



**Consolidated Financial Statements**

**For the years ended December 31, 2012 and 2011**

PACIFIC RUBIALES ENERGY CORP.

## Management's Responsibility for Financial Statements

Management is responsible for preparing the consolidated financial statements and the accompanying notes. The consolidated financial statements have been prepared by in accordance with International Financial Reporting Standards using estimates and careful judgement, particularly in those circumstances where transactions affecting a current period are dependent upon future events. Management has established and maintains a system of internal controls that is designed to provide reasonable assurance that assets are safeguarded from loss or unauthorized use and that accounting systems provide timely, accurate, and reliable information. The Company's external auditors, Ernst & Young LLP, have examined the consolidated financial statements. Their examination provides an independent view as to management's discharge of its responsibilities insofar as they relate to the fairness of reported financial results and the financial condition of the Company.

The Audit Committee of the Board of Directors, consisting exclusively of independent directors, has reviewed in detail the consolidated financial statements with management and the external auditors. The Board of Directors on the recommendation of the Audit Committee has approved the consolidated financial statements.

*"Ronald Pantin"*  
Chief Executive Officer

*"Carlos Perez Olmedo"*  
Chief Financial Officer

Toronto, Canada  
March 13, 2013

## INDEPENDENT AUDITORS' REPORT

To the Shareholders of  
**Pacific Rubiales Energy Corp.**

We have audited the accompanying consolidated financial statements of Pacific Rubiales Energy Corp., which comprise the consolidated statements of financial position as at December 31, 2012 and 2011 and the consolidated statements of income, comprehensive income, equity and cash flows for the years ended December 31, 2012 and 2011, and a summary of significant accounting policies and other explanatory information.

### **Management's responsibility for the consolidated financial statements**

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

### **Auditors' responsibility**

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditors consider internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

### **Opinion**

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Pacific Rubiales Energy Corp. as at December 31, 2012 and 2011 and its financial performance and its cash flows for the years ended December 31, 2012 and 2011 in accordance with International Financial Reporting Standards.

Toronto, Canada,  
March 13, 2013.

*Ernst + Young LLP*  
Chartered Accountants  
Licensed Public Accountants

## Consolidated Statements of Income

(In thousands of U.S. Dollars, except per share information)	Notes	Year ended December 31	
		2012	2011
<b>Oil and gas sales</b>	5	\$ 3,884,762	\$ 3,380,819
<b>Cost of operations</b>			
Production and operating costs	6	1,586,420	1,245,509
Depletion, depreciation and amortization		851,444	656,912
Impairment of exporation and evaluation assets	13	102,060	12,066
		2,539,924	1,914,487
<b>Earnings before undernoted</b>		1,344,838	1,466,332
<b>Expenses</b>			
General and administrative		279,947	176,218
Share-based compensation		32,902	48,783
		312,849	225,001
<b>Earnings from operations</b>		1,031,989	1,241,331
Finance costs		(91,299)	(86,469)
(Loss) gain from equity investments	16	(102,933)	6,829
Equity tax	7	-	(68,446)
Foreign exchange gain (loss)		577	(39,894)
Gain on risk management	23c & e	10,130	8,831
Incentive for early conversion of debentures	17	-	(46,489)
Other expenses		(30,897)	(13,207)
<b>Net earnings before income tax</b>		817,567	1,002,486
Income tax expense	8	(289,838)	(448,150)
<b>Net earnings for the year</b>		\$ 527,729	\$ 554,336
Basic earnings per share	9	\$ 1.79	\$ 2.04
Diluted earnings per share	9	\$ 1.74	\$ 1.97

See accompanying notes to the consolidated financial statements

On behalf of the Board of Directors:

Miguel de la Campa (signed)

José Francisco Arata (signed)

PACIFIC RUBIALES ENERGY CORP.

**Consolidated Statements of Comprehensive Income**

(In thousands of U.S. Dollars)	Notes	Year ended December 31	
		2012	2011
<b>Net earnings for the year</b>		\$ 527,729	\$ 554,336
<b>Other comprehensive income (loss) (nil tax effect)</b>			
Foreign currency translation	16	26,816	4,205
Fair value adjustments on equity investments	16	(20,402)	20,402
Unrealized gain (loss) on cash flow hedges	23c	70,027	(14,492)
Realized gain on cash flow hedges transferred to earnings	23c	(18,453)	(9,577)
		57,988	538
<b>Comprehensive income</b>		\$ 585,717	\$ 554,874

*See accompanying notes to the consolidated financial statements*

PACIFIC RUBIALES ENERGY CORP.

**Consolidated Statements of Financial Position**

		As at December 31	
(In thousands of U.S. Dollars)	Notes	2012	2011
<b>ASSETS</b>			
Current			
Cash and cash equivalents		\$ 243,690	\$ 729,671
Restricted cash		21,023	3,074
Accounts receivables	23a	777,143	774,759
Inventories	11	125,043	181,272
Income tax receivable		42,289	18,694
Prepaid expenses		1,922	2,462
Risk management assets	23c & e	26,390	-
		1,237,500	1,709,932
Non-current			
Oil and gas properties	12	3,832,780	2,483,153
Exploration and evaluation assets	13	877,437	437,901
Intangible assets	15	118,884	144,961
Plant and equipment	14	83,621	80,001
Investments in associates and other assets	16	695,975	492,221
Goodwill	15	240,545	100,636
Risk management assets	23c	270	-
		\$ 7,087,012	\$ 5,448,805
<b>LIABILITIES</b>			
Current			
Accounts payable and accrued liabilities		\$ 1,209,333	\$ 702,895
Risk management liability	23c & e	3,176	67,387
Income tax payable		258,501	367,674
Current portion of long-term debt	17	7,395	4,726
Convertible debenture	17	2,450	-
Current portion of obligations under finance lease	19	20,206	17,106
		1,501,061	1,159,788
Non-current			
Long-term debt	17	1,184,561	922,418
Obligations under finance lease	19	75,770	87,782
Convertible debenture	17	-	2,234
Risk management liability	23c	-	5,397
Deferred tax liability	8	245,505	284,462
Equity tax payable	7	23,289	33,522
Asset retirement obligation	18	83,228	45,400
		3,113,414	2,541,003
<b>EQUITY</b>			
Common shares	21	2,623,993	2,025,665
Contributed surplus		157,159	145,741
Accumulated other comprehensive income (loss)		37,899	(20,099)
Retained earnings		1,154,547	756,495
		3,973,598	2,907,802
		\$ 7,087,012	\$ 5,448,805

See accompanying notes to the consolidated financial statements

PACIFIC RUBIALES ENERGY CORP.

**Consolidated Statements of Equity**

(In thousands of U.S. Dollars)	Notes	Year ended December 31	
		2012	2011
<b>Common shares</b>			
Balance, beginning of year		\$ 2,025,665	\$ 1,691,838
Issued on exercise of warrants		97	6,176
Issued on exercise of options		64,636	34,420
Issued on acquisition of C&C	4	533,582	-
Issued on conversion of convertible debentures	17	13	293,231
Balance, end of year		2,623,993	2,025,665
<b>Contributed surplus</b>			
Balance, beginning of year		145,741	112,339
Exercise of warrants		-	(1,347)
Exercise of options		(18,055)	(14,034)
Share-based compensation		29,473	48,783
Balance, end of year		157,159	145,741
<b>Equity component of convertible debentures</b>			
Balance, beginning of year		-	56,766
Conversion to common shares	17	-	(56,766)
Balance, end of year		-	-
<b>Accumulated other comprehensive income (loss)</b>			
Balance, beginning of year		(20,099)	(20,637)
Other comprehensive income		57,988	538
Balance, end of year		37,889	(20,099)
<b>Retained earnings</b>			
Balance, beginning of year		756,495	304,519
Net earnings for the year		527,729	554,336
Dividends	10	(129,677)	(102,360)
Balance, end of year		1,154,547	756,495
<b>Total equity</b>		<b>\$ 3,973,588</b>	<b>\$ 2,907,802</b>

See accompanying notes to the consolidated financial statements

PACIFIC RUBIALES ENERGY CORP.

Consolidated Statements of Cash Flows

(In thousands of U.S. Dollars)	Notes	Year ended December 31	
		2012	2011
<b>OPERATING ACTIVITIES</b>			
Net earnings for the year		\$ 527,729	\$ 554,336
Items not affecting cash:			
Depletion, depreciation and amortization		851,444	656,912
Impairment of exploration and evaluation assets	13	102,060	12,066
Accretion expense	7, 17 & 18	4,633	22,866
Unrealized gain on risk management contracts	23c & e	(40,729)	(13,445)
Share-based compensation		32,902	48,783
Gain on cash flow hedges included in operating expense	23c	(18,453)	(9,577)
Deferred income tax	8	(179,379)	(65,152)
Unrealized foreign exchange loss		2,855	51,480
Loss (gain) and impairment from equity investments	16	102,933	(6,829)
Equity tax	7	-	68,446
Incentive for early conversion and debentures	17	-	46,489
Other		1,549	2,224
Changes in non-cash working capital	24	415,191	(149,542)
<b>Net cash provided by operating activities</b>		<b>1,802,735</b>	<b>1,219,057</b>
<b>INVESTING ACTIVITIES</b>			
Additions to oil and gas properties and plant and equipment		(1,100,221)	(852,552)
Additions to exploration and evaluation assets		(411,669)	(299,988)
Investment in equity investments and other assets	16	(620,040)	(141,994)
Finance loan to OBC	16	(58,040)	(102,258)
(Increase) decrease in restricted cash		(7,497)	3,035
Acquisitions	4	(199,554)	-
<b>Net cash used in investing activities</b>		<b>(2,397,021)</b>	<b>(1,393,757)</b>
<b>FINANCING ACTIVITIES</b>			
Advances from debt		84,527	4,831
Repayment of debt		(265,438)	(98,264)
Proceeds from the exercise of warrants and options		46,678	25,214
Dividends paid	10	(129,677)	(102,360)
Drawdown of revolving credit facility	17	378,494	193,000
Issuance of senior notes	17	-	300,000
Transaction cost - note exchange and debenture early conversion	17	-	(9,777)
<b>Net cash provided by financing activities</b>		<b>114,584</b>	<b>312,644</b>
Effect of exchange rate changes on cash and cash equivalents		(6,279)	(11,049)
Change in cash and cash equivalents during the year		(485,981)	126,895
Cash and cash equivalents, beginning of the year		729,671	602,776
<b>Cash and cash equivalents, end of the year</b>		<b>\$ 243,690</b>	<b>\$ 729,671</b>
Cash and cash equivalents are comprised of:			
Cash		\$ 216,993	\$ 728,760
Short-term money market instruments		26,697	911
		<b>\$ 243,690</b>	<b>\$ 729,671</b>

See accompanying notes to the consolidated financial statements



## **Notes to the consolidated financial statements**

***(U.S. \$ thousands, except share and per share amounts or unless otherwise stated)***

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### **1. Corporate information**

Pacific Rubiales Energy Corp. (the "Company") is an oil and gas company incorporated in Canada and engaged in the exploration, development and production of crude oil and natural gas primarily in Colombia, Peru, and Guatemala. The Company's common shares are listed and publicly traded on the Toronto Stock Exchange and the Bolsa de Valores de Colombia (or the Colombian Stock Exchange). On February 2, 2012, the Brazilian Depository Receipts representing the Company's common shares ("BDRs") commenced trading on Bolsa de Valores Mercadorias e Futuros (or the Brazilian Stock Exchange). The Company's registered office is located at Suite 650 – 1188 West Georgia Street, Vancouver, British Columbia, V6E4A2, Canada and it also has corporate offices in Toronto, Canada and Bogota, Colombia.

These consolidated financial statements of the Company were authorized for issuance by the Board of Directors on March 13, 2013.

### **2. Basis of preparation and significant accounting policies**

The consolidated financial statements of the Company have been prepared in accordance with International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB). The consolidated financial statements have been prepared on a historical cost basis, except for derivative financial instruments that have been measured at fair value. The consolidated financial statements are presented in US dollars and all values are rounded to the nearest thousand, except where otherwise indicated.

#### **Basis of consolidation**

The consolidated financial statements comprise the financial statements of the Company and subsidiaries.

Subsidiaries are fully consolidated from the date of acquisition, being the date on which the Company obtains control, and continue to be consolidated until the date that such control ceases. The financial statements of the subsidiaries are prepared for the same reporting period as the parent company, using consistent accounting policies.

All intra-Company balances, income and expenses and unrealized gains and losses resulting from intra-Company transactions are eliminated in full.

#### **2.1. Significant accounting judgments, estimates and assumptions**

The preparation of consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities and contingent liabilities at the date of the consolidated financial statements and reported amounts of revenues and expenses during the reporting period. Estimates and judgments are continuously evaluated and are based on management's experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. However, actual outcomes can differ from these estimates.

#### **Critical judgments in applying accounting policies**

The following critical judgments have been made by the Company in applying accounting policies which have the most significant impact on the amounts recognized in the consolidated financial statements.

Cash generating units have been identified to be the major producing fields, the lowest level at which there are identifiable cash inflows that are largely independent of cash inflows of other groups of assets. The Company prepares and reviews separate detailed budgets and forecast calculations for each of the cash generating units. Impairment assessment is generally carried out separately for each cash generating unit based on cash flow forecasts calculated based on proven and probable reserves for each cash generating unit (value in use).

The determination of the Company's functional currency requires analyzing facts that are considered primary factors, and if the result is not conclusive, the secondary factors. The analysis requires the Company to apply significant judgment since primary and secondary factors may be mixed. In determining its functional currency the Company analyzed both the primary and secondary factors, including the currency of the Company's revenues, operating costs in the countries that it operates in, and sources of debt and equity financing.

By their nature, contingencies will only be resolved when one or more future events occur or fail to occur. The assessment of contingencies inherently involves the exercise of significant judgment and estimates of the outcome of future events.

## Notes to the consolidated financial statements

*(U.S. \$ thousands, except share and per share amounts or unless otherwise stated)*

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### Estimation uncertainty and assumptions

Oil and gas properties are depreciated using the units-of-production method over proved developed and undeveloped oil and gas reserves for facilities and wells. The calculation of the unit-of-production rate of amortization could be impacted to the extent that actual production in the future is different from current forecast production based on proved reserves. This would generally result from significant changes in any of the following:

- Changes in proved reserves.
- The effect on proved reserves of differences between actual commodity prices and commodity price assumptions.
- Unforeseen operational issues.

The recoverable amounts of cash-generating units and individual assets have been determined based on the higher of value-in-use calculations and fair values less costs to sell. These calculations require the use of estimates and assumptions. It is reasonably possible that the oil price assumption may change which may then impact the estimated life of the field and may then require a material adjustment to the carrying value of goodwill and tangible assets. The Company monitors internal and external indicators of impairment relating to its tangible and intangible assets.

Certain association contracts in Colombia provide for an adjustment to the partner's share when certain volume thresholds are reached. As a result, from time to time the Company may be required to estimate the impact of such contract adjustments.

Decommissioning costs will be incurred by the Company at the end of the operating life of certain facilities and properties. The ultimate decommissioning costs are uncertain and cost estimates can vary in response to many factors including changes to relevant legal requirements, the emergence of new restoration techniques or experience at other production sites. The expected timing and amount of expenditure can also change, for example in response to changes in reserves or changes in laws and regulations or their interpretation. As a result, there could be significant adjustments to the asset retirement obligation established which would affect future financial results.

Significant assumptions with respect to share-based payment expense include an estimate of the volatility of the Company's shares and the expected life of the options, which are subject to measurement uncertainty.

The fair values of financial instruments are estimated based on market and third party inputs. These estimates are subject to changes in the underlying commodity prices, interest rates, foreign exchange rates, and non-performance risk.

## 2.2. Summary of significant accounting policies

### Interests in joint ventures

Substantially, all of the Company's operations are conducted jointly with others. Joint control is defined as contractually agreed sharing of control over an economic activity, and exists only when the strategic financial and operating decisions relating to the activity require the unanimous consent of the parties sharing control (the venturers).

#### *Jointly controlled assets*

A jointly controlled asset (JCA) involves joint control and often joint ownership by the Company and other venturers of the assets contributed to, or acquired for the purpose of, the joint venture, without the formation of a corporation, partnership or other entity.

Where the Company's activities are conducted through JCAs, the Company recognizes its share of the jointly controlled assets and liabilities it has incurred, its share of any liabilities jointly incurred with other venturers, income from the sale or use of its share of the joint venture's output, together with its share of the expenses incurred by the joint venture, and any expenses it incurs in relation to its interest in the joint venture and a share of production. The Company combines its share of the jointly controlled assets and liabilities, income and expenses of the JCA with similar items, line by line, in its consolidated financial statements.

#### *Reimbursement of the joint venture operator's costs*

When the Company acting as an operator receives reimbursement of direct costs charged to the joint venture, such

## **Notes to the consolidated financial statements**

***(U.S. \$ thousands, except share and per share amounts or unless otherwise stated)***

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charges represent reimbursements of costs that the operator incurred as an agent for the joint venture and therefore have no effect on the consolidated statement of income.

In many cases, the Company also incurs certain general overhead expenses in carrying out activities on behalf of the joint venture. As these costs can often not be specifically identified, joint venture agreements allow the operator to recover the general overhead expenses incurred by charging an overhead fee that is based on a fixed percentage of the total costs incurred for the year. Although the purpose of this recharge is very similar to the reimbursement of direct costs, the Company is not acting as an agent in this case. Therefore, the general overhead expenses and the overhead fee are recognized in the consolidated statement of income as an expense and income, respectively.

### **Business combinations and goodwill**

On the acquisition of a subsidiary, the acquisition method of accounting is used whereby the purchase consideration transferred is allocated to the identifiable assets, liabilities and contingent liabilities (identifiable net assets) on the basis of fair value at the date of acquisition. Those petroleum reserves and resources that are able to be reliably valued are recognized in the assessment of fair values on acquisition. Other potential reserves, resources and rights, for which fair values cannot be reliably determined, are not recognized.

Goodwill is initially measured at cost being the excess of the cost of the business combination over the Company's share in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities.

If the fair value attributable to the Company's share of the identifiable net assets exceeds the fair value of the consideration, the Company reassesses whether it has correctly identified and measured the assets acquired and liabilities assumed and recognizes any additional assets or liabilities that are identified in that review. If an excess remains after reassessment, the Company recognizes the resulting gain in profit or loss on the acquisition date.

After initial recognition, goodwill is measured at cost less any accumulated impairment losses. For the purpose of impairment testing, goodwill acquired in a business combination is, from the acquisition date, allocated to each of the Company's cash generating units ("CGUs") or group of CGUs that are expected to benefit from the synergies of the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units.

### **Accounts receivable**

Trade accounts receivable are recorded based on the Company's revenue recognition policy. The allowance for doubtful accounts is management's best estimate of accounts receivable balances that may not be collectible.

### **Inventories**

Oil and gas inventory and operating supplies are valued at the lower of average cost and net realizable value. Cost is determined on a weighted average basis. Cost consists of material, labour and direct overhead. Previous impairment write-downs are reversed when there is a recovery of the previously impaired inventory. Costs of diluents are included in production and operating costs.

### **Oil and gas properties, exploration and evaluation assets, and plant and equipment**

#### *Oil and gas properties and plant and equipment*

Oil and gas properties and plant and equipment are stated at cost, less accumulated depletion and depreciation and accumulated impairment losses. The initial cost of an asset comprises its purchase price or construction cost, any cost directly attributable to bringing the asset into operation, the initial estimate of the asset retirement obligation, and for qualifying assets, borrowing costs. The purchase price or construction cost is the aggregate amount paid and the fair value of any other consideration given to acquire the asset. The capitalized value of a finance lease is also included within plant and equipment.

#### *Depletion, depreciation and amortization*

Oil and gas properties are depleted on a unit-of-production basis over the proved reserves of the field concerned, except in the case of assets whose useful life is shorter than the lifetime of the field, in which case the straight-line method is applied. Rights and concessions are depleted on the unit-of-production basis over the total proved reserves of the relevant area. The unit-of-production rate for the depletion of field development costs takes into account expenditures incurred to date, together with approved future development expenditure required to develop reserves.

## Notes to the consolidated financial statements

*(U.S. \$ thousands, except share and per share amounts or unless otherwise stated)*

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Plant and equipment are generally depreciated on a straight-line basis over their estimated useful lives, which range from one to ten years. Major inspection costs are amortized over three to five years which represents the estimated period before the next planned major inspection. Plant and equipment held under finance leases are depreciated over the shorter of lease term and estimated useful life.

### *Development costs*

Expenditure on the construction, installation or completion of infrastructure facilities such as pipelines and the drilling of development wells, including unsuccessful development or delineation wells, is capitalized in oil and gas properties.

### *Exploration and evaluation costs*

All license acquisition, exploration and appraisal costs of technical services and studies, seismic acquisition, exploratory drilling and testing are initially capitalized by well, field, unit of account or specific exploration unit as appropriate. Expenditures incurred during the various exploration and appraisal phases are carried forward, until the existence of commercial reserves and when the technical feasibility and commercial viability are demonstrable and approved by regulator. If commercial reserves have been discovered and technical feasibility and commercial viability are demonstrable, the carrying value of the exploration and evaluation assets, after any impairment loss, is reclassified as oil and gas properties. If technical feasibility and commercial viability cannot be demonstrated upon completion of the exploration phase, the carrying value of the exploration and evaluation costs incurred are expensed in the period this determination is made.

Exploration and evaluation assets are tested for impairment when indicators of impairment are present and when exploration and evaluation assets are transferred to oil and gas properties. The Company has determined the level for assessing for impairment at the cash-generating unit level.

### *Pre-license costs*

Costs incurred prior to having obtained the legal rights to explore an area are expensed to the consolidated statement of income as they are incurred.

### *Major maintenance and repairs*

Expenditures on major maintenance refits or repairs comprise the cost of replacement assets or parts of assets, inspection costs and overhaul costs. Where an asset or part of an asset that was separately depreciated and is now written off is replaced and it is probable that future economic benefits associated with the item will flow to the Company, the expenditure is capitalized. Where part of the asset was not separately considered as a component, the replacement value is used to estimate the carrying amount of the replaced assets which is immediately written off. Inspection costs associated with major maintenance programs are capitalized and amortized over the period to the next inspection. All other maintenance costs are expensed as incurred.

### *Carried interest and farm-in arrangements*

The Company recognizes its expenditures under a farm-in or carried interest arrangement in respect of its interest and that retained by the other party, as and when the costs are incurred. Such expenditures are recognized in the same way as the Company's directly incurred expenditures.

## **Intangible assets**

Intangible assets are stated at the amount initially paid, less accumulated amortization and accumulated impairment losses. Intangible assets represent rights to the available capacity of a pipeline system in Colombia. Following initial recognition, the intangible asset is amortized based on the usage of the 160 million barrel capacity over the term of the agreement. The Company does not have intangible assets with an indefinite life which would not be subject to amortization. Internally generated intangible assets are not capitalized and the expenditure is reflected in the consolidated statement of income in the year in which the expenditure is incurred.

## **Investments**

When the Company determines that it has significant influence over an investment, the investment is accounted for using the equity method. Under the equity method the investment is initially recorded at cost and the carrying value is adjusted thereafter to include the Company's pro rata share of post-acquisition earnings of the investee, computed using the consolidation method. The amount of the adjustment is included in the determination of net income and the

## Notes to the consolidated financial statements

*(U.S. \$ thousands, except share and per share amounts or unless otherwise stated)*

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investment account is also increased or decreased to reflect the Company's share of capital transactions. Profit distributions received or receivable from an investee reduce the carrying value of the investment.

The Company periodically assesses its investments to determine whether there is any indication of impairment. When there is an indication of impairment, the Company tests the carrying amount of the investment to ensure it does not exceed the higher of the present value of cash flows expected to be generated (value in use) and the amount that could be realized by selling the investment (fair value less cost to sell). When a reduction to the carrying amount of an investment is required, after applying the impairment test, an impairment loss is recognized equal to the amount of the reduction.

### Impairment of assets

The Company assesses at each reporting date whether there is an indication that an asset may be impaired. If any indication exists, or when annual impairment testing for an asset is required, the Company estimates the asset's recoverable amount. An asset's recoverable amount is the higher of an asset's or cash generating unit's fair value less costs to sell and its value-in-use. Individual assets are grouped for impairment assessment purposes at the lowest level at which there are identifiable cash inflows that are largely independent of the cash flows of other groups of assets. Where the carrying amount of an asset or cash generating unit exceeds its recoverable amount, the asset is considered impaired and is written down to its recoverable amount. In assessing value-in-use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

The Company bases its impairment calculation on detailed budgets and forecast calculations which are prepared separately for each of the Company's cash generating units to which the individual assets are allocated. These budgets and forecast calculations generally cover a period of five years. For longer periods, a long term growth rate is calculated and applied to project future cash flow after the fifth year. Impairment losses are recognized in the consolidated statement of income.

For assets excluding goodwill, an assessment is made at each reporting date as to whether there is any indication that previously recognized impairment losses may no longer exist or may have decreased. If such indication exists, the Company estimates the asset's or cash generating unit's recoverable amount. A previously recognized impairment loss is reversed only if there has been a change in the assumptions used to determine the asset's recoverable amount since the last impairment loss was recognized. The reversal is limited so that the carrying amount of the asset does not exceed its recoverable amount, nor exceed the carrying amount that would have been determined, net of depreciation, had no impairment loss been recognized for the asset in prior years. Such reversal is recognized in the consolidated statement of income.

Goodwill is tested for impairment annually (as at December 31) and when circumstances indicate that the carrying value may be impaired. Impairment is determined for goodwill by assessing the recoverable amount of each cash generating unit (or group of cash generating units) to which the goodwill relates. Where the recoverable amount of the cash generating unit is less than its carrying amount an impairment loss is recognized. Impairment losses relating to goodwill cannot be reversed in future periods.

### Financial instruments

#### *Financial assets*

Financial assets within the scope of IAS 39 *Financial Instruments: Recognition and Measurement* are classified as either financial assets at fair value through profit or loss, loans and receivables, held to maturity investments, or available for sale financial assets, as appropriate. When financial assets are recognized initially, they are measured at fair value, plus, in the case of investments not at fair value through profit or loss, transaction costs. The Company considers whether a contract contains an embedded derivative when the Company first becomes a party to the contract. Embedded derivatives are separated from the host contract which is not measured at fair value through profit or loss when the analysis shows that the economic characteristics and risks of embedded derivatives are not closely related to those of the host contract.

The Company determines the classification of its financial assets at initial recognition and, where allowed and appropriate, re-evaluates this designation at each financial period end.

## Notes to the consolidated financial statements

*(U.S. \$ thousands, except share and per share amounts or unless otherwise stated)*

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### *Financial assets at fair value through profit or loss*

Financial assets at fair value through profit or loss includes financial assets held for trading and financial assets designated upon initial recognition as at fair value through profit or loss.

Financial assets are classified as held for trading if they are acquired for the purpose of selling in the near term. Derivatives, including separated embedded derivatives are also classified as held for trading unless they are designated as effective hedging instruments or a financial guarantee contract. Gains or losses on investments held for trading are recognized in profit or loss.

### *Loans and receivables*

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market.

After initial measurement, such financial assets are subsequently measured at amortized cost using the effective interest rate method less impairment.

Amortized cost is calculated by taking into account any discount or premium on acquisition and fee or costs that are an integral part of the effective interest rate. The amortization is included in finance cost in the consolidated statement of income. The losses arising from impairment are recognized in the consolidated statement of income in finance costs.

### *Available-for-sale financial assets*

Available-for-sale financial assets are non-derivative financial assets that are designated as available-for-sale and that are not classified in any of the previous categories. Subsequent to initial recognition, they are measured at fair value and changes therein, other than impairment losses and foreign currency differences, are recognized in other comprehensive income. When an investment is derecognized, the cumulative gain or loss in other comprehensive income is transferred to net earnings.

### *Cash and cash equivalents*

Cash and short term deposits in the consolidated statement of financial position comprise cash at banks and at hand and short-term deposits with an original maturity of three months or less.

For the purpose of the consolidated statement of cash flows, cash and cash equivalents consist of cash and cash equivalents as defined above, net of outstanding bank overdrafts.

### *Financial liabilities*

Financial liabilities within the scope of IAS 39 are classified as financial liabilities at fair value through profit or loss or other liabilities, as appropriate. The Company determines the classification of its financial liabilities at initial recognition. All financial liabilities are recognized initially at fair value and in the case of loans and borrowings, net of directly attributable transaction costs.

### *Interest bearing loans and borrowings*

After initial recognition, interest bearing loans and borrowings are subsequently measured at amortized cost using the effective interest rate method. Gains and losses are recognized in the consolidated statement of income when the liabilities are derecognized as well as through the effective interest rate method amortization process. Amortized cost is calculated by taking into account any discount or premium on acquisition and fee or costs. The amortization is included in finance cost in the consolidated statement of income.

### *Convertible debentures*

The component parts of compound instruments (convertible debentures) issued by the Company are classified separately as financial liabilities and equity in accordance with the substance of the contractual arrangement. At the date of issue, the debt component is recognized at the fair value of a similar debt instrument that does not have a conversion feature. The equity component of the convertible debenture is determined by deducting the amount of the debt component from the fair value of the compound instrument as a whole. The debt component presented on the consolidated statement of financial position increases over the term of the debenture to the full face value of the outstanding debentures at maturity. The difference, representing the accretion on convertible debentures, is reflected

## Notes to the consolidated financial statements

*(U.S. \$ thousands, except share and per share amounts or unless otherwise stated)*

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as finance cost with the result that adjusted interest expense reflects the effective yield of the debt component of the convertible debentures.

The equity component of the convertible debenture is presented under equity in the consolidated statement of financial position. The equity component represents the fair value of the conversion right granted to the holder, which remains a fixed amount over the term of the related debentures. Upon conversion of the debentures into common shares by the holders, the debt and equity components are transferred to common share capital. Upon the repayment of the face value of the debt, the equity component of the convertible debentures not converted before or upon maturity is transferred to contributed surplus.

Transaction costs related to the issuance of the convertible debentures are allocated on a pro rata basis to the debt and equity components based on the fair values assigned to the components, respectively.

If the compound instrument is denominated in a currency different from the Company's functional currency, the equity component, being the conversion feature, is recognized as a derivative liability and measured at its fair value.

### *Financial liabilities at fair value through profit or loss*

Financial liabilities at fair value through profit or loss includes financial liabilities held for trading and financial liabilities designated upon initial recognition as at fair value through profit and loss.

Financial liabilities are classified as held for trading if they are acquired for the purpose of selling in the near term. Derivatives, including separated embedded derivatives are also classified as held for trading unless they are designated as effective hedging instruments. Gains or losses on liabilities held for trading are recognized in profit or loss.

### *Own use exemption*

Contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the Company's expected purchase, sale or usage requirements fall within the exemption from IAS 32 and IAS 39, which is known as the 'own use exemption'. These contracts are accounted for as executory contracts. The Company recognizes such contracts in its consolidated statement of financial position only when one of the parties meets its performance obligation.

### *Fair value hierarchy*

The Company uses a three level hierarchy to categorize the significance of the inputs used in measuring the fair value of financial instruments. The three levels of the fair value hierarchy are:

Level 1 – Unadjusted quoted prices in active markets for identical assets or liabilities. Active markets are those in which transactions occur in sufficient frequency and volume to provide pricing information on an ongoing basis. Level 1 consists of financial instruments such as quoted share prices, exchange-traded oil collars and information from forward markets such as the New York Mercantile Exchange.

Level 2 – Inputs other than quoted prices that are observable for the asset or liability either directly or indirectly. Level 2 valuations are based on inputs, including quoted forward prices for commodities, time value, volatility factors and broker quotations, which can be substantially observed or corroborated in the marketplace. Instruments in this category include non-exchange traded crude oil and foreign currency derivatives.

Level 3 – Valuations in this level are those with inputs which are less observable, unavailable or where the observable data does not support the majority of the instrument's fair value. Level 3 instruments may include items based on pricing services or broker quotes where the Company is unable to verify the observability of inputs into their prices. Level 3 instruments include longer-term transactions, transactions in less active markets or transactions at locations for which pricing information is not available. In these instances, internally developed methodologies are used to determine fair value which primarily includes extrapolation of observable future prices to similar location, similar instruments or later time periods.

If different levels of inputs are used to measure a financial instrument's fair value, the classification within the hierarchy is based on the lowest level input that is significant to the fair value measurement.

## Notes to the consolidated financial statements

*(U.S. \$ thousands, except share and per share amounts or unless otherwise stated)*

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### Leases

The determination of whether an arrangement is, or contains, a lease is based on the substance of the arrangement at inception date: whether the fulfillment of the arrangement is dependent on the use of a specific asset or assets or the arrangement conveys a right to use the asset. All take or pay contracts are reviewed for indicators of a lease on inception.

Finance leases, which transfer to the Company substantially all the risks and benefits incidental to ownership of the leased item, are capitalized at the inception of the lease at the fair value of the leased property or, if lower, at the present value of the minimum lease payments. Lease payments are apportioned between finance charges and reduction of the lease liability so as to achieve a constant rate of interest on the remaining balance of the liability. Finance charges are recognized in the consolidated statement of income.

Finance leased assets are depreciated over the useful life of the asset. However if there is no reasonable certainty that the Company will obtain ownership by the end of the lease term, the asset is depreciated over the shorter of the estimated useful life of the asset and the lease term.

Operating lease payments are recognized as an expense in the consolidated statement of income on a straight-line basis.

### Asset retirement obligation

An asset retirement obligation is recognized when the Company has a present legal or constructive obligation as a result of past events, and it is probable that an outflow of resources will be required to settle the obligation, and a reliable estimate of the amount of obligation can be made. A corresponding amount equivalent to the asset retirement obligation is also recognized as part of the cost of the related oil and gas properties or exploration and evaluation assets. The amount recognized is the estimated cost of decommissioning, discounted to its present value. Changes in the estimated timing or costs of decommissioning, or discount rate are recognized prospectively by recording an adjustment to the asset retirement obligation, and a corresponding adjustment to the properties. The unwinding of the discount on the decommissioning cost is included as a finance cost.

The Company does not recognize either the deferred tax asset regarding the temporary difference on the asset retirement obligation, or the corresponding deferred tax liability regarding the temporary difference on a decommissioning asset.

### Taxes

#### *Current income tax*

Current income tax assets and liabilities for the current and prior periods are measured at the amount expected to be recovered from or paid to the taxation authorities. The tax rates and tax laws used to compute the amount are those that are enacted or substantively enacted, at the reporting date.

Current income tax relating to items recognized directly in equity is recognized in equity and not in the consolidated statement of income. Management periodically evaluates positions taken in the tax returns with respect to situations in which applicable tax regulations are subject to interpretation and establishes provisions where appropriate.

#### *Deferred income tax*

Deferred income tax is provided using the liability method on temporary differences at the date of the consolidated statement of financial position between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes.

Deferred income tax liabilities are recognized for all taxable temporary differences, except:

- Where the deferred income tax liability arises from the initial recognition of goodwill or of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting earnings nor taxable earnings or loss; and
- In respect of taxable temporary differences associated with investments in subsidiaries, associates and interests in joint ventures, where the timing of the reversal of the temporary differences can be controlled and it is probable that the temporary differences will not reverse in the foreseeable future.



## Notes to the consolidated financial statements

*(U.S. \$ thousands, except share and per share amounts or unless otherwise stated)*

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Deferred income tax assets are recognized for all deductible temporary differences, carry forward of unused tax credits and unused tax losses, to the extent that it is probable that taxable earnings will be available against which the deductible temporary differences, and the carry forward of unused tax credits and unused tax losses can be utilized except:

- Where the deferred income tax asset relating to the deductible temporary difference arises from the initial recognition of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting earnings nor taxable earnings or loss; and
- In respect of deductible temporary differences associated with investments in subsidiaries, associates and interests in joint ventures, deferred income tax assets are recognized only to the extent that it is probable that the temporary differences will reverse in the foreseeable future and taxable earnings will be available against which the temporary differences can be utilized.

The carrying amount of deferred income tax assets is reviewed at each date of the consolidated statement of financial position and reduced to the extent that it is no longer probable that sufficient taxable earnings will be available to allow all or part of the deferred income tax asset to be utilized. Unrecognized deferred income tax assets are reassessed at each date of the consolidated statement of financial position and are recognized to the extent that it has become probable that future taxable earnings will allow the deferred tax asset to be recovered.

Deferred income tax assets and liabilities are measured at the tax rates that are expected to apply to the year when the asset is realized or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted at the end of the reporting period.

Deferred income tax relating to items recognized directly in equity is recognized in equity and not in the consolidated statement of income.

Deferred income tax assets and deferred income tax liabilities are offset, if a legally enforceable right exists to set off current tax assets against current income tax liabilities and the deferred income taxes relate to the same taxable entity and the same taxation authority.

### Revenue recognition

Revenue from sale of oil and gas is recognized when the significant risks and rewards of ownership have been transferred. This generally occurs when product is physically delivered and the title passes to the buyers and collection is reasonably assured.

Sales between the Company's subsidiaries are based on prices generally equivalent to commercially available prices.

Revenue is stated after deducting royalties, sales taxes, excise duties and similar levies.

The Company follows the entitlements method in accounting when the share of production of a joint interest partner is above or below the proportionate interest. Under the entitlements method, revenue reflects the participant's share of production regardless of which participant has actually made the sale and invoiced the production. This is achieved by adjusting cost of sales.

### Borrowing costs

Borrowing costs directly relating to the acquisition, construction or production of a qualifying capital project under construction are capitalized and added to the project cost during construction until such time the assets are substantially ready for their intended use i.e. when they are capable of commercial production. Where funds are borrowed specifically to finance a project, the amount capitalized represents the actual borrowing costs incurred.

Where surplus funds are available for a short term out of money borrowed specifically to finance a project, the income generated from such short term investments is also capitalized and reduced from the total capitalized borrowing cost. Where the funds used to finance a project form part of general borrowings, the amount capitalized is calculated using a weighted average of rates applicable to relevant general borrowings of the Company during the period. All other borrowing costs are recognized in the consolidated statement of income using the effective interest rate method.

## Notes to the consolidated financial statements

*(U.S. \$ thousands, except share and per share amounts or unless otherwise stated)*

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### Share-based compensation

The Company accounts for the granting of stock options using the fair-value method on stock options granted to directors, officers, employees and consultants. Share-based compensation is recorded in the consolidated statement of income for options granted, with a corresponding amount reflected in contributed surplus. Share-based compensation is the fair value of stock options at the time of the grant, estimated using the Black-Scholes option pricing model, and amortized over the options' vesting period. When the stock options are exercised, the associated amounts previously recorded as contributed surplus are reclassified to common share capital. The Company has not incorporated an estimated forfeiture rate for stock options that will not vest as all options granted are fully vested at the date of grant.

In addition to stock options, the Company has a deferred share unit plan under which the non-employee directors receive units in consideration for services provided to the Company. Units awarded under the deferred share unit plan vest immediately and may only be settled in cash upon retirement. On the grant date the Company recognizes a share-based compensation expense for cash-settled awards at fair value with a corresponding liability. Fair value of cash-settled awards is estimated using the Black-Scholes pricing model. The liability is revalued each reporting period and the change in fair value is recorded in share-based compensation expense.

### Foreign currency translation

During the last quarter of 2011, the Company's functional currency changed from the Canadian dollar to the U.S. dollar which is the functional currency of the Company's significant subsidiaries. The change in functional currency was primarily due to a shift in the currency of the Company's financing as a result of the early conversion of Canadian dollar denominated convertible debentures and the issuance of new U.S. dollar debts.

These consolidated financial statements are presented in U.S. dollars.

Transactions denominated in a foreign currency are initially recorded at the exchange rates at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated at the closing rates at the date of the consolidated statement of financial position. All differences are recorded in net earnings or loss. Non-monetary items are translated using the historical exchange rates as at the dates of the initial transactions.

For a foreign operation whose functional currency is not the U.S. dollar, the foreign operation's assets and liabilities are translated at the closing rate as at the date of the consolidated statement of financial position, and revenue and expenses are translated using the rate as at the time of the transaction. All exchange differences resulting from the translation are recognized in other comprehensive income.

### Earnings per share

The Company computes basic earnings per share using net earnings divided by the weighted-average number of the common shares outstanding. The Company computes diluted earnings per share using net earnings adjusted for interest expense on the convertible debentures and the impact of the potential dilution if the stock options, warrants and the convertible debt were exercised and exchanged for common shares. The Company follows the treasury stock method in the calculation of diluted earnings per share. This method assumes that any proceeds received from in-the-money options and warrants would be used to buy common shares at the average market price for the period.

### 2.3. Standards issued but not yet effective

Standards issued but not yet effective up to the date of issuance of the Company's financial statements that are likely to have an impact on the Company are listed below. This listing is of standards and interpretations issued, which the Company reasonably expects to be applicable at a future date. The Company intends to adopt those standards when they become effective.

#### IFRS 9 Financial Instruments: Classification and Measurement

In November 2009, the IASB issued IFRS 9, which covers classification and measurement as the first part of its project to replace IAS 39. In October 2010, the Board also incorporated new accounting requirements for liabilities. The standard introduces new requirements for measurement and eliminates the current classification of loans and receivables, available-for-sale and held-to-maturity, currently in IAS 39. There are new requirements for the accounting of financial liabilities as well as carryover of requirements from IAS 39. The Company does not anticipate early adoption and will adopt the standard on the effective date of January 1, 2015. The Company has not determined the impact of the new standard on the consolidated financial statements.

## **Notes to the consolidated financial statements**

***(U.S. \$ thousands, except share and per share amounts or unless otherwise stated)***

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### **IFRS 10 Consolidated Financial Statements**

IFRS 10 replaces the portion of IAS 27 *Consolidated and Separate Financial Statements* that addresses the accounting for consolidated financial statements. It also addresses the issues covered by SIC-12 *Consolidation-Special Purpose Entities*. This standard becomes effective for annual periods beginning on or after January 1, 2013. IFRS 10 establishes a single control model that applies to all entities including structured entities (previously referred to as special purpose entities). The changes introduced by IFRS 10 will require management to exercise significant judgement to determine which entities are controlled and therefore are required to be consolidated by a parent, compared with the requirements in IAS 27. Based on the preliminary analysis performed, IFRS 10 is not expected to have any impact on the investments currently held by the Company.

### **IFRS 11 Joint Arrangements**

IFRS 11 replaces IAS 31 *Interests in Joint Ventures* and SIC-13 *Jointly-controlled Entities — Non-monetary Contributions by Venturers*. This standard is effective for annual periods beginning on or after January 1, 2013.

IFRS 11 removes the option to account for certain types of jointly controlled entities (JCEs) using proportionate consolidation. Instead, JCEs that meet the definition of a joint venture must be accounted for using the equity method. Based on the preliminary analysis performed, IFRS 11 is not expected to have any impact on the investments currently held by the Company.

### **IFRS 12 Disclosure of Interests in Other Entities**

IFRS 12 includes all of the disclosures that were previously in IAS 27 related to consolidated financial statements, as well as all of the disclosures that were previously included in IAS 31 and IAS 28. These disclosures relate to an entity's interests in subsidiaries, joint arrangements, associates and structured entities. A number of new disclosures are also required but will have no impact on the Company's financial position or performance. IFRS 12 is effective for annual periods beginning on or after January 1, 2013.

### **IFRS 13 Fair Value Measurement**

IFRS 13 establishes a single source of guidance under IFRS for all fair value measurements. IFRS 13 does not change when an entity is required to use fair value, but rather provides guidance on how to measure fair value under IFRS when fair value is required or permitted. The Company is currently assessing the impact that this standard will have on the financial position and performance. Based on the preliminary analyses, no material impact is expected. This standard is effective for annual periods beginning on or after January 1, 2013.

## Notes to the consolidated financial statements

(U.S. \$ thousands, except share and per share amounts or unless otherwise stated)

### 3. Composition of the Company

The following table summarizes the Company's significant subsidiaries and equity associates, the location of their registered offices, the Company's interest, and the method of consolidation.

Company	Registered Office	Recognition Method	Percentage Interest As at December 31	
			2012	2011
Pacific Rubiales Energy Corp.	Canada	Parent holding company	Parent holding company	
<b>Subsidiaries</b>				
Pacific Stratus International Energy Ltd.	Canada	Consolidated	100%	100%
Rubiales Holding Corp.	Switzerland <sup>1</sup>	Consolidated	100%	100%
Petro Rubiales Corp.	Panama	Consolidated	100%	100%
Major International Oil S.A.	Panama	Consolidated	100%	100%
Meta Petroleum Corp.	Switzerland <sup>1</sup>	Consolidated	100%	100%
Pacific Stratus Energy Colombia Corp.	Panama	Consolidated	100%	100%
Petro Eléctrica de los Llanos S.A.	Panama	Consolidated	100%	100%
Pacific & Rubiales Energy Trading Corp.	Panama	Consolidated	100%	100%
PRE-PSIE Cooperatief U.A.	Netherlands	Consolidated	100%	100%
PetroMagdalena Energy Corp.	Canada	Consolidated	100%	-
C&C Energia Ltd.	Canada	Consolidated	100%	-
C&C Energía Llanos Ltd.	Bermuda	Consolidated	100%	-
Grupo C&C Energia Llanos Ltd.	Barbados	Consolidated	100%	-
BPZ Norte Oil S.R.L.	Peru	Consolidated	100%	-
Pacific Brasil Exploração e Produção de Óleo e Gás Ltda.	Brazil	Consolidated	100%	-
Pacific Rubiales PNG Ltd.	Papua New Guinea	Consolidated	100%	-
<b>Equity interests</b>				
ODL Finance S.A.	Panama	Equity method	35.0%	35.0%
Oleoducto Bicentenario de Colombia S.A.S.	Colombia	Equity method	33.4%	32.9%
Pacific Infrastructure Inc.	Panama	Equity method	49.4%	22.6%
Pacific Power Generation Corp.	Panama	Equity method	24.9%	20.2%
Pacific Coal S.A.	Panama	Equity method	14.35%	14.35%
CGX Energy Inc.	Canada	Equity method	35.06%	18%
<b>Joint Arrangements</b>				
Maurel and Prom Colombia B.V.	Netherlands	Proportionately consolidated	49.999%	49.999%

<sup>1</sup> During 2012 the registered offices of Rubiales Holding Corp. and Meta Petroleum Corp. were migrated to Switzerland from Panama.

### 4. Business acquisition

#### Acquisition of PetroMagdalena

On July 27, 2012 the Company completed the acquisition of PetroMagdalena Energy Corp. ("PMD"), an oil and gas exploration and production company with working interests in Colombia. Under the arrangement, the Company paid C\$1.60 for each of the 140,738,004 common shares of PMD not already owned by the Company, for cash consideration of approximately C\$225.2 million. Together with the 8,653,516 shares already owned prior to the arrangement, the Company owns 100% of the issued and outstanding PMD shares. In addition, all of the unexercised share purchase warrants were cancelled under the terms of the arrangement for C\$0.25 in cash for a total of approximately C\$4.8 million. The Company also paid approximately C\$0.1 million for all unexercised in-the-money stock options.

The transaction is being accounted for as a business combination with the Company identified as the acquirer. The purchase price allocation was finalized in December 2012 resulting in an adjustment to the preliminary purchase price allocation. The adjustments resulted in an increase in exploration and evaluation assets of \$9.9 million, oil and gas properties of \$13.9 million, and a decrease in goodwill of \$13.9 million, deferred tax liabilities of \$7.1 million and working capital of \$2.8 million.

From the date of acquisition (July 27, 2012), PMD has contributed \$19 million to Company's revenue and losses of \$16 million to Company's net earnings. If the acquisition of PMD had been completed on January 1, 2012, the consolidated statement of comprehensive income would have included revenue of \$119 million and losses of \$38 million, respectively.

## Notes to the consolidated financial statements

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### Acquisition of C&C Energia Ltd

On December 31, 2012 the Company completed the acquisition of C&C Energia Ltd ("C&C"). C&C is an oil and gas company engaged in the exploration and development of oil resources in Colombia. The key assets acquired include four development blocks in the Colombian Llanos basin which are in close proximity to the Company's existing heavy oil production and pipeline infrastructure.

The Company acquired all the issued and outstanding capital of C&C by exchanging 0.3528 common Pacific Rubiales shares (approximately 22.8 million shares) and \$0.001 cash for each common share of C&C. In addition, the shareholders of C&C received one common share of Platino Energy Corp. for each C&C share exchanged; Platino is a new oil and gas exploration company to which C&C transferred certain exploration assets prior to being acquired by the Company. The Company has retained a 5% indirect interest in Platino after the acquisition of C&C.

The transaction is accounted for as a business combination with the Company identified as the acquirer. The acquisition has been accounted for on a preliminary basis taking into account the information available at the time these consolidated financial statements were prepared.

If the acquisition of C&C had been completed on January 1, 2012, the consolidated statement of comprehensive income would have included revenue and profit of \$448 million and \$87 million, respectively.

The following table summarizes the consideration paid and the fair values of the assets acquired and liabilities assumed recognized at the acquisition date.

	PMD	C&C	Total
Purchase price			
Cash consideration paid	\$ 226,598	\$ 65	\$ 226,663
Equity instruments (22.8 million of common shares of the Company) (Note 21)	-	533,582	533,582
Fair value of interest held before acquisition (Note 16)	13,639	-	13,639
Total purchase price	\$ 240,237	\$ 533,647	\$ 773,884
Fair value of assets acquired and liabilities assumed			
Cash and cash equivalents	\$ 6,313	\$ 20,796	\$ 27,109
Net non-cash working capital	(79,025)	(17,917)	(96,942)
Oil and gas properties (Note 12)	286,186	456,651	742,837
Exploration and evaluation assets (Note 13)	100,003	62,754	162,757
Plant and equipment (Note 14)	3,050	1,017	4,067
Goodwill (Note 15)	72,573	67,336	139,909
Equity and other investments (Note 16)	-	8,018	8,018
Long-term debt	(49,360)	-	(49,360)
Asset retirement obligation (Note 18)	(5,443)	(18,445)	(23,888)
Deferred tax liabilities	(94,060)	(46,563)	(140,623)
Net assets acquired	\$ 240,237	\$ 533,647	\$ 773,884
Cash paid	226,598	65	226,663
Net cash acquired	(6,313)	(20,796)	(27,109)
Net consolidation cash outflow (inflow)	\$ 220,285	\$ (20,731)	\$ 199,554

The fair values related to the C&C acquisition disclosed above are preliminary as at December 31, 2012 due to the complexity of the acquisition and the inherently uncertain nature of valuing exploration assets and oil and gas properties. The fair values of the identifiable assets and liabilities acquired will be completed within 12 months of the acquisition at the latest.

Goodwill arised for both acquisitions principally because of the synergies that the Company can realize from managing a portfolio of both acquired and existing fields in Colombia, and the requirement to recognize deferred income tax liabilities for the difference between the assigned fair values and the tax bases of net assets acquired in a business combination. None of the goodwill recognized is expected to be deductible for income tax purposes.

### 5. Segmented information

The Company is organized into business units based on the main types of activities and has one reportable segment as at December 31, 2012, being the exploration, development, and production of heavy crude oil and gas in Colombia. The Company's assets in Peru were still in the early stage of development therefore Peru was not

## Notes to the consolidated financial statements

(U.S. \$ thousands, except share and per share amounts or unless otherwise stated)

considered a reportable segment as of December 31, 2012. The Company's operation in Guatemala was not significant, and the farm-in interests in Brazil and Papua New Guinea are subject to regulatory approval as of December 31, 2012. The Company manages its operations to reflect differences in the regulatory environments and risk factors for each country.

As at December 31, 2012, all of the Company's assets are located in Colombia except for \$18 million (December 31, 2011: \$297 million) in cash and cash equivalents held in Canada and the United States; \$328 million (December 31, 2011: \$15 million) of non-current assets in Peru; \$62 million (December 31, 2011: nil) of non-current assets in Papua New Guinea; \$19 million (December 31, 2011: \$2 million) of non-current assets in Guatemala and \$85 million (December 31, 2011: Nil) of non-current assets in Brazil.

The Company's revenue based on the geographic location of customers is as follows:

	Year ended December 31	
	2012	2011
North and Central America	\$ 1,696,214	\$ 2,155,674
Europe	916,588	466,588
Asia	1,041,233	423,189
Colombia	229,776	218,927
Others	951	116,441
	\$ 3,884,762	\$ 3,380,819

### 6. Production and operating costs

	Year ended December 31	
	2012	2011
Oil and gas operating costs	\$ 1,521,400	\$ 1,239,104
Overlift	65,020	6,405
Total	\$ 1,586,420	\$ 1,245,509

Included in overlift is \$92 million representing 1.4 million barrels of future crude production owing to Ecopetrol as at December 31, 2012 arising from the conclusion of the arbitration between the Company and Ecopetrol on the high-prices clause ("PAP") in the Quifa Association Contract.

The Company's share of production before royalties under certain association contracts with Ecopetrol is subject to adjustment from time to time when the PAP is triggered. The PAP for the Quifa SW field was triggered in April 2011, resulting in additional production assigned to Ecopetrol. On April 12, 2012, the Company and Ecopetrol entered into an arbitration in Colombia to settle differences in the interpretation of the PAP clause; both parties agreed to apply a certain formula to assign the additional share of production to Ecopetrol until the arbitration was concluded. On March 13, 2013, the arbitration panel delivered its ruling in favour of Ecopetrol. As a result of the ruling the Company is required to deliver an additional 1.4 million barrels to Ecopetrol, representing Ecopetrol's additional share in Quifa SW production from April 1, 2011. The additional volumes will be delivered from future production. A provision of \$92 million for the additional volume has been recorded as an increase to overlift on the consolidated financial statements as at December 31, 2012.

### 7. Equity tax

On December 29, 2010, the Colombian Congress passed a law which imposes a 6% tax on the equity of the Colombian operations as at January 1, 2011 payable in eight equal instalments.

The equity tax is payable even in the event that the Company ceases to have taxable equity in subsequent years. As such, the Company recognized on January 1, 2011 the entire amount of the equity tax payable on the consolidated statement of financial position and a corresponding expense in the consolidated statement of income. The amount recognized is calculated by discounting the eight future equity tax payments using a rate of 10.8%.

## Notes to the consolidated financial statements

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As at December 31, 2010	\$	-
Amount expensed during the year		68,446
Unwinding of discount		6,914
Foreign exchange		(708)
Payment		(21,510)
As at December 31, 2011		53,142
Payment		(22,559)
Unwinding of discount		3,036
Foreign exchange		6,456
Acquisitions		8,772
As at December 31, 2012	\$	48,847
Current	\$	25,558
Non-current		23,289
	\$	48,847

The current portion of the equity tax payable is included in accounts payable and accrued liabilities on the consolidated statement of financial position.

### 8. Income tax

A reconciliation between income tax expense and the product of accounting profit multiplied by the Company's domestic tax rate is provided below:

	Year ended December 31	
	2012	2011
Net earnings before income taxes	\$ 817,567	\$ 1,002,486
Canadian statutory income tax rate	26.50%	28.25%
Income tax expense at statutory rate	216,655	283,202
Increase (decrease) in income tax provision resulting from:		
Other non-deductible (non-taxable) expenses	(33,347)	31,347
Special tax benefit	(7,477)	-
Share-based compensation	8,719	13,781
Risk management gain	(938)	(1,247)
Differences in tax rates in foreign jurisdictions	68,067	57,782
Losses for which no tax benefit is recorded	31,937	30,730
Non-deductible equity tax	-	19,336
Change in tax rates	6,222	-
Incentive for early conversion of debentures	-	13,219
Income tax expense	\$ 289,838	\$ 448,150
Current income tax expense	469,217	513,302
Deferred income tax recovery:		
Relating to origination and reversal of temporary differences	(179,379)	(65,152)
Income tax expense	\$ 289,838	\$ 448,150

## Notes to the consolidated financial statements

(U.S. \$ thousands, except share and per share amounts or unless otherwise stated)

The Company's deferred tax relates to the following:

	Year ended December 31	
	2012	2011
Tax loss carry forwards	\$ 3,287	\$ -
Oil and gas properties and equipment	(298,226)	(301,495)
Others	49,434	17,033
Deferred tax liability	\$ (245,505)	\$ (284,462)

	Year ended December 31	
	2012	2011
Beginning of year	\$ (284,462)	\$ (349,614)
Recognized in deferred income tax recovery		
Tax loss carry forwards	3,287	(9,155)
Oil and gas properties and equipment	143,691	44,903
Convertible debentures	-	6,486
Others	32,401	22,918
Acquisitions and others	(140,422)	-
End of year	\$ (245,505)	\$ (284,462)

The Canadian statutory income tax rate changed from 28.25% for the year ended December 31, 2011 to 26.50% for the year ended December 31, 2012 as a result of the enacted reduction of Canadian corporate tax rates. The Colombian income tax rate was 33% for the years ended December 31, 2011 and 2012. On December 26, 2012 the Colombian Congress passed the tax reform which increased the income tax rate to 34% from 33%, effective January 1, 2013 until December 31, 2016.

Deferred tax assets are recognized for the carry-forward of unused tax losses and unused tax credits to the extent that it is probable that taxable profits will be available against which the unused tax losses/credits can be utilized.

As at December 31, 2012, non-capital losses totalled \$461 million (December 31, 2011 - \$285.3 million) in Canada and expire between 2013 and 2032. No deferred tax assets have been recognized in respect of the non-capital losses as at December 31, 2012 (2011 - Nil). In Colombia, non-capital losses totalled \$83 million (December 31, 2011 - \$5.7 million) and deferred tax assets have been recognized on \$13.1 million of those losses.

The temporary differences associated with investments in subsidiaries and joint ventures, for which a deferred tax liability has not been recognized, amounted to \$1,257 million as at December 31, 2012 (2011 - \$1,786 million). The Company has other deductible temporary differences such as share issue costs, net foreign exchange and risk management contract losses totalling \$14.6 million (December 31, 2011 - \$18.2 million) for which deferred tax assets have not been recognized.

### 9. Earnings per share

Earnings per share amounts are calculated by dividing the net earnings for the period attributable to shareholders of the Company by the weighted average number of shares outstanding during the period.

	Year ended December 31	
	2012	2011
Net earnings	\$ 527,729	\$ 554,336
Adjust for interest expense on dilutive convertible debentures	-	32,499
Adjusted net earnings	\$ 527,729	\$ 586,835
Basic weighted average number of shares	294,576,424	271,985,534
Effects of dilution	8,246,805	26,285,663
Diluted weighted average number of shares	302,823,229	298,271,197
Basic earnings per share	\$ 1.79	\$ 2.04
Diluted earnings per share	\$ 1.74	\$ 1.97



## Notes to the consolidated financial statements

(U.S. \$ thousands, except share and per share amounts or unless otherwise stated)

All options, warrants and convertible debentures that are anti-dilutive have been excluded from the diluted weighted average number of common shares.

### 10. Dividends paid

	Year ended December 31	
	2012	2011
Declared and paid	\$ 129,677	\$ 102,360
Dividend per common share	\$ 0.44	\$ 0.37

### 11. Inventories

	As at December 31	
	2012	2011
Crude oil and gas	\$ 114,198	\$ 174,959
Materials and supplies	10,845	6,313
	\$ 125,043	\$ 181,272

### 12. Oil and gas properties

#### Cost

Cost as at December 31, 2010	\$	2,664,984
Additions		791,744
Change in asset retirement obligation (Note 18)		24,516
Cost as at December 31, 2011		3,481,244
Additions		1,076,623
Transfer from exploration and evaluation assets (Note 13)		95,849
Acquisitions (Note 4)		742,837
BPZ farm in		215,320
Change in asset retirement obligation (Note 18)		12,525
Cost as at December 31, 2012	\$	5,624,398

#### Accumulated depletion

Accumulated depletion as at December 31, 2010	\$	370,510
Charge for the year		627,581
Accumulated depletion as at December 31, 2011		998,091
Charge for the year		793,527
Accumulated depletion as at December 31, 2012	\$	1,791,618

#### Net book value

December 31, 2011	\$	2,483,153
December 31, 2012		3,832,780

Included in the amount subject to depletion is \$936 million (December 31, 2011 - \$800 million) of estimated future development costs that are required to bring proved undeveloped reserves to production.

During December 2012 the Company completed the acquisition of a 49% undivided participating interest in the Z-1 exploration and development block ("Block Z-1") offshore in Peru from BPZ Resources, Inc. ("BPZ"), pursuant to an agreement signed in April 2012. Under the terms of the agreement, the Company has paid \$150 million in cash and is entitled to its share of the operations of Block Z-1 effective January 1, 2012. In addition the Company has a commitment of \$118 million for BPZ's share of capital and exploratory expenditures in Block Z-1. Once the Company

## Notes to the consolidated financial statements

(U.S. \$ thousands, except share and per share amounts or unless otherwise stated)

has satisfied its commitment to BPZ in connection with the capital and exploratory expenditures, the partners will share costs at their respective ownership interest bases. The transaction was completed upon the approval of the applicable Peruvian authorities. Prior to obtaining the necessary regulatory approvals, the amounts paid by the Company to BPZ were recorded in other assets.

### 13. Exploration and evaluation assets

As at December 31, 2010	\$	150,896
Additions		299,071
Impairment		(12,066)
As at December 31, 2011		437,901
Additions		411,669
Transfer to oil and gas properties (Note 12)		(95,849)
Acquisitions (Note 4)		162,757
BPZ farm in (Note 12)		63,019
Impairment		(102,060)
As at December 31, 2012	\$	877,437

In 2012, the impairment loss of \$102 million (December 31, 2011 - \$12 million) represented the write-down of certain exploration and evaluation assets that have been or were in the process of being returned to the government or abandoned.

### 14. Plant and equipment

Cost	Land & buildings	Other plant & equipment	Total
Cost as at December 31, 2010	\$ 7,653	\$ 20,509	\$ 28,162
Additions	18,782	60,325	79,107
Disposal	-	(3,752)	(3,752)
Cost as at December 31, 2011	26,435	77,082	103,517
Additions	16,615	6,983	23,598
Acquisitions (Note 4)	1,414	2,653	4,067
Cost as at December 31, 2012	\$ 44,464	86,718	\$ 131,182
<b>Accumulated depreciation</b>			
Accumulated depreciation as at December 31, 2010	\$ 3,294	\$ 5,692	\$ 8,986
Charge for the year	8,016	7,559	15,575
Disposal	-	(1,045)	(1,045)
Accumulated depreciation as at December 31, 2011	11,310	12,206	23,516
Charge for the year	5,056	18,989	24,045
Accumulated depreciation as at December 31, 2012	\$ 16,366	\$ 31,195	\$ 47,561
<b>Net book value</b>			
December 31, 2011	\$ 15,125	\$ 64,876	\$ 80,001
December 31, 2012	28,098	55,523	83,621

## Notes to the consolidated financial statements

(U.S. \$ thousands, except share and per share amounts or unless otherwise stated)

### 15. Intangible assets and goodwill

Cost	Goodwill	Intangible assets	Total
Cost as at December 31, 2010 and 2011	\$ 100,636	\$ 190,000	\$ 290,636
Acquisitions (Note 4)	139,909	-	139,909
Cost as at December 31, 2012	\$ 240,545	\$ 190,000	\$ 430,545
Accumulated amortization			
Accumulated depreciation as at December 31, 2010	\$ -	\$ 19,033	\$ 19,033
Charge for the year	-	26,006	26,006
Accumulated amortization as at December 31, 2011	-	45,039	45,039
Charge for the year	-	26,077	26,077
Accumulated amortization as at December 31, 2012	\$ -	\$ 71,116	\$ 71,116
Net book value			
December 31, 2011	\$ 100,636	\$ 144,961	\$ 245,597
December 31, 2012	240,545	118,884	359,429

Intangible assets comprise the rights to the available capacity of the OCENSA pipeline system in Colombia. The OCENSA right is amortized based on the usage of the 160 million barrel capacity over the term of the agreement.

#### Impairment test for goodwill

The Company assessed the goodwill for impairment as at December 31, 2012 and 2011. The Company's goodwill is tested for impairment at the group of cash-generating units level, being the operating segment of the Company. The recoverable amount for the operating segment is the sum of the value-in-use for each cash-generating unit, which is calculated based on the future cash flows of the proven and probable reserves over reserve life, discounted by the Company's weighted cost of capital of 11.5%. As at December 31, 2012 and 2011, the recoverable amount for the operating segment exceeded the carrying amount including goodwill and as such no impairment was recognized. No reasonably possible change in assumptions would cause goodwill to be impaired.

### 16. Investments in associates and other assets

The Company's investments in associates and other assets are as follows:

	Investment in associates						Other assets		Total
	ODL	OBC	PII	Pacific Power	Pacific Coal	CGX	BPZ Advance	Other Assets	
As at December 31, 2010	\$ 106,074	\$ 95,784	\$ 18,109	\$ 5,735	\$ 24,119	\$ -	\$ -	\$ 435	\$ 250,256
Investment	29,750	32,290	7,286	800	30,140	39,477	-	2,291	142,034
OBC loan	-	-	-	-	-	-	-	81,806	81,806
Fair value adjustment	-	-	-	-	-	21,147	-	(745)	20,402
Income from equity investments	16,059	(2,538)	(1,846)	2,372	(7,218)	-	-	-	6,829
Foreign currency translation	(4,879)	(4,224)	(3)	-	-	-	-	-	(9,106)
As at December 31, 2011	147,004	121,312	23,546	8,907	47,041	60,624	-	83,787	492,221
Investment	34,954	-	100,000	5,040	-	29,339	278,339	184,360	632,032
OBC loan	-	-	-	-	-	-	-	58,040	58,040
OBC loan reclassified to receivables	-	-	-	-	-	-	-	(107,786)	(107,786)
Fair value adjustment	-	-	-	-	-	(21,147)	-	2,682	(18,465)
Loss (income) from equity investments	(7,427)	(5,852)	(2,712)	1,876	(9,323)	(34,230)	-	-	(57,668)
Impairment of equity investments	-	-	-	-	(29,398)	(15,867)	-	-	(45,265)
Foreign currency translation	12,846	12,231	1,749	-	-	-	-	-	26,826
PMD Acquisition (Note 4)	-	-	-	-	-	-	-	(13,639)	(13,639)
C&C Acquisition (Note 4)	-	2,299	-	-	-	-	-	5,719	8,018
Reclassified to properties (Note 12 & 13)	-	-	-	-	-	-	(278,339)	-	(278,339)
As at December 31, 2012	\$ 187,377	\$ 129,990	\$ 122,583	\$ 15,823	\$ 8,320	\$ 18,719	\$ -	\$ 213,163	\$ 695,975

#### Investments in associates

Set out below are the investments made by the Company in associates during the year ended and as at December 31, 2012. Investments in associates are accounted for using the equity method, with the Company's proportionate share of the associates' net income or loss recognized in the consolidated statement of income.

## Notes to the consolidated financial statements

*(U.S. \$ thousands, except share and per share amounts or unless otherwise stated)*

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### *ODL Finance S.A. ("ODL")*

The investment represents a 35% interest in ODL, a Panamanian company with a Colombian branch that has constructed an oil pipeline for the transportation of heavy crude oil produced from the Rubiales field. The remaining 65% interest is owned by Ecopetrol, S.A. ("Ecopetrol"), the national oil company of Colombia. In 2011, additional capital was contributed by the partners to ODL, of which the Company's share was \$29.8 million. In 2012, additional capital was contributed by the partners to ODL, of which the Company's share was \$35 million. The capital contribution did not change the company's equity interest percentage. ODL's functional currency is the Colombian peso and the currency translation adjustment upon conversion to U.S. dollars is recorded in other comprehensive income.

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 \$251 million from 2013 to 2017.

### *Pacific Power Generation Corp ("Pacific Power", previously Ronter)*

The investment in Pacific Power represents a 24.9% (2011: 20.2%) 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. In July 2011 the Company acquired an additional 2.5% equity interest in Pacific Power from an unrelated party for cash consideration of \$0.8 million. In December 2012 the Company acquired an additional 4.4 million newly issued common shares of Pacific Power for \$1.15 per share for \$5 million in aggregate.

### *Pacific Infrastructure Inc. ("PII")*

PII is a Panamanian company established for the purpose of developing an export terminal, an industrial park, and a free trade zone in Cartagena. The Company had a 22.6% interest in PII as at December 31, 2011. In March 2012, the Company acquired an additional 20 million newly issued common shares of PII for \$1.00 per share for \$20 million in aggregate. During third quarter of 2012 the Company acquired an additional 70 million newly issued common shares of PII for \$1.00 per share for \$70 million in aggregate. In November 2012, the Company acquired an additional 10 million newly issued common shares of PII for \$1.00 per share for \$10 million. The Company may subscribe for a further 40 million newly issued common shares at \$1.00 per share over the next 3 months, in tranches of at least \$20 million. The Company is able to hold a seat on PII's board of directors for as long as the Company holds 10% of the issued and outstanding common shares of PII.

As at December 31, 2012, the Company's interest in PII is 49.38% and the remaining is held by Blue Pacific Assets Corp. ("Blue Pacific"), see note 22.a), and Orinoquia Holdings Corp., companies that two directors of the Company control or provide advice to.

### *Pacific Coal Resources Ltd. ("Pacific Coal")*

Pacific Coal is engaged in the acquisition and development of coal mining assets and related businesses in Colombia. The functional currency of Pacific Coal is the Canadian dollar and currency translation adjustment is recorded in the statement of other comprehensive income. In February 2011, the Company invested an additional \$30.1 million in Pacific Coal as part of a private placement offering. On March 17, 2011, the common shares and warrants of Pacific Coal began trading on the TSX Venture Exchange. As at December 31, 2012, the Company's interest in Pacific Coal was 14.4%. The Company assessed the investment in Pacific Coal for impairment as of December 31, 2012 against its fair value estimated using the last traded share price, and as a result recorded an impairment of \$29.3 million. As at December 31, 2012 the carrying amount of the investment in Pacific Coal was \$8.3 million which was also its estimated fair value.

### *Oleoducto Bicentenario de Colombia ("OBC")*

OBC is a corporation established and owned by a consortium of oil producers operating in Colombia, led by Ecopetrol with the Company owning 33.4% (2011: 32.9%). In December, 2011, additional capital was contributed by the partners to OBC, of which the Company's share was \$32.3 million. The capital contribution did not change the Company's equity interest percentage. In December 2012, upon completion of the acquisition of C&C, the Company acquired another 0.5% interest in OBC that was previously owned by C&C. OBC will build and operate a private-use oil pipeline in Colombia between Casanare and Coveñas. The investment in OBC is accounted for using the equity method. OBC's functional currency is the Colombian peso and the currency translation adjustment upon conversion to U.S. dollars has been recorded in other comprehensive income. The shareholders of OBC are obliged to execute a

## Notes to the consolidated financial statements

(U.S. \$ thousands, except share and per share amounts or unless otherwise stated)

transport agreement before the completion of the first phase of the project for the transport of crude at a set rate per barrel.

CGX Energy Inc. ("CGX")

On June 30, 2012 the Company acquired 85,714,285 units under a private placement agreement with CGX for C\$30 million. Each unit consists of one newly issued common share in CGX and one-half common share purchase warrant, exercisable at C\$0.60 per common share for a period of 18 months. Combined with the 18% interest that the Company already held prior to the private placement, the Company's interest in CGX increased to 36% (41% on a fully diluted basis). Under the terms of the private placement, the Company obtained two seats on CGX's board of directors.

The Company has determined that it had significant influence in CGX effective upon signing the private placement. The investment in CGX, which was previously classified as an available-for-sale financial asset, was reclassified to investment in associates. The amount previously recognized as fair value adjustment in the statement of other comprehensive income was reclassified to the cost of investment. The Company began applying the equity method in accounting for the profit or loss of CGX when it became an associate. During the year ended December 31, 2012, the Company recorded a loss of \$34.2 million against the CGX investment, representing the Company's share of CGX's net loss for the year. The Company assessed the investment in CGX for impairment as of December 31, 2012 against its fair value estimated using the last traded share price, and as a result recorded an impairment of \$15.9 million against the carrying amount. As at December 31, 2012 the carrying amount of the investment in CGX was \$18.7 million which was also its estimated fair value.

The Company has determined that it holds significant influence but not control over Pacific Power, PII, ODL, OBC CGX and Pacific Coal as a result of the Company's equity interests and a number of common directors. As such the investments in Pacific Power, PII, ODL, OBC, CGX and Pacific Coal are accounted for using the equity method.

The Company did not receive any cash dividends from its equity-accounted investments during 2012 (2011: Nil).

### Summarized financial information

The table below summarizes the financial information for the Company's significant equity investments (figures represent 100% of the underlying entities' interest):

	ODL	OBC	PII
<b>As at and for the year ended December 31, 2012</b>			
Current assets	\$ 169,632	\$ 56,325	\$ 69,192
Non-current assets	1,152,467	1,245,115	72,129
Total assets	1,322,099	1,301,440	141,321
Current liabilities	142,605	118,784	9,057
Non-current liabilities	641,125	794,306	994
Total liabilities	783,730	913,090	10,051
Equity	538,369	388,350	131,270
Total liabilities and equity	1,322,099	1,301,440	141,321
Revenue	250,916	106	-
Expenses	272,166	18,376	9,505
Net losses	\$ (21,250)	\$ (18,270)	\$ (9,505)

## Notes to the consolidated financial statements

(U.S. \$ thousands, except share and per share amounts or unless otherwise stated)

	ODL	OBC	PII
<b>As at and for the year ended December 31, 2011</b>			
Current assets	\$ 200,268	\$ 193,799	\$ 9,762
Non-current assets	1,051,902	575,932	25,289
<b>Total assets</b>	<b>1,252,170</b>	<b>769,731</b>	<b>35,051</b>
Current liabilities	88,499	399,935	2,880
Non-current liabilities	741,019	-	-
<b>Total liabilities</b>	<b>829,518</b>	<b>399,935</b>	<b>2,880</b>
Equity	422,652	369,796	32,171
<b>Total liabilities and equity</b>	<b>1,252,170</b>	<b>769,731</b>	<b>35,051</b>
Revenue	297,735	170	-
Expenses	251,851	7,892	12,867
<b>Net earnings (loss)</b>	<b>\$ 45,884</b>	<b>\$ (7,722)</b>	<b>\$ (12,867)</b>

### Other assets

#### *OBC loan*

Included in other assets is a loan to OBC, classified as loans and receivables. During 2011 the Company, along with the other shareholders of OBC, entered into certain subordinated loan agreements with OBC. Pursuant to the agreement the Company will make subordinated loans to OBC for up to \$237.3 million, \$140 million of which have been made as of December 31, 2012. The principal of the subordinated loan will be repaid in 10 equal semi-annual installments starting in 2025, after OBC has repaid its bank loans in full. The loans carry an annual interest rate of 7.32% with semi-annual interest payments. As at December 31, 2012 the balance of loans outstanding to the Company under the agreement is \$32 million (December 31, 2011: \$102.3 million). Interest income of \$5.8 million was recognized and \$5.7 million was paid on the loan during 2012 (December 31, 2011: \$0.3 and Nil).

#### *Advances for farm-in interests*

Also included in other assets is \$170 million representing advances made for farm-in interest in exploration assets in Brazil, Colombia, and Papua New Guinea that were subject to regulatory approval as at December 31, 2012 (December 31, 2011: Nil).

## Notes to the consolidated financial statements

(U.S. \$ thousands, except share and per share amounts or unless otherwise stated)

### 17. Interest-bearing loans and borrowings

	Maturity	Currency	Interest Rate	As at December 31	
				2012	2011
Senior notes - 2011	2021	USD	7.25%	\$ 646,964	\$ 620,836
Senior notes - 2009	2016	USD	8.75%	89,818	110,865
Revolving credit facility - US Dollar	2015	USD	LIBOR + 3%	353,599	-
Revolving credit facility - COP	2015	COP	DTF + 2.5%	24,895	-
Revolving credit facility - US Dollar	2013	USD	LIBOR + 2.5%	-	190,717
Bank loans <sup>(1)</sup>	2024	COP	DTF + 4.2%	52,437	-
Bank loans	2016	COP	DTF + 2.65%	22,909	-
Promissory note	2015	COP	7.96%	1,334	-
Promissory note	2012	COP	6.03%	-	4,726
				\$ 1,191,956	\$ 927,144
Current portion				\$ 7,395	\$ 4,726
Non-current portion				1,184,561	922,418
				1,191,956	927,144
Convertible debenture				2,450	2,234
				\$ 1,194,406	\$ 929,378

(1) Represents bank loans received for the construction of power transmission lines to supply additional electricity to two fields in Colombia. The loan amount is for up to \$112 million with interest rate of 4.2% plus DTF (90-day benchmark rate in Colombia)

#### 2009 Senior Notes

The 2009 Senior Notes, with maturity dates of November 10, 2014 (33.3%), November 10, 2015 (33.3%), and November 10, 2016 (33.4%), are direct, unsecured subordinated obligations with interest payable in arrears at a rate of 8.75%, on May 10 and November 10 of each year. 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.

The 2009 Senior Notes are on the Official List of the Luxembourg Stock Exchange and trade on the Euro MTF. Under the terms of the notes, the Company is required to maintain (1) an interest coverage ratio of greater than 2.5; and (2) a debt to EBITDA ratio of less than 3.5. The covenants do not apply during any period of time when the notes have an investment grade rating from at least two rating agencies. The Company was compliant with the covenants during the year.

The 2009 Senior Notes are carried at amortized cost using the effective interest rate method with note discount and transaction costs netted against the principal. The principal amount outstanding on the 2009 Senior Notes as at December 31, 2012 was \$91.5 million (December 31, 2011: \$114 million). For the year ended December 31, 2012, \$8.5 million (2011: \$41.6 million) in interest expense related to the 2009 Senior Notes has been recorded in the consolidated statements of income.

#### 2011 Senior Notes

The 2011 Senior Notes, due December 12, 2021, are direct, unsecured, subordinated obligations with interest payable in arrears at a rate of 7.25% on each June 12 and December 12 of each year.

The 2011 Senior Notes are on the Official List of the Luxembourg Stock Exchange and trade on the Euro MTF. Under the terms of the notes, the Company is required to maintain (1) an interest coverage ratio of greater than 2.5; and (2) a debt to EBITDA ratio of less than 3.5. The covenants do not apply during any period of time when the notes have an investment grade rating from at least two rating agencies. The Company was compliant with the covenants during the year.

The 2011 Senior Notes are carried at amortized cost using the effective interest rate method with note discount and transaction costs netted against the principal. The principal amount outstanding on the 2011 Senior Notes as at December 31, 2012 was \$712 million (2011 – 686.9 Million). For the year ended December 31, 2012, \$24.5 million

## Notes to the consolidated financial statements

*(U.S. \$ thousands, except share and per share amounts or unless otherwise stated)*

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(2011: nil) in interest expense related to the 2011 Senior Notes has been recorded in the consolidated statements of income.

### *Revolving credit facility*

During 2012 the Company closed a \$400 million revolving credit facility (the "US Dollar Facility") and a Colombian peso equivalent of \$300 million revolving credit facility (the "Peso Facility"). The US Dollar Facility carries an interest rate of LIBOR plus 2.75% and matures on September 21, 2015, with any unused facility subject to a commitment fee of 0.95%. As of December 31, 2012 the Company draw down \$353.6 million on the US Dollar Facility. The balance of \$193 million on the previous revolving credit facility due April 26, 2013 was repaid using proceeds from the US Dollar Facility, and that revolving credit facility was terminated.

The Peso Facility has an interest rate based on the DTF and matures on September 21, 2015, as well as a commitment fee of 0.40% on any unused facility. As of December 31, 2012, the Company has drawn \$24.9 million from the Peso Facility.

Both the US Dollar Facility and the Peso Facility are subject to covenants that require the Company to maintain (1) a debt to EBITDA ratio of less than 3.5; and (2) interest coverage ratio of greater than 2.5. The Company was compliant with the covenants during the year.

### *Convertible debentures*

The Company has outstanding convertible unsecured subordinated debentures due August 29, 2013 (the "Debentures"). As at December 31, 2012 the Company had outstanding Debentures of C\$2.7 million in face amount (December 31, 2011: C\$2.7 million). The debentures are carried at amortized cost using the effective interest rate method. The outstanding Debentures are convertible into common shares of the Company at the rate of C\$12.83 (2011 – C\$12.83) per share, being equivalent to 77.9423 (2011 – 77.9423) common shares per C\$1,000 face amount of Debentures, subject to adjustments pursuant to the indenture. The Debentures bear interest at 8% annually and are payable semi-annually in arrears on September 30 and December 31.

On October 25, 2011 the Company provided notice to all holders of the Company's outstanding convertible unsecured subordinated debentures due August 29, 2013 (the "Debentures") of an incentive to convert the Debentures at the current conversion rate of 77.9423 plus an additional 8.6310 common shares per C\$1,000 face amount of Debentures (together, the "Incentive Conversion Rate") during a temporary period between November 9, 2011 and November 29, 2011 (the "Early Conversion Period"). The additional 8.6310 common shares was calculated by dividing the daily volume weighted average trading price of the common shares traded on the TSX during the period October 27, 2011 up to and including November 4, 2011 by C\$200 for each C\$1,000 face amount of the Debentures.

During the Early Conversion Period, C\$236.2 million, or 98.9% of the Debentures were converted, representing an issuance of 20,450,600 common shares of the Company, of which 2,040,352 represents the incentive common shares. Debenture holders who did not convert during the Early Conversion Period were not entitled to the benefit of the Incentive Conversion Rate and to receive the additional common shares.

Included on the consolidated statement of income for the year ended December 31, 2011 was a \$46.5 million expense representing the fair value of the incentive provided for the Debentures that were converted under the early conversion program.

The conversion feature of the Debentures is recognized as a derivative liability and revalued to its fair value with the change in fair value recorded in the consolidated statements of income.



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As at December 31, 2010	\$	186,416
Accretion expense		14,870
Foreign currency translation		(6,058)
Conversion to common shares		(192,994)
As at December 31, 2011		2,234
Accretion expense		182
Foreign currency translation		37
Conversion to common shares		(3)
As at December 31, 2012	\$	2,450

### 18. Asset retirement obligation

The Company makes full provision for the future cost of decommissioning oil production facilities on a discounted basis on the installation of those facilities.

As at December 31, 2010	\$	20,609
Arising during the year		24,516
Accretion expense		1,082
Derecognition		(807)
As at December 31, 2011		45,400
Arising during the year		12,525
Acquisitions (Note 4)		23,888
Accretion expense		1,415
As at December 31, 2012	\$	83,228

The asset retirement obligation represents the present value of decommissioning costs relating to oil and gas properties, which are expected to be incurred up to \$93 million (December 31, 2011 - \$60.2 million). The future decommissioning costs are discounted using the risk free rate between of 2.50% and 2.92% (December 31, 2011 – 3.6%) to arrive at the present value. Assumptions, based on the current economic environment, have been made which management believe are a reasonable basis upon which to estimate the future liability. These estimates are reviewed regularly to take into account any material changes to the assumptions. However, actual decommissioning costs will ultimately depend upon future market prices for the necessary decommissioning expenditures which will reflect market conditions at the relevant time. Furthermore, the timing of decommissioning is likely to depend on when the fields cease to produce at economically viable rates. This in turn will depend upon future oil and gas prices, which are inherently uncertain.

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(U.S. \$ thousands, except share and per share amounts or unless otherwise stated)

### 19. Finance lease

The Company has entered into two power generation arrangements to supply electricity for three of its oil fields in Colombia until June 2016 and August 2021. In addition, the Company has lease and take or pay arrangements for airplanes, IT equipment and a fuel transport vessel that are accounted for as finance leases. The arrangements have been accounted for as finance leases with an average effective interest rate of 12.85%. The Company's minimum lease payments are as follows:

	As at December 31	
	2012	2011
Within 1 year	\$ 31,910	\$ 30,105
Year 2	28,895	29,625
Year 3	23,586	27,706
Year 4	19,299	22,386
Year 5	7,095	14,618
Thereafter	25,598	31,849
Total minimum lease payments	136,383	156,289
Amounts representing interest	(40,407)	(51,401)
Present value of net minimum lease payments	\$ 95,976	\$ 104,888
Current portion	\$ 20,206	\$ 17,106
Non-current portion	75,770	87,782
Total obligations under finance lease	\$ 95,976	\$ 104,888

For the year ended December 31, 2012, interest expense of \$13.1 million (2011 - \$9.4 million) was incurred on these finance leases.

### 20. Contingencies and commitments

A summary of the Company's commitments, undiscounted, by calendar year is presented below:

	2013	2014	2015	2016	2017	Subsequent to 2017	Total
OBC transport service	\$ 46,525	\$ 94,343	\$ 94,343	\$ 94,343	\$ 94,343	\$ 660,918	\$ 1,084,815
LNG Project and conversion service	-	59,088	59,088	59,088	59,088	649,964	886,316
Minimum work commitments	340,765	221,868	51,055	-	-	-	613,688
Operating leases and purchase	49,093	31,694	30,788	30,406	29,871	131,763	303,615
ODL transport service	51,464	51,464	51,464	51,464	45,243	-	251,099
Transmission line project	35,546	-	-	-	-	-	35,546
Community obligations	30,000	-	-	-	-	-	30,000
Other transportation commitments	3,613	3,613	3,613	3,613	3,613	-	18,065
Total	\$ 557,006	\$ 462,070	\$ 290,351	\$ 238,914	\$ 232,158	\$ 1,442,645	\$ 3,223,144

The Company has various guarantees in place in the normal course of business. As at December 31, 2012 the Company has issued letters of credit and guarantees for exploration and operational commitments for a total of \$257 million (December 31, 2011 – \$193.9 million).

#### 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. Ecopetrol has decided to back in to two fields during 2012.

#### 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 favour. The Company does not currently believe that the outcome of adverse decisions in any pending or threatened

## Notes to the consolidated financial statements

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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.

### NCT arbitration

The Company is presently undergoing an arbitration proceeding in connection with a dispute filed against it by NCT Energy Group ("NCT") with respect to NCT's claim that it is entitled to a payment of \$11 million for a share of the reserves acquired in Cubiro by the Company in 2009. The Company has recorded a provision of \$11 million over this claim.

### PMD class action lawsuit

There is an ongoing class action lawsuit against PetroMagdalena Energy Corp. ("PMD") that was filed in May 2011 claiming total damages of C\$50 million. The lawsuit was initiated while PMD was a listed public company. PMD has filed a Notice of Intent to Defend and the class has not yet been certified. As the outcome of this matter cannot be determined at this time, the Company has made no provision as at December 31, 2012.

### Natural gas supply agreements

Since the discovery of the La Creciente field in early 2007, the Company has focused on developing a commercial strategy to service the domestic market while concurrently exploring export opportunities. The Company has entered into take or pay contracts, and interruptible contracts, totalling 60MMBTU per day.

## 21. Issued capital

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

The Company has an unlimited number of common shares with no par value.

Continuity schedule of share capital:

	Number of Shares	Amount
As at December 31, 2010	267,648,853	\$ 1,691,838
Issued on exercise of warrants	597,232	6,176
Issued on exercise of options	3,481,370	34,420
Issued on conversion of convertible debentures <sup>(1)</sup>	20,450,600	293,231
As at December 31, 2011	292,178,055	2,025,665
Issued on exercise of warrants	9,766	97
Issued on exercise of options	3,408,759	64,636
Issued on conversion of convertible debentures	1,012	13
Issued on the C&C acquisition (Note 4)	22,771,496	533,582
As at December 31, 2012	318,369,088	\$ 2,623,993

<sup>(1)</sup> In addition to the 18,410,248 shares issued upon conversion, 2,040,352 shares were issued as an incentive for early conversion.

### (b) Stock options

The Company has established a "rolling" Stock Option Plan (the "Plan") in compliance with the applicable 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 the TSX Company Manual) of the Company's stock at the date of grant.

## Notes to the consolidated financial statements

(U.S. \$ thousands, except share and per share amounts or unless otherwise stated)

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

	Number of options outstanding	Weighted average exercise price (C\$)
As at December 31, 2010	21,228,088	\$ 10.98
Granted during the year	4,623,500	26.09
Expired during the year	(750)	20.09
Exercised during the year	(3,481,370)	5.63
As at December 31, 2011	22,369,468	14.92
Granted during the year	5,964,500	22.83
Expired during the year	(66,744)	22.96
Exercised during the year	(3,408,759)	13.50
As at December 31, 2012	24,858,465	\$ 16.99

The weighted average share price at the time when the stock options were exercised during the year ended December 31, 2012 was C\$27.60 (2011 – C\$22.97).

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

Outstanding & exercisable	Exercise price (C\$)	Expiry date	Remaining contractual life (years)
1,455,791	\$ 4.70	October 23, 2013	0.8
166,667	5.70	May 9, 2017	4.4
316,001	6.30	July 10, 2017	4.5
3,951,600	7.38	February 11, 2013	0.1
10,000	10.86	July 30, 2014	1.6
2,253,900	13.09	October 12, 2014	1.8
4,085,300	14.08	February 9, 2015	2.1
18,000	19.00	March 16, 2015	2.2
2,792,750	20.56	April 23, 2015	2.3
15,250	20.09	May 17, 2015	2.4
5,000	24.41	June 22, 2015	2.5
44,500	27.58	September 29, 2015	2.7
250,000	34.43	February 2, 2016	3.1
3,846,506	25.76	March 16, 2016	3.2
53,000	28.01	May 3, 2016	3.3
12,000	25.59	May 26, 2016	3.4
160,000	22.05	September 27, 2016	3.7
21,000	24.68	October 24, 2016	3.8
5,330,700	22.75	January 20, 2017	4.1
70,500	29.10	March 30, 2017	4.2
24,858,465	\$ 16.99		2.4

The following stock options with a 5 year life were granted to employees, directors and consultants during 2011 and 2012.

	Number of options granted	Weighted average exercise price (C\$)	Weighted average fair value (C\$)
During the year ended December 31, 2011	4,623,500	\$ 26.09	\$ 10.47
During the year ended December 31, 2012	5,964,500	\$ 22.83	\$ 8.58

## Notes to the consolidated financial statements

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The fair value of the stock options issued have been calculated using the Black-Scholes option pricing model, based on the following assumptions:

For options granted during the year ended:	As at December 31	
	2012	2011
Weighted average risk-free interest rate:	0.95%	1.55%
Expected life:	2.5 years	2.5 years
Weighted expected volatility:	38%	62%
Expected weighted average dividend yield:	1.10%	1.34%

### (c) Warrants

Each warrant outstanding is exercisable into one common share.

A summary of the changes in warrants is presented below:

	Outstanding & exercisable	Weighted average exercise price (C\$)
As at December 31, 2010	611,682	\$ 7.80
Exercised during the year	(597,232)	7.80
Balance, December 31, 2011	14,450	7.80
Exercised during the year	(9,766)	7.80
Forfeited during the year	(4,684)	7.80
Balance, December 31, 2012	-	\$ -

The weighted average share price at the time when the warrants were exercised during the year ended December 31, 2012 was C\$28.03 (2011 – C\$26.94).

### (d) Deferred share units

The Company established the Deferred Share Unit Plan (the “DSU Plan”) for its non-employee directors during 2012. Each DSU represents the right to receive a cash payment on retirement equal to the volume weighted average market price of the Company’s shares at the time of surrender. Cash dividends paid by the Company are credited as additional DSUs. As at December 31, 2012, 145,563 DSUs were outstanding with a fair value of \$3.3 million. The fair value of the DSUs was recognized as share-based compensation on the consolidated statement of income with a corresponding amount recorded in accounts payable and accrued liabilities on the consolidated statement of financial position.

## 22. Related party transactions

The following sets out the details of the Company’s related party transactions

- In June 2007, the Company entered into a 5-year lease agreement with Blue Pacific for administrative office space in one of its Bogota, Colombia locations. Monthly rent expense of \$57 is payable to Blue Pacific under this agreement. Three directors and officers of the Company control, or provide investment advice to the holders of, 67.2% of the shares of Blue Pacific. During 2011, the lease was amended to include additional space in Bogota for a 10-year term with a monthly rent of \$0.4 million, and assignment of the lessor to an entity controlled by Blue Pacific.
- As at December 31, 2012, the Company had trade accounts receivable of \$4.4 million (December 31, 2011 - \$2.4 million) from Proelectrica, in which the Company has a 24.9% indirect interest and which is 31.49% owned by Blue Pacific. The Company’s and Blue Pacific’s indirect interests are held through Pacific Power. Revenue from Proelectrica in the normal course of the Company’s business was \$39.3 million for the year ended December 31, 2012 (2011 - \$25.6 million).

In October, 2012, the Company and Ecopetrol signed two build, own, manage, and transfer (“BOMT”) agreements with Consorcio Genser Power-Proelectrica (“Genser-Proelectrica”) to acquire certain power generation assets for the Rubiales field. Genser-Proelectrica is a joint venture between Proelectrica and Genser Power Inc. which is 51% owned by Pacific Power. Total commitment under the BOMT agreements is \$229.7 million over ten years. At the end of the Rubiales Association Contract in 2016, the Company’s

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obligations along with the power generation assets will be transferred to Ecopetrol. As of December 2012, those assets are under construction and the Company has not made any payment.

- c) During the year ended December 31, 2012, the Company paid \$40.7 million (2011 - \$47.1 million) to Transportadora Del Meta S.A.S. ("Transmeta") in crude oil transportation costs. In addition the Company has accounts receivable of \$2.4 million (2011 - \$3.2 million) from Transmeta and accounts payable of \$8.5 million (2011 - \$5.5 million) to Transmeta as at December 31, 2012. Transmeta is controlled by a director of the Company.
- d) Loans receivable from related parties in the aggregate amount of \$179 (2011 - \$490) are due from three directors and three officers (2011 - three directors and three officers) of the Company. The loans are non-interest bearing and payable in equal monthly payments over a 48-month terms.
- e) The Company has entered into aircraft transportation agreements with Petroleum Aviation Services S.A.S. ("PAS"), a company controlled by a director of the Company. During 2012, the Company paid \$14.3 million (2011 - \$9.5 million) in fees as set out under the transportation agreements. The Company accounts payable to PAS as at December 31, 2012 \$2.8 million (2011- Nil)
- f) During the year ended, December 31, 2012 the Company paid \$125.8 million to ODL (2011 - \$80.2 million) for crude oil transport services under the pipeline take or pay agreement, and has accounts payable of \$5 million to ODL as at December 31, 2012 (2011 -\$1 million). In addition, the Company received \$0.8 million from ODL during the year ended December 31, 2012 (2011 - \$1.6 million) with respect to certain administrative services and rental equipment and machinery. The Company accounts receivable from ODL as at December 31, 2012 \$0.2 million (2011 -nil).
- g) The Company will make subordinated loans to OBC for up to \$237.3 million, \$140 million of which have been made as of December 31, 2012. The principal of the subordinated loan will be repaid in 10 equal semi-annual installments starting in 2025, after OBC has repaid its bank loans in full. The loans carry an annual interest rate of 7.32% with semi-annual interest payments. As at December 31, 2012 the balance of loans outstanding to the Company under the agreement is \$32 million, (December 31, 2011: \$102.3 million). The Company has received \$2.1 million as at December 31, 2012 (2011: Nil) with respect to certain administrative services and rental equipment and machinery. As at December 31, 2012 the Company has not short-term advance (December 31, 2011 - \$8 million) to OBC to fund on-going work commitments. Interest income of \$5.8 million was recognized and \$5.7 million was paid on the loan during 2012 (December 31, 2011: \$0.3 and Nil).
- h) As at December 31, 2012, the Company has not accounts payable (December 31, 2011 \$0.4 million) due to Helicopteros Nacionales de Colombia S.A.S. "Helicol" with respect to air transportation services and paid during the year \$2.5 million for this service (2011 - \$1.3 million). Helicol is controlled by a director of the Company
- i) In October 2012 the Company entered into an agreement and consent with Pacific Coal, Blue Advanced Colloidal Fuels Corp. ("Blue ACF"), Alpha Ventures Finance Inc. ("Alpha"), and an unrelated party whereby the Company acquired from Pacific Coal a right to a 5% equity interest in Blue ACF for cash consideration of \$5 million. Blue ACF is a company engaged in developing colloidal fuels, and is currently 100% owned by Alpha which is controlled by Blue Pacific. As part of the purchase Pacific Coal has also assigned to the Company the right to acquire up to an additional 5% equity interest in Blue ACF for an additional investment of up to \$5 million. The Company currently has a 14.4% equity interest in Pacific Coal.

### Compensation of key management personnel of the Company

The Company's key management personnel include its Directors of the Board and the executive officers.

	As at December 31, 2012	
	2012	2011
Short-term employee benefits	\$ 15,390	\$ 9,810
Post-employment pension and medical benefits	1,951	1,953
Share-based payments	21,387	29,435
	\$ 38,728	\$ 41,198

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### 23. Financial risk management objectives and policies

The Company's principal financial liabilities, other than derivatives, comprise accounts payable and accrued liabilities, long-term debt, finance lease obligations and convertible debentures. The main purpose of these financial instruments is to manage short term cash flow and raise financing for the Company's capital expenditure program. The Company has various financial assets such as accounts receivable and cash and cash equivalents and restricted cash, which arise directly from its operations.

It is the Company's policy that no speculative trading in derivatives shall be undertaken.

The main risks that could adversely affect the Company's financial assets, liabilities or future cash flows are credit risk, interest rate risk, foreign currency risk, liquidity risk, and commodity price risk. Management reviews and agrees policies for managing each of these risks which are summarized below.

The following discussion also includes a sensitivity analysis that is intended to illustrate the sensitivity to changes in market variables on the Company's financial instruments and show the impact on profit or loss and equity, where applicable. Financial instruments affected by market risk include bank loans and overdrafts, accounts receivable, accounts payable and accrued liabilities and derivative financial instruments.

The sensitivity analysis has been prepared using the amounts of debt and other financial assets and liabilities held as at those dates.

#### (a) Credit risk

	As at December 31	
	2012	2011
Trade receivable	\$ 298,277	\$ 229,005
Advances / deposits	143,624	93,684
Recoverable VAT	81,192	301,169
Other receivables	70,883	52,797
Receivable from joint ventures	184,443	78,613
Allowance for doubtful accounts	(1,276)	(961)
Loan to OBC (current, note 16)	-	20,452
	<u>\$ 777,143</u>	<u>\$ 774,759</u>
Loan to OBC (non-current, note 16)	32,555	81,806
	<u>\$ 809,698</u>	<u>\$ 856,565</u>

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. Two of the Company's customers had accounts receivable that were greater than 10% of total trade accounts receivable. The Company's credit exposure to these customers was \$95 million and \$38 million or 31% and 13% of trade accounts receivable, respectively (2011 - two customers at \$106 million and \$59 million or 46% and 26% of trade accounts receivable. Revenues from these customers for 2012 were \$195 million and \$89 million or 5% and 2% of net revenue (2011 - \$407 million and \$277 million or 12% and 8% of net revenue, respectively).

The entire amount of the recoverable VAT as at December 31, 2012 and December 31, 2011 is due from the Colombian tax authority.

#### (b) Interest rate risk

The Company is exposed to interest rate risk on its outstanding variable rate revolving credit borrowings due to fluctuations in market interest rates. The Company monitors its exposure to interest rates on an ongoing basis. A 10% variation in the interest rate would increase or decrease interest expense by \$0.4 million respectively.

#### (c) Foreign currency risk

The Company is exposed to foreign currency fluctuations in Colombian pesos (COP). Such exposure arises primarily from expenditures that are denominated in currencies other than the functional currency. The Company monitors its exposure to foreign currency risks. To reduce its foreign currency exposure associated with operating expenses

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incurred in COP, the Company may enter into foreign currency derivatives to manage such risks. The Company has the following currency risk management contracts outstanding:

As at December 31, 2012

### Asset

Instrument	Term	Notional amount	Floor-ceiling (COP/\$)	Fair value
Currency collar	January to December 2013	\$ 525,000	1825-1986	\$ 22,590
Forward	March to December 2013	17,500	1890	1,699
Forward	May 2013 to February 2014	17,500	1910	1,348
		\$ 560,000		\$ 25,637
			Current	\$ 25,367
			Non-current	270
			Total	\$ 25,637

As at December 31, 2011

### Liability

Instrument	Term	Notional amount	Floor-ceiling (COP/\$)	Fair value
Currency collar	January to December 2012	\$ 650,400	1805 - 1975	\$ (27,504)
Currency collar	January to December 2013	120,000	1870 - 1930	(5,397)
		\$ 770,400		\$ (32,901)
			Current	\$ (27,504)
			Non-current	(5,397)
			Total	\$ (32,901)

The Company has designated currency collars as cash flow hedges. The effective portion of the change in the fair value of the currency collars is recognized in other comprehensive income as unrealized gains or losses on cash flow hedges. The effective portion is re-classified as production and operating expenses in net earnings in the same period as the hedged operating expenses are incurred. During the year ended December 31, 2012, \$70 million of unrealized gains (2011 - \$14.5 million of unrealized losses) were initially recorded in other comprehensive income, and \$18.5 million (2011 - \$9.6 million) were subsequently transferred to production and operating cost when the gains became realized. The Company excludes changes in fair value due to the time value of the investments and records these amounts along with hedge ineffectiveness in foreign exchange gains or losses in the period that they arise. During 2012, \$13.2 million (2011 - \$19.5 million) of ineffectiveness was recorded as foreign exchange loss.

The currency forwards are COP-US dollar forwards that provide an early termination option to the counterparty when certain thresholds are reached. The currency forwards have not been designated as hedges and the change in fair value is recorded in profit or loss. For the year ended December 31, 2012, the Company recorded an unrealized gain of \$3 million (2011: Nil) representing the change in the fair value of the forward currency price risk management contracts in net earnings.



## Notes to the consolidated financial statements

(U.S. \$ thousands, except share and per share amounts or unless otherwise stated)

### (d) 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 process for managing liquidity risk includes 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. As at December 31, 2012, the Company had available \$317 million of undrawn revolving credit available. The following are the contractual maturities of non-derivative financial liabilities (undiscounted):

Financial liability due in	2013	2014	2015	2016	2017	Subsequent to 2017	Total
Accounts payable and accrued liabilities	\$ 1,209,333	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 1,209,333
Long-term debt and bank indebtedness	7,395	40,666	363,837	41,537	5,244	746,382	1,205,061
Obligations under finance lease (Note 19)	31,910	28,895	23,586	19,299	7,095	25,598	136,383
Equity tax (Note 7)	25,558	23,289	-	-	-	-	48,847
Convertible debentures - principal	2,646	-	-	-	-	-	2,646
<b>Total</b>	<b>\$ 1,276,842</b>	<b>\$ 92,850</b>	<b>\$ 387,423</b>	<b>\$ 60,836</b>	<b>\$ 12,339</b>	<b>\$ 771,980</b>	<b>\$ 2,602,270</b>

### (e) 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 statement of financial position. None of the Company's commodity price derivatives currently qualify as fair value hedges or cash flow hedges, and accordingly, changes in their fair value are recognized in net earnings.

The Company has the following commodity price risk management contracts outstanding:

As at December 31, 2012

#### Asset

Instrument	Term	Volume (bbl)	Floor/ceiling or strike price (\$/bbl)	Benchmark	Fair value
Zero cost collars	January to June 2013	1,200,000	80 - 115/118	WTI	\$ 1,023
<b>Total</b>					<b>\$ 1,023</b>
Current					1,023
<b>Total</b>					<b>\$ 1,023</b>

#### Liabilities

Instrument	Term	Volume (bbl)	Floor/ceiling or strike price (\$/bbl)	Benchmark	Fair value
Zero cost collars	January to June 2013 extendible July to December 2013	5,280,000	80 / 111-121	WTI	\$ (3,176)
<b>Total</b>					<b>\$ (3,176)</b>
Current					(3,176)
<b>Total</b>					<b>\$ (3,176)</b>

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(U.S. \$ thousands, except share and per share amounts or unless otherwise stated)

As at December 31, 2011

### Liabilities

Instrument	Term	Volume (bbl)	Floor/ceiling or strike price (\$/bbl)	Benchmark	Fair value
Call option	February 2012 to December 2012	8,790,000	109.50 -120	WTI	\$ (29,353)
Sold put	August 2012 to December 2012	5,350,000	61.5 - 64	WTI	(8,732)
Zero cost collars	January 2012 to December 2012	10,051,404	70-80 / 115-121	WTI	(1,798)
Total					\$ (39,883)
Current					\$ (39,883)
Total					\$ (39,883)

For the year ended December 31, 2012, the Company recorded a gain of \$7.1 million (2011 \$8.8 million) on commodity price risk management contracts in net earnings. Included in these amounts were \$37.7 million in unrealized gain (2011: \$13.4 million) representing the change in the fair value of the contracts, and \$30.6 million (2011: \$4.6 million) of realized loss resulting from premiums paid.

If the forward WTI crude oil price estimated at December 31, 2012 had been \$1/bbl higher or lower, the unrealized gain or loss on these contracts would change by approximately \$3 million (2011: \$0.7 million).

### (f) Fair value risk

The Company's financial instruments are cash and cash equivalents, restricted cash, accounts receivable and accounts payable and accrued liabilities, risk management assets and liabilities, bank debt, finance lease obligation, Debentures and available-for-sale investments on the statement of financial position. The carrying value and fair value of these financial instruments are disclosed below by financial instrument category.

Financial instrument	As at December 31, 2012		As at December 31, 2011	
	Carrying value	Fair value	Carrying value	Fair value
<b>Assets held for trading</b>				
Cash and cash equivalents	\$ 243,690	\$ 243,690	\$ 729,671	\$ 729,671
Restricted cash	21,023	21,023	3,074	3,074
Commodity price derivatives	1,023	1,023	-	-
Foreign currency forward	3,047	3,047	-	-
<b>Loans and receivables</b>				
Accounts receivable	777,143	777,143	774,759	774,759
Loan to OBC (Long term)	32,555	32,555	81,806	81,806
<b>Available for sale financial assets</b>				
Investment in other assets (2011: CGX and other assets)	10,249	10,249	62,667	62,667
<b>Assets (liabilities) designated as cash flow hedges</b>				
Foreign currency derivatives	22,590	22,590	(32,901)	(32,901)
<b>Liabilities held for trading</b>				
Commodity price derivatives	(3,176)	(3,176)	(39,883)	(39,883)
<b>Other Liabilities</b>				
Accounts payable and accrued liabilities	(1,209,333)	(1,209,333)	(702,895)	(702,895)
Long-term debt (1)	(1,191,956)	(1,379,179)	(927,144)	(941,556)
Convertible debentures (2)	(2,450)	(4,165)	(2,234)	(4,245)
Obligations under finance lease	(95,976)	(101,734)	(104,888)	(111,181)

- (1) Fair value of the 2009 senior notes is estimated using the last traded price, representing 111% of the face value of the 2009 senior notes as at December 31, 2012. The fair value of the 2011 Senior Notes is estimated using the last traded price, representing 116% of the face value of the 2011 senior notes as at December 31, 2012.
- (2) The closing price of the convertible debenture (PRE.DB – TSX) at December 31, 2012 represented 170% of the face value of the convertible debenture (December 31, 2011 – 190%). The fair value of the convertible debenture includes both the fair value of the conversion feature and the debt itself.

## Notes to the consolidated financial statements

(U.S. \$ thousands, except share and per share amounts or unless otherwise stated)

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.

The following table summarizes the Company's financial instruments that are carried at fair value, in accordance with the classification of fair value input hierarchy in IFRS 7 *Financial Instruments - Disclosures*.

Fair value as at December 31, 2012				
	Level 1	Level 2	Level 3	Total
Available-for-sale financial assets	\$ 5,224	\$ -	\$ 5,025	\$ 10,249
Risk management assets	-	26,660	-	26,660
Risk management liabilities	-	(3,176)	-	(3,176)
<b>Total</b>	<b>\$ 5,224</b>	<b>\$ 23,484</b>	<b>\$ 5,025</b>	<b>\$ 33,733</b>

Fair value as at December 31, 2011				
	Level 1	Level 2	Level 3	Total
Available-for-sale financial assets	\$ 62,667	\$ -	\$ -	\$ 62,667
Risk management liabilities	-	(72,784)	-	(72,784)
<b>Total</b>	<b>\$ 62,667</b>	<b>\$ (72,784)</b>	<b>\$ -</b>	<b>\$ (10,117)</b>

The Company uses Level 1 inputs, being the last quoted price of the traded investments, to measure the fair value of its available-for-sale financial assets.

The Company uses Level 2 inputs to measure the fair value of its risk management contracts. The fair values of these contracts are estimated using internal discounted cash flows based upon forward prices and quotes obtained from counterparties to the contracts taking into account the credit worthiness of those counterparties or the Company's credit rating when applicable.

The Company uses Level 3 inputs to measure the fair value of certain investments that do not have an active market.

### (g) Capital management

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. 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-standardized IFRS 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.

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

The Company defines its capital as follows:

	As at December 31	
	2012	2011
Equity	\$ 3,973,598	\$ 2,907,802
Long-term debt	1,191,956	927,144
Convertible debentures	2,450	2,234
Working capital deficit (surplus)	253,716	(554,870)
	<b>\$ 5,421,720</b>	<b>\$ 3,282,310</b>

## Notes to the consolidated financial statements

(U.S. \$ thousands, except share and per share amounts or unless otherwise stated)

### 24. Supplemental disclosure on cash flows

Changes in non-cash working capital:

	Year ended December 31	
	2012	2011
Decrease (Increase) in accounts receivable	\$ 170,595	\$ (472,741)
Increase in income taxes receivable	(14,358)	(17,158)
Increase in accounts payable and accruals	299,606	176,887
Decrease (Increase) in inventories	62,807	(112,413)
(Decrease) Increase in income taxes payable	(104,032)	271,947
Decrease in prepaid expenses	573	3,936
	\$ 415,191	\$ (149,542)

The significant non-cash financing transaction for 2011 included the exchange of 2009 Senior Notes for 2011 Senior Notes and the early conversion of the Debentures into common shares of the Company (refer to Note 17).

Other cash flow information:

	Year ended December 31	
	2012	2011
Cash income taxes paid	\$ 618,168	\$ 291,540
Cash interest paid	95,748	66,670
Cash interest received	3,778	2,441

### 25. Subsequent events

- a) The Company granted the following employees stock options under the rolling Plan after December 31, 2012:

Number of options granted	Weighted average exercise price (C\$)
7,061,000	23.27

- b) In February 8, 2013, the Company acquired an additional 2.3 million issued common shares of PII for \$1.00 per share for \$2.3 million in cash, increasing the Company's interest to 50.2%. This additional investment results in the Company acquiring control of PII on the day of acquisition. On March 1, 2013, the Company acquired an additional 20 million newly issued common shares of PII for \$1.00 per share for \$20 million, increasing the Company's interest to 53.4%.
- c) On February 6, 2013, the Company entered into a Committed Credit Facility for a total amount of \$100 million with Banco Itau BBA. S.A. ("Itau"). The Credit Facility has an interest rate of LIBOR + 2.4%. In addition, the Company is required to pay a commitment fee of 0.7% of the unutilized portion.
- d) On February 27, 2013, the Company entered into a binding term sheet with CGX, pursuant to which the Company has agreed to invest C\$35 million in CGX at a price of C\$0.14 per unit for an aggregate of 250 million units. Each unit will consist of one common share and one common share purchase warrant of CGX, with each warrant being exercisable to acquire one CGX common share at an exercise price of C\$0.20 for a period of five years following the date of issuance of the units.
- e) On April 30, 2012, the Company entered into an agreement with InterOil Corporation to acquire a 10% net participating interest in the PPL237 Petroleum Prospecting License and the Triceratops structure located within PPL237 in Papua New Guinea for an estimated total investment of \$345 million. The investment is comprised of an upfront payment, funding of an agreed exploration work program and cash payments based on the independently certified resources of the Triceratops structure. As of December 31, 2012 the

## **Notes to the consolidated financial statements**

*(U.S. \$ thousands, except share and per share amounts or unless otherwise stated)*

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Company has recorded in other assets \$60 million representing the amounts advanced and accrued under the agreement. The Papua New Guinea authorities approved the transaction on January 24, 2013.

### **26. Comparative financial statements**

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