# CANACOL ENERGY LTD.

## MANAGEMENT'S DISCUSSION AND ANALYSIS
## THREE MONTHS ENDED SEPTEMBER 30, 2013

## FINANCIAL & OPERATING HIGHLIGHTS

*(in United States dollars (tabular amounts in thousands) except as otherwise noted)*

| Financial | Three months ended September 30, | | |
|---|---|---|---|
| | **2013** | 2012 | Change |
| Petroleum and natural gas revenues, net of royalties | **48,222** | 41,592 | 16% |
| Adjusted petroleum and natural gas revenues, net of royalties, including revenues related to the Ecuador IPC [2] | **51,622** | 41,795 | 24% |
| Adjusted funds from operations [1] [2] [4] | **24,278** | 14,072 | 73% |
| Per share – basic and diluted ($) | **0.28** | 0.23 | 23% |
| Net income (loss) [4] | **2,981** | (7,156) | n/a |
| Per share – basic and diluted ($) | **0.03** | (0.12) | n/a |
| Capital expenditures, net | **17,408** | 14,971 | 16% |
| Adjusted capital expenditures, net, including capital expenditures related to the Ecuador IPC [1][2] | **23,743** | 18,931 | 25% |
| | **September 30, 2013** | June 30, 2013 | Change |
| Cash and cash equivalents | **61,623** | 52,290 | 18% |
| Restricted cash | **28,297** | 26,394 | 7% |
| Working capital surplus, excluding the current portion of bank debt and non-cash items [1] | **67,509** | 69,148 | (2%) |
| Short-term and long-term bank debt | **134,730** | 134,316 | - |
| Total assets | **503,581** | 469,592 | 7% |
| Common shares, end of period (000s) | **86,615** | 86,506 | - |

| Operating | Three months ended September 30, | | |
|---|---|---|---|
| | **2013** | 2012 | Change |
| Petroleum and natural gas production, before royalties (boepd) [3] | | | |
| Petroleum | **6,110** | 6,021 | 1% |
| Natural gas | **3,022** | - | n/a |
| Total | **9,132** | 6,021 | 52% |
| Petroleum and natural gas sales, before royalties (boepd) [3] | | | |
| Petroleum | **6,307** | 7,322 | (14%) |
| Natural gas | **3,052** | - | n/a |
| Total | **9,359** | 7,322 | 28% |
| Realized sales prices ($/boe) | | | |
| LLA-23 (oil) | **92.40** | - | n/a |
| Esperanza (natural gas) | **29.67** | - | n/a |
| Rancho Hermoso (tariff and non-tariff oil and liquids) | **94.18** | 67.33 | 40% |
| Ecuador (tariff oil) [2] | **38.54** | 38.54 | - |
| Total [2] | **65.38** | 67.25 | (3%) |
| Operating netbacks ($/boe) [1] | | | |
| LLA-23 (oil) | **67.27** | - | n/a |
| Esperanza (natural gas) | **25.07** | - | n/a |
| Rancho Hermoso (tariff and non-tariff oil and liquids) | **16.92** | 25.24 | (33%) |
| Ecuador (tariff oil) [2] | **38.54** | 38.54 | - |
| Total [2] | **39.33** | 23.85 | 65% |

(1) Non-IFRS measure – see "Non-IFRS Measures" section within MD&A.
(2) Inclusive of amounts related to the Ecuador IPC – see "Non-IFRS Measures" section within MD&A.
(3) Includes tariff oil production and sales related to the Ecuador IPC.
(4) Effective December 20, 2012, the Corporation completed a 10:1 consolidation of its common shares. Consequently, per share information presented above was restated to a post-consolidation basis for comparability.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

Canacol Energy Ltd. ("Canacol" or the "Corporation") and its subsidiaries are primarily engaged in petroleum and natural gas exploration and development activities in Colombia and Ecuador, with non-core activities in Brazil, Guyana and Peru. The Corporation's head office is located at 4500, 525 - 8th Avenue SW, Calgary, Alberta, T2P 1G1, Canada. The Corporation's shares are traded on the Toronto Stock Exchange under the symbol CNE and the Bolsa de Valores de Colombia under the symbol CNEC.

**Advisories**

The following management's discussion and analysis ("MD&A") is dated November 8, 2013 and is the Corporation's explanation of its financial performance for the period covered by the financial statements along with an analysis of the Corporation's financial position. Comments relate to and should be read in conjunction with the unaudited interim condensed consolidated financial statements of the Corporation for the three months ended September 30, 2013 and 2012 (the "financial statements"), and the audited consolidated financial statements and management's discussion and analysis for the year ended June 30, 2013. The financial statements have been prepared in accordance with International Accounting Standard 34, "Interim Financial Reporting", and all amounts herein are expressed in United States dollars, unless otherwise noted, and all tabular amounts are expressed in thousands of United States dollars, except per share amounts or as otherwise noted. Additional information for the Corporation, including the Annual Information Form, may be found on SEDAR at www.sedar.com.

***Forward-Looking Statements*** *– Certain information set forth in this document contains forward-looking statements. All statements other than historical fact contained herein are forward-looking statements, including, without limitation, statements regarding the future financial position, business strategy, production rates, and plans and objectives of or involving the Corporation. By their nature, forward-looking statements are subject to numerous risks and uncertainties, some of which are beyond the Corporation's control, including the impact of general economic conditions, industry conditions, governmental regulation, volatility of commodity prices, currency fluctuations, imprecision of reserve estimates, environmental risks, competition from other industry participants, the lack of availability of qualified personnel or management, stock market volatility and the ability to access sufficient capital from internal and external sources. In particular with respect to forward-looking comments in this MD&A, readers are cautioned that there can be no assurance that the Corporation will complete its planned capital projects on schedule or that petroleum and natural gas production will result from such capital projects, that additional natural gas sales contracts will be secured, or that hydrocarbon-based royalties assessed will remain consistent or that royalties will continue to be applied on a sliding-scale basis as production increases on any one block. The Corporation's actual results, performance or achievement could differ materially from those expressed in, or implied by, these forward-looking statements and, accordingly, no assurance can be given that any of the events anticipated by the forward-looking statements will transpire or occur, or if any of them do so, what benefits the Corporation will derive therefrom.*

*In addition to historical information, this MD&A contains forward-looking statements that are generally identifiable as any statements that express, or involve discussions as to, expectations, beliefs, plans, objectives, assumptions or future events of performance (often, but not always, through the use of words or phrases such as "will likely result," "expected," "is anticipated," "believes," "estimated," "intends," "plans," "projection" and "outlook"). These statements are not historical facts and may be forward-looking and may involve estimates, assumptions and uncertainties which could cause actual results or outcomes to differ materially from those expressed in such forward-looking statements. Actual results achieved during the forecast period will vary from the information provided herein as a result of numerous known and unknown risks and uncertainties and other factors. Such factors include, but are not limited to: general economic, market and business conditions; fluctuations in oil and gas prices; the results of exploration and development drilling and related activities; fluctuations in foreign currency exchange rates; the uncertainty of reserve estimates; changes in environmental and other regulations; and risks associated with oil and gas operations, many of which are beyond the control of the Corporation. Accordingly, there is no representation by the Corporation that actual results achieved during the forecast period will be the same in whole or in part as those forecasted. Except to the extent required by law, the Corporation assumes no obligation to publicly update or revise any forward-looking statements made in this MD&A or otherwise, whether as a result of new information, future events or otherwise. All subsequent forward-looking statements, whether written or oral, attributable to the Corporation or persons acting on the Corporation's behalf, are qualified in their entirety by these cautionary statements.*

*Readers are further cautioned not to place undue reliance on any forward-looking information or statements.*

***Change in Accounting Policy*** **–** International Financial Accounting Standard ("IFRS") 11 "Joint Arrangements", which became effective for the Corporation on July 1, 2013, divides joint arrangements into two types, joint operations and joint ventures, each with their own accounting model. All joint arrangements are required to be reassessed on transition to IFRS 11 to determine their type to apply the appropriate accounting.

Upon the adoption of IFRS 11, the Corporation reviewed and assessed the legal form and terms of the contractual arrangements in relation to the Corporation's investments in joint arrangements. The adoption of IFRS 11 resulted in a change in the method of accounting for the Corporation's interest in the incremental production contract for the Libertador and Atacapi fields in Ecuador (the "Ecuador IPC") from a jointly-controlled entity, using the proportionate consolidation method, to being accounted for using the equity method. This change in accounting for the Corporation's investment in the Ecuador IPC has been applied in accordance with the relevant IFRS transitional provisions. The initial investment in the Ecuador IPC as at July 1, 2012 for the purposes of applying the equity method was measured as the aggregate of the carrying amounts of the assets and liabilities that the Corporation had previously proportionately consolidated. The change in accounting method has affected the amounts previously reported in the Corporation's financial statements.

As further described in the next section, the Corporation has provided supplemental disclosures related to revenues, expenditures and funds flows from the Ecuador IPC.

***Non-IFRS Measures*** *– Due to the nature of the equity method of accounting the Corporation applies under IFRS 11 to its interest in the Ecuador IPC, the Corporation does not record its proportionate share of revenues and expenditures as would be typical in oil and gas joint interest arrangements. Therefore, within this MD&A, management has provided supplemental measures of adjusted revenues and expenditures, which are inclusive of the Ecuador IPC, to supplement the IFRS disclosures of the Corporation's operations. Such supplemental measures should not be considered as an alternative to, or more meaningful than, the measures as determined in accordance with IFRS as an indicator of the Corporation's performance, and such measures may not be comparable to that reported by other companies.*

*One of the benchmarks the Corporation uses to evaluate its performance is adjusted funds from operations. Adjusted funds from operations is a measure not defined in IFRS. It represents cash provided by operating activities before changes in non-cash working capital and decommissioning obligation expenditures, and includes the Corporation's proportionate interest of those items that would otherwise have contributed to funds from operations from the Ecuador IPC had it been accounted for under the proportionate consolidation method of accounting. The Corporation considers adjusted funds from operations a key measure as it demonstrates the ability of the business to generate the cash flow necessary to fund future growth through capital investment and to repay debt. Adjusted funds from operations should not be considered as an alternative to, or more meaningful than, cash provided by operating activities as determined in accordance with IFRS as an indicator of the Corporation's performance. The Corporation's determination of adjusted funds from operations may not be comparable to that reported by other companies. The Corporation also presents adjusted funds from operations per share, whereby per share amounts are calculated using weighted-average shares outstanding consistent with the calculation of earnings per share. The following table reconciles the Corporation's cash provided by operating activities to adjusted funds from operations:*

| | Three months ended September 30, | |
|---|---|---|
| | **2013** | 2012 |
| Cash provided by operating activities | **$ 19,724** | $ 6,391 |
| Changes in non-cash working capital | **1,154** | 7,478 |
| Ecuador IPC revenue | **3,400** | 203 |
| **Adjusted funds from operations** | **$ 24,278** | $ 14,072 |

*In addition to the above, management uses working capital and operating netback measures. Working capital is calculated as current assets less current liabilities, excluding non-cash items such as the current portion of commodity contracts, the current portion of warrants, and the current portion of any embedded derivatives asset/liability, and is used to evaluate the Corporation's financial leverage. Operating netback is a benchmark common in the oil and gas industry and is calculated as total petroleum and natural gas sales, less royalties, less production and transportation expenses, calculated on a per barrel equivalent ("boe") basis of sales volumes using a conversion. Operating netback is an important measure in evaluating operational performance as it demonstrates field level profitability relative to current commodity prices. Working capital and operating netback as presented do not have any standardized meaning prescribed by IFRS and therefore may not be comparable with the calculation of similar measures for other entities.*

*The term "boe" is used in this MD&A. Boe may be misleading, particularly if used in isolation. A boe conversion ratio of cubic feet of natural gas to barrels of oil equivalent is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead. In this MD&A we have expressed boe using the Colombian conversion standard of 5.7 Mcf: 1 bbl required by the Ministry of Mines and Energy of Colombia.*

## RESULTS OF OPERATIONS

### Producing Field Overview

For the three months ended September 30, 2013, the Corporation's production primarily consisted of crude oil and natural gas liquids from its Labrador and Rancho Hermoso fields in the Llanos Basin in Colombia, natural gas from its Esperanza block in the Lower Magdalena Basin in Colombia, crude oil from the Ecuador IPC, and, to a lesser extent, crude oil from its Capella and Santa Isabel properties in Colombia.

During the quarter ended September 30, 2013, the Corporation drilled an additional well into the Labrador field on the LLA-23 block, Labrador-5, which was placed onto production in October 2013. There are currently four producing wells in the Labrador field producing light oil from the C7, Middle and Lower Gacheta reservoirs. The Corporation plans to drill a fifth development well, Labrador-4, in the first quarter of calendar 2014. The Corporation also plans to drill two exploration wells, Leono-1 and Leono Sur, located in the northern part of the LLA-23 block. Leono- 1 is expected to commence drilling in mid-November 2013.

The Esperanza block, located in the Lower Magdelana Basin in Colombia, produces dry natural gas for sale to local customers under long-term contracts. The Corporation continues to pursue new sales contracts for the natural gas associated with the Nelson field.

The Corporation, through a consortium, participates in an incremental production contract for the Libertador and Atacapi fields in Ecuador whereby the Corporation receives a tariff price of $38.54/bbl for each incremental barrel of oil produced over a pre-determined production base curve. Such incremental production volumes are reported as production in this MD&A. As further described above, the Corporation changed its accounting policy with respect to the Ecuador IPC as required under IFRS 11, which became effective to the Corporation on July 1, 2013. This resulted in the Ecuador IPC being accounted for under the equity method of accounting versus the proportionate consolidation method of accounting, which was previously applied. For purposes of this MD&A, management has provided supplemental measures for adjusted revenues and expenditures, which are inclusive of the Ecuador IPC, to supplement the IFRS disclosures of the Corporation's operations.

Ecuador tariff production has steadily increased since the year ended June 30, 2013 and is expected to continue to increase into calendar 2016, when it is expected to reach peak production. During the quarter ended September 30, 2013, the Corporation participated in the drilling of three new development wells and the work over of two existing wells to add new production. The consortium plans to drill one additional new development well and work over seven existing producing wells in calendar Q4 2013.

Crude oil production from Rancho Hermoso falls under either: i) "non-tariff", which represents crude oil produced under a production sharing contract with Ecopetrol S.A. ("Ecopetrol"), the state oil company of Colombia; or ii) "tariff" production, which represents crude oil produced under a risk service contract with Ecopetrol whereby the Corporation receives a set tariff price per barrel of oil produced. Tariff production is limited to one specific formation, the Mirador formation, while non-tariff production is derived from the remaining formations, including the Ubaque, Guadalupe, Barco Los Cuervos, Carbonera and Gacheta. Natural gas liquids production includes naphtha and LPGs from the processing of associated gas from the Rancho Hermoso field. Under its contracts with Ecopetrol, the Corporation is responsible for 100% of the production expenses of the field, while it recognizes 100% of gross tariff production and only 24-25% of gross non-tariff production before royalties. Consequently, average production expenses per barrel are higher due to this additional cost burden under the non-tariff production sharing contract. Similarly, the price received for tariff oil (currently established at $17.36.bbl to the end of the contract) is significantly below benchmark oil prices and, therefore, reduces average sales prices in the field, depending on the level of tariff oil production. Rancho Hermoso is a mature field and the Corporation plans to undertake certain additional work over activities with the objective to maintain profitable operations and maximize free cash flows until it reaches its economic limit.

For the three months ended September 30, 2013, the Corporation also had other crude oil production from its Capella and Santa Isabel properties in Colombia. At Capella, the operator plans to commence additional drilling activities in calendar Q4 2013.

In addition to its producing fields, the Corporation has interests in a number of exploration blocks in Colombia, Brazil, Guyana and Peru.

**Average Daily Petroleum and Natural Gas Production and Sales Volumes**

Production and sales volumes in this MD&A are reported before royalties.

| | Three months ended September 30, | | |
|---|---|---|---|
| | **2013** | 2012 | Change |
| **Production (boepd)** | | | |
| LLA-23 (oil) | **3,024** | - | n/a |
| Esperanza (gas) | **3,022** | - | n/a |
| Rancho Hermoso (tariff and non-tariff oil and liquids) | **1,916** | 5,843 | (67%) |
| Ecuador (tariff oil) | **959** | 56 | >999% |
| Other (oil) | **211** | 122 | 73% |
| Total production | **9,132** | 6,021 | 52% |
| Inventory movements, power generation and other | **227** | 1,301 | (83%) |
| **Total sales** | **9,359** | 7,322 | 28% |
| **Sales (boepd)** | | | |
| LLA-23 (oil) | **3,303** | - | n/a |
| Esperanza (gas) | **3,052** | - | n/a |
| Rancho Hermoso (tariff and non-tariff oil and liquids) | **1,609** | 7,117 | (77%) |
| Ecuador (tariff oil) | **959** | 56 | >999% |
| Other (oil) | **436** | 149 | 193% |
| **Total sales** | **9,359** | 7,322 | 28% |

The overall increase in production volumes in the three months ended September 30, 2013 compared to 2012 is primarily due to new production from the Labrador discovery on the LLA-23 block (3,024 bopd), production from the Esperanza block (3,022 boepd) which was acquired in December 2012, and production increases from the Libertador and Atacapi fields in Ecuador (903 bopd).

**Petroleum and Natural Gas Revenues**

| | Three months ended September 30, | | |
|---|---|---|---|
| | **2013** | 2012 | Change |
| LLA-23 | **$ 28,078** | $ - | n/a |
| Esperanza | **8,330** | - | n/a |
| Rancho Hermoso | **13,941** | 44,088 | (68%) |
| Other | **2,542** | 1,012 | 151% |
| Petroleum and natural gas revenues, before royalties | **52,891** | 45,100 | 17% |
| Royalties | **(4,669)** | (3,508) | 33% |
| Petroleum and natural gas revenues, after royalties, as reported | **48,222** | 41,592 | 16% |
| Ecuador | **3,400** | 203 | >999% |
| **Adjusted petroleum and natural gas revenues, after royalties** [(1)] | **$ 51,622** | $ 41,795 | 24% |

(1) Non-IFRS measure – inclusive of amounts related to the Ecuador IPC – see "Non-IFRS Measures" section above.

Adjusted petroleum and natural gas revenues include tariff revenues from the Corporation's risk service contract at Rancho Hermoso and its incremental production contract in Ecuador.

The increase in adjusted petroleum and natural gas revenues in the three months September 30, 2013 compared to 2012 is primarily the result of the increased overall sales of 28% by volume, partially offset by a decrease in overall realized prices of 3%.

### Average Benchmark and Realized Sales Prices

| | Three months ended September 30, | | |
|---|---|---|---|
| | **2013** | 2012 | Change |
| Brent ($/bbl) | **$ 110.23** | $ 109.63 | 1% |
| West Texas Intermediate ($/bbl) | **$ 105.83** | $ 92.17 | 15% |
| LLA-23 ($/bbl) | **$ 92.40** | $ - | n/a |
| Esperanza ($/boe) | **29.67** | - | n/a |
| Rancho Hermoso ($/bbl) | **94.18** | 67.33 | 40% |
| Ecuador ($/bbl) | **38.54** | 38.54 | - |
| Other ($/bbl) | **63.37** | 73.87 | (14%) |
| **Average realized sales price ($/boe)** (1) | **$ 65.38** | $ 67.25 | (3%) |

(1) Non-IFRS measure – inclusive of amounts related to the Ecuador IPC – see "Non-IFRS Measures" section above.

### Royalties

| | Three months ended September 30, | |
|---|---|---|
| | **2013** | 2012 |
| LLA-23 | **$ 2,709** | $ - |
| Esperanza | **662** | - |
| Rancho Hermoso | **1,127** | 3,427 |
| Other | **171** | 81 |
| **Total royalties** | **$ 4,669** | $ 3,508 |

In Colombia, crude oil royalties are generally at a rate of 8% until net field production reaches 5,000 boepd, then increase on a sliding scale to 20% up to field production of 125,000 boepd. Crude oil royalties in Rancho Hermoso are taken in kind. The Corporation's LLA-23 block is subject to an additional x-factor royalty of 3% (effectively 2.76%). Crude oil royalties in LLA-23 are calculated from crude oil revenue net of transportation expenses. The Corporation's Capella heavy oil field is subject to a 6% royalty. There are no royalties on tariff production in Ecuador. Natural gas royalties are calculated from natural gas revenue, generally at a rate of 6.4%. In addition, the Corporation's natural gas production is subject to an additional overriding royalty of 2%.

### Production and Transportation Expenses

Total production and transportation expenses were as follows:

| | Three months ended September 30, | | |
|---|---|---|---|
| | **2013** | 2012 | Change |
| Production expenses | **$ 13,000** | $ 21,732 | (40%) |
| Transportation expenses | **4,761** | 3,995 | 19% |
| **Total production and transportation expenses** | **$ 17,761** | $ 25,727 | (31%) |
| $/boe | **$ 20.63** | $ 38.19 | (46%) |

An analysis of production expenses is provided below:

| | Three months ended September 30, | | |
|---|---|---|---|
| | **2013** | 2012 | Change |
| LLA-23 | **$ 3,147** | $ - | n/a |
| Esperanza | **630** | - | n/a |
| Rancho Hermoso | **7,652** | 20,394 | (62%) |
| Other | **1,571** | 1,338 | 17% |
| **Total production expenses** | **$ 13,000** | $ 21,732 | (40%) |
| **$/boe** | | | |
| LLA-23 | **$ 10.36** | **$** - | n/a |
| Esperanza | **$ 2.24** | **$** - | n/a |
| Rancho Hermoso | **$ 51.69** | **$** 31.15 | 66% |
| **Total production expenses** | **$ 15.10** | **$** 32.26 | (53%) |

The Corporation commenced production from the LLA-23 block in fiscal Q2 2013 and acquired the Esperanza block during the same period. Consequently, there are no comparative amounts for these properties.

Production expenses at Rancho Hermoso decreased 62% in the three months ended September 30, 2013 compared to 2012. The decrease is the result of decreased production in the field. However, since much of the costs of the field are not directly variable with production volumes, per boe production expenses have increased significantly from fiscal Q1 2013 to fiscal Q1 2014. Under its contract with Ecopetrol, the Corporation pays 100% of the production expenses at Rancho Hermoso while only recognizing non-tariff production before royalties of approximately 24-25% of gross non-tariff production. As a result, production expenses per boe for Rancho Hermoso oil are higher than a similar operation that is subject to an ANH contract, such as LLA-23, Capella, VMM-2 and Santa Isabel. As Rancho Hermoso is a mature field, the Corporation intends to manage the operation with the objective to maintain profitable operations and maximize free cash flows until it reaches its economic limit.

The Corporation does not pay production costs in Ecuador.

An analysis of transportation expenses is provided below:

| | Three months ended September 30, | | |
|---|---|---|---|
| | **2013** | 2012 | Change |
| LLA-23 | **$ 1,782** | $ - | n/a |
| Rancho Hermoso | **2,658** | 3,739 | (29%) |
| Other | **321** | 256 | 25% |
| **Total transportation expenses** | **$ 4,761** | $ 3,995 | 19% |
| **$/boe** | | | |
| LLA-23 | **$ 5.86** | $ - | n/a |
| Rancho Hermoso | **$ 17.96** | $ 5.71 | 214% |
| **Total transportation expenses** | **$ 5.53** | $ 5.93 | (7%) |

Total transportation expenses have increased in the three months ended September 30, 2013 compared to 2012 mainly due to increased sales volumes. In addition, transportation expenses at Rancho Hermoso were impacted by significant additional distances for the delivery of crude oil.

The Corporation does not pay transportation costs at Esperanza or in Ecuador.

**Operating Netbacks**

| $/boe | Three months ended September 30, 2013 | 2012 | Change |
|---|---|---|---|
| Petroleum and natural gas revenues | $ 65.38 | $ 67.25 | (3%) |
| Royalties | (5.42) | (5.21) | 4% |
| Production and transportation expenses | (20.63) | (38.19) | (46%) |
| **Operating netback** [(1)] | $ 39.33 | $ 23.85 | 65% |

(1) Non-IFRS measure – inclusive of amounts related to the Ecuador IPC – see “Non-IFRS Measures” section above.

Operating netbacks by major production categories were as follows:

| $/boe | Three months ended September 30, 2013 | 2012 | Change |
|---|---|---|---|
| **LLA-23** | | | |
| Crude oil revenues | $ 92.40 | $ - | n/a |
| Royalties | (8.91) | - | n/a |
| Production and transportation expenses | (16.22) | - | n/a |
| **Operating netback** | $ 67.27 | $ - | n/a |
| **Esperanza** | | | |
| Natural gas revenues | $ 29.67 | $ - | n/a |
| Royalties | (2.36) | - | n/a |
| Production expenses | (2.24) | - | n/a |
| **Operating netback** | $ 25.07 | $ - | n/a |
| **Rancho Hermoso** | | | |
| Crude oil, natural gas liquids and tariff revenues | $ 94.18 | $ 67.33 | 40% |
| Royalties | (7.61) | (5.23) | 46% |
| Production and transportation expenses | (69.65) | (36.86) | 89% |
| **Operating netback** | $ 16.92 | $ 25.24 | (33%) |
| **Ecuador** | | | |
| Tariff revenues [(1)] | $ 38.54 | $ 38.54 | - |
| **Operating netback** [(1)] | $ 38.54 | $ 38.54 | - |

(1) Revenues related to the Ecuador IPC are not included in Petroleum and Natural Gas Revenues as reported under IFRS – see “Non-IFRS Measures” section above.

Other fields in Colombia contributed only a minor amount to total revenues (<5%) in the three months ended September 30, 2013 and 2012 and, therefore, a separate operating netback analysis is not provided.

**General and Administrative Expenses**

| | Three months ended September 30, 2013 | 2012 | Change |
|---|---|---|---|
| Gross costs | $ 5,899 | $ 5,205 | 13% |
| Less: capitalized amounts / reversal | (488) | (482) | 1% |
| **General and administrative expenses** | $ 5,411 | $ 4,723 | 15% |
| $/boe | $ 6.28 | $ 7.01 | (10%) |

Gross general and administrative expenses increased 13% in the three months ended September 30, 2013 compared to 2012 primarily due to the acquisition of Shona Energy Company, Inc. in December 2012 as well as a general increase in costs required to support operations in Colombia.

### Net Finance Income and Expense

| | Three months ended September 30, 2013 | 2012 | Change |
|---|---|---|---|
| Net financing (expense) income (paid) received | $ 1,326 | $ (53) | n/a |
| Non-cash financing costs | 617 | 264 | 133% |
| **Net finance expense** | **$ 1,943** | $ 211 | 821% |

Net finance expense increased in the three months ended September 30, 2013 compared the same period in 2012 due to additional interest and financing costs incurred on bank debt and the amortization of non-cash financing costs.

### Commodity Contracts

The Corporation enters into derivative risk management contracts in order to ensure a certain level of cash flows to fund planned capital projects. At September 30, 2013, the Corporation had two financial oil collars outstanding under the following terms:

| Period | Volume | Type | Price Range |
|---|---|---|---|
| Jul 2013 – Dec 2013 | 500 bbls/day | Financial Brent Oil Collar | $85.00 – $107.50 |
| Jul 2013 – Dec 2013 | 500 bbls/day | Financial Brent Oil Collar | $85.00 – $106.80 |

Gains and losses on commodity contracts recognized in net income/loss are summarized below:

| | Three months ended September 30, 2013 | 2012 |
|---|---|---|
| Unrealized change in fair value | $ (39) | $ 3,732 |
| Realized cash settlement | 231 | 517 |
| **Total loss** | $ **192** | $ 4,249 |

### Stock-Based Compensation Expense

| | Three months ended September 30, 2013 | 2012 | Change |
|---|---|---|---|
| Gross costs | $ 605 | $ 2,074 | (71%) |
| Less: capitalized amounts | (374) | (893) | (58%) |
| **Stock-based compensation expense** | **$ 231** | $ 1,181 | (80%) |

Stock-based compensation expense is a non-cash expense that is based on the fair value of stock options granted. The fair value is calculated on grant date and amortized over the vesting period.

### Restricted Share Units

| | Number (000s) | Amount |
|---|---|---|
| Balance at June 30, 2013 | 1,404 | $ 3,914 |
| Settled | (468) | (1,321) |
| Unrealized loss | - | 1,347 |
| Foreign exchange loss | - | 74 |
| **Balance at September 30, 2013** | **936** | $ **4,014** |

One-third of restricted share units vested and were settled during the three months ended September 30, 2013. The remaining amounts vest on May 2, 2014.

### Depletion and Depreciation Expense

| | Three months ended September 30, | | |
|---|---|---|---|
| | 2013 | 2012 | Change |
| Depletion and depreciation expense | $ 7,298 | $ 13,246 | (45%) |
| $/boe | $ 8.48 | $ 19.66 | (57%) |

Depletion and depreciation expense decreased 45% in the three months ended September 30, 2013 compared to 2012 primarily as a result of the lower depletable base at Rancho Hermoso after a one-time impairment charge was recognized in the three months ended June 30, 2013.

### Income Tax Expense

| | Three months ended September 30, | |
|---|---|---|
| | 2013 | 2012 |
| Current income tax expense | $ 1,622 | $ (885) |
| Deferred income tax expense (recovery) | (406) | (1,553) |
| **Income tax expense (recovery)** | $ 1,216 | $ (2,438) |

The Corporation's pre-tax income is subject to the Colombian statutory income tax rate of 34%.

### Cash and Funds from Operations and Net Income (Loss)

| | Three months ended September 30, | | |
|---|---|---|---|
| | 2013 | 2012 | Change |
| Cash provided by operating activities | $ 19,724 | $ 6,391 | 209% |
| Adjusted funds from operations [(1)] [(2)] | $ 24,278 | $ 14,072 | 73% |
| Per share – basic and diluted | $ 0.28 | $ 0.23 | 23% |
| Net income (loss) [(2)] | $ 2,981 | $ (7,156) | n/a |
| Per share – basic and diluted | $ 0.03 | $ (0.12) | n/a |

(1) Non-IFRS measure – inclusive of amounts related to the Ecuador IPC – see "Non-IFRS Measures" section above.

(2) Effective December 20, 2012, the Corporation completed a 10:1 consolidation of its common shares. Consequently, per share information presented above was restated to a post-consolidation basis for comparability.

### Capital Expenditures

| | Three months ended September 30, | |
|---|---|---|
| | 2013 | 2012 |
| Drilling and completions | $ 10,868 | $ 5,554 |
| Facilities, work overs and infrastructure | 1,949 | 2,862 |
| Seismic, capitalized general and administrative expenses, capitalized borrowing costs and other | 4,591 | 6,555 |
| Net capital expenditures | 17,408 | 14,971 |
| Ecuador | 6,335 | 3,960 |
| **Adjusted net capital expenditures** [(1)] | $ 23,743 | $ 18,931 |
| **Net capital expenditures recorded as:** | | |
| Expenditures on exploration and evaluation assets | $ 7,036 | $ 4,781 |
| Expenditures on property, plant and equipment | 10,372 | 10,190 |
| **Net capital expenditures** | $ 17,408 | $ 14,971 |

(1) Non-IFRS measure – inclusive of amounts related to the Ecuador IPC – see "Non-IFRS Measures" section above.

Capital expenditures in fiscal Q1 2014 primarily related to:

- Drilling and completion costs at LLA-23 related to the Labrador discovery;
- Drilling and completion costs at Santa Isabel related to the Oso Pardo discovery;
- Drilling and completion costs at Coati (non-operated);
- Recompletion costs at Rancho Hermoso;
- Facilities costs at Esperanza; and
- Drilling, completion and recompletion costs related to the Ecuador IPC (accounted for under the equity method of accounting)

## LIQUIDITY AND CAPITAL RESOURCES

**Capital Management**

The Corporation's policy is to maintain a strong capital base in order to provide flexibility in the future development of the business and maintain investor, creditor and market confidence. The Corporation manages its capital structure and makes adjustments in response to changes in economic conditions and the risk characteristics of the underlying assets. The Corporation considers its capital structure to include common share capital, convertible debentures, bank debt and working capital, defined as current assets less current liabilities, excluding non-cash items such as the current portion of commodity contracts, warrants and any embedded derivatives asset/liability. In order to maintain or adjust the capital structure, from time to time the Corporation may issue common shares or other securities, sell assets or adjust its capital spending to manage current and projected debt levels.

The Corporation monitors leverage and adjusts its capital structure based on the ratio of net debt to adjusted funds from operations. This ratio is calculated as net debt, defined as the principal amount of its outstanding bank debt plus the principal amount of its convertible debentures, unless the debentures are in-the-money or may otherwise be settled in common shares at the option of the Corporation, less working capital, as defined above and less the current portion of bank debt and convertible debentures included above, divided by annualized adjusted funds from operations. The Corporation uses the ratio of net debt to adjusted funds from operations as a key indicator of the Corporation's leverage and to monitor the strength of its financial position.

In order to facilitate the management of this ratio, the Corporation prepares annual budgets, which are updated as necessary depending on varying factors including current and forecast crude oil prices, changes in capital structure, execution of the Corporation's business plan and general industry conditions. The annual budget is approved by the Board of Directors and updates are prepared and reviewed as required.

| | | September 30, 2013 |
|---|---|---|
| Bank debt (current and long-term) – principal | $ | 140,000 |
| Working capital surplus, excluding the current portion of bank debt and derivatives | | (67,509) |
| Net debt | $ | 72,491 |
| Annualized adjusted funds from operations (1) | $ | 97,112 |
| Net debt to adjusted funds from operations | | 0.7 |

(1) Non-IFRS measure – inclusive of amounts related to the Ecuador IPC – see "Non-IFRS Measures" section above. Calculated as adjusted funds from operations for the three months ended September 30, 2013, annualized.

**Credit Facilities and Debt**

*Senior Secured Term Loan*

The Corporation has in place a credit agreement for a $140 million senior secured term loan with a syndicate of banks. The Senior Secured Term Loan is for a five-year term, with interest payable quarterly and principal repayable in 15 equal quarterly instalments starting in October 2014, following an initial 18 month grace period. The Senior Secured Term Loan carries interest at LIBOR plus 4.50% and is secured by all of the material assets of the Corporation. The carrying value of the Senior Secured Term Loan includes $5.3 million of transaction costs netted against the principal amount as at September 30, 2013. The Corporation was in compliance with its covenants as at September 30, 2013.

*Other Colombian Credit Facilities*

The Corporation has revolving lines of credit in place in Colombia with an aggregate borrowing base of $35.8 million (COP$ 68.5 billion). These lines of credit have interest rates ranging from 6% to 9% and are unsecured. The facilities were undrawn as at September 30, 2013.

*Letters of Credit*

At September 30, 2013, the Corporation had letters of credit outstanding totaling $30.5 million to guarantee work commitments on exploration blocks and to guarantee other contractual commitments. The total of these letters of credit, net of amounts counter-guaranteed by other financial institutions, reduce the amounts available under the Colombian revolving lines of credit by $15.5 million.

*Convertible Debentures*

The Corporation has convertible debentures outstanding with a face value of $24.8 million (fair value – $24.9 million) that mature on July 15, 2015, and bear an annual coupon rate of 8%, payable semi-annually. The debentures are convertible into common shares of the Corporation at the option of the holder at a conversion price of C$10.526 per share, being the ratio of 95 common shares per C$1,000 principal amount of the debentures. On the maturity date, the Corporation has a right to repay the outstanding principal amount and any accrued interest in common shares of the Corporation, subject to certain conditions, including customary regulatory approvals.

**Share Capital**

At November 8, 2013, the Corporation had 86.7 million common shares, 4.3 million warrants, 6.9 million stock options, 0.9 million cash-settled restricted share units, and 2.7 million cash-settled phantom warrants outstanding.

**Contractual Obligations**

The following table provides a summary of the Corporation's cash requirements to meet its financial liabilities and contractual obligations existing at September 30, 2013:

| | Less than 1 year | 1-3 years | Thereafter | Total |
|---|---|---|---|---|
| Bank debt – principal | $ - | $ 76,667 | $ 63,333 | $ 140,000 |
| Trade and other payables | 58,513 | - | - | 58,513 |
| Deferred income | - | 3,731 | - | 3,731 |
| Commodity contracts | 241 | - | - | 241 |
| Equity tax payable – undiscounted | 1,113 | - | - | 1,113 |
| Other long term obligations | - | 10,764 | - | 10,764 |
| Convertible debentures – principal | - | 24,812 | - | 24,812 |
| Phantom warrants | - | 3,785 | - | 3,785 |
| Warrants | 343 | 4,446 | - | 4,789 |
| Restricted share units | 4,014 | - | - | 4,014 |
| Exploration and production contracts | 28,633 | 9,562 | - | 38,195 |
| Office leases | 1,057 | 1,784 | 4,683 | 7,524 |

**Exploration and Production Contracts**

The Corporation has entered into a number of exploration contracts in Colombia, Brazil, Guyana and Peru which require the Corporation to fulfill work program commitments and issue financial guarantees related thereto. In aggregate, the Corporation has outstanding exploration commitments at September 30, 2013 of $38.2 million and has issued $21.7 million in financial guarantees related thereto. These commitments are planned to be satisfied by means of seismic work, exploration drilling and farm-outs.

**Ecuador Incremental Production Contract**

In addition to the contractual obligations described above, the Corporation has a non-operated 25% equity participation interest (27.9% capital participation interest) in a joint-venture consortium which in 2012 was awarded an incremental production contract for the Libertador and Atacapi mature oil fields in Ecuador. The consortium is committed to incur project expenditures for a total of $334 million ($93.3 million net to the Corporation) over the 15

year term of the contract. As at September 30, 2013, the Corporation had incurred $27.0 million of expenditures in connection with its Ecuador IPC commitment.

## OUTLOOK

The Corporation is increasing net average production guidance before royalties for calendar 2013 from 7,500 to 8,500 boepd to between 8,500 and 9,000 boepd. The Corporation plans to spend capital expenditures of up to $72 million, net of dispositions and inclusive of amounts related to the Ecuador IPC, in calendar 2013 on drilling, work overs, seismic, production facilities and pipelines in Colombia and Ecuador. The timing of several planned capital projects is expected to overlap into calendar 2014.

In the remainder of calendar 2013, the Corporation will focus on: 1) building out production and reserves from recent oil discoveries on LLA-23 and VMM-2 and increasing production levels from the Esperanza block in Colombia via new gas sales contracts; 2) continuing to increase production and reserves from the Libertador and Atacapi oil fields in Ecuador; and 3) executing a significant oil-focused exploration program in Colombia targeting management estimated 48 million barrels of net risked prospective conventional light and heavy oil, and unconventional light oil resources. Development drilling for the remainder of calendar 2013 is expected to include one new well in the Libertador – Atacapi fields in Ecuador. Exploration projects of significance for the remainder of calendar 2013 include the first of two additional exploration wells on LLA-23, Leono-1 and Leono Sur, targeting light oil, testing of the Mono Arana deep shale oil exploration discovery on VMM-2, up to two new wells on the Corporation's Middle Magdalena blocks (VMM-2 and VMM-3) targeting both shallow conventional light oil and deeper unconventional shale oil, and the continuation of the heavy oil exploration program on assets in the Putumayo-Caguan Basin. Funding for the remaining calendar 2013 capital program is expected to come from working capital, operating cash flows and debt facilities.

## SUMMARY OF QUARTERLY RESULTS

| | **2014** | 2013 | | | | 2012 | | |
|---|---|---|---|---|---|---|---|---|
| | **Q1** | Q4 | Q3 | Q2 | Q1 | Q4 | Q3 | Q2 |
| **Financial** | | | | | | | | |
| Petroleum and natural gas revenues, net of royalties | **48,222** | 38,960 | 34,602 | 26,200 | 41,592 | 45,702 | 48,632 | 55,241 |
| Adjusted petroleum and natural gas revenues, net of royalties, including revenues relate to the Ecuador IPC [1] | **51,622** | 41,796 | 36,725 | 27,350 | 41,795 | 45,702 | 48,632 | 55,241 |
| Adjusted funds from operations [1] | **24,278** | 19,102 | 15,578 | 3,203 | 14,072 | 9,656 | 19,663 | 24,954 |
| Per share – basic [1][3] | **0.28** | 0.22 | 0.18 | 0.05 | 0.23 | 0.15 | 0.32 | 0.46 |
| Per share – diluted [1][3] | **0.28** | 0.22 | 0.18 | 0.05 | 0.23 | 0.15 | 0.31 | 0.46 |
| Net income (loss) | **2,981** | (119,046) | (3,425) | 1,820 | (7,156) | 3,830 | 3,663 | (2,423) |
| Per share – basic [3] | **0.03** | (1.38) | (0.04) | 0.03 | (0.12) | 0.06 | 0.06 | (0.04) |
| Per share – diluted [3] | **0.03** | (1.38) | (0.04) | 0.03 | (0.12) | 0.06 | 0.06 | (0.04) |
| Capital expenditures, net | **17,408** | 13,099 | 3,021 | 19,452 | 14,971 | 39,927 | 52,424 | 62,425 |
| Adjusted capital expenditures, net, including capital expenditures related to the Ecuador IPC [1] | **23,743** | 15,758 | 10,434 | 22,688 | 18,931 | 39,927 | 52,424 | 62,425 |
| **Operations (boepd)** | | | | | | | | |
| Petroleum and natural gas production, before royalties | | | | | | | | |
| Petroleum [2] | **6,110** | 5,390 | 4,785 | 5,035 | 6,021 | 10,670 | 13,598 | 13,837 |
| Natural gas | **3,022** | 2,879 | 2,874 | 319 | - | - | - | - |
| Total [2] | **9,132** | 8,269 | 7,659 | 5,354 | 6,021 | 10,670 | 13,598 | 13,837 |

(1) Non-IFRS measure – inclusive of amounts related to the Ecuador IPC – see "Non-IFRS Measures" section above.
(2) Includes tariff oil production related to the Ecuador IPC.
(3) Effective December 20, 2012, the Corporation completed a 10:1 consolidation of its common shares. Consequently, per share information presented above was restated to a post-consolidation basis for comparability.

## RISKS AND UNCERTAINTIES

There have been no significant changes in the three months ended September 30, 2013 to the risks and uncertainties as identified in the MD&A for the year ended June 30, 2013.

## CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The Corporation's management made judgements, assumptions and estimates in the preparation of the financial statements. Actual results may differ from those estimates, and those differences may be material. The basis of presentation and the Corporation's significant accounting policies can be found in the notes to the financial statements.

## CHANGES IN ACCOUNTING POLICIES

A detailed discussion of new accounting policies that affect the Corporation is provided in the notes to financial statements.

## REGULATORY POLICIES

**Disclosure Controls and Procedures**

Disclosure Controls and Procedures ("DC&P") are designed to provide reasonable assurance that all relevant information is gathered and reported on a timely basis to senior management so that appropriate decisions can be made regarding public disclosure. Subject to scope limitation described below, the Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), along with other members of management, have designed, or caused to be designed, under the CEO and CFO's supervision, disclosure controls and procedures and established processes to ensure that they are provided with sufficient knowledge to support the representations made in the interim certificates required to be filed under National Instrument 52-109. In addition to the processes that specifically fall into the category of DC&P, the Corporation has also adopted a company-wide Corporate Disclosure Policy and has additional procedures in place to provide reasonable assurance that any material information required to be disclosed by the Corporation in its interim filings is recorded, processed, summarized and reported within the time periods specified in securities legislation. With the assistance of expert advisors and other members of management, the Corporation's CEO and CFO have assessed (subject to the scope limitation described below) the design effectiveness of the Corporation's DC&P as at September 30, 2013 and have not identified any material weaknesses relating to the design effectiveness of the Corporation's DC&P framework.

**Internal Controls over Financial Reporting**

The CEO and CFO, along with participation from other members of management, are responsible for establishing and maintaining adequate Internal Control over Financial Reporting ("ICFR") to provide reasonable assurance regarding the reliability of financial statements prepared in accordance with IFRS. With the assistance of expert advisors and other members of management, the Corporation's CEO and CFO have assessed (subject to the scope limitation described below) the design effectiveness of the Corporation's ICFR as at September 30, 2013, using the framework and criteria established in Internal Control – Integrated Framework ("1992 COSO Framework") published by The Committee of Sponsoring Organizations of the Treadway Commission ("COSO") and have not identified any material weaknesses relating to the design effectiveness of the Corporation's ICFR framework.

During the quarter ended September 30, 2013, there has been no change in the Corporation's ICFR that has materially affected, or is reasonably likely to materially affect, the Corporation's ICFR.

**Limitation on Scope of Design**

In accordance with section 3.3(1)(b) of National Instrument 52-109, which allows an issuer to limit its design of DC&P and ICFR to exclude controls, policies and procedures of a business that the issuer acquired not more than 365 days prior to the end of the fiscal period, the controls, policies and procedures of Shona, which was acquired by the Corporation effective December 21, 2012, have been excluded from the control design assessments discussed above. The scope limitation is based on the time required to document and assess the DC&P and ICFR of Shona in a manner consistent with the Corporation's other operations. The Corporation's management is currently in the process of integrating Shona into the existing internal controls and procedures of Canacol.

Shona constitutes 13% of net assets, 16% of net revenues, and $3.5 million of income before income taxes of the consolidated financial statement amounts as at and for the three months ended September 30, 2013.

**Limitations of Controls and Procedures**

The Corporation's management, including its CEO and CFO, believe that any DC&P or ICFR, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, they cannot provide absolute assurance that all control issues and instances of fraud, if any, within the Corporation have been prevented or detected. These inherent limitations include the realities that judgements in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Accordingly, because of the inherent limitations in a cost effective control system, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.