative small foreign exchange loss in 2004 in the amount of $69 (2003 - $64).

**Non-cash compensation expense**

| $ '000's | 2004 | 2003 | Change | % |
|---|---|---|---|---|
| Non-cash compensation expense | $ 17 | $ 6 | $ 9 | 150 |

The increase in non-cash compensation expense was mainly due to the options granted in 2004.

**Gain on disposal of capital assets**

| $ '000's | 2004 | 2003 | Change | % |
|---|---|---|---|---|
| Gain on disposal of capital assets | $ 1,088 | $ 205 | $ 883 | 431 |

The gain on disposal of capital assets can vary significantly from year-to-year as almost all of the disposals relate to downhole equipment lost-in-hole. Cathedral recovers lost-in-hole equipment costs including previously expensed depreciation on the related assets and this resulted in a gain on disposal of capital assets of $1,088 in 2004 which compares to $205 in 2003.

**Taxes**

| $ '000's | | **2004** | | 2003 | | Change | % |
|---|---|---|---|---|---|---|---|
| Taxes | **$** | **2,103** | $ | 386 | $ | 1,717 | 445 |

The effective tax rate for 2004 was 18.7% while the comparative figure for 2003 was 8.0%. The Trust on a non-consolidated basis, as a mutual fund trust and pursuant to the Declaration of Trust, allocates all of its taxable income to the unitholders of the Trust. The Trust's operating subsidiaries are subject to statutory corporate income taxes and certain provincial capital taxes and recognizes future income taxes on "temporary differences" in the operating subsidiaries. As a result of the substantial increase in operating results of the Trust's subsidiaries in 2004 the interest on the subordinated note between Cathedral Energy Services Ltd. and the Trust was not able to fully shelter the subsidiaries from current taxes and this resulted in a higher effective tax rate.

## LIQUIDITY AND CAPITAL RESOURCES

The Trust's principal source of liquidity is cash generated from operations. The Trust also has the ability to fund liquidity requirements through its credit facility and the issuance of debt and/or equity. At December 31, 2005, the Trust had an operating line of credit with a major Canadian bank in the amount of $9,000 (2004 - $4,500) of which $5,310 (2004 - $nil) was drawn. In mid-February 2006, the Trust's operating line of credit was increased to $12,500. In addition, the Trust has a non-reducing revolving term loan facility in the amount of $12,000 (2004 - $7,000) of which the full amount of $12,000 (2004 - $nil) was drawn as at December 31, 2005. In addition, at December 31, 2005, the Trust had obligations under capital leases in the amount of $969 (2004 - $nil) and other long-term debt of $383 (2004 - $nil) – these capital lease and other long-term debt obligations were assumed as part of the Advance Wireline and Xtreme Wireline acquisitions.

**Operating activities** Cash provided by operating activities before changes in non-cash operating working capital in 2005 increased from $12,988 in 2004 to $27,943 – an increase of $14,955. This increase is a direct reflection of the strong operating results of the Trust for 2005 which includes the contribution of the three acquisitions in 2005. As a result of the increased level of operations in 2005 over 2004, the Trust invested an additional $6,333 in non-cash working capital related to operations in 2005. The Trust has a strong working capital position at December 31, 2005 at $10,571 which compares to $10,839 at the end of 2004.

**Investing activities** Cash used in investing activities for the year ended December 31, 2005 amounted to $26,294 which compares to $7,298 in 2004. Excluding the changes in non-cash working capital related to investing activities, cash used in investing activities increased by $20,988 from $6,170 in 2004 to $27,158 in 2005. In 2005, The Trust's operating entities acquired $18,584 (2004- $8,038) of capital assets including 14 Measurement-While-Drilling ("MWD") systems as well as additions to the mud motor and drill collar fleet to complement the increase in directional/horizontal drilling job capacity, 7 production testing units and various specialty wireline logging tools and ancillary wireline equipment. As well, the additions include the replacement of tools that were lost-in-hole. At December 31, 2005, the Trust has 54 MWD systems, 236 mud motors, 16 production testing units and 14 wireline units. Included in the 14 MWD systems added in 2005 are 6 of Cathedral's newly developed positive pulse MWD systems which were announced as being "commercial" on November 1, 2005. Proceeds on disposal of capital assets amounted to $4,086 (2004 - $2,302) and is mainly related to recovery of downhole equipment costs that were lost-in-hole in 2005 as well as previously expensed depreciation. Included in 2005 investing activities is the use of funds in the amount of $12,661 (2004 - $434) related to the acquisition of Tier One, Advance Wireline and Xtreme Wireline (figure excludes the value of Trust Units issued as part of the acquisitions in the amount of $13,712). The Advance Wireline acquisition structure includes additional contingent consideration of up to a maximum of $3,000, payable in Trust Units with an assigned value based upon an average trading price immediately prior to the issuance of the related Trust Units, and will be paid over a 2-year period based upon the financial results of Advance for the periods ended on the first and second anniversary of the closing date. At December 31, 2005, no additional contingent consideration has been recorded. Additional consideration paid will be recorded as an additional cost of the purchase and allocated to goodwill.

**Financing activities** Cash provided by financing activities for the year ended December 31, 2005 amounted to $3,625 which compares to $1,251 in 2004. During 2005, the Trust received advances of long-term debt in the amount of $12,050 of which $12,000 related to financing of the acquisition of Advance Wireline including the retirement of Advance Wireline's bank debt outstanding at the date of acquisition. Repayments of long-term debt and capital lease obligations in 2005 amounted to $617 (2004 - $6,000). As at December 31, 2005, the Trust was in compliance with all covenants under its credit facility.

The capital asset additions in 2005 were financed by way of cash flow from operations, working capital, proceeds from the disposal of capital assets and proceeds on exercise of Trust Unit options.

Distributions declared for 2005 amounted to $14,810 (2004 - $5,768) and included cash distributions of $11,162 (2004 - $5,768) and a non-cash in-kind distribution of $3,648 (2004 - $nil). Pursuant to the Trust's Declaration of Trust, the Trust is required to allocate all of its taxable income to Unitholders and in order to allocate all of its taxable income to Unitholders a non-cash in-kind distribution in the form of additional Trust Units was allocated to Unitholders of record on December 31, 2005. The December 31, 2005, non-cash in-kind distribution was $0.12139 per Trust Unit for a total of $3,648. The Declaration of Trust also requires there is an immediate consolidation of the Trust Units issued such that each Unitholder has the same number of Trust Units after the consolidation as they had prior to the non-cash in-kind distribution. Based upon a year-end Trust Unit price of $11.90 per Trust Unit the in-kind distribution represented the issuance of 306,534 Trust Units which were immediately consolidated.

Distributions paid to Unitholders for 2005 amounted to $10,281 (2004 - $6,354). The year-over-year increase is due to: i) three increases in the per Trust Unit distribution in 2005 (approximate 10% increase effective May 2005, a further 36.4% increase effective September 2005 and another 33.3% increase effective November 2005); and ii) the increased number of Trust Units outstanding as a result of options exercised, two private placements in 2004 and 1,891,261 Trust Units issued as part of 2005 business acquisitions.

The following is a summary of distributions declared in 2005 and 2004.

| | 2005 | 2004 | Change | % |
|---|---|---|---|---|
| Declared ($ '000's): | | | | |
| Cash | **$ 11,612** | $ 5,768 | $ 5,394 | 94 |
| In-kind | **3,648** | - | 3,648 | n/a |
| Total | **$ 14,810** | $ 5,768 | $ 9,042 | 157 |
| Declared per Trust Unit: | | | | |
| Cash | **$ 0.38500** | $ 0.245 | $ 0.14000 | 57 |
| In-kind | **0.12139** | - | 0.12139 | n/a |
| Total | **$ 0.50639** | $ 0.245 | $ 0.26139 | 107 |

Effective January 2004, the Trust converted to a monthly distribution policy.

**Contractual obligations** In the normal course of business, the Trust's operating entities incur contractual obligations. The following is summary of the Trust's contractual obligations as at December 31, 2005 for the following items:

| $ '000's | Total | 2006 | 2007 | 2008 | 2009 | 2010 | There-after |
|---|---|---|---|---|---|---|---|
| Capital asset additions | $ 4,378 | $ 4,378 | $ - | $ - | $ - | $ - | $ - |
| Operating lease obligations | 8,390 | 1,424 | 1,687 | 1,497 | 1,195 | 990 | 1,597 |
| Long-term debt and capital lease obligations(1) | 13,352 | 555 | 2,390 | 4,184 | 4,111 | 2,112 | - |
| | $ 26,120 | $ 6,357 | $ 4,077 | $ 5,681 | $ 5,306 | $ 3,102 | $ 1,597 |

(1) - Minimum principal amounts to be paid under long-term debt assumes the Trust elects prior to the maturity date of the revolving term loan to repay the loan over 36 months.

## DISTRIBUTABLE INCOME

Distributable income is calculated as follows:

| $ '000's | Year ended December 31 2005 | 2004 |
|---|---|---|
| Funds from operations | **$27,942** | $12,988 |
| Less: - required principal repayments on long-term debt and capital lease obligations | **(177)** | - |
| - maintenance capital expenditures | **(214)** | (64) |
| Distributable income | **$27,551** | $12,924 |
| Cash distributions declared | **$11,162** | $ 5,768 |
| Payout ratio | **41%** | 45% |

Cathedral's operations in Western Canada are subject to seasonality as activity levels in the oilfield services industry are generally lower during "spring breakup" which normally commences in late March and continues through to May. It is the Trust's policy to pay consistent distributions throughout the year despite the seasonality of a portion of Cathedral's business.

As a result of the Trust's equipment being relatively new and the extensive maintenance program for its equipment (such repairs and maintenance cost are expensed in operating expenses), expenditures for maintenance capital are currently minimal. Current maintenance capital expenditure levels may not be indicative of future maintenance capital expenditure levels.

The Trustees review the level and nature of distributions on an on-going basis giving consideration to current performance, historical and future trends in the business and the expected sustainability of those trends as well as required long-term debt repayments and maintenance capital expenditures required to sustain performance. Distributable income is not a standardized measure under Canadian Generally Accepted Accounting Principles and distributable income cannot be assured. The Trust's calculation of distributable income may differ from similarly titled measures used by other trusts. Distributable income is a main performance measurement used by management and investors to evaluate the performance of the Trust.

## INTERNAL REORGANIZATION

Management of the Trust had concluded that in order to maximize cash distributions to unitholders it would make future investments in new business initiatives, lines of business, services, product expansion and other investments through a wholly-owned trust and a limited partnership. Furthermore management believed that by combining Cathedral Energy Services Ltd. ("LTD"), Tier One Oil Services Ltd. ("Tier One") and a new partnership (as opposed to operating as separate entities) there would be savings in administrative costs and effort. As a result, effective June 16, 2005, a new structure was implemented in which the Canadian operations of LTD and Tier One were combined into a limited partnership ("Cathedral Energy Services Limited Partnership"). The combining of the operations of LTD and Tier One have reduced administrative costs and efforts and provided a "combined" platform for future investments/growth in a tax efficient manner.

**RELATED PARTY TRANSACTION**

A Trustee of the Trust and Director of Cathedral Energy Services Ltd., is a partner in a law firm and, through that law firm, is involved in providing and managing the legal services provided to the Trust at market rates. The total cost of these legal services in 2005 was $237 (2004 - $104).

**FOURTH QUARTER RESULTS**

Results for 2005 Q4 represent record quarterly figures for any quarter in the history of the Trust and its predecessor. Record revenues came in at $32,101 which is an increase of $16,009 or 99% over the 2004 Q4 revenues of $16,092. In 2005 Q4, the Trust had 2,664 (2004 – 2,003) activity days related to providing horizontal and directional drilling services with an average day rate of $7,963 (2004 - $7,598). The quarter-over-quarter increase in activity days is a reflection on the increased activity levels and the Trust's increased market share in both regions in which it operates. The 2005 acquisitions of Tier One, Advance Wireline and Xtreme Wireline accounted for $9,891 or 62% of the quarter-over-quarter increase in revenues. Quarter-over-quarter EBITDA increased $5,341 or 79% from $6,750 in 2004 to $12,091 in 2005. Included in 2005 Q4 results is a gain on disposal of capital assets of $873 (2004 - $431) related to equipment lost-in-hole. The above items contributed to a 64% increase in pre-tax income to $9,336.

Net income for 2005 Q4 was $7,762 ($0.25 per diluted Trust Unit) which compares to $4,221 ($0.17 per diluted Trust Unit) in 2004 Q4. The effective tax rate decreased from 25.8% in 2004 Q4 to 15.0% in 2005 Q4 – the decrease is attributed to the June 16, 2005 internal reorganization of the Trust which has shifted a portion of the tax burden to unitholders as opposed to the Trust and its operating entities.

**SUMMARY OF QUARTERLY RESULTS (in $ '000's except per Trust Unit amounts)**

| | 2005 | | | | 2004 | | | |
|---|---|---|---|---|---|---|---|---|
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 |
| | | restated | | | | | | |
| Revenues | $16,458 | $14,617 | $22,826 | $32,101 | $10,604 | $ 8,016 | $11,766 | $16,092 |
| Income before taxes | 5,321 | 2,889 | 7,272 | 9,335 | 2,107 | 444 | 2,994 | 5,686 |
| Net income | 3,858 | 4,008 | 6,179 | 7,762 | 1,709 | 791 | 2,407 | 4,221 |
| Net income per Trust Unit | | | | | | | | |
| Basic | 0.14 | 0.14 | 0.21 | 0.26 | 0.08 | 0.04 | 0.10 | 0.17 |
| Diluted | 0.14 | 0.14 | 0.21 | 0.25 | 0.07 | 0.03 | 0.10 | 0.17 |

The majority of Cathedral's operations are carried on in Western Canada where activity levels in the oilfield services industry are subject to a degree of seasonality. Operating activities in Western Canada are generally lower during "spring breakup" which normally commences in late March and continues through to May. Operating activities generally increase in the fall and peak in the winter months from December till late March. Activity levels in the Rocky Mountain region of the U.S. are not subject to the seasonality to the extent that it occurs in the Western Canada region.

**CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

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. Management believes the accounting principles selected are appropriate under the circumstances and the Audit Committee of Cathedral has approved the policies selected.

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 management at the time the estimate or assumption is made. The estimates and assumptions used by management 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. Management believes the estimates, judgments and assumptions involved in its financial reporting are reasonable.

The following accounting policies require management's more significant judgments and estimates in the preparation of the Trust's consolidated financial statements, and as such, are considered to be critical.

**Capital assets** Capital assets are recorded at cost less accumulated depreciation. Depreciation is computed based upon the Trust's depreciation policies (see note 2 to consolidated financial statements). The depreciation policies selected are intended to depreciate the related capital assets over their useful life. The use of different assumptions with regard to the useful life could result in different carrying amount for these assets as well as for depreciation expense.

**Impairment of long-lived assets** Capital assets are reviewed for impairment when events or changes in circumstances indicate that the carrying value of assets may not be recoverable. In the assessment process management is required to make certain judgments, assumptions and estimates in identifying such events and changes in circumstances, and in assessing their impact on the valuations and economic lives of the affected assets. Impairments are recognized when the book values exceed management's estimate of the undiscounted future cash flows, or net recoverable amounts, associated with the affected assets.

**Deferred development costs** Costs associated with the development of downhole equipment are capitalized during the development process. These costs are identified as deferred development costs and are recorded with capital assets. Once the equipment becomes commercial in nature, the related deferred development costs are amortized over 5 years.

Cathedral undertakes periodic reviews of each project on which deferred development costs have been recorded to determine if the carrying value of the project can be recovered for the undiscounted expected net future cash flow generated from the related equipment. If there is no reasonable expectation that the costs can be recovered, the carrying value of the project is reduced and the excess is charged to earnings. This process of estimation is subject to significant judgment with respect to revenues and direct costs associated with the equipment as well as market acceptance.

**Goodwill and intangibles** The carrying value of goodwill and intangibles on acquisitions is compared to its fair value at least annually to determine if a permanent impairment exists, at which time the impairment would be recorded as a charge to earnings. Valuations are inherently subjective and necessarily involve judgments and estimates regarding future cash flows and other operational variables.

**Income taxes** 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. As a result, a projection of taxable income is required for those years, as well as an assumption of the ultimate recovery/settlement period for the temporary differences. The projection of future taxable income is based on management's best estimate and may vary from actual taxable income. On an annual basis, the Trust assesses its need to establish a valuation allowance for its deferred income tax assets and if it is deemed more likely than not that its deferred income tax assets will not be realized on its taxable income projections a valuation allowance is recorded.

In addition, Canadian and U.S. tax rules and regulations are subject to interpretation and require judgment by management that may be challenged by the taxation authorities. Management believes that its provisions for taxes are adequate pertaining to any assessments from the taxation authorities.

**Stock-based compensation** Stock-based compensation is calculated using the fair value method based upon the Black-Scholes model. In order to establish fair value, we use estimates and assumptions to determine risk-free interest rate, expected term, anticipated volatility and anticipated distribution yield. The use of different assumptions could result in different book values for stock-based compensation.

## FUTURE ACCOUNTING CHANGES

The Accounting Standards Board ("AcSB") of the Canadian Institute of Chartered Accountants ("CICA") continually amends and improves certain standards or guidelines contained in the CICA Handbook. We monitor these changes as they are proposed and will make changes to our accounting policies and disclosures as necessary.

**Non-Monetary Transactions** In June 2005, the AcSB issued a new Section 3831, Non-Monetary Transactions, replacing Section 3830 of the same title. It requires all non-monetary transactions to be measured at fair value unless certain specific criteria apply. The new requirements are effective for non-monetary transactions initiated in periods beginning on or after January 1, 2006, and are not to be applied retroactively.

**Comprehensive Income** The CICA issued section 1530 of the CICA Handbook, Comprehensive Income. The section is effective for fiscal years beginning on or after October 1, 2006. It describes how to report and disclose comprehensive income and its components. Comprehensive income is the change in a trust's net assets that results from transactions, events and circumstances from sources other than the trust's unitholders. It includes items that would not normally be included in net earnings, such as unrealized gains or losses on available-for-sale investments.

The CICA also made changes to section 3250 of the CICA Handbook, Surplus, and reissued it as section 3251, Equity. The section is also effective for fiscal years beginning on or after October 1, 2006. The changes in how to report and disclose equity and changes in equity are consistent with the new requirements of section 1530, Comprehensive Income.

Adopting these sections on January 1, 2007, will require us to start reporting the following items in the consolidated financial statements:

- Comprehensive income and its components; and
- Accumulated other comprehensive income and its components.

**Financial Instruments - Recognition and Measurement** The CICA issued section 3855 of the CICA Handbook, Financial Instruments - Recognition and Measurement. The section is effective for fiscal years beginning on or after October 1, 2006. It describes the standards for recognizing and measuring financial assets, financial liabilities and non-financial derivatives. This section requires that:

- All financial assets be measured at fair value, with some exceptions, such as loans and investments that are classified as held-to-maturity;
- All financial liabilities be measured at fair value if they are derivatives or classified as held for trading purposes. Other financial liabilities are measured at their carrying value; and
- All derivative financial instruments be measured at fair value, even when they are part of a hedging relationship.

We will adopt this section effective January 1, 2007 but we do not expect this section to materially impact on our consolidated financial statements.

**Hedges** The CICA recently issued section 3865 of the CICA Handbook, Hedges. The section is effective for fiscal years beginning on or after October 1, 2006, and describes when and how hedge accounting can be used. Hedging is an activity used by a company to change an exposure to one or more risks by creating an offset between:

- Changes in the fair value of a hedged item and a hedging item;
- Changes in the cash flows attributable to a hedged item and a hedging item; or
- Changes resulting from a risk exposure relating to a hedged item and a hedging item.

Hedge accounting ensures that all gains, losses, revenues and expenses from the derivative and the item it hedges are recorded in the income statement in the same period. We will adopt this section effective January 1, 2007 but we do not expect this section to materially impact on our consolidated financial statements.

## DISCLOSURE CONTROLS AND PROCEDURES

Disclosure controls and procedures have been designed to ensure that relevant and accurate information need to comply with the Trust's continuous disclosure obligations is accumulated and summarized to allow timely decisions regarding disclosure and to ensure that the risk of a material error or fraud is minimal. Management of the Trust's Administrator have concluded that the Trust's disclosure controls and procedures, as of the end of the period covered by the annual filings are effective in ensuring that material information is accumulated and disclosed accurately. Management of the Trust's Administrator believe that "cost effective" disclosure controls, disclosure procedures and internal control systems can only provide reasonable assurance, and not absolute assurance, that the objective of controls and procedures are met.

## BUSINESS RISKS

**Dependence of Cathedral Energy Services Ltd. and Cathedral Energy Services Limited Partnership** The Trust is an open-ended, limited purpose mutual fund trust which is entirely dependent upon the operations and assets of Cathedral Energy Services Ltd. and Cathedral Energy Services Limited Partnership (collectively "Cathedral") through the ownership of the Cathedral Energy Services Ltd. shares and subordinated notes and an indirect wholly-owned partnership interest in Cathedral Energy Services Limited Partnership. Accordingly, the cash distributions to the Unitholders is dependent upon the ability of Cathedral Energy Services Ltd. to pay its interest obligations under the subordinated notes and to declare and pay dividends on its shares and the ability of Cathedral Energy Services Limited Partnership to provide cash distributions from partnership profits.

**Distributions are not guaranteed and will fluctuate with Cathedral's performance** There can be no assurance regarding the amounts of income which will be generated by Cathedral and paid to the Trust. The actual cash amount distributed in respect of the Trust Units will depend upon numerous factors, including profitability, determination of taxable income and taxes payable, fluctuations in working capital, the sustainability of margins and capital expenditures as well as the actual cash amount distributed from Cathedral.

**Changes in legislation** There can be no assurance that the treatment of mutual fund trusts will not be changed in a manner which adversely affects Unitholders. If the Trust ceases to qualify as a "mutual fund trust" under the Tax Act (Canada), the Trust Units will cease to be qualified investments for registered retirement savings plans, deferred profit sharing plans and registered retirement income funds.

**Non-resident ownership of Trust Units** In order for the Trust to maintain its status as a mutual fund trust under the Tax Act (Canada), the Trust must not be established or maintained primarily for the benefit of non-resident of Canada ("non-residents") within the meaning of the Tax Act (Canada). The Declaration of Trust authorizes the Trust to take certain actions to maintain the non-resident ownership to less than 50% (refer to Declaration of Trust – Limitation on Non-resident Ownership filed on SEDAR). The current estimate of non-resident ownership is approximately 25%.

**Unitholder liability** The Declaration of Trust provides that no Trust Unitholder will be subject to any liability in connection with the Trust or its assets or obligations and, in the event that a court determines that Unitholders are subject to any such liabilities, the liabilities will be enforceable only against, and will be satisfied only out of, the Unitholder's share of the Trust's assets. On July 1, 2004, the Province of Alberta proclaimed the Income Trust Liability Act (Alberta) in force. This legislation provides that beneficiaries of Alberta based public income trusts are not liable, as beneficiaries, for any act, default, obligation or liability of the income trust. Unitholders of the Trust will have the benefit of this legislation with respect to liabilities arising on or after July 1, 2004. This legislation has not been subject to interpretation by courts in the Province of Alberta or elsewhere.

Specific business risks relating to Cathedral Energy Services Ltd and Cathedral Energy Services Limited Partnership are as follows:

**Crude oil and natural gas prices** Demand for the services provided by Cathedral is directly impacted by the prices our customers receive for crude oil and natural gas they produce in that it has a direct relation to the cash flow available to invest in drilling activity and other oilfield services. World crude oil prices and North American natural gas prices are not subject to control by Cathedral. With that in mind, Cathedral attempts to partially manage this risk by way of maintaining a low cost structure and a variable cost structure that can be adjusted to reflect activity levels. A significant portion of Cathedral fieldwork is performed by sub-contractors which allows us to operate with lower fixed overhead costs in seasonally low activity periods.

**Key personnel and employee/sub-contractor relationships** Unitholders must rely upon the ability, expertise, judgment, discretion, integrity and good faith of the management of Cathedral. The success of Cathedral is dependent upon its personnel and key sub-contractors. The unexpected loss or departure of any of Cathedral's key officers, employees or sub-contractors could be detrimental to the future operations of Cathedral. Cathedral does not maintain key man insurance on its officers. The success of Cathedral's business will depend, in part, upon Cathedral's ability to attract and retain qualified personnel as they are needed. Historically, Cathedral has not had any significant issues with respect to attracting and maintaining quality office, shop and field staff (including sub-contractors). During high levels of activity, attracting quality staff can be challenging due to competition for such services. Cathedral provides its staff with a quality working environment, effective training, tools with current technology and competitive remuneration packages that allows it to attract and maintain the quality of its workforce, whether in the field, shop or office. There can be no assurance that Cathedral will be able to engage the services of such personnel or retain its current personnel.

**Interest rates** The Trust's operating loan and its non-reducing revolving term credit facility bear interest at a floating interest rate and, therefore, to the extent the Trust borrows under this facility, is at risk of rising interest rates. Management continually monitors interest rates and would consider locking in the rate of its term debt.

**Additional financing** The Trust may require additional financing which may not be available or, if available, may not be available on favorable terms.

**Competition** The oil and natural gas service industry in which Cathedral operates is highly competitive. Cathedral competes with other more established entities which have greater financial, marketing and other resources and certain of which are large international oil and natural gas service companies which offer a wider array of oil and natural gas services to their clients than does Cathedral.

**Access to parts, consumables and technology and relationships with key suppliers** The ability of the Trust to compete and expand will be dependant on the Trust having access, at a reasonable cost, to equipment, parts and components, which are at least technologically equivalent to those utilized by competitors and to the development and acquisition of new competitive technologies. Although the Trust has very good relationships with its key suppliers, there can be no assurances that those sources of equipment, parts, components or relationships with key suppliers will be maintained. If these are not maintained, the Trust's ability to compete may be impaired. If the relationships with key suppliers come to an end, the availability and cost of securing certain parts, components and equipment may be adversely affected. It should be noted that Cathedral competes with other more established companies which have greater financial resources to develop new technologies.

**Operating risks and insurance** The Trust has an insurance and risk management plan in place to protect its assets, operations and employees. The Trust also has programs in place to address compliance with current safety and regulatory standards. The Trust has a safety coordinator responsible for maintaining and developing policies and monitoring operations vis-a-vis those policies. However, the Trust's oilfield services are subject to risks inherent in the oil and gas industry, such as equipment defects, malfunctions, failure and natural disasters. These risks could expose the Trust to substantial liability for personal injury, loss of life, business interruption, property damage or destruction, pollution and other environmental damages. In addition, the Trust's operating activities includes a significant amount of transportation and therefore is subject to the inherent risks including potential liability which could result from, among other things, personal injury, loss of life or property damage from motor vehicle accidents.

**Weather and seasonality** The majority of Cathedral's operations are carried on in Western Canada where activity levels in the oilfield services industry are subject to a degree of seasonality. Operating activities in Western Canada are generally lower during "spring breakup" which normally commences in late March and continues through to May. Operating activities generally increase in the fall and peak in the winter months from December till late March. Activity levels in the Rocky Mountain region of the U.S. are not subject to the seasonality to the extent that it occurs in the Western Canada region.

**Foreign currency exchange rates** Cathedral derives revenues from the U.S. which are denominated in the local currency. This causes a degree of foreign currency exchange rate risk which Cathedral attempts to mitigate by matching local purchases in the same currency. Furthermore, Cathedral's Canadian operations are subject to foreign currency exchange rate risk in that some purchases for parts, supplies and components in the manufacture of equipment are denominated in U.S. dollars.

**Acquisitions** The Trust makes acquisitions of businesses and assets in the ordinarily course of business. Achieving the benefits of acquisitions depends in part on successfully consolidating functions and integrating operations and procedures in a timely and efficient manner. Such integration may require substantial management effort, time and resources and may divert management's focus from other strategic opportunities and operational matters. Management continually assesses the value and contribution of services provided and assets required to provide such services.

**Credit risk** The Trust's accounts receivables are with customers involved in the oil and natural gas industry, whose revenue may be impacted by fluctuations in commodity prices. Although collection of these receivables could be influenced by economic factors affecting this industry, management considers risk of significant loss to be minimal at this time.

**Customer mix** Overall Cathedral has a good mix of customers with only one customer accounting for revenues in excess of 5% (at 14%) of the Trust's consolidated revenues for 2005 (2004 – one customer at 22%).

In addition to the comments noted above, Cathedral manages its business risks by providing the highest level of service and results available to the customer, maintaining a comprehensive insurance program, strict adherence to the Cathedral's safety standards and complying with current environmental requirements.

### OFF-BALANCE SHEET ARRANGEMENTS

As at December 31, 2005, the Trust has not entered into any off-balance sheet arrangements.

### GOVERNANCE

The Audit Committee of the Board of Trustees has reviewed this MD&A and the related audited consolidated financial statements and recommended they be approved by the Board of Trustees. Following a review by the full Board, the MD&A and audited consolidated financial statements were approved.

### SUPPLEMENTARY INFORMATION

As at March 21, 2006, the Trust had 30,426,687 Trust Units and 2,570,606 options to purchase Trust Units outstanding. Additional information regarding the Trust, including our Annual Information Form ("AIF"), is available on SEDAR at www.sedar.com.

### OUTLOOK

We are coming off a record level of 24,803 wells drilled in Western Canada in 2005 and industry analysts are projecting new record levels of drilling activity in Western Canada for 2006 and again in 2007. Producers are expected to have increased levels of capital expenditures in 2006 over that in 2005. Demand for directional drilling services in the Rocky Mountain region of the U.S. continues to expand and the Trust expects to expand its job capability in the region in 2006 Q1 to meet demand. The overall fundamentals behind the oil and natural gas industry remain strong and industry analysts continue to forecast strong oil and natural gas prices for 2006 and 2007.

To date, the Trust's board of trustees has approved a $19,000 capital expenditure budget for 2006 with the major items being the addition of 12 MWD systems as well as mud motors and drill collars to complement this increased directional drilling job capacity, 4 production testing units and 12 wireline units.

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, 2005 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
March 21, 2006

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, 2005 and 2004 and the consolidated statements of income 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, 2005 and 2004 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
March 6, 2006

# CONSOLIDATED BALANCE SHEETS

**December 31, 2005 and 2004**

| | 2005 | 2004 |
|---|---|---|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | $ 2,091,902 | $ 3,151,037 |
| Accounts receivable | 31,069,792 | 17,606,834 |
| Other receivables (note 3) | 611,455 | – |
| Inventory | 2,712,130 | 1,268,358 |
| Prepaid expenses and deposits | 524,732 | 255,969 |
| | 37,010,011 | 22,282,198 |
| Capital assets (note 4) | 46,926,785 | 22,915,640 |
| Intangibles, net of accumulated amortization of $46,125 | 883,875 | – |
| Goodwill (note 3) | 17,955,131 | 1,623,867 |
| Other asset (note 3) | 132,000 | – |
| | $ 102,907,802 | $ 46,821,705 |
| Liabilities and Unitholders' Equity | | |
| Current liabilities: | | |
| Bank indebtedness (note 5) | $ 5,310,000 | $ – |
| Accounts payable and accrued liabilities | 17,788,806 | 10,043,493 |
| Distribution payable to Unitholders (note 11) | 1,502,535 | 621,469 |
| Taxes payable | 1,282,483 | 778,000 |
| Current portion of capital lease obligations (note 6) | 304,199 | – |
| Current portion of long-term debt (note 7) | 250,918 | – |
| | 26,438,941 | 11,442,962 |
| Capital lease obligations (note 6) | 664,479 | – |
| Long-term debt (note 7) | 12,132,393 | – |
| Future income taxes (note 8) | 4,057,318 | 1,814,463 |
| Unitholders' equity: | | |
| Unitholders' capital (note 9) | 37,093,979 | 18,774,751 |
| Contributed surplus (note 10) | 756,193 | 22,140 |
| Accumulated income | 49,149,000 | 27,342,287 |
| Accumulated distributions | (27,384,501) | (12,574,898) |
| | 59,614,671 | 33,564,280 |
| Commitments (note 17) | | |
| | $ 102,907,802 | $ 46,821,705 |

See accompanying notes to consolidated financial statements.

**Approved by the Trustees:**

Mark Bentsen Trustee    Rod Maxwell Trustee

Mark L. Bentsen    Rod Maxwell

# CONSOLIDATED STATEMENTS OF INCOME AND ACCUMULATED INCOME

**Years ended December 31, 2005 and 2004**

| | 2005 | 2004 |
|---|---|---|
| Revenues (note 15) | **$ 86,001,535** | $ 46,477,855 |
| Expenses: | | |
| Operating | **42,312,048** | 22,452,594 |
| General and administrative | **14,124,789** | 9,878,590 |
| Depreciation and amortization | **5,686,181** | 3,582,210 |
| Interest - long-term debt and capital lease obligations | **235,060** | 278,554 |
| Interest - other | **71,100** | 57,663 |
| Foreign exchange loss | **25,196** | 69,124 |
| Non-cash compensation expense | **842,353** | 16,540 |
| | **63,296,727** | 36,335,275 |
| | **22,704,808** | 10,142,580 |
| Gain on disposal of capital assets | **2,112,034** | 1,088,497 |
| Income before taxes | **24,816,842** | 11,231,077 |
| Taxes (note 8): | | |
| Current | **1,267,084** | 772,849 |
| Future income taxes | **1,743,045** | 1,330,411 |
| | **3,010,129** | 2,103,260 |
| Net income | **21,806,713** | 9,127,817 |
| Accumulated income, beginning of year | **27,342,287** | 18,214,470 |
| Accumulated income, end of year | **$ 49,149,000** | $ 27,342,287 |
| Net income per Trust Unit (note 12): | | |
| Basic | **$ 0.76** | $ 0.39 |
| Diluted | **$ 0.76** | $ 0.38 |

See accompanying notes to consolidated financial statements.

# CONSOLIDATED STATEMENTS OF CASH FLOWS

**Years ended December 31, 2005 and 2004**

| | **2005** | 2004 |
|---|---|---|
| Cash provided by (used in): | | |
| Operating activities: | | |
| Net income | **$ 21,806,713** | $ 9,127,817 |
| Items not involving cash: | | |
| Depreciation and amortization | **5,686,181** | 3,582,210 |
| Future income taxes | **1,743,045** | 1,330,411 |
| Unrealized foreign exchange (gain) loss | **(23,809)** | 19,100 |
| Non-cash compensation expense | **842,353** | 16,540 |
| Gain on disposal of capital assets | **(2,112,034)** | (1,088,497) |
| Funds from operations | **27,942,449** | 12,987,581 |
| Changes in non-cash operating working capital (note 14) | **(6,332,938)** | (4,177,547) |
| | **21,609,511** | 8,810,034 |
| Investing activities: | | |
| Capital asset additions | **(18,583,595)** | (8,037,955) |
| Proceeds on disposal of capital assets | **4,086,428** | 2,302,164 |
| Acquisition of Tier One Oil Services Ltd., net of purchased cash of $497,776 (note 3) | **(3,193,037)** | – |
| Acquisition of Advance Wireline Inc. (note 3) | **(7,998,643)** | – |
| Acquisition of Xtreme Wireline (note 3) | **(1,469,078)** | |
| Acquisition of The Directional Company, Inc. (note 3) | **–** | (434,324) |
| Changes in non-cash investing working capital (note 14) | **863,993** | (1,127,599) |
| | **(26,293,932)** | (7,297,714) |
| Financing activities: | | |
| Advances under long-term debt | **12,050,330** | 300,000 |
| Repayments of long-term debt | **(526,567)** | (6,000,000) |
| Repayments of capital lease obligations | **(90,010)** | – |
| Distributions paid to Unitholders (note 11) | **(10,280,784)** | (6,353,553) |
| Proceeds from the issuance of Trust Units (note 9) | **–** | 13,137,249 |
| Trust Units issuance costs (note 9) | **(17,552)** | (735,120) |
| Proceeds on exercise of Trust Unit options (note 9) | **637,374** | 1,197,025 |
| Increase (decrease) in bank indebtedness | **1,852,495** | (295,000) |
| | **3,625,286** | 1,250,601 |
| Increase (decrease) in cash and cash equivalents | **(1,059,135)** | 2,762,921 |
| Cash and cash equivalents, beginning of year | **3,151,037** | 388,116 |
| Cash and cash equivalents, end of year | **$ 2,091,902** | $ 3,151,037 |

See accompanying notes to consolidated financial statements.

**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's operating entities, Cathedral Energy Services Ltd., Cathedral Energy Services Limited Partnership and Cathedral Energy Services Inc. (collectively the "Company") are engaged in the business of providing oilfield 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 six brand names: *Directional Plus* and *The Directional Company* which provide horizontal and directional drilling services; *CAT Downhole Tools* which provides downhole equipment including drilling jars, shock tools and high performance drilling motors on a rental basis; *Tier One Oil Services* which provides oil and natural gas production testing services; *Advance Wireline* which provides cased hole logging and perforating, complete slickline services and casing integrity inspection logging; and *Xtreme Wireline* which provides slickline services.

The Trust owns, directly and indirectly, 100% of the common shares and subordinated notes of Cathedral Energy Services Ltd., 100% of the common shares of Cathedral Energy Services Inc. and 100% of the partnership units of Cathedral Energy Services Limited Partnership. Pursuant to a note indenture, the Trust is entitled to an interest payment from Cathedral Energy Services Ltd. in relation to the subordinated notes.

**2. Significant accounting policies:**

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 entities, Cathedral Energy Services Commercial Trust, Cathedral Energy Services Ltd., Cathedral Energy Services Limited Partnership, Advance Wireline Inc. and Cathedral Energy Services Inc.

(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 and operating supplies. Inventory is valued at the lower of cost and market, with market represented by replacement value.

**2. Significant accounting policies (continued):**

(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 |
|---|---|
| Directional drilling equipment | 10 - 25% |
| Production testing equipment | 20 - 25% |
| Wireline equipment | 20% |
| Automotive equipment | 20 - 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 the pre-commercialization of downhole equipment. These costs are amortized on a straight-line basis over 5 years upon commercialization of the equipment.

(e) Future income taxes:

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.

(f) Revenue recognition:

Revenue is recognized as services are rendered based upon daily, hourly or job rates. 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 is computed by dividing net income by the weighted average number of Trust Units outstanding for the year. 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 the fourth quarter of 2003, the Trust elected early adoption of the revised Canadian accounting standards for stock-based compensation and other stock-based payments which requires that a fair value method of accounting be applied to all stock-based compensation payments to both employees and non-employees. In accordance with the transitional provisions of the revised recommendations, the Trust has prospectively applied the fair value method of accounting for option awards granted on or after January 1, 2003, and, accordingly, has recorded the related compensation expense during 2003. Prior to January 1, 2003, the Trust accounted for its employee options using the settlement method and no compensation expense was recognized. For awards granted in 2002, the revised recommendations require the disclosure of pro forma net income and net income per Trust Unit information as if the Trust had accounted for employee options under the fair value method and this information is disclosed in note 9 to the consolidated financial statements. The pro forma effect of awards granted prior to January 1, 2002 has not been included in the pro forma net income and net income per Trust Unit information.

(i) 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.

# NOTES OF CONSOLIDATED FINANCIAL STATEMENTS

**2. Significant accounting policies (continued):**

(j) Distributions to Unitholders:

Distributions to Unitholders are declared on the last business date of each month and paid on or about the 15th of the following month. The amount of the distributions to Unitholders is as declared and approved by the Trustees of the Trust. On an annual basis the net income of the Trust, being equal to the total interest earned by the Trust on the Notes, dividends, if any, from its wholly-owned subsidiaries and income allocated from Cathedral Energy Services Commercial Trust through its investment in Cathedral Energy Services Limited Partnership, less administrative expenses incurred by the Trust and amounts paid in connection with any cash redemption of Trust Units is allocated to Unitholders.

(k) Goodwill:

Goodwill represents the excess of the purchase price over the value attributed to the net tangible and intangible assets acquired. Goodwill is not subject to amortization but is subject to an annual review for impairment (or more frequently if events or changes in circumstances indicate that goodwill is impaired) which consists of a comparison of the Trust's fair value of the net assets to their carrying value. The net carrying value of goodwill would be written down if the value is determined to be impaired.

(l) Intangible assets

Intangible assets are comprised of values attributed to customer relationships and non-compete agreements and are amortized on a straight-line basis over 8 and 4 years, respectively. Management assesses the carrying value of intangible assets on a periodic basis for indications of impairment. When an indication of impairment is present, a test for impairment is carried out by comparing the carrying value of the asset to its expected future cash flows. If the carrying amount is greater than the expected future cash flow, the asset would be considered impaired and an impairment loss would be realized to reduce the asset's carrying value to its estimated fair value.

(m) 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. The most significant estimates relate to the depreciation of capital assets, the cost recovery of capital assets, goodwill and intangible assets and the determination of stock-based compensation. Actual results could differ from those estimates.

**3. Acquisitions:**

(a) Tier One Oil Services Ltd.:

Effective May 6, 2005, the Trust acquired all the issued and outstanding shares of Tier One Oil Services Ltd. ("Tier One"), a private company involved in providing production testing services in Western Canada, for consideration of $6,136,039 (net of a working capital adjustment). Consideration was comprised of $3,193,037 of cash and $2,943,002 of Trust Units (668,864 Trust Units with an assigned value of $4.40 per Trust Unit – assigned value is based upon a weighted average trading price immediately prior to the effective date of the acquisition). Included in the 668,864 Trust Units issued were 32,500 units issued to senior managers of Tier One pursuant to employment contracts entered into under the terms of the acquisition. In addition, 67,500 Trust Units have been issued and are being held in trust for senior managers of Tier One. These Trust Units vest over a three-year period from the date of the Tier One acquisition. The unamortized compensation has been recorded as an other asset on the consolidated balance sheet.

The acquisition has been accounted for by the purchase method whereby the assets and liabilities were recorded at their fair market values as at the effective date and the operating results are included in the Trust's consolidated financial statements from the effective date.

# NOTES OF CONSOLIDATED FINANCIAL STATEMENTS

**3. Acquisitions (continued):**

(a) Tier One Oil Services Ltd. (continued):

Details of the acquisition are as follows:

| | |
|---|---|
| Net assets acquired: | |
| Net non-cash working capital deficiency, including bank indebtedness of $672,885 | $ (334,619) |
| Capital assets | 2,523,000 |
| Goodwill | 4,224,277 |
| Future income taxes | (276,619) |
| | $ 6,136,039 |
| Purchase price: | |
| 668,864 Trust Units at $4.40 per Trust Unit | $ 2,943,002 |
| Cash (including transaction costs totaling $54,765 and net of acquired cash of $497,776) | 3,193,037 |
| | $ 6,136,039 |

(b) Advance Wireline Inc.:

Effective September 8, 2005, the Trust acquired all the issued and outstanding shares of Advance Wireline Inc. ("Advance"), a private company involved in providing wireline services in Western Canada, for consideration of $16,998,646 (net of a working capital and long-term debt adjustment). Consideration was comprised of $7,998,643 of cash and $9,000,003 of Trust Units (1,072,706 Trust Units with an assigned value of $8.39 per Trust Unit – assigned value is based upon a weighted average trading price immediately prior to the effective date of the acquisition). The cash consideration noted above is net of a receivable from the former shareholders of Advance in the amount of $611,455. This amount has been included in the balance sheet under other receivables within current assets.

Additional contingent consideration of up to a maximum of $3.0 million, payable in Trust Units with an assigned value based upon a weighted average trading price immediately prior to the issuance of the related Trust Units, will be paid over a 2-year period based upon the financial results of Advance for the periods ended on the first and second anniversary of the closing date. Additional consideration paid will be recorded as an additional cost of the purchase and allocated to goodwill.

The acquisition has been accounted for by the purchase method whereby the assets and liabilities were recorded at their fair market values as at the effective date and the operating results are included in the Trust's consolidated financial statements from the effective date.

Details of the acquisition are as follows:

| | |
|---|---|
| Net assets acquired: | |
| Net non-cash working capital deficiency, including bank indebtedness of $2,784,620 | $ (1,153,679) |
| Capital assets | 8,711,000 |
| Intangibles | 930,000 |
| Goodwill | 10,102,842 |
| Future income taxes | (247,000) |
| Capital lease obligations | (484,969) |
| Long-term debt | (859,548) |
| | $ 16,998,646 |
| Purchase price: | |
| 1,072,706 Trust Units at $8.39 per Trust Unit | $ 9,000,003 |
| Cash (including transaction costs totaling $110,101) | 7,998,643 |
| | $ 16,998,646 |

# NOTES OF CONSOLIDATED FINANCIAL STATEMENTS

**3. Acquisitions (continued):**

(c) Xtreme Wireline:

Effective December 22, 2005, the Trust acquired all the capital assets and business of Xtreme Wireline ("Xtreme"), which is involved in providing slickline services in Western Canada, for consideration of $3,238,426. Consideration was comprised of $1,469,078 of cash and $1,769,348 of Trust Units (149,691 Trust Units with an assigned value of $11.82 per Trust Unit – assigned value is based upon a weighted average trading price immediately prior to the effective date of the acquisition).

The acquisition has been accounted for by the purchase method whereby the assets and liabilities were recorded at their fair market values as at the effective date and the operating results are included in the Trust's consolidated financial statements from the effective date.

Details of the acquisition are as follows:

| | |
|---|---|
| Net assets acquired: | |
| Capital assets | $ 1,808,000 |
| Goodwill | 2,004,145 |
| Capital lease obligations | (573,719) |
| | $ 3,238,426 |
| Purchase price: | |
| 149,691 Trust Units at $11.82 per Trust Unit | $ 1,769,348 |
| Cash (including transaction costs totaling $21,426) | 1,469,078 |
| | $ 3,238,426 |

(d) The Directional Company, Inc. –

On 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 $2,774,848 (including a working capital adjustment). The fixed consideration comprised $2,505,454 of cash and $269,394 of Trust Units (225,812 Trust Units with an assigned value of $1.193 per Trust Unit).

Additional contingent consideration of up to a maximum of $1.25 million, payable in cash, was to be paid over a 2-year period based upon the financial results of TDC for the periods ended December 31, 2003 and 2004. As at December 31, 2004, the maximum contingent consideration in the amount of $1,250,000 has been recorded in the accounts of which $498,907 was recognized during the year ended December 31, 2004 and has been accordingly recorded as an additional cost of the purchase and allocated to goodwill.

The acquisition has been accounted for by the purchase method whereby the assets and liabilities were recorded at their fair market values as at the effective date and the operating results are included in the Trust's consolidated financial statements from the closing date of the acquisition.

Details of the acquisition are as follows:

| | |
|---|---|
| Net assets acquired: | |
| Net non-cash working capital | $ 873,053 |
| Capital assets | 2,500,000 |
| Goodwill | 1,623,867 |
| Long-term debt | (816,655) |
| Future income taxes | (220,000) |
| | $ 3,960,265 |
| Purchase price: | |
| 225,812 Trust Units at $1.193 per Trust Unit | $ 269,394 |
| Cash (including transaction costs totaling $197,089 and net of acquired cash of $88,187) | 2,440,871 |
| Contingent consideration | 1,250,000 |
| | $ 3,960,265 |

4. **Capital assets:**

| 2005 | Cost | Accumulated depreciation | Net book value |
|---|---|---|---|
| Directional drilling equipment | $ 43,447,633 | $ 14,877,753 | $ 28,569,880 |
| Production testing equipment | 5,645,089 | 644,904 | 5,000,185 |
| Wireline equipment | 7,921,262 | 389,131 | 7,532,131 |
| Automotive equipment | 3,917,668 | 278,919 | 3,638,749 |
| Office and computer equipment | 1,688,697 | 688,773 | 999,924 |
| Leasehold improvements | 252,460 | 199,540 | 52,920 |
| Deferred development costs | 1,538,936 | 405,940 | 1,132,996 |
| | $ 64,411,745 | $ 17,484,960 | $ 46,926,785 |

Included in 2005 capital assets are assets under capital leases with a cost of $1,180,000 and a net book value of $1,101,333.

| 2004 | | | |
|---|---|---|---|
| Directional drilling equipment | $ 33,097,390 | $ 11,847,463 | $ 21,249,927 |
| Office and computer equipment | 1,083,398 | 527,445 | 555,953 |
| Leasehold improvements | 207,701 | 166,755 | 40,946 |
| Deferred development costs | 1,268,390 | 199,576 | 1,068,814 |
| | $ 35,656,879 | $ 12,741,239 | $ 22,915,640 |

5. **Bank indebtedness:**

The Trust has a $9,000,000 (2004 - $4,500,000) operating line of credit that bears interest at the bank's prime rate (2004 – bank's prime rate) per annum (December 31, 2005 – 5.0%) with interest payable monthly and is secured as described in note 7.

6. **Capital lease obligations:**

| | 2005 | 2004 |
|---|---|---|
| Capital lease obligations secured by related equipment are with interest rates ranging from 6.5% to 11.62% and maturing on various dates up to 2010 | $ 968,678 | $ – |
| Less: current portion of capital lease obligations | (304,199) | – |
| | $ 664,479 | $ – |

Principal amounts to be paid under these capital leases during the next five years are approximately as follows:

| | |
|---|---|
| 2006 | $ 304,199 |
| 2007 | 291,651 |
| 2008 | 150,643 |
| 2009 | 109,773 |
| 2010 | 112,412 |

**7. Long-term debt:**

| | 2005 | 2004 |
|---|---|---|
| Bank revolving term loan at an authorized amount of $12,000,000 (2004 - $7,000,000), bearing interest at the bank's prime rate plus 1.00% per annum (December 31, 2005 – 6.0%), without repayment terms, maturing June 30, 2007 subject to an annual extension upon agreement between the borrower and the bank for a further one-year period. Prior to maturity the borrower may convert to a non-revolving term loan repayable monthly over 36 months | $ 12,000,000 | $ – |
| Non-interest bearing loans secured by the related automotive equipment with various maturity dates up to 2009 | 383,311 | – |
| | 12,383,311 | – |
| Less: current portion of long-term debt | (250,918) | |
| | $ 12,132,393 | $ – |

The bank revolving term loan 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 capital assets and are subject to certain covenants regarding the payment of dividends, cash distributions and the maintenance of certain financial ratios.

Minimum principal amounts to be paid under long-term debt (assuming the Trust elects prior to the maturity date of the revolving term loan to repay the loan over 36 months) during the next five years are approximately as follows:

| | |
|---|---|
| 2006 | $ 250,918 |
| 2007 | 2,098,348 |
| 2008 | 4,032,765 |
| 2009 | 4,001,280 |
| 2010 | 2,000,000 |

**8. Taxes:**

The Trust is a mutual fund trust as defined under the Income Tax Act (Canada). All taxable income earned by the Trust has been allocated to unitholders and such allocations are deducted for income tax purposes. The Trust follows the Canadian Institute of Chartered Accountants EIC-107 guidance, whereby it does not recognized any future income tax assets or liabilities on "temporary differences" (differences between the accounting basis and tax basis of assets and liabilities) in the Trust. As at December 31, 2005, this "temporary difference" (accounting basis exceeds tax basis) is $8,040,000 (2004 - $588,000 - tax basis exceeds accounting basis). 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.

**8. Taxes (continued):**

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:

| | | 2005 | | 2004 |
|---|---|---|---|---|
| Effective tax rate | | 38% | | 35.7% |
| Income before taxes | $ | 24,816,842 | $ | 11,231,077 |
| Income of Trust subject to tax in the hands of the Unitholders, not the Trust | | (15,308,620) | | (5,242,144) |
| Income before taxes of subsidiary companies | $ | 9,508,222 | $ | 5,988,933 |
| Effective tax rate applied to income before taxes of subsidiary companies | $ | 3,613,124 | $ | 2,138,049 |
| Adjustment to future income tax asset/liability for change in effected tax rates | | 183,849 | | 37,041 |
| Non-deductible expenses | | 135,461 | | 69,871 |
| Non-taxable portion of gain on disposal of capital assets | | (92,229) | | (171,119) |
| Capital taxes | | 75,000 | | 58,975 |
| Benefit of internal reorganization | | (1,017,000) | | – |
| Other | | 111,924 | | (29,557) |
| | $ | 3,010,129 | $ | 2,103,260 |

The components of the net future income tax liability at December 31, 2005 and 2004 are as follows:

| | | 2005 | | 2004 |
|---|---|---|---|---|
| Future income tax liability: | | | | |
| Capital assets | $ | (632,416) | $ | (1,814,463) |
| Partnership interests | | (1,178,887) | | – |
| Deferred partnership income | | (2,246,015) | | – |
| Net future income tax liability | $ | (4,057,318) | $ | (1,814,463) |

**9. Unitholders' capital:**

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

(b) Issued:

| | Number of Units | | Amount |
|---|---|---|---|
| Balance, December 31, 2003 | 21,948,333 | $ | 5,175,597 |
| Issued on non-brokered private placements at $2.35 per Unit | 1,335,000 | | 3,137,250 |
| Issued on brokered private placement at $3.00 per Unit | 3,333,333 | | 9,999,999 |
| Issued on exercise of options | 1,004,200 | | 1,197,025 |
| Less: Trust Unit issuance costs | – | | (735,120) |
| Balance, December 31, 2004 | 27,620,866 | $ | 18,774,751 |
| Issued on acquisitions (note 3) | 1,891,261 | | 13,712,353 |
| Issued as deferred compensation (note 3) | 67,500 | | 297,000 |
| Issued on exercise of options | 471,065 | | 637,374 |
| In-kind distribution (note 11) | 306,534 | | 3,647,753 |
| Consolidation for in-kind distribution (note 11) | (306,534) | | – |
| Contributed surplus on options exercised (note 10) | – | | 42,300 |
| Less: Trust Unit issuance costs | – | | (17,552) |
| Balance, December 31, 2005 | 30,050,692 | $ | 37,093,979 |

**9. Unitholders' capital (continued):**

(c) Trust Unit options:

Effective January 1, 2005, the Trust's Trust Unit based compensation plan was converted to a "rolling number" type option plan which provides for the number of authorized but unissued Trust Units that may be subject to options granted under the unit option plan at anytime can be up to 10% of the number of Trust Units outstanding from time to time. Prior to January 1, 2005, the Trust's Trust Unit based compensation plan had a fixed number plan in which the combined total of 2,218,000 options to purchase Trust Units could be granted.

Under the plan, the exercise price of each option at the date of issuance equals the fair market value of the Trust Units on the day immediately prior to the grant, subject to a potential future reduction, and has a maximum term till expiry of ten years. Options vest over a period of three to five years from the date of grant as employees, trustees or consultants render continuous service to the Trust. At the option of the optionholder, the exercise price may be reduced annually by the amount by which the Trust's net income per diluted Trust Unit for a fiscal year exceeds a prescribed threshold return for the fiscal year. The threshold return is between 10% and 15% (percentage is set annually by the Board of Directors of Cathedral Energy Services Ltd.) of the weighted average Unitholders' Equity for the fiscal year calculated on a diluted per Trust Unit basis. The reduction is calculated annually and is effective March 15 following each fiscal year. The March 15, 2005 reduction available to Unitholders was $0.28 (March 15, 2004 - $0.09) per option.

A summary of the status of the Trust Unit based compensation plan as at December 31, 2005 and 2004, and changes during the years then ended is presented below:

| | 2005 | | 2004 | |
|---|---|---|---|---|
| | Number of options | Weighted average exercise price | Number of options | Weighted average exercise price |
| Outstanding, beginning of year | 786,833 | $ 1.64 | 1,605,900 | $ 1.19 |
| Granted | 2,702,000 | 4.49 | 260,000 | 2.59 |
| Exercised | (471,065) | 1.35 | (1,004,200) | 1.19 |
| Forfeited | (71,167) | 2.59 | (74,867) | 1.20 |
| Outstanding, end of year | 2,946,601 | $ 5.41 | 786,833 | $ 1.64 |
| Exercisable, end of year | 49,266 | $ 1.72 | 98,313 | $ 1.20 |

The range of exercise prices for options outstanding as at December 31, 2005 are as follows:

| | Total options outstanding | | | Exercisable options | |
|---|---|---|---|---|---|
| Exercise price | Number | Weighted average exercise price | Weighted average remaining contractual life (years) | Number | Weighted average exercise price |
| $ 12.18 | 15,000 | $ 12.18 | 6.0 | – | $ 12.18 |
| $ 9.98 | 237,000 | $ 9.98 | 5.9 | – | $ 9.98 |
| $ 9.45 | 470,000 | $ 9.46 | 5.7 | – | $ 9.45 |
| $ 4.96 | 340,000 | $ 4.96 | 5.3 | – | $ 4.96 |
| $ 4.14 | 1,620,000 | $ 4.14 | 5.2 | – | $ 4.14 |
| $ 2.59 | 180,001 | $ 2.59 | 4.7 | 20,666 | $ 2.59 |
| $ 1.25 | 32,600 | $ 1.25 | 1.2 | 1,600 | $ 1.25 |
| $ 1.20 | 25,000 | $ 1.20 | 3.2 | – | $ 1.20 |
| $ 1.09 | 22,000 | $ 1.09 | 2.3 | 22,000 | $ 1.09 |
| $ 1.06 | 5,000 | $ 1.06 | 2.9 | 5,000 | $ 1.06 |
| | 2,946,601 | $ 5.41 | 3.9 | 49,266 | $ 1.72 |

**9. Unitholders' capital (continued):**

(c) Trust Unit options (continued):

During the year ended December 31, 2005, the Trust has recorded non-cash compensation expense of $776,353 (2004 - $16,540) for options granted on or after January 1, 2003. For options granted in 2002, the Trust has elected to disclose pro forma results as if the revised accounting recommendations had been applied retroactively. Had compensation expense been determined based upon the fair value method for awards granted in 2002, the Trust's net income and net income per Trust Unit for the year ended December 31, 2004 and 2003 would have been adjusted to the pro forma amounts noted below:

| | 2005 | 2004 |
|---|---|---|
| Net income – as reported | $ 21,806,713 | $ 9,127,817 |
| Pro forma compensation expense | (29,149) | (100,000) |
| Net income – pro forma | $ 21,777,564 | $ 9,027,817 |
| Net income per Trust Unit – as reported | $ 0.76 | $ 0.39 |
| Net income per Trust Unit – pro forma | $ 0.76 | $ 0.39 |
| Diluted net income per Trust Unit – as reported | $ 0.76 | $ 0.38 |
| Diluted net income per Trust Unit – pro forma | $ 0.76 | $ 0.38 |

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 2005 and 2004:

| | Date of issue | | | | | |
|---|---|---|---|---|---|---|
| | Aug 25 2004 | Mar 11 2005 | May 6 2005 | Sep 15 2005 | Dec 1 2005 | Dec 22 2005 |
| Expected distribution yield | 9.27% | 7.25% | 6.65% | 4.76% | 6.01% | 4.93% |
| Risk-free interest rate | 3.826% | 3.3% | 3.4% | 3.33% | 3.94% | 3.91% |
| Expected volatility | 34% | 52.5% | 54% | 61% | 65.5% | 65.6% |
| Expected life (in years) | 5.0 | 3.5 | 3.5 | 3.5 | 3.5 | 3.5 |
| Fair value per option | $0.34 | $1.08 | $1.39 | $3.34 | $3.57 | $4.63 |

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 expect time until exercise, that can cause a significant variation in the estimate of the fair value of the options.

**10. Contributed surplus:**

| | |
|---|---|
| Balance, December 31, 2003 | $ 5,600 |
| Non-cash compensation expense related to Trust Unit option plan (note 9) | 16,540 |
| Balance, December 31, 2004 | $ 22,140 |
| Non-cash compensation expense related to Trust Unit option plan (note 9) | 776,353 |
| Less: Contributed surplus on options exercised | (42,300) |
| Balance, December 31, 2005 | $ 756,193 |

# NOTES OF CONSOLIDATED FINANCIAL STATEMENTS

**11. Distributions:**

**2005**

| Record Date | Payment date | Distribution per Trust Unit | Distribution paid/payable |
|---|---|---|---|
| January 31, 2005 | February 15, 2005 | $ 0.025 | $ 691,129 |
| February 28, 2005 | March 15, 2005 | 0.025 | 692,649 |
| March 31, 2005 | April 15, 2005 | 0.025 | 695,870 |
| April 30, 2005 | May 16, 2005 | 0.025 | 696,094 |
| May 31, 2005 | June 15, 2005 | 0.0275 | 785,954 |
| June 30, 2005 | July 15, 2005 | 0.0275 | 788,875 |
| July 31, 2005 | August 15, 2005 | 0.0275 | 789,051 |
| August 31, 2005 | September 15, 2005 | 0.0275 | 789,150 |
| September 30, 2005 | October 17, 2005 | 0.0375 | 1,117,703 |
| October 31, 2005 | November 15, 2005 | 0.0375 | 1,118,065 |
| November 30, 2005 | December 15, 2005 | 0.05 | 1,494,775 |
| December 31, 2005 | January 15, 2006 | 0.05 | 1,502,535 |
| | | $ 0.385 | $ 11,161,850 |
| December 31, 2005 (in-kind) | December 31, 2005 | 0.12139 | 3,647,753 |
| | | $ 0.50639 | $ 14,809,603 |

Pursuant to the Trust's Declaration of Trust, the Trust is required to allocate all of its taxable income to Unitholders and in order to allocate all of its taxable income to Unitholders a non-cash in-kind distribution in the form of additional Trust Units was allocated to Unitholders of record on December 31, 2005. The December 31, 2005, non-cash in-kind distributions was $0.12139 per Trust Unit for a total of $3,647,753 The Declaration of Trust also requires there is an immediate consolidation of the Trust Units issued such that each Unitholder has the same number of Trust Units after the consolidation as they had prior to the non-cash in-kind distribution. Based upon a year-end Trust Unit price of $11.90 the in-kind distribution represented the issuance of 306,534 Trust Units which were immediately consolidated.

**2004**

| Record Date | Payment date | Distribution per Trust Unit | Distribution paid/payable |
|---|---|---|---|
| January 31, 2004 | February 15, 2004 | $ 0.02 | $ 439,779 |
| February 28, 2004 | March 15, 2004 | 0.02 | 440,538 |
| March 31, 2004 | April 15, 2004 | 0.02 | 445,795 |
| April 30, 2004 | May 16, 2004 | 0.02 | 446,225 |
| May 31, 2004 | June 15, 2004 | 0.02 | 449,245 |
| June 30, 2004 | July 15, 2004 | 0.02 | 453,037 |
| July 31, 2004 | August 15, 2004 | 0.02 | 478,021 |
| August 31, 2004 | September 15, 2004 | 0.02 | 482,763 |
| September 30, 2004 | October 17, 2004 | 0.02 | 483,091 |
| October 31, 2004 | November 15, 2004 | 0.02 | 483,123 |
| November 30, 2004 | December 15, 2004 | 0.0225 | 544,778 |
| December 31, 2004 | January 17, 2005 | 0.0225 | 621,469 |
| | | $ 0.245 | $ 5,767,864 |

# NOTES OF CONSOLIDATED FINANCIAL STATEMENTS

**12. 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, 2005, the basic weighted average number of Trust Units outstanding was 28,711,081 (2004 –23,233,164). At December 31, 2005, the diluted weighted average number of Trust Units outstanding was 28,711,551 (2004 – 23,782,781), which includes the addition of 470 (2004 – 549,617) Trust Units to the basic weighted average number of Trust Units outstanding during the year ended December 31, 2005 for the dilutive effect of the Trust Unit options.

**13. Financial instruments:**

(a) Credit risk:

Substantially all of the Trust's accounts receivable are due from customers in the oil and 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, 2005 and 2004 due to the relatively short period to maturity of the instruments. The fair value of long-term debt at December 31, 2005 approximated its carrying value as it bears interest at floating rates. The fair value of capital lease obligations at December 31, 2005 approximated its carrying value.

**13. Financial instruments (continued):**

(c) Foreign currency exchange risk:

The Trust has an exposure to fluctuations in the Canada/United States foreign currency exchange rate primarily due its operations in the United States. Management attempts to mitigate this exposure be matching local purchases in the same currency. Currently, the Trust's net foreign currency exposure risk is not significant enough to warrant an active management program to mitigate the foreign currency exchange exposure.

(d) Interest rate risk:

At December 31, 2005, the Trust was exposed to changes in interest rates on its bank indebtedness and long-term debt (see notes 5 and 7).

**14. Supplemental cash flow disclosure:**

| | 2005 | 2004 |
|---|---|---|
| Components of changes in non-cash working capital are as follows: | | |
| Accounts receivable | $ (8,517,732) | $ (7,487,107) |
| Other receivables | (611,455) | – |
| Inventory | (1,067,718) | 159,749 |
| Prepaid expenses and deposits | (77,418) | 8,929 |
| Accounts payable and accrued liabilities | 5,344,772 | 1,219,559 |
| Taxes payable | (539,394) | 793,724 |
| | $ (5,468,945) | $ (5,305,146) |
| Less: changes in working capital related to investing activities | 863,993 | (1,127,599) |
| | $ (6,332,938) | $ (4,177,547) |
| Interest paid | $ 285,627 | $ 344,727 |
| Taxes paid (recovered) | $ 1,775,467 | $ (20,967) |

# NOTES OF CONSOLIDATED FINANCIAL STATEMENTS

**15. Segmented information:**

The Trust, through its wholly-owned entities, Cathedral Energy Services Ltd. and Cathedral Energy Services Limited Partnership, 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 | 2005 | 2004 |
|---|---|---|
| Canada | $ 66,344,484 | $ 36,534,514 |
| United States | 19,657,051 | 9,943,341 |
| | $ 86,001,535 | $ 46,477,855 |

| Capital assets, goodwill and intangibles | 2005 | 2004 |
|---|---|---|
| Canada | $ 57,952,385 | $ 19,913,158 |
| United States | 7,813,406 | 4,626,349 |
| | $ 65,765,791 | $ 24,539,507 |

During the year ended December 31, 2005, one customer accounted for 14% (2004 – 22%) of consolidated revenues.

**16. Related party transaction:**

A Trustee of the Trust and Director of Cathedral Energy Services Ltd., is a partner in a law firm and, through that law firm, is involved in providing and managing the legal services provided to the Trust at market rates. The total cost of these legal services in 2005 was $236,556 (2004 - $104,244).

**17. Commitments:**

a) Leases:

The Trust has commitments under operating leases for office and shop space and automotive equipment. Amounts to be paid under these leases during the next five years are approximately as follows:

| | |
|---|---|
| 2006 | $ 1,424,000 |
| 2007 | 1,687,000 |
| 2008 | 1,497,000 |
| 2009 | 1,195,000 |
| 2010 | 990,000 |
| Thereafter | 1,597,000 |

b) Capital additions:

As at December 31, 2005, the Trust has committed to purchase $4,378,000 (2004 – $2,082,000) of capital assets.

**18. Prior year amounts:**

Certain prior year amounts have been reclassified to conform to the current year's presentation.

# CORPORATE INFORMATION

**TRUSTEES/DIRECTORS:**

**Rod Maxwell** (1) (2) (4)
Managing Director
StoneBridge Merchant Capital Corp.
Calgary, Alberta

**Herman S. Hartley** (1) (2)
Secretary Treasurer
Linvest Resources Corp.
Calgary, Alberta

**Jay Zammit** (2) (3)
Managing Partner
Burstall Winger LLP
Calgary, Alberta

**Scott Sarjeant** (1) (3)
President and Chief Executive Officer
Premiax Financial Corp.

**Mark L. Bentsen**
President and Chief Executive Officer
Cathedral Energy Services Ltd.
Calgary, Alberta

**Randal H. Pustanyk**
Vice President, Operations
Cathedral Energy Services Ltd.
Millet, Alberta

(1) Member, Audit Committee
(2) Member, Compensation Committee
(3) Member, Governance Committee
(4) Lead Director

**AUDITORS**
KPMG LLP
Calgary, Alberta

**LEGAL COUNSEL**
Burstall Winger LLP
Calgary, Alberta

**OFFICERS AND SENIOR MANAGEMENT OF CATHEDRAL ENERGY SERVICES LTD. AND CATHEDRAL ENERGY SERVICES LIMITED PARTNERSHIP**

**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

**David Diachok**
Vice President, Sales – Directional Plus

**Ron Schell**
General Manager – The Directional Company

**Richard DeFreitas**
President - Tier One Oil Services

**Doug Hartle**
Vice President, Sales – Advance Wireline

**Lance McGuire**
Vice President, Operations – Advance Wireline

**Cory Loverin**
General Manager – Xtreme Wireline

**REGISTER AND TRANSFER AGENT**
Computershare Trust Company of Canada
Calgary, Alberta

**BANKER**
The Bank of Nova Scotia
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