# PACIFIC RUBIALES ENERGY CORP.

Interim Consolidated Financial Statements

For the three and nine months ended
September 30, 2009 and 2008
(unaudited)
(In United States dollars)

# PACIFIC RUBIALES ENERGY CORP.
## Interim Consolidated Balance Sheets
## (unaudited)

| *(In thousands of U.S. dollars)* | As at September 30, 2009 | As at December 31, 2008 |
|---|---|---|
| **ASSETS** | | |
| Current | | |
| Cash and cash equivalents | $ 165,389 | $ 90,391 |
| Restricted cash (note 14) | 4,050 | 7,224 |
| Accounts receivable | 113,905 | 70,491 |
| Inventories | 16,865 | 13,873 |
| Prepaid expenses | 3,445 | 7,119 |
| Future income tax | 3,704 | 1,119 |
| | 307,358 | 190,217 |
| Oil and gas properties and equipment (note 4) | 1,980,969 | 1,907,504 |
| Restricted cash (note 14) | 11,362 | 11,441 |
| Future income tax | - | 8,431 |
| Investments and other assets (note 5) | 99,600 | 120,771 |
| Goodwill | 99,586 | 60,744 |
| | $ 2,498,875 | $ 2,299,108 |
| **LIABILITIES** | | |
| Current | | |
| Accounts payable and accrued liabilities | $ 160,665 | $ 173,911 |
| Risk management liability (note 15) | 20,537 | 6,574 |
| Income tax payable | 15,011 | 19,482 |
| Current portion of long-term debt (note 7) | 38,334 | 18,392 |
| Current portion of obligations under capital lease (note 9) | 10,409 | - |
| Future income tax | - | 1,144 |
| | 244,956 | 219,503 |
| Long-term debt (note 7) | 213,248 | 11,646 |
| Obligations under capital lease (note 9) | 28,374 | - |
| Convertible debentures (note 8) | 159,322 | 132,001 |
| Risk management liability (note 15) | 1,439 | - |
| Future income tax | 445,970 | 420,502 |
| Asset retirement obligation (note 6) | 16,334 | 14,671 |
| | 1,109,643 | 798,323 |
| Non-controlling interest (note 11) | - | 1,270 |
| Contingencies and commitments (note 14) | - | - |
| **SHAREHOLDERS' EQUITY** | | |
| Equity component of convertible debentures (note 8) | 66,130 | 66,130 |
| Common shares (note 10) | 1,212,995 | 1,187,925 |
| Contributed surplus (note 10) | 152,318 | 158,660 |
| Accumulated other comprehensive income (note 10) | 229 | 229 |
| Retained earnings (deficit) | (42,440) | 86,571 |
| | 1,389,232 | 1,499,515 |
| | $ 2,498,875 | $ 2,299,108 |

*See accompanying notes to the unaudited interim consolidated financial statements*

# PACIFIC RUBIALES ENERGY CORP.
## Interim Consolidated Statements of Operations, Comprehensive Income (Loss) and Retained Earnings (Deficit)
## (unaudited)

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| *(In thousands of U.S. dollars, except share and per share amounts)* | 2009 | 2008 | 2009 | 2008 |
| | | (Restated see note 1) | | (Restated see note 1) |
| **Revenues** | | | | |
| Net sales | $ 156,557 | $ 202,354 | $ 427,551 | $ 455,848 |
| **Cost of operations** | | | | |
| Operating | 75,357 | 73,317 | 202,400 | 181,408 |
| Overlift / (underlift) | (22,322) | (231) | (3,542) | 641 |
| Depletion, depreciation and amortization | 46,898 | 24,770 | 133,432 | 66,569 |
| | 99,933 | 97,856 | 332,290 | 248,618 |
| **Earnings before undernoted** | 56,624 | 104,498 | 95,261 | 207,230 |
| **Expenses** | | | | |
| General and administrative | 20,836 | 11,800 | 47,900 | 29,714 |
| Stock-based compensation (note 10) | 351 | 334 | 662 | 31,948 |
| | 21,187 | 12,134 | 48,562 | 61,662 |
| **Operating income** | 35,437 | 92,364 | 46,699 | 145,568 |
| **Other (expenses) income** | | | | |
| Foreign exchange gain (loss) | (69,279) | 5,012 | (93,582) | (26,547) |
| Interest expense | (11,284) | (3,334) | (25,194) | (4,089) |
| Gain (loss) on risk management contracts (note 15) | 7,282 | - | (15,399) | - |
| Other expense | (4,590) | (1,622) | (15,317) | (16) |
| | (77,871) | 56 | (149,492) | (30,652) |
| **Net income (loss) before non-controlling interest and income taxes** | (42,434) | 92,420 | (102,793) | 114,916 |
| Income tax expense | | | | |
| Current | 10,840 | (3,070) | 17,767 | 26,074 |
| Future | 9,833 | 16,425 | 8,451 | 23,762 |
| | 20,673 | 13,355 | 26,218 | 49,836 |
| Non-controlling interest | - | 741 | - | 937 |
| **Net (loss) income and comprehensive (loss) income** | (63,107) | 78,324 | (129,011) | 64,143 |
| **Retained earnings (deficit), beginning of period** | 20,667 | (4,308) | 86,571 | 9,873 |
| **Retained earnings (deficit), end of period** | $ (42,440) | $ 74,016 | $ (42,440) | $ 74,016 |
| Net Income per share (note 16) | | | | |
| - Basic | $ (0.29) | $ 0.37 | $ (0.61) | $ 0.33 |
| - Diluted | $ (0.29) | $ 0.35 | $ (0.61) | $ 0.30 |

*See accompanying notes to the unaudited interim consolidated financial statements*

## PACIFIC RUBIALES ENERGY CORP.
## Interim Consolidated Statements of Cash Flows
## (unaudited)

| *(In thousands of U.S. dollars)* | Three months ended September 30, 2009 | Three months ended September 30, 2008 (Restated see note 1) | Nine months ended September 30, 2009 | Nine months ended September 30, 2008 (Restated see note 1) |
|---|---|---|---|---|
| **CASH FLOWS FROM OPERATING ACTIVITIES** | | | | |
| Net income (loss) | $ (63,107) | $ 78,324 | $ (129,011) | $ 64,143 |
| Items not affecting cash: | | | | |
| Depletion, depreciation and amortization | 46,898 | 24,770 | 133,432 | 66,569 |
| Asset retirement obligation accretion (note 6) | 512 | 91 | 1,489 | 1,643 |
| Unrealized (gain) loss on risk management contracts | (7,279) | - | 15,402 | - |
| Non-cash interest expense on of convertible debentures (note 8) | 2,745 | 1,180 | 7,421 | 1,180 |
| Stock-based compensation | 351 | 334 | 662 | 31,948 |
| Future income tax | 9,833 | 16,425 | 8,451 | 23,762 |
| Unrealized foreign exchange loss (gain) | 64,538 | (5,012) | 87,524 | 26,547 |
| Non-controlling interest | - | 741 | - | 937 |
| Share of loss from equity investment | 1,186 | 179 | 789 | 444 |
| Changes in non-cash working capital (note 13) | 8,906 | (19,514) | (18,363) | (61,341) |
| Net cash provided by operating activities | 64,583 | 97,518 | 107,796 | 155,832 |
| **CASH FLOWS FROM INVESTING ACTIVITIES** | | | | |
| Additions to oil and gas properties and equipment | (88,141) | (66,311) | (272,604) | (173,003) |
| Acquisition of Pacific Stratus | | | | |
| cash acquired less acquisition costs (note 3) | - | - | - | 19,490 |
| Acquisition of Kappa net of cash acquired (note 3) | - | (167,747) | - | (167,747) |
| Restricted cash | (153) | (1,129) | 3,253 | (874) |
| Investments and other assets | - | (46,553) | 1,395 | (46,540) |
| Net cash used in investing activities | (88,294) | (281,740) | (267,956) | (368,674) |
| **CASH FLOWS FROM FINANCING ACTIVITIES** | | | | |
| Advances from long-term debt | 84,191 | - | 303,791 | - |
| Issuance of convertible debt | - | 216,014 | - | 216,014 |
| Repayment of long-term debt | (42,763) | (3,450) | (91,276) | (15,350) |
| Proceeds from the exercise of warrants and options (note 10) | 5,723 | 3,695 | 14,804 | 41,202 |
| Net cash provided by financing activities | 47,151 | 216,259 | 227,319 | 241,866 |
| **Effect of exchange rate changes on cash and cash equivalents** | 3,403 | (879) | 7,839 | (259) |
| **Change in cash and cash equivalents during the period** | 26,843 | 31,158 | 74,998 | 28,765 |
| **Cash and cash equivalents, beginning of the period** | 138,546 | 138,115 | 90,391 | 140,508 |
| **Cash and cash equivalents, end of the period** | $ 165,389 | $ 169,273 | $ 165,389 | $ 169,273 |
| Cash and cash equivalents are comprised of: | | | | |
| Cash | $ 141,484 | $ 158,391 | $ 141,484 | $ 158,391 |
| Short-term money market instruments | 23,905 | 10,882 | 23,905 | 10,882 |
| | $ 165,389 | $ 169,273 | $ 165,389 | $ 169,273 |

Supplemental disclosure with respect to cash flows (note 13)

*See accompanying notes to the interim consolidated financial statements*

## 1. SIGNIFICANT ACCOUNTING POLICIES

These unaudited interim consolidated financial statements of Pacific Rubiales Energy Corp. (the "Company") which include the accounts of the Company and its subsidiaries have been prepared by management in U.S. dollars in accordance with Canadian generally accepted accounting principles ("GAAP"). The unaudited interim consolidated financial statements have been prepared following the same accounting policies and methods of computation as the audited consolidated financial statements for the fiscal year ended December 31, 2008, except as noted in note 2. The unaudited interim consolidated financial statements do not include all of the disclosures included in the annual audited consolidated financial statement and accordingly should be read in conjunction with the audited annual consolidated financial statements and the notes thereto in the Company's annual report for the year ended December 31, 2008.

a) Restatement of 2008 unaudited interim consolidated financial statements

The Company has restated its September 30, 2008 unaudited interim consolidated financial statements as a result of its accounting for a special 40% tax deduction to be taken in the year of acquisition of qualified expenditures in Colombia. As the tax benefit from these expenditures is greater than its cost, the application of CICA 3465 requires the recognition of a future tax asset and a reduction in the cost base of the expenditure capitalized in oil and gas properties. The effect is to recognize the special 40% deduction through a reduction in the cost of oil and gas properties and hence a reduction in depreciation and depletion over the life of the asset compared to the previous accounting which recorded a direct recognition of the income tax benefit in the year the eligible expenditure was made.

The impact of this restatement was already included in the annual consolidated financial statements for the year ended December 31, 2008. The impact on the 2008 interim consolidated financial statements is as follows:

| | Three months ended September 30, 2008 | | | Nine months ended September 30, 2008 | | |
|---|---|---|---|---|---|---|
| | Previously Reported | Adjustment | Restated | Previously Reported | Adjustment | Restated |
| Oil and gas properties and equipment | $ 1,947,006 | $ (38,105) | $ 1,908,901 | $ 1,947,006 | $ (38,105) | $ 1,908,901 |
| Future income tax liabilty | 495,744 | (16,948) | 478,796 | 495,744 | (16,948) | 478,796 |
| Retained earnings, ending | 94,756 | (21,157) | 73,599 | 94,756 | (21,157) | 73,599 |
| Depletion, depreciation and amortizatior | 25,101 | (331) | 24,770 | 67,356 | (787) | 66,569 |
| Future income tax expense | 8,048 | 8,377 | 16,425 | 6,773 | 16,989 | 23,762 |
| Net income (loss) | 86,370 | (8,046) | 78,324 | 80,344 | (16,201) | 64,143 |
| Net income (loss) per share - basic | $ 0.41 | $ (0.04) | $ 0.37 | $ 0.41 | $ (0.08) | $ 0.33 |
| Net income (loss) per share - diluted | $ 0.39 | $ (0.04) | $ 0.35 | $ 0.38 | $ (0.08) | $ 0.30 |

The correction had no effect on reported cash provided by operating activities.

## 2. CHANGES IN ACCOUNTING POLICIES

Adopted

a) 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". The changes are applicable to financial statements relating to fiscal years beginning on or after October 1, 2008. Accordingly, the Company retrospectively adopted the new standard for its fiscal year beginning January 1,

**3. CHANGES IN ACCOUNTING POLICIES** (cont'd)

2009. The new standard establishes the recognition, measurement, presentation and disclosure of goodwill subsequent to its initial recognition and of intangible assets. This new guidance requires recognizing all goodwill and intangible assets in accordance with CICA Section 1000, "Financial Statement Concepts." Section 3064 has eliminated the practice of recognizing items as assets that do not meet the Section 1000 definition and recognition criteria. Under this new guidance, fewer items meet the criteria for capitalization. The adoption of this standard had no significant impact on the Company's consolidated financial statements.

b) Credit Risk and Fair Value of Financial Assets and Liabilities

On January 1, 2009, the Company retrospectively adopted the CICA's EIC-173, "Credit Risk and the Fair Value of Financial Assets and Financial Liabilities". This abstract provides guidance on how to take into account credit risk of an entity and its counterparty when determining the fair value of the financial assets and financial liabilities, including derivative instruments. The adoption of this abstract did not have a significant impact on the Company's consolidated financial statements as at September 30, 2009.

c) Leases

Leases are classified as either capital or operating. Assets that are held by the Company under leases, which transfer to the Company substantially all the benefits and risks of ownership, are accounted for as assets acquired under capital leases. The capitalized lease obligations reflect the present value of future lease payments, discounted at an appropriate interest rate. Leases that are not classified as capital leases are accounted for as operating leases with payments included in operating expenses in the year incurred.

Pending Accounting Pronouncements

d) Business Combinations

In January 2009, the CICA issued Handbook Sections 1582, "Business Combinations" ("Section 1582"), 1601, "Consolidated Financial Statements" ("Section 1601") and 1602, "Non-controlling Interests" ("Section 1602"). Section 1582 replaces CICA Handbook Section 1581, "Business Combinations", and establishes standards for the accounting for business combinations that are equivalent to the business combination accounting standard under International Financial Reporting Standards. Section 1582 is applicable 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 1, 2011, with early adoption permitted. Section 1601 together with Section 1602 replaces CICA Handbook Section 1600, Consolidated Financial Statements. Section 1601 establishes standards for the preparation of consolidated financial statements and Section 1602 establishes standards for accounting for a non-controlling interest in a subsidiary in consolidated financial statements subsequent to a business combination. Sections 1601 and 1602 are applicable for interim and annual consolidated financial statements relating to fiscal years beginning on or after January 1, 2011, with early adoption permitted. An entity must adopt Section 1582, 1601 or 1602 at the same time. The Company plans to adopt these standards effective January 1, 2011 and does not expect the adoption will have a material impact on the results of operations or financial position.

e) Financial Instruments – Disclosures

In May 2009, the CICA amended Section 3862, Financial Instruments – Disclosures, to include additional disclosure requirements about fair value measurement for financial instruments and liquidity risk disclosures. These amendments require a three level hierarchy that reflects the significance of the inputs used in making the fair value measurements. Fair values of assets and liabilities included in Level 1 are determined by reference to quoted prices in active markets for identical assets and liabilities. Assets and liabilities in Level 2 include valuations using inputs other than quoted prices for which all significant outputs are observable, either directly or indirectly. Level 3 valuations are based on inputs that are unobservable and significant to the overall fair value measurement. These amendments are effective for the Company on December 31, 2009.

### 3. BUSINESS ACQUISITIONS

*2009 acquisitions*

On February 11, 2009, the Company acquired for $12.0 million the remaining 34% of the outstanding shares of Pacific Rubiales Energy Trading S.A. ("PRET") that it did not own, increasing its ownership from 66% to 100%. An amount of $2.6 million was paid on closing and the balance of $9.4 million was paid during the three months ended September 30, 2009.

*2008 acquisitions*

*Kappa*

On September 3, 2008, the Company acquired 100% of Kappa Energy Holdings Ltd. ("Kappa"), an oil and gas exploration and production company, for $170.4 million cash and acquisition costs of $2.7 million.

The above acquisition has been accounted for using the purchase method with the Company being identified as the acquirer and Kappa as the acquiree. Therefore the results of operations for Kappa commencing September 3, 2008 are included in the Company's results. The purchase price allocation was finalized in September 2009 and the resulted in an adjustment to the preliminary purchase price allocation. The adjustment to the preliminary purchase price is attributable to the final valuation for the proved, probable, possible and exploration properties acquired in the acquisition. The final valuation for oil and gas properties was $243.3 million compared to $292.9 million previously estimated. Also included in this final valuation is goodwill of $33.7 million compared to previously estimated balance of nil. The difference from the preliminary estimate was due to the finalization of the fair market valuation including an independent valuation of reserves acquired.

*Pacific Stratus*

On January 23, 2008, the Company completed the acquisition of Pacific Stratus Energy Ltd. (the "Pacific Stratus Acquisition") through an amalgamation with a wholly-owned subsidiary of the Company. Consideration for the acquisition was the issuance of 79.3 million (475.5 million pre-consolidation) shares of the Company to Pacific Stratus Energy Ltd. ("Pacific Stratus") shareholders at a fair value of C$8.34 (C$1.39 pre-consolidation) per each share issued for a total amount of $648.9 million in exchange for all the shares of Pacific Stratus that were outstanding at closing, at a ratio of 9.5 pre-consolidation shares of the Company for every Pacific Stratus share. In addition 5.1 million (30.4 million pre-consolidation) Company warrants with a fair value of $28.0 million and 6.0 million (35.8 million pre-consolidation) Company incentive stock options with a fair value of $29.6 million were issued to existing Pacific Stratus warrant and option-holders upon closing based on the same exchange ratio. Acquisition costs amounted to $8.8 million.

The above acquisition has been accounted for using the purchase method with the Company being identified as the acquirer and Pacific Stratus as the acquiree. Therefore the results of operations for Pacific Stratus commencing January 23, 2008 are included in the Company's results. The purchase price allocation was finalized at December 31, 2008 and the fair value of the assets acquired and liabilities assumed are based on management's best estimate and an independent valuation. The adjustment to the preliminary purchase price is attributed to the final independent valuation of the proved, probable and exploration properties in the acquisition. The final valuation for oil and gas properties was $837 million compared to $913 million previously estimated. Also included in this final valuation is goodwill of $64,006 compared to previously estimated balance of nil. The difference from the preliminary estimate was due to the finalization of the independent valuation of the fair market valuation of properties acquired.

Pursuant to the acquisition of La Creciente by Pacific Stratus in 2004 the Company was required to issue 538,334 common shares to the sellers of the La Creciente properties upon achieving certain cash flow targets. As at the end of March 31, 2009 the cash flows targets were met and a liability of $3.3 million to recognize the issuance of the common shares was recorded in accounts payable. The liability was included in the purchase price of Pacific Stratus and accordingly goodwill has been measured (see note 17). On April 16, 2009, 538,334 common shares of the Company were issued to one of the sellers, now a director of the Company, as settlement.

**3. BUSINESS ACQUISITIONS** (cont'd)

A summary of the purchase price allocations for the acquisitions is found in the following table:

| | 2008 Acquisitions | | |
|---|---|---|---|
| | Kappa | Pacific Stratus | Total |
| Purchase price: | | | |
| Cash | $ 170,399 | $ - | $ 170,399 |
| Accounts payable | - | - | - |
| Common shares, warrants and stock options | - | 707,041 | 707,041 |
| Acquisition costs | 2,697 | 8,780 | 11,477 |
| | $ 173,096 | $ 715,821 | $ 888,917 |
| Net assets acquired: | | | |
| Cash | $ 5,349 | $ 28,270 | $ 33,619 |
| Non-cash working capital deficiency | (27,676) | (24,838) | (52,514) |
| Oil and gas properties | 240,611 | 836,568 | 1,077,179 |
| Goodwill | 35,580 | 64,006 | 99,586 |
| Restricted cash | - | 13,930 | 13,930 |
| Investments | 471 | 3,919 | 4,390 |
| Asset retirement obligation | (566) | (3,497) | (4,063) |
| Long-term debt | (10,000) | - | (10,000) |
| Future income tax liability | (70,673) | (202,537) | (273,210) |
| | $ 173,096 | $ 715,821 | $ 888,917 |

**4. OIL AND GAS PROPERTIES AND EQUIPMENT**

Details are as follows:

| | September 30, 2009 | | |
|---|---|---|---|
| | Cost | Accumulated DD & A | Net Book Value |
| Oil and gas properties and equipment | $ 2,177,642 | $ (244,858) | $ 1,932,784 |
| Corporate and other | 21,264 | (11,249) | 10,015 |
| Power generation unit under capital lease | 38,783 | (613) | 38,170 |
| | $ 2,237,689 | $ (256,720) | $ 1,980,969 |

| | December 31, 2008 | | |
|---|---|---|---|
| | Cost | Accumulated DD & A | Net Book Value |
| Oil and gas properties and equipment | $ 2,011,069 | $ (121,790) | $ 1,889,279 |
| Corporate and other | 19,723 | (1,498) | $ 18,225 |
| | $ 2,030,792 | $ (123,288) | $ 1,907,504 |

As at September 30, 2009, costs of $385.5 million (December 31, 2008 - $404.8 million) related to unproved properties and undeveloped land have been excluded from the depletion, depreciation and amortization calculation. As of September 30, 2009 $1.4 billion (December 31, 2008 - $1.4 billion) in future capital expenditures has been included in the calculation of depletion, depreciation and amortization. The Company has capitalized interest of $1.8 million (December 31, 2008 - $nil) related to financing on acquisition of oil and gas properties.

The Company accounted for the power generation unit as a capital lease. Under this accounting treatment, the Company recorded its proportionate share of an asset and an obligation. The asset is amortized using the unit of production method over the term of the lease. As at September 30, 2009, amortization expense of $0.6 million (December 31, 2008 - $ nil) related to the leased property is charged to depletion, depreciation and amortization (note 9).

## 5. INVESTMENTS AND OTHER ASSETS

The investments and other assets consist of the following:

| | September 30, 2009 | December 31, 2008 |
|---|---|---|
| 1. Investment in ODL Finance S.A. | $ 90,103 | $ 105,323 |
| 2. Investment in Ronter Inc. | 8,657 | 8,427 |
| 3. Other assets | 840 | 7,021 |
| | $ 99,600 | $ 120,771 |

1. The investment represents a 35% interest in ODL Finance S.A. (“ODL”), a special purpose Panamanian company with a Colombian branch that is constructing an oil pipeline that will allow for the transportation of heavy crude oil produced out of the Rubiales field. The remaining 65% interest is owned by Ecopetrol S.A., the national oil company of Colombia. The investment is accounted for using the equity method and the Company’s share of net income is included in the Company’s net income under other income. Phase I connects the Rubiales field to the Monterrey station and Phase II completes the pipeline such that full capacity can be reached. As of September 30, 2009, Phase I of the pipeline construction was substantially complete.

   On March 12, 2009, ODL completed a debt facility for approximately $200 million, equivalent to COP520,000,000. The loan is provided by Grupo Aval, a Colombian banking group led by Banco de Bogota. The facility has an interest rate of DTF (Colombia base for fixed rate deposits over three months) + 5%, a maturity of five years with a one year grace period and blended quarterly payments. The loan is non-recourse to the sponsors.

   On February 25, 2009, the ODL board of directors approved the reduction of the original investment by its shareholders from $301.5 million of which the Company’s share was $105.3 million to $260 million of which the Company’s share is $91 million.

   The Company has ship or pay contracts with ODL for the transportation of crude oil from the Rubiales field to Colombia´s oil transportation system, for a total commitment of $114 million over a five-year period.

2. The investment in Ronter Inc. represents a 21.7% indirect interest in Promotora de Energia Electrica de Cartagena & Cia, S.C.A. ESP (“Proelectrica”). Proelectrica is a private, Cartagena, Colombia-based 90 megawatt electrical utility peak demand supplier to the local Cartagena utility. This investment is accounted for using the equity method and the Company’s share of Proelectrica’s net income or loss is included in the Company’s net income under other income.

## 6. ASSET RETIREMENT OBLIGATION

The amount required to settle the future asset retirement obligation was estimated by management based on the Company’s net ownership interest in all wells and facilities, estimated costs to reclaim those wells and facilities and estimated timing of the costs to be incurred in future periods. The Company has estimated its total asset retirement obligations to be $16.8 million as at September 30, 2009 (December 31, 2008 - $14.7 million) based on a total undiscounted future liability of $43.3 million (December 31, 2008 - $39.8 million) assuming an annual inflation rate of 4.4% until the time the liability is settled. The obligation is expected to be settled at the end of the useful lives of the underlying assets determined by the expiration date on concession agreements which is expected to be incurred subsequent to 2016. The obligation has been discounted using a credit adjusted risk free interest rate of 15% (December 31, 2008 – 15%).

## 6. ASSET RETIREMENT OBLIGATION (cont'd)

Changes to the asset retirement obligation were as follows:

| | September 30, 2009 | December 31, 2008 |
|---|---|---|
| Balance, beginning of the period | $ 14,671 | $ 1,498 |
| Assumed on the Pacific Stratus Acquisition | - | 3,497 |
| Assumed on the Kappa Acquisition (1) | (480) | 1,046 |
| Obligations incurred during the period | 654 | 7,932 |
| Accretion expense | 1,489 | 698 |
| Balance, end of the period | $ 16,334 | $ 14,671 |

(1) Adjustment as at September 30, 2009 resulted from the final valuation of Kappa acquisition.

## 7. LONG-TERM DEBT

At September 30, 2009, the Company has a syndicated $250 million extendible revolving credit facility with a stated term date of June 30, 2013. The facility is available on a revolving basis for a period of 24 months. On May 5, 2011, the facility will be available on a non-revolving basis for a 26 month term with principal and interest payable on a quarterly basis. At September 30, 2009, $225 million (December 31, 2008 - $nil) was drawn under this credit facility. Under the terms of the revolving credit facility, the Company is required to maintain (1) a debt to EBITDA ratio of less than 3.5; (2) a guaranteed debt to EBITDA ratio of less than 2.5; (3) current ratio of greater than 1.0; (4) a reserve tail ratio, which is defined as net present value of proved reserve divided by total debt, of less than 1.4; and (5) at least $5 million in cash or banking commitments. The Company was fully compliant with these financial covenants at September 30, 2009. The revolving credit facility is secured by a first floating charge over the Company's reserve base and its assets.

In addition to the revolving credit facility, at September 30, 2009, the Company also has a non-revolving bilateral credit facility for up to $18.7 million. Subject to the bank's right to demand payment, the repayment terms are monthly repayments of principal and interest maturing on April 23, 2010. At September 30, 2009, $3.3 million (December 31, 2008 - $6.6 million) was drawn under this credit facility. Under the terms of the non-revolving bilateral credit facility, the Company is required to maintain a debt to cash flow ratio of less than 3.5. The Company was fully compliant with this financial covenant at September 30, 2009. The non-revolving bilateral credit facility is unsecured.

In the nine months ended September 30, 2009, the Company issued six promissory notes payable carried at $5.9 million, $2.2 million, $10.9 million, $3.9 million, $3.4 million and $0.8 million. The notes are due on October 5, 2009, October 25, 2009, November 25, 2009, November 30, 2009, December 9, 2009 and March 30, 2010, respectively. The notes bear interest at rates detailed in the table below, payable semi-annually and upon maturity. The six promissory notes are unsecured.

Total long-term debt was carried at amortized cost with financing cost of $12.4 million (December 31, 2008 - $nil) netted against the principal of the revolving credit facility. The financing costs are amortized into carrying value of the debt at each reporting period using effective interest method.

| | Maturity | Currency | Interest Rate | September 30, 2009 | December 31, 2008 |
|---|---|---|---|---|---|
| Bank overdrafts | | | | $ 52 | $ 212 |
| Bilateral term credit | April 23, 2010** | COP | DTF* + 3.5 | 3,342 | 6,583 |
| Promissory note | March 10, 2009 | COP | DTF* + 3.5 | - | 319 |
| Promissory note | April 3, 2009 | COP | 17.32% | - | 2,227 |
| Promissory note | June 4, 2009 | COP | 16.50% | - | 10,697 |
| Promissory note | October 15, 2012 | USD | LIBOR + 3.0% | - | 10,000 |
| Promissory note | November 25, 2009 | COP | 8.18% | 10,907 | - |
| Promissory note | December 9, 2009 | COP | 7.60% | 3,434 | - |
| Promissory note | October 25, 2009 | COP | 6.90% | 2,169 | - |
| Promissory note | October 5, 2009 | COP | DTF*+3.5% | 5,929 | - |
| Promissory note | December 24, 2009 | COP | 10.00% | 7,804 | - |
| Promissory note | November 30, 2009 | COP | 9.70% | 3,917 | - |
| Promissory note | March 30, 2010 | COP | 9.70% | 780 | - |
| Revolving credit facility | June 30, 2013 | USD | Libor + 5.5% | 213,248 | - |
| | | | | $ 251,582 | $ 30,038 |
| Current portion | | | | $ 38,334 | $ 18,392 |
| Long-term debt | | | | 213,248 | 11,646 |
| | | | | $ 251,582 | $ 30,038 |

* DTF = fixed- term-deposit rate in Colombia
** Subject to the bank's right to demand payment

## 8. CONVERTIBLE DEBENTURES

On August 28, 2008, the Company issued $228.2 million (C$240 million) of convertible unsecured subordinated debentures due August 29, 2013 and convertible into common shares of the Company at C$13 per share. The debentures bear interest at 8% annually, payable semi-annually in arrears on June 30 and December 31.

The debentures have been classified into their debt and equity components. The fair value of the equity component was valued using the Black-Scholes option pricing model assuming a risk free rate of 3.65%, no dividends paid, expected life of 5 years and an expected volatility of 50% with the residual of the cash received allocated to the debt component. As a result, on the issuance of the debentures, $149.7 million (net of $8.5 million issuance costs) was classified as the debt component and $66.1 million (net of $3.8 million issuance costs) was classified as the equity component. The debt component will accrete up to the principal balance over the term of the debenture using the effective interest method. The accretion and interest paid are expensed as interest expense yielding an effective annual rate of 18%.

| Convertible debenture - debt component | Amount |
|---|---|
| Gross proceeds due on maturity (C$240 million) | $ 228,159 |
| Costs | (12,316) |
| | $ 215,843 |
| Fair value of equity component (net of $3,773 issuance costs) | 66,130 |
| Value attributed to liability component on issuance (net of $8,543 issuance costs) | 149,713 |
| Non-cash interest | 3,954 |
| Foreign exchange gain upon conversion to US$ | (21,666) |
| Balance as at December 31, 2008 | $ 132,001 |
| Non-cash interest | 2,105 |
| Foreign exchange gain upon conversion to US$ | (4,853) |
| Balance as at March 31, 2009 | $ 129,253 |
| Non-cash interest | 2,571 |
| Foreign exchange loss upon conversion to US$ | 11,648 |
| Balance as at June 30, 2009 | $ 143,472 |
| Non-cash interest | 2,745 |
| Foreign exchange loss upon conversion to US$ | 13,105 |
| **Balance as at September 30, 2009** | **$ 159,322** |

## 9. OBLIGATIONS UNDER CAPITAL LEASE

The Company has entered into a power generation arrangement to supply electricity for three of its oil fields in Colombia from August 2009 to June 2016. The arrangement has been accounted for as a capital lease. Under this arrangement, the Company's proportionate share of annual minimum lease payments as follows as at September 30, 2009:

| | Minimum lease payment |
|---|---|
| 2009 | $ 4,368 |
| 2010 | 11,306 |
| 2011 | 11,306 |
| 2012 | 11,337 |
| 2013 | 11,306 |
| Thereafter | 28,250 |
| Total minimum lease payments | 77,873 |
| Amounts representing interest portion (22.9%) | (39,090) |
| Present value of net minimum lease payments | 38,783 |
| Less current portion | (10,409) |
| **Long term portion of obligations under capital lease** | **$ 28,374** |

Interest expense of $1.5 million was incurred on the capital leases during the three and nine months ended September 30, 2009 (December 31, 2008 – $nil).

## 10. SHARE CAPITAL

### *(a) Authorized, issued and fully paid common shares*

Unlimited number of common shares with no par value.

Continuity schedule of share capital and contributed surplus:

| | Number of Shares | Share Capital | Contributed surplus | Accumulated Comprehensive Income |
|---|---|---|---|---|
| Balance, January 1, 2008 | 118,993,149 | $ 453,321 | $ 106,710 | $ 229 |
| Issued on the Pacific Stratus Acquisition | | | | |
| - Common shares issued | 79,251,491 | 648,901 | - | - |
| - Warrants and options issued | - | - | 58,139 | - |
| Issued on the exercise of warrants | 8,833,254 | 45,198 | (24,540) | - |
| Issued on the exercise of options | 3,488,446 | 40,505 | (20,222) | - |
| Stock-based compensation | - | - | 38,573 | - |
| Balance, December 31, 2008 | 210,566,340 | $ 1,187,925 | $ 158,660 | $ 229 |
| Issued on the exercise of warrants | 446,502 | 213 | - | - |
| Issued on the exercise of options | 29,123 | 198 | (146) | - |
| Stock-based compensation | - | - | 64 | - |
| Balance, March 31, 2009 | 211,041,965 | $ 1,188,336 | $ 158,578 | $ 229 |
| Issued on Pacific Stratus Acquisition | 538,334 | $ 3,262 | $ - | $ - |
| Issued on the exercise of warrants | 45,830 | 22 | - | - |
| Issued on the exercise of options | 1,949,918 | 11,179 | (2,385) | - |
| Stock-based compensation | - | - | 247 | - |
| Balance, June 30, 2009 | 213,576,047 | $ 1,202,799 | $ 156,440 | $ 229 |
| Issued on the exercise of options | 999,928 | 10,196 | (4,473) | - |
| Stock-based compensation | - | - | 351 | - |
| Balance, September 30, 2009 | 214,575,975 | $ 1,212,995 | $ 152,318 | $ 229 |

**10. SHARE CAPITAL** (cont'd)

***(b) Stock options***

The Company has established a "rolling" Stock Option Plan (the "Plan") in compliance with the TSX policy for granting stock options. Under the Plan, the maximum number of shares reserved for issuance may not exceed 10% of the total number of issued and outstanding common shares. The exercise price of each option shall not be less than the market price (as defined under TSX Policy) of the Company's stock at the date of grant.

A summary of the changes in stock options is presented below:

| | Outstanding | Weighted average exercise price |
|---|---|---|
| Balance, January 1, 2008 | 2,357,500 | C$ 6.06 |
| Granted during the year | 14,907,944 | C$ 6.54 |
| Granted on the Pacific Stratus Acquisition | 5,970,750 | C$ 4.26 |
| Exercised during the year | (3,488,446) | C$ 5.74 |
| Balance, December 31, 2008 | 19,747,748 | C$ 5.94 |
| Granted during the period | 50,000 | C$ 2.79 |
| Cancelled during the period | (148,892) | C$ 5.54 |
| Exercised during the period | (29,117) | C$ 2.22 |
| Balance, March 31, 2009 | 19,619,739 | C$ 5.94 |
| Granted during the period | 100,000 | C$ 5.72 |
| Cancelled during the period | (24,334) | C$ 5.62 |
| Exercised during the period | (1,949,918) | C$ 5.08 |
| Balance, June 30, 2009 | 17,745,487 | C$ 6.03 |
| Granted during the period | 65,000 | C$10.86 |
| Cancelled during the period | (41,002) | C$ 6.33 |
| Exercised during the period | (999,928) | C$ 6.29 |
| Balance, September 30, 2009 | 16,769,557 | C$ 6.03 |

The following table summarizes information about the stock options outstanding and exercisable:

| Outstanding & Exercisable | Exercise price | Expiry date | Remaining contractual life |
|---|---|---|---|
| 227,426 | C$ 1.92 | May 2, 2010 | 0.6 |
| 10,075 | C$ 1.92 | October 16, 2011 | 2.0 |
| 1,757,502 | C$ 2.22 | August 21, 2011 | 1.9 |
| 241,460 | C$ 2.40 | October 27, 2009 | 0.1 |
| 50,000 | C$ 2.79 | February 11, 2014 | 4.4 |
| 3,183,076 | C$ 4.70 | October 23, 2013 | 4.1 |
| 333,335 | C$ 5.70 | May 9, 2017 | 7.6 |
| 1,091,670 | C$ 6.30 | July 10, 2017 | 7.8 |
| 1,256,378 | C$ 6.78 | April 20, 2012 | 2.6 |
| 14,134 | C$ 7.02 | April 25, 2012 | 2.6 |
| 8,519,083 | C$ 7.38 | February 11, 2013 | 3.4 |
| 15,835 | C$ 8.46 | May 3, 2012 | 2.6 |
| 9,583 | C$ 8.46 | April 16, 2013 | 3.5 |
| 60,000 | C$10.86 | July 30, 2014 | 4.8 |
| 16,769,557 | C$ 6.03 | | |

**10. SHARE CAPITAL** (cont'd)

The following stock options with a 5 year life were granted to employees during the period. All of these options vested immediately.

| Date of stock option grant | Granted | Exercise price | Fair value |
|---|---|---|---|
| July 30, 2009 | 65,000 | C$10.86 | C$5.40 |

The fair value of the stock options issued during the three months and nine months ended September 30, 2009 has been calculated using the Black-Scholes option pricing model, based on the following weighted assumptions:

| | |
|---|---|
| Risk-free interest rate: | 1.39% |
| Expected life: | 2.5 years |
| Weighted expected volatility: | 80% |
| Expected dividend yield: | 0 |

***(c) Warrants***

Each warrant outstanding is exercisable into one common share.

The following table summarizes information about the warrants outstanding and exercisable:

| Outstanding & exercisable | Exercise price | Expiry date |
|---|---|---|
| 44,311,219 | C$ 7.80 | July 12, 2012 |

A summary of the changes in warrants is presented below:

| | Outstanding & exercisable | Weighted average exercise price |
|---|---|---|
| Balance, January 1, 2008 | 48,479,098 | C$ 7.26 |
| Issued on the Pacific Stratus Acquisition | 5,157,708 | C$ 2.52 |
| Exercised during the year | (8,833,254) | C$ 2.39 |
| Balance, December 31, 2008 | 44,803,552 | C$ 7.72 |
| Exercised during the period | (446,502) | C$ 0.60 |
| Balance, March 31, 2009 | 44,357,050 | C$ 7.79 |
| Exercised during the period | (45,830) | C$ 0.60 |
| Balance, June 30 and September 30, 2009 | 44,311,220 | C$ 7.80 |

## 11. NON-CONTROLLING INTEREST

The following table summarizes the changes in the non-controlling interest as presented on the unaudited interim consolidated balance sheets:

| | | Amount |
|---|---|---|
| Non-controlling interest as at January 1, 2008 | $ | - |
| Net earnings attributable to non-controlling interest | | 1,270 |
| Non-controlling interest as at December 31, 2008 | | 1,270 |
| Net earnings attributable to non-controlling interest | | - |
| Acquisition of the remaining 34% interest in PRET (Note 3) | | (1,270) |
| Non-controlling interest as at September 30, 2009 | $ | - |

## 12. CAPITAL DISCLOSURES

The Company's objectives when managing capital are: (i) to maintain a flexible capital structure, which optimizes the cost of capital at acceptable risk; and (ii) to maintain investor, creditor and market confidence to sustain the future development of the business.

The Company manages its capital structure and makes adjustments to it in light of changes in economic conditions and the risk characteristics of its underlying assets. The Company considers its capital structure to include shareholders' equity, debt, convertible debt and working capital. To maintain or adjust the capital structure, the Company may from time to time issue shares, raise debt and/or adjust its capital spending to manage its current and projected debt levels.

The Company monitors capital based on the following non-GAAP measures: current and projected ratios of debt to cash flow from operations and debt to capital employed. The Company's objective, which is currently met, is to maintain a debt to cash flow from operations ratio of less than three times. The ratio may increase at certain times as a result of acquisitions. To facilitate the management of this ratio, the Company prepares annual budgets, which are updated depending on varying factors such as general market conditions and successful capital deployment.

The Company's share capital is not subject to external restrictions; however the Company's debt is subject to the financial covenants detailed in Note 7. The Company was fully compliant with the covenants at September 30, 2009.

There were no changes in the Company's approach to capital management from the previous year.

| | | September 30, 2009 | | December 31, 2008 |
|---|---|---|---|---|
| Shareholders' equity | $ | 1,389,232 | $ | 1,499,515 |
| Long-term debt | | 251,582 | | 30,038 |
| Convertible debt | | 159,322 | | 132,001 |
| Working capital (surplus) deficit | | (100,736) | | 10,894 |
| | $ | 1,699,400 | $ | 1,672,448 |

## 13. SUPPLEMENTAL CASH FLOW INFORMATION

Changes in non-cash working capital items were:

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| *Changes in non-cash working capital balances* | 2009 | 2008 | 2009 | 2008 |
| Decrease (increase) in accounts receivable | $ 9,210 | $ (2,668) | $ (43,414) | $ (53,163) |
| Increase (decrease) in accounts payable and accrued | (8,764) | (43,964) | 26,752 | (47,110) |
| Decrease (increase) in inventory | (342) | 1,177 | (2,992) | 7,924 |
| Increase (decrease) in income taxes payable | 9,024 | 25,864 | (4,471) | 25,864 |
| Decrease in prepaid expenses and other | (222) | 77 | 5,762 | 5,144 |
| Attributable to operating activities | $ 8,906 | $ (19,514) | $ (18,363) | $ (61,341) |

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| *Other cash flow information* | 2009 | 2008 | 2009 | 2008 |
| Cash interest paid | 2,200 | 550 | 16,273 | 1,900 |
| Cash interest received | 259 | 442 | 1,104 | 713 |
| Cash income tax paid | 1,750 | 918 | 8,592 | 2,553 |

## 14. CONTINGENCIES AND COMMITMENTS

The Company has various guarantees in place in the normal course of business.

As at September 30, 2009, the Company has issued letters of credit for exploration and operational commitments for a total of $84.0 million (December 31, 2008 - $38.6 million). In addition, the Company has $15.4 million in bank guarantees (December 31, 2008 - $18.7 million) which are secured by restricted cash.

*Association contracts*

Certain association contracts signed before 2003 with Ecopetrol include clauses in which Ecopetrol may commence participating in the operation of new discoveries made by the Company at any time, without prejudice to the Company's right to be reimbursed for the investments made on their sole account and risk (back-in right). The contract provides that if Ecopetrol decides to declare the commerciality of the field and participate in the commercial phase of the association contract, the Company shall have the right to be reimbursed for 200% of the total costs incurred during the exploration phase of the contract. Once the reimbursement has been made, Ecopetrol is entitled to acquire a 50% share of the oil production of the fields. The back-in right was not exercised as at September 30, 2009.

*Contingencies*

The Company is involved in various claims and litigation arising in the normal course of business. While the outcome of these matters is uncertain, there can be no assurance that such matters will be resolved in the Company's favor. The Company does not currently believe that the outcome of adverse decisions in any pending or threatened proceedings related to these and other matters or any amount which it may be required to pay by reason thereof would have a material impact on its financial position, results of operations or cash flows.

*Natural gas supply agreements*

The Company has entered into the following take or pay contracts, and interruptible contracts, totaling 60 MMBTU per day for the period 2009-2010:

**14. CONTINGENCIES AND COMMITMENTS** (cont'd)

| | | 2009 | | 2010 | |
|---|---|---|---|---|---|
| *Client* | *Contract* | Quantity (MMBTUD) | Price ($/MMBTU) | Quantity (MMBTUD) | Price ($/MMBTU) |
| GECELCA | take or pay | 34,807 | RMP + 28% | 45,000 | RMP + 28% |
| PROELECTRICA | take or pay | 14,000 | RMP + 12% | 14,000 | RMP + $ 0.50 |
| Interruptible supply | | 11,193 | RMP | 1,000 | 4.98 |
| Total | | 60,000 | RMP + 19% | 60,000 | RMP + 24% |

RMP represents the Colombian Regulated Market Price.

The Company anticipates having sufficient production to meet all future delivery commitments.

**15. FINANCIAL RISK MANAGEMENT**

The nature of the oil and natural gas operations and the issuance of debt expose the Company to fluctuations in commodity prices, foreign currency exchange rates and interest rates. The Company manages these risks through periodic use of derivative instruments. The Board of Directors periodically reviews the results of all risk management activities and all outstanding positions.

**Credit Risk**

The Company actively limits the total exposure to individual client counterparties and holds a trade credit insurance policy for indemnification for losses from non-collection of trade receivables. Four (December 31, 2008 – one) of the Company's customers had accounts receivable that were greater than 10% of total trade accounts receivable. At September 30, 2009, the Company's credit exposure in accounts receivable to these customers were $6.9, $4.9, $4.8, and $3.8 million or 25%, 18%, 17%, and 14% of trade accounts receivable, respectively (December 31, 2008 – one customer, with accounts receivable of $12.7 million or 75%). Revenue from these customers for the three months ended September 30, 2009 was $6.9, $0.9, $8.2, and $12.5 million or 4.4%, 0.5%, 5.2%, and 8.0% of net revenue, respectively (December 31, 2008 - $45.7 million or 7.9%).

The Company's trade accounts receivables are aged as follows:

| | September 30 2009 | December 31 2008 |
|---|---|---|
| Not past due (less than 45 days) | $ 12,950 | $ 17,190 |
| Past due (0-30 days) | 10,231 | 5 |
| Past due (31-120 days) | 816 | - |
| Past due (over 120 days) | 3,707 | - |
| Allowance for doubtful accounts | - | (205) |
| Total trade accounts receivable | 27,704 | 16,990 |
| VAT and withholding taxes recoverable | 53,494 | 37,866 |
| Advances and deposits | 20,353 | 6,914 |
| Other | 12,354 | 8,721 |
| | $ 113,905 | $ 70,491 |

**Interest Rate Risk**

The Company is exposed to interest rate risk on its outstanding floating rate borrowings and short-term investments due to fluctuations in market interest rates. The Company monitors its exposure to interest rates. The variable rates on floating rate bank debts are re-priced monthly. A 1% hypothetical change in the variable interest rate exposes the Company to $2.1 million interest expense or income. The remainder of the Company's financial assets and liabilities are not exposed to interest rate risk.

## 15. FINANCIAL RISK MANAGEMENT (cont'd)

### Foreign Currency Exchange Risk

The Company is exposed to foreign currency fluctuations as certain expenditures and borrowings are incurred in Colombian pesos and Canadian dollars. Currently, the Company has not entered into any foreign currency forward exchange contracts to manage this risk.

In addition, following the Rubiales acquisition in 2007 and Pacific Stratus Acquisition and the Kappa Acquisition in 2008, the Company recorded $478 million of future income tax liabilities on proved and unproved properties which are denominated in Colombian Pesos as the assets to which the future income tax liabilities relate to are in Colombia. The future income tax liabilities are monetary items, which are revalued each period end at the current exchange rates, with the gain or loss recorded in net earnings in the period. Based on the net exposure at September 30, 2009, a 10% depreciation or appreciation of the Colombian Peso against the US dollar would result in a $35 million increase or decrease in the Company's after-tax net earnings.

### Liquidity Risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they become due. The Company's processes for managing liquidity risk include ensuring, to the extent possible, that it will have sufficient liquidity to meet its liabilities when they become due. The Company prepares annual capital expenditure budgets which are monitored and updated as required. In addition, the Company requires authorizations for expenditures on projects to assist with the management of capital.

The following are the contractual maturities of financial liabilities as at September 30, 2009:

| Financial liability | < 1 Year | 1-2 Years | Thereafter | Total |
|---|---|---|---|---|
| Accounts payable and accrued liabilites | $ 160,665 | $ - | $ - | $ 160,665 |
| Long-term debt and bank indebtedness (1) | 38,334 | - | 213,248 | 251,582 |
| Risk management liabilities | 20,537 | 1,439 | | 21,976 |
| Convertible debentures - principal (2) | - | - | 224,090 | 224,090 |
| Obligations under capital lease (3) | 10,409 | 7,694 | 20,680 | 38,783 |
| Total | $ 229,945 | $ 9,133 | $ 458,018 | $ 697,096 |

(1) Current portion of long-term debt of $38.3 million is comprised of bank overdrafts, bilateral term credit facilities and promissory notes with various maturity dates before September 30, 2010. Long-term portion of $213.2 million is a revolving credit facility maturing on June 30, 2013.

(2) The convertible debentures are due August 29, 2013 in the principal amount of Cdn$240 million. The balance due is converted to US$ using the September 30, 2009 exchange rate of $1.071.

(3) Obligations arising from the power generation arrangement to supply electricity to the Company from August 2009 to June 2016. The arrangement has been accounted for as a capital lease.

### Commodity Price Risk

Commodity price risk is the risk that the cash flows and operations of the Company will fluctuate as a result of changes in commodity prices. Significant changes in commodity prices can also impact the Company's ability to raise capital or obtain additional debt financing. Commodity prices for crude oil are impacted by world economic events that dictate the levels of supply and demand. From time to time the Company may attempt to mitigate commodity price risk through the use of financial derivatives. The Company recognizes the fair value of its derivative instruments as assets or liabilities on the balance sheet. None of the Company's derivative instruments currently qualify as fair value hedges or cash flow hedges, and accordingly, changes in fair value of the derivative instruments are recognized as income or expense in the interim consolidated statement of operations and retained earnings with a corresponding adjustment to the fair value of derivative instruments recorded on the balance sheet.

Under the terms of the revolving credit facility (Note 7), the Company was required to enter into derivative instruments for the purpose of obtaining protection against fluctuations in the price of oil for a minimum of 10,000 barrels per day from July 2009 to June 2010 and 6,500 barrels per day from July 2010 to June 2011 but not exceeding 80% of anticipated monthly production.

The Company had the following derivative instruments outstanding at September 30, 2009:

| Type of Instrm. | Term | Volume | Strike Price (USD$/bbl) | Benchmark | Fair value |
|---|---|---|---|---|---|
| Zero Cost Collar | Jul 1 - Dec 31, 2009 | 3,012,000 | 45 floor / 80 ceiling | WTI | $ (3,972) |
| Zero Cost Collar | Jul 1 - Dec 31, 2009 | 900,000 | 45 floor / 92 ceiling | WTI | $ (131) |
| | **Total** | **3,912,000** | | | **$ (4,103)** |

| Type of Instrm. | Term | Volume | Strike Price (USD$/bbl) | Benchmark | Fair value |
|---|---|---|---|---|---|
| Written call option | Jan 1 - Feb 28, 2010 | 300,000 | 80 | WTI | $ (1,219) |
| Written call option | Mar 1 - Apr 30, 2010 | 300,000 | 76.1 | WTI | $ (2,138) |
| Written call option | May1 - May 31, 2010 | 152,000 | 80 | WTI | $ (1,107) |
| Written call option | Jun 1 - Aug 31, 2010 | 504,000 | 90 | WTI | $ (2,674) |
| Written call option | Jan 1 - May 31, 2010 | 785,000 | 80 | WTI | $ (4,436) |
| Written call option | Jun 1 - Jul 31, 2010 | 304,000 | 80 | WTI | $ (2,496) |
| | **Total** | **2,345,000** | | | **(14,070)** |

| Type of Instrm. | Term | Volume | Strike Price (USD$/bbl) | Premium (USD$/bbl) | Fair value |
|---|---|---|---|---|---|
| Put option | Jan 1 - Jun 30, 2010 | 900,000 | 40 | $ 1.95 | $ (332) |
| Put option | Jul 1 - Dec 31, 2010 | 600,000 | 40 | $ 2.45 | $ (707) |
| Put option | Jan 1 - Jun 30, 2010 | 900,000 | 40 | $ 1.28 | $ (688) |
| Put option | Jan 1 - Jun 30, 2010 | 900,000 | 40 | $ 1.41 | $ (891) |
| Put option | Jan 1 - Jul 31, 2011 | 700,000 | 40 | $ 2.45 | $ (525) |
| Put option | Jul 1 - Dec 31, 2010 | 585,000 | 40 | $ 1.91 | $ (450) |
| Put option | Jan 1 - Jun 30, 2011 | 585,000 | 40 | $ 1.91 | $ (210) |
| | **Total** | **4,585,000** | | | **$ (3,803)** |
| | **Total** | | | | **$ (21,976)** |
| | Short-term | | | | $ (20,537) |
| | Long-term | | | | $ (1,439) |
| | **Total** | | | | **$ (21,976)** |

For the three month and nine month periods ended September 30, 2009 there was a $3 realized loss and $0.4 million realized gain, respectively, on these contracts for actual monthly settlements and are included in revenue. The unrealized gain (loss) on risk management contracts represents the change in the fair value of the contracts outstanding as at September 30, 2009 related to the expected future settlements, which totaled $7.3 million in gain and $15.4 million in loss for the three month and nine month periods ended September 30, 2009, respectively. The unrealized losses were recorded in statement of operations.

If the forward WTI crude oil price estimated at September 30, 2009 had been $1/bbl higher or lower, the unrealized loss on these contracts would change by approximately $1.7 million and would be reflected in the statement of operations of the Company.

**Fair Value Risk**

The Company’s financial instruments are classified as cash and cash equivalents, restricted cash, accounts receivable and accounts payable and accrued liabilities, commodity risk management liabilities, bank debt and convertible debentures on the balance sheet. The carrying value and fair value of these financial instruments at September 30, 2009 are disclosed below by financial instrument category, as well as any related interest expense for the three months and nine months ended September 30, 2009:

## 15. FINANCIAL RISK MANAGEMENT (cont'd)

| Financial Instrument | Carrying value | Fair value | 3 months ended September 30, 2009 Interest expense | 9 months ended September 30, 2009 Interest expense |
|---|---|---|---|---|
| *Assets held for trading* | | | | |
| Cash and cash equivalents | $ 165,389 | $ 165,389 | $ - | $ - |
| Restricted cash | 15,412 | 15,412 | - | - |
| *Loans and receivables* | | | | |
| Accounts receivable and other current assets | 113,905 | 113,905 | - | - |
| *Liabilities held for trading* | | | | |
| Derivative contracts (1) | 21,976 | 21,976 | - | - |
| *Other liabilities* | | | | |
| Accounts payable and accrued liabilities | 160,665 | 160,665 | - | - |
| Long-term debt (2) | 251,582 | 263,334 | 7,767 | 13,223 |
| Convertible debtentures (3), (4) | 159,332 | 197,572 | 7,779 | 22,911 |

(1) The fair value of the derivative contracts during the three months ended September 30, 2009 decreased by $7.3 million, and is included on the statement of operations, comprehensive income (loss) and retained earnings (deficit).
(2) Included in interest expense on the statement of operations. The amortization of deferred financing costs of $12.4 million in relation to the Company's long-term debt is included on the statement of cash flows from operating activities.
(3) The fair value of the convertible debt and equity components are difficult to measure reliably due to the lack of active trading volume. The closing price of the convertible debenture (PRE.DB – TSX) at September 30, 2009 represented 124% of the carrying value of the convertible debenture.
(4) Included in interest expense on the statement of operations. The non-cash interest expense relating to the accretion of the initial discount and transaction costs that are netted against this liability are included in accretion on convertible debentures on the statement of cash flow from operating activities. The effective yield of the convertible debentures is 18%.

The oil collars, calls and deferred premium put options are recorded at their fair values which are calculated based on quoted commodity forward strip price in the futures market on the balance sheet date; accordingly, there is no difference between fair value and carrying value. When drawn, bank debt bears interest at a floating rate and accordingly the fair value approximates the carrying value. Due to the short term nature of cash and cash equivalents, accounts receivable and other current assets, accounts payable and accrued liabilities, their carrying values approximate their fair values.

## 16. WEIGHTED AVERAGE SHARES AND DILUTED SHARES OUTSTANDING

The weighted average number of common shares outstanding for the three months and nine months ended September 30, 2009 was 214,158,123 and 212,254,026, respectively, to calculate basic loss per share (210,279,063 and 197,225,603 for the same respective periods in 2008). All options, warrants and convertible debt that are anti-dilutive are excluded from the calculation of diluted weighted average number of shares. If the options, warrants and convertible debt were dilutive at September 30, 2009, weighted average number of shares for the three months and nine months ended September 30, 2009 would be 222,548,097 and 215,658,765, respectively (223,803,264 and 210,225,052 for the same respective periods in 2008).

## 17. SEGMENTED INFORMATION

The Company currently operates in one reporting segment, being the exploration, development and production of heavy crude oil and gas in Colombia. As at September 30, 2009 all of the Company's assets are located in Colombia except for $1.6 million in cash and cash equivalents which are held in Canada and $2.9 million of oil property, plant and equipment in Peru.

## 18. RELATED-PARTY TRANSACTIONS

a) On April 16, 2009, 538,334 common shares ($3.3 million) of the Company were issued to a director of the Company as settlement of a contingent consideration on acquisition of La Creciente by Pacific Stratus in 2004.

b) For the three and nine months ended September 30, 2009, the Company paid Endeavour Financial Corp. ("Endeavour"), a company related by way of a director in common, $45 and $135 in retainer fees respectively (three and nine months ended September 30, 2009 - $nil and $105). The Company also paid Endeavour financing fees of $nil and $3 million (2008 - nil) for the three and nine months ended September 30, 2009, for the ODL pipeline pursuant to an advisory agreement dated November 8, 2007.

c) On May 5, 2009 the Company closed on initial commitments totaling $180 million of a senior secured revolving credit facility of up to $250 million. The facility consists of $50 million commitments from each of BNP Paribas, Calyon and Banco Davivienda S.A. and $30 million from West LB A.G. In June 2009, the Company paid Endeavour an amount of $2.6 million in retainer and advisory fees for the arrangement of this revolving credit facility. During the three months ended September 30, 2009, the Company received an additional $45 million under the revolving credit facility and paid Endeavour an amount of $862 in advisory fees related to the additional credit.

d) In June 2007, the Company entered into a 5-year lease agreement with Blue Pacific Assets Corp. ("Blue Pacific"), a British Virgin Islands corporation, for administrative office space in one of its Bogota, Colombia locations. Monthly rent expense of $55 is payable to Blue Pacific under this agreement. Three directors and officers of the Company control, or provide investment advice to the holders of, 75% of the shares of Blue Pacific. In addition, the Company has a receivable of $15 from Blue Pacific related to certain administrative costs paid by the Company on behalf of Blue Pacific.

e) As at September 30, 2009 the Company has an accounts receivable in the amount of $225 (December 31, 2008 - $13) from Medoro Resources Ltd., a company related by way of a director and an officer in common. The receivable balance is related to the Company's share of general and office expenses, including administrative support and office premises in Canada.

f) Loans receivable from related parties in the aggregate amount of $308 (December 31, 2008 – nil) are due from one director and one officer of the Company. The loans are non-interest bearing and repayable in equal monthly payments over a 48-month term.

All these transactions are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

## 19. SUBSEQUENT EVENTS

a. Subsequent to September 30, 2009, the Company issued Stand By and letters of credit and guarantees for exploration and operational commitments for a total of $24.2 million, Most of these Bank Guarantees are related to naphtha and light oil purchases.

b. On October 12, 2009, the Company granted 4,310,000 stock options under the rolling Plan with an exercise price of C$13.09 and an expiry date of October 12, 2014. The options vested immediately and the fair value of the options was C$6.28, calculated using the Black-Scholes option pricing model.

c. On October 28, 2009, the Company proposed to offer a cash payment of C$1.50 per warrant as an incentive for holders of the warrants to exercise their warrants during a 30-day early exercise period (the "Early Exercise Period") which, if approved by share and warrant holders, is expected to commence on or about December 14, 2009 and end on or about January 13, 2010.

**19. SUBSEQUENT EVENTS** (cont'd)

d. On November 10, 2009, the Company closed a senior notes offering with an aggregate principle amount of U.S. $450 million and maturity dates of November 10, 2014 (33.3%), November 10, 2015 (33.3%), and November 10, 2016 (33.4%). The notes carry an interest rate of 8.75%, payable on May 10 and November 10 of each year, beginning on May 10, 2010. The notes may be redeemed in whole (but not in part) at any time at the discretion of the Company with a redemption price equal to the greater of (1) 100% of the principal amount of the Notes to be redeemed, and (2) the sum of the present values of the remaining scheduled payments of principal and interest discounted to the date of redemption on a semi-annual basis at the applicable Treasury Rate plus 75 basis points, in each case plus accrued and unpaid interest on the outstanding principal amount. As a condition of closing, the proceeds from the offering are to be used to repay the outstanding revolving credit facility. The notes are senior unsecured and will rank equal in right of payment with all of the Company's existing and future senior unsecured debt. Application has been made to list the notes on the Official List of the Luxembourg Stock Exchange and to trade the notes on the Euro MTF.

**20. COMPARATIVE FINANCIAL STATEMENTS**

The comparative interim consolidated financial statements have been reclassified from statements previously presented to conform to the presentation of the current interim consolidated financial statements.