

Canacol Energy Ltd.

A large, semi-transparent blue globe with a white grid of latitude and longitude lines. The globe is centered on the Americas, with North and South America clearly visible. It has a soft shadow underneath, giving it a three-dimensional appearance.

Management Discussion and Analysis  
Three and nine months ended March 31, 2010

May 24, 2010

## CAUTIONARY NOTE

This Management's Discussion and Analysis ("MD&A") for Canacol Energy Ltd. ("Canacol" or the "Corporation") (formerly BrazAlta Resources Corp. ("BrazAlta")) of the financial results and related data is reported in Canadian dollars, has been prepared in accordance with Canadian Generally Accepted Accounting Principles ("GAAP"), and should be read in conjunction with the interim financial statements for the three and nine months ended March 31, 2010, as well as the audited consolidated financial statements for the fiscal year ended June 30, 2009 (F2009) and the respective notes thereto. Additional information relating to the Corporation is on SEDAR at [www.sedar.com](http://www.sedar.com).

Information provided herein in respect of barrels of oil equivalent ("boe") may be misleading, particularly if used in isolation. A boe conversion ratio of 6 Mcf: 1 bbl is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead.

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 ability to access sufficient capital from internal and external sources. In particular to forward-looking comments in this MD&A readers are cautioned that there can be no assurance that: the Corporation will be able to attain sufficient capital and financing to fund its expected obligations; that the Corporation will be able to increase production in Brazil, Colombia, or Guyana and achieve expected variable cost efficiencies and an overall reduction of costs on a per barrel basis; that hydrocarbon based royalties assessed by the Brazilian and Colombian governments will remain consistent or that the Brazilian and Colombian 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 there from.

In addition to historical information, the 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; fluctuation 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 Canacol 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, Canacol 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 Canacol

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.

Unless otherwise stated, all dollar amounts presented in this MD&A are in thousands of Canadian dollars (unaudited). All references to C\$ or \$ are to Canadian dollars, references to US\$ are United States (U.S.) dollars, references to BRL\$ are to Brazilian Real, and references to COP\$ are to Colombian Pesos.

FINANCIAL RESULTS <i>(\$000s), except share data</i>	Three Months Ended March 31,		Nine Months Ended March 31,	
	2010	2009	2010	2009
Petroleum and natural gas sales, net				
Colombia <sup>(1)</sup>	3,874	1,200	8,463	2,071
Brazil <sup>(2)</sup>	1,322	767	2,541	2,942
Canada <sup>(3)</sup>	-	-	-	70
	5,196	1,967	11,004	5,083
Tariff revenue	1,673	1,069	4,741	2,039
Interest and other	172	123	1,127	490
<b>Total revenue, recurring operations</b>	<b>7,041</b>	<b>3,159</b>	<b>16,872</b>	<b>7,612</b>
Cash from (used in) recurring operating activities	(4,747)	(2,446)	(4,136)	1,736
Per share - basic and diluted	(0.01)	(0.02)	(0.02)	0.02
Net loss from continuing operations	(5,340)	(5,050)	(10,512)	(16,542)
Per share - basic and diluted	(0.02)	(0.04)	(0.04)	(0.16)
Capital expenditures				
Colombia <sup>(1)</sup>	2,126	1,875	12,276	4,689
Brazil <sup>(2)</sup>	1,689	39	2,316	1,803
Guyana	508	-	2,088	-
Canada <sup>(3)</sup>	-	(262)	82	(790)
	4,323	1,652	16,762	5,702
<b>Total assets</b>	<b>97,565</b>	<b>87,958</b>	<b>97,565</b>	<b>87,958</b>
<b>Total long-term liabilities</b>	<b>17,811</b>	<b>13,828</b>	<b>17,811</b>	<b>13,828</b>
Weighted average shares outstanding				
Basic (000s)	332,288	117,041	271,706	103,562
Basic and Diluted (000s)	332,288	117,041	271,706	104,911

<sup>(1)</sup> Colombian operations commenced on October 30, 2008.

<sup>(2)</sup> Brazil results were estimated based on Agencia Nacional do Petróleo "ANP" data.

<sup>(3)</sup> Canadian producing properties were sold effective January 1, 2009. Therefore there is no impact for the 3 month periods ended March 31, 2010 or 2009.

OPERATING RESULTS	Three Months Ended March 31,				Nine Months Ended March 31,					
	2010		2009		2010			2009		
	Colombia	Brazil (1)	Colombia	Brazil	Colombia (2)	Brazil(1)	Canada (3)	Colombia (2)	Brazil	Canada (3)
<b>Production</b>										
Crude oil and NGLs (bbl/d)	729	128	318	133	455	114	-	325	134	1
Natural gas (mcf/d)	-	-	-	-	-	-	-	-	-	48
Total (boe per day)	729	128	318	133	455	114	-	335	134	9
Total tariff production (bbl/d)	1,549	-	1,157	-	1,525	-	-	1,354	-	-
<b>Average sale prices</b>										
Crude oil (\$/bbl) <sup>(9)</sup>	64.94	72.50	47.87	71.79	67.93	72.10	-	45.69	100.25	-
Natural gas (\$/mcf)	-	-	-	-	-	-	-	-	-	-
Oil equivalent (\$/boe)	-	-	-	71.79	-	-	-	-	100.25	46.82
<b>Operating netback (\$/boe)</b>										
Commodity sales revenue	64.94	72.50	47.87	71.79	67.93	72.10	-	45.69	100.25	46.82
Tariff revenue <sup>(4)</sup>	17.15	-	10.27	-	14.42	-	-	10.92	-	-
Non-refundable sales taxes	-	(7.05)	-	(1.78)	-	(4.14)	-	-	(4.46)	-
Realized gain on financial derivative	-	-	-	44.90	-	-	-	-	-	-
Royalties <sup>(5)</sup>	(5.20)	(5.97)	(3.83)	(6.05)	(5.43)	(6.21)	-	(3.66)	(8.26)	(5.17)
Transportation & processing <sup>(6)</sup>	(4.18)	(14.94)	(4.75)	(23.59)	(3.37)	(14.28)	-	(6.56)	(20.68)	-
Well workover & repair	(0.03)	(3.05)	(0.03)	(2.38)	(0.73)	(2.54)	-	(0.03)	(2.00)	-
MEP work unit provision	-	(3.87)	-	(4.61)	-	(3.22)	-	-	(4.53)	-
Operating expenses <sup>(7)</sup>	(11.95)	(29.08)	(10.11)	(37.41)	(12.36)	(28.80)	-	(12.23)	(36.49)	(11.48)
<b>Netback <sup>(8)</sup></b>	<b>43.58</b>	<b>8.54</b>	<b>29.15</b>	<b>40.87</b>	<b>46.04</b>	<b>12.91</b>	<b>-</b>	<b>23.21</b>	<b>23.83</b>	<b>30.17</b>

<sup>(1)</sup> Brazil results were estimated based on Agencia Nacional do Petroleo "ANP" data.

<sup>(2)</sup> Colombian operations commenced on October 30, 2008.

<sup>(3)</sup> Canadian producing properties were sold effective January 1, 2009. Therefore there is no impact for the 3 month periods ended March 31, 2010 or 2009.

<sup>(4)</sup> Colombian Tariff revenue includes transportation revenue included in "other revenue".

<sup>(5)</sup> Royalties apply to non-tariff oil production.

<sup>(6)</sup> Colombian transportation and processing charges relate to non-tariff production.

<sup>(7)</sup> Colombian operating expenses relate to both tariff and non-tariff oil production volumes.

<sup>(8)</sup> "Netback" per boe is calculated as revenues net of sales taxes and royalties, less transportation & processing charges, well workover and repair and operating expenses and then divided by boes produced. Netbacks do not have a standard meaning prescribed by GAAP and therefore may not be comparable to similar measures used by other companies. Management feels this is a useful metric as it is a common metric used by other companies operating in the oil and gas industry in order to provide a comparison of relative overall performance between companies. Management uses the metric to assess the Corporation's overall performance relative to that of its competitors and for internal planning purposes.

## HIGHLIGHTS FROM Q3-F2010

- On February 1, 2010, the Corporation engaged Citivalores S.A. Sociedad Comisionista de Bolsa in Colombia ("Citi") to assist in facilitating the listing of Canacol on the Registro Nacional de Valores y Emisores in Colombia "RNVE", as well as on the Bolsa de Valores de Colombia "BVC". Both listings will qualify as secondary listings, and the Corporation's primary exchange will remain the TSX Venture Exchange.
- On February 8, 2010, the Corporation announced a US\$46 million capital budget in calendar 2010 for exploration and development activities in Colombia, Guyana and Brazil. The budget includes the drilling of 15 wells, which includes 3 exploration wells, one each in Colombia, Guyana and Brazil, and 3 appraisal and 9 development wells in Colombia. The budget also provided for the acquisition of 100 km of 3D seismic and 160 km of 2D seismic in Colombia and Brazil, the building of a 2,000 barrel of fluid per day early production facility at the Capella discovery in Colombia, and the expansion of the Canacol operated Rancho Hermoso production facilities in Colombia. Although not included in the announced calendar 2010 budget, Canacol also plans to participate in the exploration bid round scheduled in Colombia for late June as a qualified operator.

- On March 4, 2010, The Corporation provided an update on its workover program on its Rancho Hermoso 4 well, which tested at a combined gross rate of 2,339 bbl/d (580 bbl/d net) from 3 productive zones. The workover involved separately perforating and flow testing the Guadalupe and Los Cuervos Formations.
- On March 31, 2010, the Corporation cased the Recio 1 exploration well as a potential oil discovery. The well is located on the Sierra Exploration and Production Contract in Colombia. The Corporation will test in early June two zones encountered while drilling, both of which showed good oil and gas shows.

### ***SUBSEQUENT EVENTS AFTER Q3-F2010***

- On April 12, 2010, the Corporation entered into the following financial WTI oil collar under the following terms:

<b>Period</b>	<b>Volume</b>	<b>Type</b>	<b>Price Range</b>
May 1, 2010 – August 31, 2011	500 bbls/day	Financial WTI Oil Collar	US\$70.00 - US\$100.45

- On April 21, 2010, the Corporation executed a contract with Tuscany South America Limited to provide a drilling rig for its Guyana exploration well. The rig is currently being mobilized to location. Construction of the drilling pad, access roads and staging areas is complete and tubular and wellheads sufficient for 3 wells are on location.
- On May 3, 2010, the Corporation spudded the Romero A1 well, the first of a 7 well drilling program at its Capella heavy oil discovery in Colombia. It also commenced the acquisition of 185 square kilometres of 3D development seismic over the field.
- On May 4, 2010, the Corporation was awarded the Cedrela Exploration and Production Contract by the Agencia Nacional de Hidrocarburos in Colombia. The Cedrela E&P Contract, approximately 129,418 hectares in size, is located approximately 50 kilometres directly southwest of the Ombu E&P Contract and contains 2 large structures similar in character to the Capella heavy oil discovery. The terms of the 6 year contract are as follows:

Phase 1 Exploration Period: The Corporation will acquire, process, and interpret 250 kilometres of 2D seismic, and interpret all existing magnetic and gravity geophysical data. The duration of this phase is 18 months, with an anticipated cost of approximately US\$5,400.

Phase 2 Exploration Period: The Corporation will drill 1 exploration well. The duration of this phase is 18 months, with an anticipated cost of approximately US\$2,000.

Phase 3 Exploration Period: The Corporation will acquire, process, and interpret 60 square kilometres of 3D seismic. The duration of this phase is 18 months, with an anticipated cost of approximately US\$3,000.

Phase 4 Exploration Period: The Corporation will drill 1 exploration well. The duration of this phase is 18 months, with an anticipated cost of approximately US\$2,000.

Based upon the results of the Phase 1 Exploration Period activities, the Corporation has the option to proceed to the Phase 2 Exploration Period and associated activity or relinquish the contract.

- On May 5, 2010, the Corporation closed a “bought deal” equity financing with a syndicate of underwriters co-led by Canaccord Financial Ltd. and First Energy Capital Corp. and including Cormark Securities Inc. and Mackie Research Capital Corporation (collectively the “Underwriters”), pursuant to which the Underwriters purchased 66,667,000 common shares of the Corporation (“Common Shares”) at \$0.75 per common share and raised gross proceeds of \$50,000 (net \$47,630) for the Corporation (the “Offering”). The Underwriters were also granted an over-allotment option to purchase, on the same terms as the Offering, up to an additional 10,000,050 common shares. This option was fully exercised bringing additional gross proceeds of \$7,500 (net \$7,125). Total equity proceeds aggregated to \$57,500 gross (\$54,756 net).

## *COMPANY OVERVIEW AND BACKGROUND*

Canacol Energy Ltd. (“Canacol” or the “Corporation”) (TSX-Venture: CNE) is a Canadian-based independent oil exploration company operating primarily in Colombia, Guyana and Brazil. The Corporation's worldwide production is approximately 3,240 barrels of oil per day (“bbl/d”), which consists of 1,890 bbl/d net royalty production and 1,350 bbl/d of tariff production. Through the drilling of 12 new development wells in Colombia the Corporation anticipates worldwide production to average 4,200 bbl/d for calendar 2010, with an exit rate of 7,000 bbl/d which excludes any production resulting from exploration success, and is dependent on that completion on schedule of planned drilling programs.

### **Colombia**

Canacol has interests in 7 exploration and production contracts in Colombia, and plans to spend US\$37 million on various exploration and development projects in its contract areas in calendar 2010. The capital programs, which include the drilling of 13 wells, the acquisition of 60 km of 2D seismic and 185 square kilometres of 3D seismic, acquisition of 2,250 kilometres of aero magnetic gravity data (Pacarana) and construction of new facilities and expansion of existing facilities are outlined below, but does not include spending that might arise from the new bid round schedule for June 2010 or the exploration work for the Cedrella block.

### *Llanos Basin*

The Corporation has operated interests in the Rancho Hermoso Field (100% working interest) and Entrerrios Field (60% working interest) producing fields in the Llanos Basin. Both contracts are operated under Production Sharing and Risked Service contracts with Ecopetrol, the state oil company of Colombia.

### *Rancho Hermoso Production Contract (100% operated working interest) and Entrerrios Production Contract (60% operated working interest)*

The Corporation's current share of production from Rancho Hermoso and Entrerrios field is approximately 3,060 *bbl/d*, comprised of 1,710 *bbl/d* net of government royalty, and 1,350 *bbl/d* of tariff production. A portion of the Corporation's net oil production is currently hedged at a floor of US\$55.00 and a ceiling of US\$80.25 per barrel until August 2011. In addition to the current hedge, the Corporation entered into a new hedge with a floor of US\$70.00 and a ceiling of US\$100.45 for an additional daily production of 500 barrels. The new hedge became effective on May 1, 2010 and expires in August 2011. For the tariff oil production, the Corporation receives an operating tariff per gross produced barrel of oil from Ecopetrol. The average tariff price for calendar 2009 was

approximately US\$9.63 per gross barrel plus transportation reimbursement, and was insensitive to West Texas Intermediate oil price fluctuations. Under an existing agreement with Ecopetrol, the tariff increases through a series of steps each year to approximately US\$17.36 per gross barrel in calendar 2012 plus transportation reimbursement and will remain at that level for the duration of the life of the field. The average tariff price for calendar 2010 will be approximately US\$12.04 per barrel plus transportation reimbursement.

The Corporation completed the calendar 2009 drilling program schedule in early December 2009. The original drilling program consisted of the drilling of three development wells- two wells in the Rancho Hermoso Field and one development well in Entrerrios Field. The program also included working over three existing wells (Entrerrios 1, Entrerrios 3 and Rancho 4) to increase productivity by perforating oil bearing reservoirs behind pipe and comingling with existing oil production. The drilling and work over activities at Rancho Hermoso and Entrerrios increased the Corporation's production capacity in Colombia at a net cost of approximately US\$10.1 million.

The Rancho Hermoso 5 well, drilled in late 2009, is currently producing 36° API light oil at a rate of 5,150 bbl/d gross (1,167 bbl/d net) from the Los Cuervos reservoir using an electro submersible pump. The Los Cuervos reservoir was placed on production in late February 2010, and has been on constant production to date with a water cut less than anticipated. The underlying Guadalupe reservoir was tested at a final stable rate of 1,037 bbl/d gross (234 bbl/d net) of 34° API oil from January to mid February 2010, and was isolated in order to test the overlying Los Cuervos reservoir.

The Rancho Hermoso 4 well, recently recompleted in first the Guadalupe and then the Los Cuervos in January 2010, is currently producing 34° API light oil at a rate of 1,300 bbl/d gross (294 bbl/d net) from the Los Cuervos reservoir. Current production from the well is higher than the 910 bbl/d gross (229 bbl/d net) production reported in the press release of March 3, 2010 as a result of the Corporation installing a larger pump. The Corporation is currently in the process of installing larger pumps in its wells in the field in order to maximize production rates. Upon completion of the extended production test of the Los Cuervos in the Rancho Hermoso 4 and 5 wells, the Corporation plans to comingle production with that of the underlying Guadalupe reservoir within each well.

Entrerrios 1 and 3: In January 2010 the Corporation successfully recompleted the Entrerrios 1 and 3 wells, comingling a new productive zone with the existing productive zone in each well to increase overall productivity. Prior to the workovers the field was producing approximately 727 bbl/d gross (160 bbl/d of net). After the workovers the field is currently producing approximately 1,110 bbl/d gross (247 bbl/d net), for a net gain of 54%. The Corporation has no plans to spend additional capital in the Entrerrios field in 2010.

The Corporation plans to drill up to 5 infill development wells as a direct result of the success of the Rancho Hermoso #5 well drilled in December 2009, which tested over 8,000 bbl/d combined flow of 33° to 36° API gravity oil from a new pool discovery in the Guadalupe and Los Cuervos reservoirs. The 5 new wells will target production from the Mirador, Los Cuervos, Guadalupe, and Ubaque reservoirs, all of which are currently producing reservoirs. The drilling program is anticipated to commence in June 2010 (see outlook section), and will continue through to December 2010, focusing primarily on obtaining production from the Los Cuervos, Guadalupe, and Ubaque reservoirs, in which the Corporation has a net royalty interest. In addition to the new development wells, the Corporation plans to expand fluid handling capacity of existing facilities in order to handle additional production.

### *Putumayo - Caguan Basin*

The Corporation is one of the largest exploration landholders in the Putumayo - Caguan Basin of southern Colombia, with working interests in two exploration and production contracts and one technical evaluation area, all of them awarded under the new terms as regulated by the Agencia Nacional de Hidrocarburos ("ANH").

### *Ombu E&P Contract - Capella Oil Discovery Appraisal*

The Corporation, under a farm out agreement entered into in July 2008, earned a 10% working interest in the Capella conventional heavy oil discovery operated by Sinochem Corporation (formerly Emerald Energy Plc.) on the Ombu E&P contract, where the operator is continuing with its appraisal drilling. The Corporation received formal assignment of its 10% working interest in the contract by the ANH in July 2009.

The field is a large seismically defined structure at the Mirador reservoir interval. The southern part of the field, approximately 89 square kilometres in area, is currently being appraised. Six wells have been drilled to date. The Capella 1 and 2 wells tested 240 and 345 gross *bbl/d* from the Mirador Formation. The Capella 3 well, the first deviated well to be drilled in the block, has a surface location adjacent to the Capella 1 vertical well and penetrated the reservoir approximately 340 metres away. The Capella 4 vertical well was drilled approximately 1.6 kilometres to the southwest of the Capella 1 location. The Capella 3 and Capella 4 wells both encountered the target Cretaceous Mirador reservoirs with net hydrocarbon pay intervals similar to those encountered in Capella 1 and 2. The Capella 5 vertical well, located approximately 3.4 kilometres to the northeast of Capella 1, has been drilled and completed. The Capella 6 vertical well, located 4.2 kilometres to the southwest of Capella 1, was also drilled and completed.

In the northeast part of the discovery, the Corporation is currently drilling the first of 3 appraisal wells, commencing with the Romero 1 well. The Corporation is then planning on drilling one horizontal well within the southwest part of the discovery, conducting a steam injection pilot utilizing one of the existing vertical wells, the construction of an early production facility to handle 2,000 barrels of fluid per day, the laying of flow lines to all producing wells, and the upgrading of existing roads and bridges. In addition, commencing in the third calendar quarter of 2010, the Corporation will participate in the drilling of 3 infill wells in the central part of the discovery, which may be vertical or horizontal depending on the success of the first horizontal well, and will participate in the acquisition of 185 square km of 3D seismic, and in the drilling of a water disposal well.

The Corporation and its joint venture operating partner plan to spend approximately US\$42 million gross on drilling and infrastructure programs at this significant discovery in calendar 2010.

The primary objectives of the program are to:

- 1) Continue appraisal of the discovery through the drilling of appraisal wells to increase production, reserves and resources;
- 2) Formulate a full field development plan by December 2010 through the acquisition of a 3D seismic program, the quantification of horizontal well performance on oil production rate and recovery, and the quantification of the steam injection pilot results in terms of oil rate and ultimate recovery; and
- 3) Install an early production facility, flow lines, and upgraded roads and bridges to increase the volume of oil sales from the field from the currently producing wells and new wells to be drilled this year.

### *Tamarin E&P contract (100% operated working interest)*

Effective August 31, 2009, Canacol, through its subsidiary Rancho Hermoso, was awarded the Tamarin Exploration and Production Contract ("Tamarin E&P contract") by the ANH.

The Corporation has a 100% working interest in the block, which is approximately 27,487 hectares in size and is located approximately 25 km to the southwest of the Ombu contract. Based upon the available geophysical and geological data in this frontier area, the Corporation has determined that the fault trend present at its Capella discovery to the northeast continues onto the Tamarin contract, setting up the potential for another Capella type heavy oil prospect. Together with the nearby Pacarana TEA, awarded to the Corporation in July 2009, Canacol now has a significant operated exploration position at 100% working interest immediately offsetting its Capella heavy oil discovery. Canacol has acquired 60 km of 2D exploration seismic in satisfaction of the Phase 1 work program

commitments. The seismic is currently being processed and interpreted; estimated to be completed in June 2010.

*Pacarana Technical Evaluation Area (100% operated working interest)*

Effective July 2, 2009, Canacol, through its subsidiary Rancho Hermoso, was awarded the Pacarana Technical Evaluation Area ("Pacarana TEA") by the ANH. The Pacarana block is located adjacent and to the south of the Ombu E&P.

The Corporation has a 100% working interest in the block, which is approximately 469,968 hectares in size and is located in the Caguan - Putumayo Basin of Colombia. Interpretation of existing geotechnical data on the block identified prospective structural trends similar to the Capella heavy oil discovery located immediately to the north on the Ombu E&P contract. The work obligation associated with the contract requires the Corporation to acquire 2,240 km of aeromagnetic and gravity data and to conduct geotechnical studies including the interpretation of available LandSat image data over a period ending September 2010, for an anticipated cost of approximately US\$0.47 million.

The Corporation acquired 2,500 km aeromagnetic gravity survey.

*Cedrela Exploration and Production Contract (100% operated working interest)*

Effective May 2, 2010, Canacol, through its subsidiary Rancho Hermoso SA, was awarded the Cedrela Exploration and Production Contract ("Cedrela") by the ANH. Cedrela is located immediately south of the Tamarin E&P Contract.

The Corporation has a 100% working interest in the block, which is approximately 129,418 hectares in size and is located in the Caguan - Putumayo Basin of Colombia. Based upon the available geophysical and geological data in this frontier area, the Corporation has identified 2 large structures similar in character to Capella on the Cedrela block. During the Phase 1 Exploration Period, the Corporation will acquire, process, and interpret 250 kilometres of 2D seismic, and interpret all existing magnetic and gravity geophysical data. The duration of this phase is 18 months, with an anticipated cost of approximately US\$ 5.4 million.

*Middle Magdalena Valley Basin*

*La Sierra E&P Contract (25.5% operated working interest)*

The Corporation has a 25.5% working interest in the block, which covers approximately 8,204 net acres. The Sierra contract is located along the western margin of the prolific Middle Magdalena Basin, and was also awarded under terms as regulated by the ANH. The contract contains a discovery well, Sierra 1, drilled in 1991, which recovered 22 barrels of 17° API medium gravity oil during swabbing from 10 feet of interpreted oil pay within the Tertiary aged Honda sandstone at a measured depth of 1,700 feet, a prolific producing reservoir within the Basin. Management estimates that the discovery contains approximately 8 million barrels of gross mean unrisked recoverable prospective resources. Canacol acquired 46 square km of 3D seismic at a net cost of \$1.1 million over the discovery in calendar 2009, and drilled 2 exploration wells (Recio 1 and 2).

The Recio 1 well targeted the Lower Tertiary Honda Formation, which is a prolific oil producer within the Middle Magdalena Basin of Colombia. The Recio 1 well encountered approximately 10 feet of potential oil pay within a sandstone of the Middle Honda Formation at 1,548 to 1,558 feet measured depth with good oil and gas shows, and also encountered approximately 27 feet of potential oil pay within a sandstone of the Lower Honda Formation at 1,608 to 1,635 feet, also with good oil and gas shows while drilling. Both zones will be stimulated prior to testing in June or July 2010. Recio 2 was drilled and abandoned as a dry hole.

## **Guyana E&P**

In May 2008, the Corporation negotiated a farm-in to a 7,800 sq km exploration contract located in the Takutu Basin, onshore Guyana adjacent to the border with Brazil, awarded to Groundstar Resources Ltd. ("Groundstar") in July 2005 for a four year period. The operator was successful recently in extending the term of the contract to July 2012 with a commitment to drill 2 wells by May 2011. The block contains the Karanambo discovery made by Home Oil in 1982. The Karanambo 1 well tested 411 boe/d (42-degree API) from a sub-salt reservoir during a drill stem test proving the existence of a light oil hydrocarbon system within this frontier basin. Based on a report prepared by Gaffney, Cline & Associates dated December 2009, the mean risked recoverable prospective resources associated with the Karanambo discovery are 128 million barrels gross (83 million barrels net). The block also contains 2 exploration prospects, Pirara and Rewa High, with mean prospective resources of 133 million barrels (86 million barrels net) in Pirara and 169 million barrels gross (110 million barrels net) in Rewa High. Civil works and location construction have been completed. Under the terms of the farm-in agreement, Canacol was required to fund the first US\$12 million of costs in order to earn a 55% working interest in the contract. On May 15, 2009, the Corporation announced that it had entered into a Share Purchase Agreement to acquire 35% of Groundstar's 45% remaining working interest in the exploration contract for consideration of US\$3.45 million. This transaction closed on October 26, 2009 increasing Canacol's working interest to 90% and eliminating the farm-in earning requirement. On November 5, 2009, the Corporation completed a farmout agreement with Sagres Energy Inc ("Sagres") whereby Sagres acquired a 25% interest in the exploration agreement by agreeing to fund 30% (US\$1.25 million) of costs of drilling the K-2 exploration well, bringing the Corporation's net working interest to 65%. Under the terms of the agreement, the Corporation and Sagres will carry Groundstar's 10% remaining working interest until first commercial oil production.

Canacol and its joint venture operator, Groundstar Resources Ltd., have signed an agreement for a drilling rig and associated services. The rig is expected to arrive on location in early July to drill the K-2 exploration well. The bottom hole location for the K-2 well will be approximately 400 metres northwest of the Karanambo 1 discovery well, and will target the same productive reservoirs that tested 411 bbl/d of 42° API gravity oil in 1982. The joint venture to date has completed construction of the drilling pad, access roads, and staging areas in preparation of drilling, and has purchased and mobilized tubulars and wellheads sufficient to drill 3 wells, which are now in country and on location. The well is anticipated to spud in early of third calendar quarter 2010, and is anticipated to take 50 days to drill and test, and if successful will be put on a long term production test to establish the deliverability and performance of the reservoir. The approximate cost of drilling the K-2 well net to Canacol is US\$6 million, and upon completion of drilling operations operatorship will be transferred from Groundstar to Canacol. Gaffney Cline and Associates attributed gross mean risked recoverable prospective resources of 128 million barrels of oil to the discovery in the December 2009 report compiled for the Corporation.

## **Brazil E&P**

Effective January 5, 2006, Canacol through its wholly owned subsidiary, Brazalta Brazil Norte, entered into a Consortium and Joint Operating Agreement with W. Washington Empreendimentos E. Participações Ltda, which subsequently has changed its name to W. Washington Petroleo S.A. ("W. Washington"), for the creation and operation of a Brazilian domiciled joint venture entity ("Brazil Joint Venture") to hold, explore, develop and produce hydrocarbons in Brazil. Canacol holds a 47.5% interest and W. Washington, the operator, holds a 52.5% interest in the Brazil Joint Venture.

Canacol's E&P operations are primarily engaged in the exploration, development and production of oil and gas in the Recôncavo, Sergipe, Espirito Santo, and Tucano basins of Brazil. To date, the bulk of activity has been undertaken jointly by Canacol and W. Washington in the Recôncavo and Sergipe basins and has been higher risk and exploratory in nature with minimal success achieved, which has resulted in no appreciable increase in oil production or reserves.

Canacol holds a 47.5% working interest and W. Washington holds a 52.5% interest in four main production concessions in Recôncavo, from which over 90% of Canacol's current Brazilian production originates. The concession contracts were originally awarded to W. Washington by the Agência Nacional do Petróleo, Gás Natural e Biocombustível ("ANP"), Brazil's national regulator, and Canacol subsequently registered its 47.5% interest on these contracts directly with the ANP. Canacol holds rights to produce hydrocarbons from these four producing blocks run until 2025. As operator, W. Washington sells all of the produced oil to Petrobras in Recôncavo at prices based on North Sea Brent less costs for transportation and processing.

#### ***Reconcavo Basin***

##### ***Block 170 (37.5% non-operated working interest)***

Canacol was granted an extension by the ANH for the drilling of the Catu exploration prospect located on Block 170 due to issues with access to the lands, and anticipates drilling in the last quarter of calendar 2010. The prospect contains three prospective stacked reservoir sandstones that management estimates may contain up to 6 million barrels of gross mean unrisked recoverable light oil resource. The preferred well location is situated updip from an old well that recovered light oil from one of three prospective intervals.

#### ***Espirito Santo Basin***

##### ***Block 318 (100% operated working interest)***

Canacol acquired 100 km of 2D seismic during the Q3-F2010. This data is currently being processed and it is anticipated that a drilling decision will be made by December 2010.

#### **Canada and Ireland E&P**

Operations in Canada are considered to be non-core. The Corporation continues to hold minor interests in some non-producing properties and is seeking to dispose of its interest in these remaining properties. The Corporation does not expect to receive any significant proceeds from the sale of the remaining interests and is not planning any operations activities for these Canadian interests.

Exploration in Ireland is considered to be non-core and high risk and includes oil and natural gas exploration and the potential for development of salt cavern gas storage. The Corporation is currently reviewing potential alternatives for its Ireland interests and currently has no planned activity in Ireland.

### ***FINANCIAL HIGHLIGHTS AND SUMMARY OF RESULTS - ONGOING OPERATIONS***

Unless otherwise stated, amounts presented in this MD&A are in thousands of Canadian dollars. All discussions under the financial highlights section relate to the ongoing operations of the Corporation and exclude the operations of BCH Ltd. Ongoing operations of the Corporation relate to the oil and gas exploration and production operations of the Corporation. Detailed discussion on the discontinued operations of BCH for the nine months ended March 31, 2010 and 2009 is contained in the "Discontinued Operations" section. The Colombian and Guyanese operations of the acquired Canacol Energy Inc. are for the period October 31, 2008 through March 31, 2010.

Quarterly Information - Recurring Operations <i>(\$000s, except production data and per share)</i>	F2010			F2009				F2008
	Q3	Q2	Q1	Q4	Q3	Q2 <sup>(1)</sup>	Q1	Q4
<b>Petroleum and natural gas sales</b>								
Colombia <sup>(1)</sup>	3,874	2,180	2,409	2,247	1,200	871	-	-
Brazil	1,322	619	600	80	767	862	1,313	1,515
Canada <sup>(2)</sup>	-	-	-	-	-	33	37	33
<b>Total production revenue</b>	<b>5,196</b>	<b>2,799</b>	<b>3,009</b>	<b>2,327</b>	<b>1,967</b>	<b>1,766</b>	<b>1,350</b>	<b>1,548</b>
<b>Tariff revenue</b>	<b>1,673</b>	<b>1,703</b>	<b>1,365</b>	<b>1,001</b>	<b>1,069</b>	<b>970</b>	<b>-</b>	<b>-</b>
Interest and other	172	280	675	496	123	338	29	232
<b>Total operating revenue</b>	<b>7,041</b>	<b>4,782</b>	<b>5,049</b>	<b>3,824</b>	<b>3,159</b>	<b>3,074</b>	<b>1,379</b>	<b>1,780</b>
<b>Total production (boe)</b>	<b>77,194</b>	<b>38,519</b>	<b>40,427</b>	<b>37,855</b>	<b>39,413</b>	<b>33,251</b>	<b>13,637</b>	<b>62,697</b>
<b>Total tariff production (bbl)</b>	<b>139,370</b>	<b>151,907</b>	<b>126,673</b>	<b>92,367</b>	<b>104,101</b>	<b>82,600</b>	<b>-</b>	<b>-</b>
<b>Cash used in (from) operating activities</b>	<b>(4,747)</b>	<b>1,702</b>	<b>(1,091)</b>	<b>(3,815)</b>	<b>(2,446)</b>	<b>5,673</b>	<b>(1,491)</b>	<b>(604)</b>
Per share <sup>(1)</sup>	(0.02)	0.01	(0.00)	(0.03)	(0.02)	0.01	(0.02)	(0.01)
<b>Net (loss) gain <sup>(3)</sup></b>	<b>(5,340)</b>	<b>(4,394)</b>	<b>(778)</b>	<b>(5,250)</b>	<b>(5,050)</b>	<b>(8,847)</b>	<b>(2,645)</b>	<b>(1,390)</b>
Per share <sup>(1)</sup>	(0.02)	(0.01)	(0.01)	(0.04)	(0.04)	(0.08)	(0.03)	(0.02)
<b>Total assets <sup>(3)</sup></b>	<b>97,565</b>	<b>107,515</b>	<b>84,442</b>	<b>85,209</b>	<b>87,958</b>	<b>89,106</b>	<b>48,299</b>	<b>42,703</b>
<b>Total long term liabilities <sup>(3)</sup></b>	<b>17,811</b>	<b>22,579</b>	<b>24,423</b>	<b>26,967</b>	<b>13,828</b>	<b>30,789</b>	<b>3,245</b>	<b>21,892</b>

<sup>(1)</sup> Colombian operations commenced October 30, 2008.

<sup>(2)</sup> Canadian producing properties were sold effective January 1, 2009.

<sup>(3)</sup> The amounts for Q1-F2010 have been updated to reflect future tax and foreign exchange adjustments reflected in Q2-F2010.

### Petroleum and Natural Gas Sales (Net of Royalties)

The operating revenue from continuing operations for the three months ended March 31, 2010 totalled \$7,041(Q3-F2009 - \$3,159), representing an increase of \$3,882 or 123% compared to Q3-F2009. Operating revenue from continuing operations for the nine months ended March 31, 2010 was \$16,872(Q1 through Q3 F2009 - \$7,612).

The operating revenue consists of production revenue (non-tariff production), tariff production and interest and other revenue. The production revenue during Q3-F2010 totalled \$5,196 (Q3-F2009 - \$1,967) representing an increase of \$3,229 or 164% compared to Q3-F2009. For the nine months ended March 31, 2010, production revenue totalled \$11,004 (Q1 through Q3 F2009 - \$5,083), representing an increase of \$5,921 or 116% on a year over year basis. The tariff revenue during Q3-F2010 totalled \$1,673 (Q3-F2009 - \$1,069) representing an increase of \$604 or 57% compared to Q3-F2009. For the nine months ended March 31, 2010, the tariff revenue was \$4,741 (Q2 through Q3 F2009 - \$2,039). Interest and other income are discussed below.

The increases in the operating revenue and tariff revenue for Q3-F2010 compared to Q3-F2009 are due to higher production volumes achieved by the Corporation.

In Colombia, production volumes of crude oil achieved during the three months ended March 31, 2010 totalled 65,632 bbls (729 bbl/d) (Q3-F2009 - 28,635 bbls (318 bbl/d)). Production volumes for the nine months ended March 31, 2010 totalled 124,785 bbls (455 bbl/d) (Q1 through Q3 F2009 - 49,097 bbls (325 bbl/d)). The average price achieved in Colombia in Q3-F2010 was \$64.94/bbl compared to \$47.87/bbl in Q3-F2009. During Q3-F2010, approximately 13,000 bbls of production were delivered in satisfaction of a sales commitments made in Q2-F2010. In Colombia, tariff production volumes during Q3-F2010 totalled 139,370 bbls (1,549 bbl/d) (Q3-F2009 104,101 bbls (1,157 bbl/d)). For the nine months ended March 31, 2010, the tariff production totalled 417,950 bbls (1,525 bbl/d) (Q2 and Q3 F2009 (November and December, 2009 through March, 2010 only) - 186,701 bbls (1,236 bbl/d)). The average tariff price for Q3-F2010 was \$17.15/bbl (including \$5.15 of transportation revenue); (Q3-

F2009 was \$10.27/bbl (including \$1.06 of transportation revenue). The increase in transportation revenue is due to Canacol shipping tariff oil to a terminal further away from the field.

The increase in the production volume for Q3-F2010 was due to the start up of RH-5 totalled 40,030 bbls (444/bbls/d).

Brazil production volumes during Q3-F2010 totalled 11,562 bbls of light oil (128 bbl/d); (Q3-F2009 - 10,778 bbls (133 bbl/d). Production from Brazil totalled 31,356 bbls of light oil in the first nine months of F2010 (114 bbl/d) (Q1 through Q3 F2009 - 35,519 bbls (134 bbl/d). The average price achieved per bbl in Brazil in the Q3-F2010 was \$72.50/bbl (Q3-F2009 - \$71.79/bbl).

As noted above, the Canadian properties were sold effective January 1, 2009. Thus, there is no impact for the three months ended March 31, 2010 and 2009. The total production from Canada for the nine months ended March 31, 2010 totalled Nil (Q1 through Q3, F2009 1,685 boe (9 boe/d).

Production Volumes (boe)	Three Months Ended March 31,		Nine Months ended March 31,	
	2010	2009	2010	2009
Colombia *	65,632	28,635	124,784	49,097
Brazil	11,562	10,778	31,356	35,519
Canada**	-	-	-	1,685
<b>Total net production</b>	<b>77,194</b>	<b>39,413</b>	<b>156,140</b>	<b>86,301</b>
Tariff production	139,370	104,101	417,950	186,701
<b>Total</b>	<b>216,564</b>	<b>143,514</b>	<b>574,090</b>	<b>273,002</b>

\* Colombian operations commenced on October 30, 2008.

\*\* Canadian producing properties were sold effective January 1, 2009.

Royalties as a percentage of gross petroleum and natural gas revenues by geographic region for the three months ended March 31, 2010 and the prior period comparables are shown in the table below. The current base royalty regime in Brazil averages between 5% and 10% of gross production revenue. The actual rate the Corporation achieved for the nine months ended March 31, 2010 in Brazil was 8.6% compared to 9.5% during the Q3 F2009 period. In Brazil, royalty rates are based on a sliding scale on incremental production over and above certain production thresholds, calculated on a block by block basis. Therefore, if aggregate production on any one block increases above the contracted thresholds, the royalty on that block should decline over time. In Colombia, royalties are taken in kind and at a rate of approximately 8%. During Q3-F2010 Colombian royalties averaged 8%.

Royalties	Three months ended March 31,		Nine months ended March 31,	
	2010	2009	2010	2009
Colombia *	8.0%	8.0%	8.0%	8.0%
Brazil	8.2%	9.5%	8.6%	9.5%
Canada**	-	-	-	11.0%

\* Colombian operations commenced October 30, 2008

\*\* Canadian producing properties were sold effective January 1, 2009.

Brazil oil sales are subject to non-refundable sales taxes. This totalled \$138 during the nine months ended March 31, 2010 (Q1 through Q3 F2009 - \$132). This has been recorded and netted against revenue for the three and nine month periods ended March 31, 2010.

## Interest and Other Income

During the three months ended March 31, 2010 interest and other income of \$172 (Q3-F2009 - \$123) was recorded. The increase in the interest and other income was due to interest earned on cash investments. During the nine months ended March 31, 2010 interest and other income was \$1,127 (Q1 through Q3 F2009 - \$490).

### Operating Expenses - Petroleum and Natural Gas

For the three months ended March 31, 2010, operating expenses totalled \$3,944 (Q3-F2009 - \$2,368) and for the nine months ended March 31, 2010 overall operating expenses totalled \$10,696 (Q1 through Q3 F2009 - \$5,666). The Colombian operating expenses relate to both tariff and non-tariff oil production. Details by operating segment are outlined in the table below.

Operating Expenses (\$000s)	Three months ended March 31,		Nine Months Ended March 31,	
	2010	2009	2010	2009
Operating expenses				
Colombia <sup>(1)</sup>	2,609	1,616	7,414	3,159
Brazil <sup>(2)</sup>	235	245	904	1,116
Canada <sup>(3)</sup>	-	-	-	20
	2,844	1,861	8,318	4,295
Colombia transportation & processing charges <sup>(4)</sup>	858	136	1,827	322
Colombia well workover & repair	5	4	396	6
Brazil transportation & processing charges	202	283	478	797
Brazil well workover & repair	35	29	91	78
MEP work unit provision	-	55	(414)	168
	3,944	2,368	10,696	5,666
Operating expenses per boe				
Colombia <sup>(2)</sup>	11.95	10.11	12.36	12.23
Brazil <sup>(1)</sup>	29.08	37.41	28.80	36.49
Canada <sup>(3)</sup>	-	-	-	11.48
Weighted Average	13.02	12.37	13.27	33.73

<sup>(1)</sup> Colombian operations commenced October 30, 2008. Colombian operating expenses relate to both tariff and non-tariff oil production volumes.

<sup>(2)</sup> Expenditures related to the planned non-routine enhancement workover program undertaken are presented separately and excluded from the calculation of ongoing operating costs. Transportation and processing charges and MEP work unit provision are also shown separately.

<sup>(3)</sup> Canadian producing properties were sold effective January 1, 2009.

<sup>(4)</sup> Non tariff oil only.

### Depletion, Depreciation, and Accretion (DD&A)

For the three months ended March 31, 2010, DD&A from recurring operations totalled \$3,852 (Q1 through Q3 F2009 - \$1,362) while for the nine months ended March 31, 2010, overall DD&A expense was \$8,481 (Q1 through Q3 F2009 - \$4,118). The respective increase is a result of an increase in the production volume.

### General and Administrative

For the three months ended March 31, 2010, general and administrative (G&A) expenses from recurring operations were \$2,858 (Q3-F2009 - \$1,696) while G&A expenses from recurring operations for nine months ended March 31, 2010 were \$6,700 (Q1 through Q3 F2009 - \$4,967). The increase in the G&A is primarily due to increase in personnel costs. G&A expenses are incurred in Canada, Colombia, and Brazil and primarily consist of management and advisory fees, professional fees, travel, and other administrative expenses needed to support the Corporation's operations. Canacol did not capitalize any indirect overhead costs.

### Interest and Financial Expense

For the three months ended March 31, 2010, interest and financial expense was \$724 (Q3-F2009 - \$838). For the nine months ended March 31, 2010, interest and financial expenses were \$2,370 (Q1 through Q3 F2009-\$1,947). Interest and financial expense is comprised of interest on the Corporation's long-term debt facilities, capital leases, and non-cash interest charges. Non-cash interest charges relate to the accretion of the deferred financing charges incurred on the Corporation's debt facilities, the non-cash interest charged on the convertible debenture and the accretion of the convertible debentures. Non-cash interest charges for Q3-F2010 totalled \$313 (Q3-F2009 - \$254) while the non-cash interest charges for the nine months ended March 31, 2010 totalled \$1,010 (Q1 through Q3 F2009 - \$591).

### **Foreign Exchange**

The Corporation's activities in Brazil use the Brazilian Real (BRL\$) and the Corporation's activities in Colombia use the Colombian Peso (COP\$) as the functional currency and therefore the Corporation is exposed to the risk of fluctuations in foreign exchange rates. The Corporation's sales contracts for oil produced in Brazil and Colombia are based on US dollar reference prices but are paid in Brazilian Real in Brazil and through a combination of US dollars and Colombian Pesos in Colombia. The Corporation's long-term reserves based debt facilities are denominated in US\$ while the Corporation's line of credit facilities are denominated in Colombian Pesos.

For the three months ended March 31, 2010, the Corporation incurred a net foreign exchange loss of \$81 (Q3-F2009 - loss \$1,355). For the nine months ended March 31, 2010, the Corporation incurred a net foreign exchange gain of \$2,226 (Q1 through Q3 F2009 - loss of \$2,220). The foreign exchange gain for the nine months ended March 31, 2010 is a result of the appreciation of the Canadian dollar relative to the US dollar, and the corresponding impact on the Corporation's US dollar denominated debt balances, as well as the foreign exchange gain on translation resulting from the appreciation of the Brazilian Real and Colombian Peso relative to the Canadian dollar.

The Corporation currently has not entered into any foreign currency derivative contracts to manage its exposure to the Brazilian Real, Colombian Peso, or the US Dollar. Refer to the Risk Factors Section below for additional details.

### **Financial Derivatives**

For the three months ended March 31, 2010, the Corporation had one financial derivative in place. This was a WTI oil financial option collar with an expiry in August 2011. The Corporation has not designated this embedded derivative as a hedge and has therefore recorded the unrealized gain on the contract on the balance sheet with changes in its fair value recorded in the net earnings for the period. Refer to the Risk Factors section for specific details of the current financial derivative contract that remains outstanding as of March 31, 2010.

At March 31, 2010, the Corporation had a total net financial derivative liability of \$655 (June 30, 2009 - \$497) relating to the oil financial option collar.

For the three months ended March 31, 2010, the Corporation had a net realized financial derivative gain of \$85 (Q3-F2009 - gain of \$348) on its oil collar hedge while for the nine months ended March 31, 2010, the Corporation had a net realized financial derivative loss of \$158 (Q1 through Q3 F2009 - gain of \$4,224).

On April 12, 2010, the Corporation entered into a new hedge agreement which involves an additional 500 bbls/day oil collar with a floor of US\$70.00 and the ceiling of US\$100.45. This new hedge agreement became effective on May 1, 2010.

### **Stock Based Compensation**

For the three months ended March 31, 2010, a total of \$1,491 (Q3-F2009 - \$214) was expensed relating to the vesting of stock options while for nine months ended March 31, 2010, a total of \$2,523 was expensed (Q1 through Q3 F2009-\$377). The year-over-year increase can primarily be attributed

to a combination of the relative timing of options granted during the year, the vesting of previously granted options, and the assessed value of the options issued during the current period.

### **Income Taxes**

Canacol is subject to taxation in Canada, Brazil, and Colombia. The current income tax expense for Q3-F2010 was a charge of \$423 (Q3-F2009 - \$103) relating to Colombian income taxes. Due to operating losses in Brazil and Canada, the Corporation was not subject to income taxes in these jurisdictions during Q3-F2010.

A future income tax asset is not recognized for the Corporation's Canadian net capital losses, non-capital loss, or other tax pool balances. Further, a future income tax asset has not been recognized on the Corporation's Brazilian tax losses or other tax pools. A valuation allowance for Canada and Brazil has conservatively been applied to the remainder of the future income tax assets in the entity due to uncertainty of realization.

As at March 31, 2010, the Company had a deferred income tax liability relating to the book value in excess of the tax basis value on its petroleum and natural gas assets acquired through the acquisition of Canacol Energy Inc. The future income tax liability recorded in conjunction with the acquisition totalled \$11,382. During the three months ended March 31, 2010, future income tax recovery was \$907, resulting in an outstanding future income tax liability of \$7,137 at March 31, 2010 (June 30, 2009 - \$11,378).

## ***CASH FLOWS FROM OPERATING, FINANCING, AND INVESTING ACTIVITIES - ONGOING OPERATIONS***

### **Operating**

For the three months ended March 31, 2010, cash flow from ongoing operating activities totalled an outflow of \$4,747 (Q3-F2009 - \$2,446) while for the nine months ended March 31, 2010, it totalled an outflow of \$4,136 (Q1 through Q3 F2009 - inflow of \$1,736). For the three months period ending March 31, 2010, cash flow from operating activities before changes in non-cash working capital totalled an outflow of \$1,209 (Q3-F2009 - outflow of \$879), while for the nine months ended March 31, 2010, it totalled an outflow of \$2,362 (Q1 through Q3 F2009 - \$1,937).

### **Financing**

For the three months ended March 31, 2010, the Corporation recorded net cash outflow from ongoing financing activities of \$530 (Q3-F2009 - \$486). For the nine months ended March 31, 2010, the Corporation recorded net cash inflow from ongoing financing activities of \$31,145 (Q1 through Q3 F2009 - outflow of \$11,557). Cash inflow from financing activities for the nine months primarily relates to a \$41,835 issuance of share capital, less repayments of the Corporation's line of credit and long term debt.

### **Investing**

For the three months ended March 31, 2010, cash flows from ongoing investing activities totalled an outflow of \$7,741 (Q3-F2009 - inflow of \$1,652). For the nine months ended March 31, 2010, cash flows from ongoing investing activities totalled an outflow of \$9,562 (Q1 through Q3 F2009 - \$4,811). For the three months ended March 31, 2010, the Corporation incurred \$4,323 in capital expenditures while for the nine months ended March 31, 2010 - \$16,762. The majority of the capital spent was related to the Corporation's Colombian operations.

## ***DISCONTINUED OPERATIONS - BCH LTD.***

Effective December 31, 2008, Canacol sold all of its 11,717,093 BCH Common Shares to Allis Chalmers for proceeds of US\$5,000. Under the terms of the transaction, Allis Chalmers assumed the liability for the US\$23.5 million long-term debt facility and the US\$40 million convertible debenture already owned by Allis Chalmers.

Financial highlights from BCH's operations, which are "Discontinued Operations" for the nine months ended March 31, 2010 and 2009 include:

### **Drilling Services Revenue**

As noted above, BCH was sold on December 31, 2008. Thus, there is no impact for the three months ended March 31, 2010 and 2009. The total drilling services segment revenue, before inter-company consolidation eliminations for the nine months ended March 31, 2010 was \$Nil (F2009 - \$20,083).

<b>Drilling Services Revenue</b> <i>(\$000s)</i>	<b>Nine Months Ended March 31,</b>	
	<b>2010</b>	<b>2009</b>
Drilling services segment revenue	-	20,083
Less: Inter-segment sales <sup>(1)</sup>	-	(44)
Less: Sales taxes	-	(1,328)
<b>Drilling services revenue</b>	<b>-</b>	<b>18,711</b>

<sup>(1)</sup> Inter-segment revenue and profit have been netted against exploration and production capital expenditures on consolidation.

### **Operating Expenses and Operating Margin**

Drilling services operating costs for the nine months ended March 31, 2010 totalled \$Nil (F2009 - \$13,854). Operating margin for the nine months ended March 31, 2010 was \$Nil (F2009 - \$4,857).

### **Depreciation**

During the nine months ended March 31, 2010, depreciation expense relating to the operations of BCH totalled \$Nil (F2009 - \$2,102).

### **General and Administrative**

During the nine months ended March 31, 2010, general and administrative (G&A) expenses related to BCH were \$Nil (F2009 - \$2,445).

### **Income Taxes**

BCH was subject to taxation in Canada and Brazil. During the nine months ended March 31, 2010 future income tax was \$Nil (F2009 - recovery of \$3,877). For the nine months ended March 31, 2010, the net tax recovery was \$Nil (Q2-F2009 - \$2,497).

### **Stock Based Compensation**

During the nine months March 31, 2010, stock compensation expense of \$Nil (F2009 - \$17) was recognized relating to stock options issued by BCH.

### **Interest and Financial Expenses**

During the nine months March 31, 2010, interest and financial expenses were \$Nil (F2009 - \$6,079). Interest and financial expense was comprised of interest on the long-term debt facilities, convertible debenture, capital leases, and non-cash interest charges. Non-cash interest charges relate to the

accretion of the deferred financing charges incurred on debt facilities as well as accretion of the convertible debenture. Non-cash interest charges for nine months ended March 31, 2010 totalled \$Nil (F2009 - \$1,404).

### Foreign Exchange

BCH's activities in Brazil used the Brazilian Real (BRL\$) as its functional currency and therefore it was exposed to the risk of fluctuations in foreign exchange rates. BCH's drilling services contracts were based on a US\$ price with a portion paid in BRL\$ and a portion of which was paid in US\$. Both BCH's long-term debt facilities and its Convertible Debenture are denominated in US\$.

During the nine months ended March 31, 2010, BCH incurred a foreign exchange loss of \$Nil (F2009 - loss of \$11,609). The foreign exchange loss was a result of the depreciation of the Canadian dollar relative to the US dollar and the corresponding impact on US denominated debt balances.

### Derivatives

BCH had two types of derivative contracts in place; three foreign currency derivative contracts and an embedded derivative associated with drilling contracts. These embedded derivatives were not designated as hedges and therefore unrealized gains on these contracts were recorded on the balance sheet with changes in their fair value recorded in the net earnings for the period. Details of the outstanding contracts were as follows:

<b>Period</b>	<b>Notional Balance</b>	<b>Type</b>	<b>Settlement</b>	<b>Average BRL/US Exchange Rate</b>
June 2008 - April 2009	US\$500,000 / month	Non-Deliverable Forward	Financial	1.7621
July 2008 - April 2009	US\$200,000 / month	Deliverable Forward	Physical Delivery	1.7306
July 2008 - April 2009	US\$100,000 / month	Deliverable Forward	Physical Delivery	1.7570

During the nine months ended March 31, 2010, BCH had a net realized financial derivative loss of \$Nil (F2009 - 640). During the nine months ended March 31, 2010, BCH had a net unrealized financial derivative loss of \$Nil (F2009 - loss of \$1,498).

## *LIQUIDITY AND CAPITAL RESOURCES*

### **Working Capital**

Funding for the Corporation's expenditures during the three and nine months ended March 31, 2010 was provided by cash on hand from private placements. At March 31, 2010, the Corporation had positive working capital of \$10,185 (June 30, 2009 - deficiency of \$15,262).

During the nine months ended March 31, 2010, the Corporation placed \$4,000 of convertible debentures with interest payable in common shares and closed a \$40 million common share financing. Management believes that a combination of cash on hand, cash generated from operating activities, funding from Gemini, an equity offering that closed on May 5, 2010 for total gross proceeds of \$57,500 including the over-allotment option and potential farm-ins will allow it to execute its planned drilling programs and exploration commitments in Colombia, Guyana and Brazil.

### **Cash Flow From Operating Activities**

The Corporation has generally had a history of negative cash flow from operating activities and may not be able to generate sufficient cash flow to finance operations and other requirements. Following the conclusion of the acquisition of Canacol Energy Inc. and the disposition of BCH, Canacol completed a detailed review of its operations and administrative functions in order to reduce inefficiencies and better integrate operations. In addition, significant financing initiatives have been completed to ensure that operations activities and exploration obligations are met. See "Working Capital".

### **Debt Facilities**

The Corporation has been successful in reducing its overall debt levels.

The Corporation repaid its original amount on the mezzanine debt of US\$11,600 in full and reduced the reserve based credit facility by US\$7,045.

As at March 31, 2010, Canacol had a reserve based credit facility with US\$10,455 drawn: the Rancho Hermoso reserves based revolving line of credit facility. Subsequent to March 31, 2010, the Corporation repaid US\$818, decreasing the credit facility to US\$9,637.

### *Capital program commitments*

In Colombia and Guyana, the Corporation has non-discretionary work program commitments totalling approximately \$21,000 due within a year or less. The Corporation will continue to focus its efforts in calendar 2010 on its operated development programs in Colombia, its project in Guyana and on its non-operated appraisal project at the Colombia Capella discovery, to provide operating cash flow, and seek to reduce its exposure to its non-operated production and exploration operations in Brazil. The majority of the Corporation's committed and discretionary development drilling programs in Colombia focus on increasing oil production from the Rancho Hermoso Field. Further, the Corporation is seeking to sell remaining non-core operations in Canada and Ireland and intends to focus its capital on Colombia, Guyana, and Brazil. The Corporation intends to continue to finance these commitments through a combination of working capital on hand, cash flow from operations and through additional debt and equity financings. The Corporation is also actively seeking additional farm-in partners for its exploration projects in Brazil.

### *Other*

The Corporation continues to assess its requirements for capital on an on-going basis. The Corporation has successfully attracted the required investment capital to fund operations and planned programs for calendar 2010.

## COMMITMENTS, GUARANTEES, AND OFF-BALANCE SHEET ARRANGEMENTS

As at March 31, 2010, Canacol has minimum exploration program (“MEP”) work unit commitments to complete negotiated exploration work on its onshore blocks awarded by the Agência Nacional do Petróleo, Gás Natural e Biocombustível (“ANP”), Brazil’s National Petroleum Agency. MEP work units are satisfied through completion of exploration wells, seismic programs, and other exploration survey methods all of which have prescribed work units for completion. Therefore, although actual dollars spent on projects do not directly correlate to reducing the MEP work units, the financial guarantees related to non-performance are shown in the table below. The commitment will be reduced as work is performed.

Bid Round	Basin	Commitment Date	Extension	Gross Remaining MEP Work Units	Gross Financial Guarantee	Net Remaining MEP Work Units	Net Financial Guarantee <sup>1</sup>
9	Recôncavo <sup>2</sup>	March 12, 2010	March 12, 2011	600	BRL \$1,800	320	BRL \$960
9	Recôncavo	June 5, 2010	N/A	1,000	BRL \$3,000	320	BRL \$960
9	Espirito Santo	March 12, 2011	N/A	1,020	BRL \$3,060	408	BRL \$1,224

<sup>1</sup> Net financial guarantee based on Canacol’s net working interest.

<sup>2</sup> The ANP has granted an extension of 12 months of the contract BT-REC-60, block REC-T-170, until the Corporation obtains permission to access the area.

In addition, the Corporation has commitments for office premises and other operating leases. As at March 31, 2010, the lease payments required in each of the next five years are as follows:

Leases	\$
2010	75
2011	100
2012	100
2013	100
2014	105

### Gemini Oil and Gas Funds

The Corporation executed a series of agreements with Gemini Oil and Gas Fund II, L.P. (“Gemini”), a Jersey based oil and gas investment fund, on April 17, 2009, whereby Gemini agreed, subject to certain preconditions, to invest up to US\$9 million, to be used to fund portions of the Corporation’s development and appraisal programs in Colombia. As at March 31, 2010, the Corporation had drawn US\$9 million from the agreements with Gemini.

Under the terms the agreements, Gemini agreed to invest:

- Up to US\$3 million towards the drilling of a development well and the workover of 2 existing wells in the Entrerrios Field;
- Up to US\$3 million towards the drilling of 2 development wells and the workover of one existing well in Rancho Hermoso Field; and
- Up to US\$3 million towards the drilling of additional delineation wells in the Capella Field, its new heavy oil discovery on the Ombu E&P contract.

In return, Gemini was entitled to royalties from 11% to 31% of the Corporation’s interest in gross revenue after government royalty less field operating costs from the field up to either a 400% payout ratio or until 95% of the ultimate recoverable reserves as determined from time to time as underlying the Concession area have been produced, whichever is the sooner. The Corporation has no obligation to repay these funds if the underlying properties defined in the transaction have no revenues.

## *PENDING LAND AUCTION AWARD TRANSACTIONS*

### **Round 8 Land Auction**

The Corporation qualified for and bid for onshore land blocks offered by the ANP, Brazil's National Petroleum Agency in Brazil's Round 8 land auction held on November 28th and 29th, 2006 ("Round 8 Bid"). Canacol and its partners in the Round 8 Bid, W. Washington and Brownstone, were successful in winning and being awarded five separate blocks, each block totalling 180 square kilometres of exploration lands ("Round 8 Bid Lands") in the Tucano Basin which lies directly west of the Recôncavo Basin. However, the Round 8 Bid is the subject of a court injunction filed in Brasilia against the ANP. The premise for the injunction is that the restriction for any one E&P company to purchase more than four blocks of land in any one area, in any given bid round of land is not constitutional. As of this report date, the court injunction has been lifted in the superior court from one of two jurisdictions. Canacol and its partners in the Round 8 Bid have no information indicating that their successful Round 8 Bid Lands will not be retained by them.

No capital commitments are currently included in Canacol's capital budget for the round 8 lands.

## *SUBSEQUENT EVENTS*

Discussed in relevant sections in the MD&A.

## *TRANSACTIONS WITH RELATED PARTIES*

During the three and nine months period ended March 31, 2010, companies controlled by a director of the Corporation were paid a total \$Nil (Q1 through Q3 F2009 - \$Nil and \$91 respectively) in professional and consulting fees and office rent. All of the transactions were completed on normal industry terms. None of these amounts remained outstanding at each respective period end. Effective February 6, 2009, this individual ceased to be a director of the Corporation.

Canacol has an operating agreement under standard industry terms on the properties in Brazil with W. Washington. Previously, W. Washington was considered a related party by virtue that it was controlled by a director of the Corporation. Following the changes in the composition of the Corporation's Board of Directors after the acquisition of Canacol Energy Inc., effective October 30, 2008, W. Washington ceased to be considered a related party of the Corporation. Total management fee payments made to W. Washington for the three and nine months ended March 31, 2010 totalled \$248 and \$742, respectively (Q1 through Q3 F2009 - \$249 and \$812 respectively) and are included in general and administrative expenses. These transactions were in the normal course of operations and were measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

## *OUTLOOK*

Canacol's goal is to build a significant oil production and exploration company in Latin America. The Corporation has established a production platform in its core operating countries of Colombia and Brazil, along with a large onshore appraisal and exploration positions in Colombia, Brazil, and Guyana. The Corporation is using its strong technical management team to realize the full production and reserves potential of its producing assets. In Colombia, the Corporation has identified a number of

low risk opportunities within its operated fields that it intends to pursue, which are expected to result in a significant increase in existing production and reserves. The Corporation estimates an exit rate of 7,000 bbl/d for these properties at December 31, 2010, subject to completion of planning drilling programs on schedule. The Corporation has completed long term production testing of the Guadalupe reservoir in the Rancho Hermoso 5 well, and is currently conducting a long term production test of the overlying Los Cuervos reservoir. Upon completion of the long term production test of the Los Cuervos, the Corporation plans to commingle production from both the Los Cuervos and Guadalupe reservoirs and place the well on permanent long term production. The Corporation is also preparing to drill up to 5 new infill development wells in the Rancho Hermoso field commencing in June, 2010, subject to completion of planning drilling programs on schedule, and will also expand the capacity of the permanent facilities to handle the additional fluids. On the exploration side, the Corporation has met with success in its non-operated Ombu E&P contract in Colombia, with the discovery of the Capella oil field. This significant discovery, currently being appraised, will yield near term production and reserves gains, and represents a long term development project with large heavy oil reserves upside. The Corporation has acquired the Pacarana, Tamarin and Cedrela contracts adjacent to the Capella oil field. The Corporation has completed a seismic program on the Tamarin E&P contract, and has also completed an airborne magnetic gravity survey on the Pacarana TEA. In Guyana, the Corporation has a working interest in a large onshore exploration block that contains an existing light oil discovery, Karanambo, and 2 large exploration prospects. The Corporation has plans in place to delineate the discovery and drill one exploration well in calendar 2010.

### *SHARES OUTSTANDING (as at May 24, 2010)*

There are an unlimited number of no par value common shares authorized for issuance. Details of the issued and outstanding shares are as follows:

#### **Issued & Outstanding Share Capital**

Number of shares issued and outstanding, March 31, 2010	333,314,920
Private Placement	76,667,050
Issued to consultants	97,382
Warrants exercised	2,600,000
Stock options exercised	29,000
Debentures converted	555,556
<hr/>	
Number of shares issued and outstanding, May 24, 2010	413,263,908

Subsequent to the period ended March 31, 2010, 29,000 shares were issued on exercise of options, 2,600,000 shares were issued on exercise of warrants, 97,382 shares were issued in lieu of cash to consultants, and \$200,000 in debentures were converted, resulting in the issuance of 555,556 common shares.

## Options Outstanding (as at May 24, 2010)

### Stock Options Outstanding

	Number	Weighted Average Exercise Price	Expiry Date Range
Balance, March 31, 2010	23,755,067	\$0.37	
Cancelled & Expired Options	8,333	\$0.35	November 6, 2014
	8,333	\$0.60	January 19, 2015
	<u>16,666</u>		
Exercised	9,000	\$0.65	March 1, 2013
	10,000	\$0.10	March 4, 2014
	10,000	\$0.10	January 6, 2014
	<u>29,000</u>		
Balance, May 24, 2010	23,800,733	\$0.37	

The following are the outstanding stock options issued by the Corporation and their respective exercise prices and expiry dates. At May 24, 2010, vested stock options totalling 9,638,071 options were exercisable at a weighted average exercise price of \$0.37 per common share and a total of 23,709,401 options were issued and outstanding at a weighted average exercise price of \$0.33.

## WARRANTS OUTSTANDING (as at May 24, 2010)

Warrants Outstanding	Number	Weighted Average Exercise Price	Expiry Date
Warrants Outstanding at March 31, 2010	30,657,024	\$0.40	2 years
Exercised Warrants	(60,000)	\$0.30	July 24, 2011
	(180,000)	\$0.30	January 7, 2011
	(2,050,000)	\$0.20	May 14, 2011
	(310,000)	\$0.20	May 28, 2011
Warrants Outstanding at May 24, 2010	28,057,024	\$0.41	2 years

As part of the Rancho Hermoso debt financing, 10,000,000 warrants were issued to the lender on August 29, 2008 at an exercise price of \$0.80 per share and will expire on August 29, 2013. The warrants have a mandatory exercise clause in which they must be exercised if the closing price of Canacol's shares exceeds \$0.95 per share for 60 consecutive trading days. These warrants replaced 3,500,000 cancelled warrants (at an exercise price of US\$2.00 per common share) which were previously issued in conjunction with the Corporation entering into the W. Washington reserves based revolving credit facility.

In addition, as part of the May 14 and 28, 2009 private placements, 24,000,000 warrants were issued.

Each warrant entitles the holder to acquire one common share at a price of \$0.20 until May 14, 2011 (first closing) and May 28, 2011 (second closing). 6,982,500 of these warrants have been exercised as of May 24, 2010.

On July 23, 2009, the Corporation issued 1,109,524 warrants in connection with a private placement at an exercise price of \$0.30. In addition, the Corporation issued 1,500,000 warrants in connection with the sale of a promissory note receivable at an exercise price of \$0.30 for 18 months. 70,000 of these warrants have been exercised as of May 24, 2010.

Subsequent to the three months ended March 31, 2010, 240,000 warrants were exercised at an exercise price of \$0.30 and 1,935,000 warrants were exercised at an exercise price of \$0.20.

## *RISK FACTORS*

The Corporation is subject to several risk factors including, but not limited to: the volatility of oil and natural gas prices; foreign exchange and currency risks; general risks related to foreign operations such as political, economic, regulatory and other uncertainties as they relate to both foreign investment policies and energy policies; governments exercising from time to time significant influence on the economy to control inflation; developing environmental regulations in foreign jurisdictions; discovery of new oil and natural gas reserves; concentration of oil sales receipts with a few major customers; substantial capital expenditures for the acquisition, exploration, development and production of oil and natural gas reserves in the long-term for which additional financings may be required to implement Canacol's business plan.

As the Corporation has not experienced sufficient positive cash flow from operations to independently finance its growth and operations, it has been reliant on access to capital in the form of both debt and equity to fund on-going operations and to fund capital investments. Although periodic volatility of financial and capital markets may severely limit access to capital, the Corporation has been able to successfully attract the required investment capital.

The Corporation is exposed to foreign exchange and currency risk as a result of fluctuations in exchange rates through its cash deposits and investments denominated in the Colombian Peso (COP\$), the Brazil Real (BRL\$), and the United States dollar (US\$) as well as its debt balances which are denominated in US\$. At March 31, 2010, the Corporation held \$158 (BRL\$ 278) on deposit in Brazilian currency (June 30, 2009 - \$13 (BRL\$ 22) and \$1,930 (COP\$ 3.6 billion) on deposit in Colombian Pesos (June 30, 2009 - \$31 (COP\$ 58,285)) and \$15.6 million (US\$ 15.4 million) on deposit in US dollars (June 30, 2009 - \$84 (US\$ 72)). As at March 31, 2010, the Corporation had \$10,618 (US\$10,455) in US dollar denominated debt outstanding (June 30, 2009 - \$20,344 (US\$ 17,500)) in connection with its debt facilities and \$621 (COP\$1.1 million) (June 30, 2009 - 5,686 (COP\$10.3 billion) in connection with the unsecured line of credit drawn by its subsidiary Rancho Hermoso in Colombia.

Much of the Corporation's revenue and exploration and development costs are expected to be received/paid in or referenced to US\$ denominated prices while a significant portion of its operating and general and administrative costs are denominated in Canadian dollars, the BRL\$, and the COP\$. As a result of ongoing adverse conditions, the Brazilian Real and the Colombian Peso have seen significant variation against the US\$ during 2009 and it continues to have significant daily fluctuations making this particular currency risk more acute. The Corporation has not entered into currency derivatives for its continuing operations in order to hedge its exposure to fluctuations between the US dollar, Colombian Peso, or the Brazilian Real. Such derivatives may be considered in future periods.

The Corporation's main debt facilities are based on a LIBOR plus applicable spread. As such, the Corporation is subject to changes in the LIBOR interest rates. Although central bank government interest rates have declined, the Corporation has not seen significant declines in its borrowing costs

as LIBOR spreads have increased over government rates as a result of the credit crisis. The Corporation will continue to be subject to interest rate volatility associated with LIBOR based credit facility. The line of credit in Colombia bears interest at the Deposit a Termino Fijo (“DTF”) interest rate, a Colombian benchmark interest rate, plus spreads of 5.0% to 7.0% per annum on the balance outstanding resulting in an average rate of 9.9%.

In addition to the line of credit of discussed above, the Corporation through its subsidiary Rancho Hermoso, also obtained two additional unsecured revolving lines of credit in February 2010 and April 2010, respectively, aggregating borrowing bases of \$4,824 (US\$4,750). The lines of credit have similar interest rates as described above. The Corporation has not drawn down any amounts under these lines of credit.

Fluctuations in energy prices will not only impact revenues of the Corporation but may also affect lending policies of the Corporation’s lenders for existing and new borrowings. Crude oil prices are correlated with overall global economic growth and activity. The continuing volatility in the global economic environment has resulted in significant variation in crude oil prices over the last year. Any dramatic drop in crude oil prices will have a negative impact on the profitability of the Corporation which in turn will impact the operational cash flows of the Corporation as well as on its ability to finance capital expenditures. In absence of externally-source capital, this could limit growth prospects over the short run or may even require the Corporation to dispose of assets and to reduce bank borrowings as discussed further in the Liquidity and Capital Resources section.

In conjunction with the reserves based revolving credit facilities, the Corporation entered into one oil price financial derivative collar with the following terms.

*WTI crude oil financial option collar:*

<b>Period</b>	<b>Volume</b>	<b>Type</b>	<b>Price Range</b>
Jan – Dec 2010	140 bbls/day	Financial WTI Oil Collar	US\$55.00 - US\$80.25
Jan – Aug 2011	114 bbls/day	Financial WTI Oil Collar	US\$55.00 - US\$80.25

In addition to the current hedge, on April 12, 2010 the Corporation entered into a new hedge with a floor of US\$70.00 and a ceiling of US\$ 100.45 for daily production of 500 barrels.

The fair value of these transactions is based upon the estimated amounts that would have been paid to or received from counter parties in order to settle the transactions outstanding with reference to the forward prices as of the reporting date. The contracts have been transacted with a counter party with whom management has assessed credit risk and deemed no adjustment for credit risk is required in determining the estimated settlement price. In addition, the contracts are based on standard industry contracts and the Corporation does not feel that there is a liquidity risk associated with them and no adjustment has been recorded in computing their valuation. While hedging activities may have opportunity costs when realized prices exceed hedged pricing, such transactions are not meant to be speculative and are considered within the broader framework of financial stability and flexibility. Management continuously reviews the need to utilize such techniques.

The Corporation’s policy is to enter into agreements with customers that are well established and well-financed entities in the oil and gas industry such that the level of risk associated with one or more of its customers facing financial difficulties is mitigated while balancing factors of economic dependence with profit maximizing. To date, the Corporation has not experienced any material credit loss in the collection of accounts receivable. All Brazilian oil sales made through the Joint Venture are to a single customer who is the government energy Company (Petrobras), while in Colombia all oil sales revenue and tariff oil revenue comes from three customers of which two are also government entities (Petrobras Colombia, Ecopetrol and Hocol). Management continuously reviews its relationships with its customers to minimize any exposure risks.

Debt covenants relating to the Corporation’s Rancho Hermoso reserves-based revolving credit facility

did not take effect until periods occurring on or after March 31, 2009. There is a risk that the Corporation will not be able to meet its debt covenants in upcoming periods. Failure to meet the debt covenants could, at the discretion of the lender, constitute an event of default giving the lender the right to demand repayment of some, or all, of the loan. As of the date of these statements, the Corporation is in compliance with all non-financial and financial covenants including the borrowing base of the credit facility.

The Corporation attempts to mitigate its business and operational risk exposures by maintaining comprehensive insurance coverage on its assets and operations, by employing or contracting competent technicians and professionals, by instituting and maintaining operational health, safety and environmental standards and procedures and by maintaining a prudent approach to exploration and development activities. The Corporation also addresses and regularly reports on the impact of risks to its shareholders, writing down the carrying values of assets that may not be recoverable.

### ***CRITICAL ACCOUNTING ESTIMATES***

Canacol's significant accounting policies are contained in Note 2 to the audited consolidated financial statements for the year ended June 30, 2009.

#### **Currency translation**

The accounts of the self-sustaining Colombian subsidiaries are translated using the current rate method, whereby assets and liabilities are translated at the period-end exchange rates and revenues and expenses are translated using average period exchange rates. Translation gains and losses relating to the self-sustaining operations are included as part of accumulated other comprehensive income. The Corporation continues to use the temporal method to translate the operations of its Brazilian subsidiaries as detailed in the Corporation's annual consolidated financial statements.

#### **Revenue recognition**

The Corporation receives tariff revenue under a risk service contract with Ecopetrol in which a tariff price per barrel of tariff oil production is paid to the Corporation. Ecopetrol is a Mixed Economy Company, with a commercial orientation, organized as an "Anonymous Society" (equivalent to a Corporation), under the Ministry of Mines and governed by the Social Statutes. Ecopetrol S.A. carries out hydrocarbon exploration, production, and transportation activities in Colombia both directly and through participation agreements with other companies operating in Colombia. The Corporation recognizes revenue based on production of tariff oil and collection is reasonably assured.

All contracts that Rancho Hermoso S.A. ("RSHA") has signed with Ecopetrol are "risk contracts" because RSHA makes all investments and is in charge of producing at its own cost and risk. RSHA takes the risk regardless of the outcome. However, there are differences depending how the contract rewards RSHA. There are two cases:

In the case of Mirador in the RSHA field, it is a service contract because all of the crude belongs to Ecopetrol and RSHA gets paid through a tariff per barrel. RSHA provides the service for oil production. This is referred to as a Risk Service Contract.

In the other cases (such as Ubaque in Rancho Hermoso and all formations in Entrerrios), the contract is a participation contract because RSHA is entitled to a proportion of the production. Therefore, RSHA gets paid its share of the oil production sold in the market. This is referred to as a Risk Participation Contract.

Exploration contracts refer to activities that the Corporation performs to determine the existence and location of hydrocarbons in the subsurface, including but not limited to geophysical and geochemical methods, and other operations to determine whether the discovery is a commercial field.

With regards to the Corporation's accounting policies, certain policies are recognized as critical because in applying these policies management is required to make judgments, assumptions, and estimates that have a significant impact on the financial results of the Corporation. The estimates used in applying these critical accounting policies are regularly reviewed and have been discussed with the Audit Committee. These policies include:

#### **Income taxes**

The Corporation uses the liability method of accounting for income taxes. Under this method, future income tax assets and liabilities are based on the differences between asset and liability balances reported for financial accounting purposes and those reported for income tax. Future income tax assets and liabilities are measured using the substantively enacted tax rates expected to apply in the years in which the temporary differences are expected to be recovered or settled. Future income tax assets are recognized to the extent that they are more likely than not to be realized.

#### **Property, plant, and equipment**

##### *Depletion and depreciation*

Petroleum and natural gas properties are recorded in accordance with the Canadian Institute of Chartered Accountants' guideline on full cost accounting for the oil and gas industry whereby all costs relating to the exploration and development of petroleum and natural gas reserves are capitalized on a country-by-country basis. Such costs include land acquisition costs, geological and geophysical costs, costs of drilling both productive and non-productive wells, production equipment, and overhead charges directly related to acquisition, exploration, and development activities. Gains or losses on disposal of properties are recognized only when crediting the proceeds to the recorded costs would result in a change of 20% or more in the depletion and depreciation rate.

##### *Ceiling test and unproved properties*

An impairment loss is recognized in net earnings when the carrying amount of a cost centre of petroleum and natural gas assets and properties is not recoverable and the carrying amount of the cost centre exceeds its fair value. The carrying amount of the cost centre is tested for recoverability by determining if the carrying amount exceeds the sum of the undiscounted cash flows from proved reserves. If the sum of the cash flows is less than the carrying amount, the impairment loss is limited by the amount by which the carrying amount exceeds the sum of the fair value of the proved and probable reserves and the costs of unproved properties that are subject to a separate impairment test.

Certain costs related to unproved properties and major development projects are excluded from costs subject to depletion and depreciation until the earliest of a portion of the property becomes capable of production, development activity ceases, or impairment occurs. These properties are reviewed quarterly and are subject to a separate impairment test. Any impairment is transferred to the costs being depleted. If the properties are located in a cost centre where there is no reserve base, the impairment is charged directly to earnings.

#### **Asset retirement obligations**

The fair value of the estimated asset retirement obligations is recognized in the consolidated balance sheet in the period which the liability is identified and incurred and a reasonable estimate of the fair value can be made. The obligations recognized are the legal obligations of the Corporation to retire and perform site restoration on tangible long-lived assets such as well sites. The obligations are discounted to their present value using the Corporation's credit adjusted risk-free interest rate. The corresponding amount increases the carrying amount of the related asset. The liability is accreted over time for changes in the fair value of the liability through charges to accretion expense. The amounts capitalized to the related assets are amortized to earnings over the expected remaining life of the underlying resources using the unit of production method. Actual costs incurred upon settlement of the asset retirement obligations are charged against the obligation to the extent of the liability recorded.

### **Stock based compensation plan**

The Corporation records compensation expense in the consolidated financial statements for stock options granted to employees, directors, and consultants using the fair value method. Fair values are determined using the Black-Scholes option pricing model with compensation costs recognized over their vesting period. Any consideration paid to the Corporation on the exercise of stock options, along with amounts previously credited to Contributed Surplus, is credited to share capital.

### **Financial instruments**

The Corporation's financial assets and liabilities consist of cash and cash equivalents, accounts receivable, accounts payable, accrued liabilities, convertible debentures, currency and commodity derivatives, and long-term debt. The fair value of these financial assets and liabilities approximates their carrying value, unless otherwise noted.

## ***IMPACT OF NEW AND PROPOSED ACCOUNTING STANDARDS***

### **Business combinations**

In January 2009, the Accounting Standards Board ("AcSB") issued Section 1582, Business Combinations, which replaces former guidance on business combinations. Section 1582 establishes principles and requirements of the acquisition method for business combinations and related disclosures. This statement applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after January 2011 with earlier application permitted. The Corporation plans to adopt this standard July 1, 2011 and does not expect the adoption of this statement to have a material impact on its results of operations or financial position.

### ***Consolidated financial statements and Non-controlling interests***

In January 2009, the AcSB issued Sections 1601, Consolidated Financial Statements, and 1602, Non-controlling Interests, which replaces existing guidance. Section 1601 establishes standards for the preparation of consolidated financial statements. Section 1602 provides guidance on accounting for a non-controlling interest in a subsidiary in consolidated financial statements subsequent to a business combination. These standards are effective on or after the beginning of the first annual reporting period beginning on or after January 2011 with earlier application permitted. The Corporation plans to adopt these standards effective July 1, 2011 and does not expect the adoption will have a material impact on its results of operations or financial position.

### ***Goodwill and intangible assets***

In February 2008, the CICA issued Section 3064, "Goodwill and Intangible Assets", replacing Section 3062, "Goodwill and Other Intangible Assets" and Section 3450, "Research and Development Costs". Various changes have been made to other sections of the CICA Handbook for consistency purposes. The new Section will be applicable to financial statements relating to fiscal years beginning on or after October 1, 2008. Accordingly, the Company has adopted the new standards for its fiscal year beginning July 1, 2009. It establishes standards for the recognition, measurement, presentation, and disclosure of goodwill subsequent to its initial recognition and of intangible assets by profit-oriented enterprises. Standards concerning goodwill are unchanged from the standards included in the previous Section 3062.

### ***International Financial Reporting Standards (IFRS)***

In April 2008, the CICA published the exposure draft "Adopting IFRSs in Canada". The exposure draft proposes to incorporate IFRS into the CICA Accounting Handbook effective for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. At this date, publicly accountable enterprises will be required to prepare financial statements in accordance with IFRS. The Corporation is preparing the diagnostic analysis that identifies differences between the

Corporation's current accounting policies and IFRS to determine the impact of these differences and assess the need for amendments to existing accounting policies in order to comply with IFRS.

The Corporations' June 30 fiscal year end requires IFRS financial statements for its fiscal year beginning on July 1, 2011.

### *MAINTENANCE OF DISCLOSURE CONTROLS AND PROCEDURES (DC&P) AND INTERNAL CONTROL OVER FINANCIAL REPORTING (ICFR)*

Management and the Board of Directors are committed to the promotion of investor confidence by ensuring that trading in the Corporation's securities takes place in an efficient, competitive, and informed market. In accordance with the continuous disclosure requirements under the securities commission rules and TSX Venture Exchange policies, the Corporation has adopted a Corporate Disclosure Policy and has procedures in place to ensure that any sensitive information is identified, reviewed by management, and disclosed in a timely manner to the regulatory authorities, shareholders, and the public.

However, in contrast to the requirements under National Instrument 52-109 Certification of Disclosure in Issuers' Annual and Interim Filings (NI 52-109), the Corporation has opted out under the rules afforded to TSX Venture issuers and Management and the Board do not make any representations relating to the establishment and maintenance of disclosure controls and procedures (DC&P) and internal control over financial reporting (ICFR), as defined in NI 52-109.

### **ADDITIONAL INFORMATION**

Additional information relating to the Corporation's regulatory filings can be found on SEDAR at [www.sedar.com](http://www.sedar.com).

# Corporate Information

## Management Team

Charle Gamba – President & Chief Executive Officer

Mark Holliday – Chief Operating Officer

Mark Teare – Vice President Exploration

Brian Hearst – Chief Financial Officer

## Board of Directors

Michael Hibberd, Chairman

Luis Baena

Alvaro Barrera

Jason Bednar

Charle Gamba

Stuart Hensman

David Winter

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## Auditors

Deloitte & Touche LLP Calgary, Alberta

## Bankers

HSBC Bank Canada – Calgary, Canada

HSBC Bank Brasil - Rio de Janeiro, Brazil

Citibank, Bogota, Colombia

## Independent Reserve Engineers

Ryder Scott Company LP

DeGolyer and MacNaughton Canada Limited

Netherland, Sewell & Associates, Inc.

## Legal Counsel

Davis LLP - Canada

Schmidt, Valois, Miranda, Ferreira & Agel – Brazil

Salazar Asociados Abogados - Colombia

## Stock Exchange Listing

TSX Venture Exchange: CNE

## Transfer Agent & Registrar

Olympia Trust Company

2300, 125 - 9th Avenue SE

Calgary, Alberta T2G 0P6

